

PIABA BAR JOURNAL

VOLUME 25, No. 1 • 2018

**UNPAID ARBITRATION AWARDS
THE CASE FOR AN INVESTOR RECOVERY POOL**
Andrew Stoltmann and Hugh D. Berkson

**CHARACTERISTICS OF A WELL-CONSTRUCTED
AND WELL-MANAGED INVESTMENT PORTFOLIO**
Michael B. Engdahl

**PONZI VICTIMS: THE SKY IS FALLING
UNDER TRUMP'S NEW TAX ACT**
Kevin Diamond

**CRYPTOCURRENCIES AND TOKENS:
WHAT ARE THEY AND WHO REGULATES THEM?**
Celiza P. Bragança and Louis L. Straney

**CRYPTOCURRENCIES – INVESTMENT OR
ELECTRONIC CURRENCY OF THE FUTURE**
Douglas Schulz, Christopher Riley, and Tracy Pride Stoneman

**RETURN OF VOLATILITY HIGHLIGHTS
EXPOSURES TO RISK ASSESSMENT**
Tyler D. Nunnally and Aradhana Gupta Kejriwal

CASES & MATERIALS
Sara Hanley

RECENT ARBITRATION AWARDS
Christopher J. Gray

WHERE WE STAND

a publication of

Public Investors Arbitration Bar Association

PIABA BAR JOURNAL

VOLUME 25

2018

No. 1

EDITORIAL BOARD

RYAN COOK <i>Editor-in-Chief</i> Houston, Texas	MICHAEL EDMISTON <i>Associate Editor</i> Studio City, California	BIRGITTA SIEGEL <i>Associate Editor</i> New York, New York
JOE WOJCIECHOWSKI <i>Managing Editor</i> Chicago, Illinois	JAY ENG <i>Associate Editor</i> Palm Beach Gardens, Florida	BRADLEY STARK <i>Associate Editor</i> Coral Gables, Florida
SARA HANLEY <i>Cases & Materials</i> Naples, Florida	JASON M. KUESER <i>Associate Editor</i> Lees Summit, Missouri	JOHN SUTHERLAND <i>Associate Editor</i> Boston, Massachusetts
ELISSA GERMAINE <i>From the Professor</i> White Plains, New York	LANCE C. MCCARDLE <i>Associate Editor</i> New Orleans, Louisiana	PATRICIA VANNOY <i>Associate Editor</i> Lincoln, Nebraska
CHRISTOPHER J. GRAY <i>Recent Arbitration Awards</i> New York, New York	DAVID E. ROBBINS <i>Associate Editor</i> New York, New York	ADAM WEINSTEIN <i>Associate Editor</i> New York, New York
JASON BURGE <i>Associate Editor</i> New Orleans, Louisiana	FREDERICK W. ROSENBERG <i>Associate Editor</i> South Orange, New Jersey	

Generally published three times per year by PIABA, 2415 A Wilcox Drive, Norman, Oklahoma 73069. Subscriptions, copies of this issue and/or all back issues may be ordered only through PIABA. Inquiries concerning the cost of annual subscriptions, current and/or back issues should be directed to PIABA.

It is our policy that unless a claim is made for nonreceipt of a *Bar Journal* number within six months after the mailing date, PIABA cannot be held responsible for supplying such number without charge.

The *PIABA Bar Journal* is interested in receiving submissions from PIABA members and non-members including experts, mediators, arbitrators, securities regulators and educators. Manuscripts are reviewed prior to publication and are accepted for publication based on, *inter alia*, quality, timeliness and the subject's importance to PIABA and the arbitration/investor-attorney community. Individuals interested in contributing should contact the PIABA office at 888.621.7484. Comments and contributions are always welcome.

PIABA BAR JOURNAL

VOLUME 25

2018

No. 1

In this Issue

UNPAID ARBITRATION AWARDS THE CASE FOR AN INVESTOR RECOVERY POOL <i>Andrew Stoltmann and Hugh D. Berkson</i>	1
CHARACTERISTICS OF A WELL-CONSTRUCTED AND WELL-MANAGED INVESTMENT PORTFOLIO <i>Michael B. Engdahl</i>	17
PONZI VICTIMS: THE SKY IS FALLING UNDER TRUMP'S NEW TAX ACT <i>Kevin Diamond</i>	35
CRYPTOCURRENCIES AND TOKENS: WHAT ARE THEY AND WHO REGULATES THEM? <i>Celiza P. Bragança and Louis L. Straney</i>	39
CRYPTOCURRENCIES – INVESTMENT OR ELECTRONIC CURRENCY OF THE FUTURE <i>Douglas Schulz, Christopher Riley, and Tracy Pride Stoneman</i>	57
RETURN OF VOLATILITY HIGHLIGHTS EXPOSURES TO RISK ASSESSMENT <i>Tyler D. Nunnally and Aradhana Gupta Kejriwal</i>	87
CASES & MATERIALS <i>Sara Hanley</i>	101
RECENT ARBITRATION AWARDS <i>Christopher J. Gray</i>	113
WHERE WE STAND	123

PIABA BAR JOURNAL

VOLUME 25

2018

No. 1

PIABA Bar Journal is a publication of The Public Investors Arbitration Bar Association (PIABA) and is intended for the use of its members. Statements and opinions expressed in articles are not those of PIABA, its Board of Directors, the Journal's Editorial Board, or individual PIABA members. Information is from sources deemed reliable, but should be used subject to verification. No part of this publication may be reproduced in any manner without the written permission of the publisher.

2018 © PIABA

UNPAID ARBITRATION AWARDS THE CASE FOR AN INVESTOR RECOVERY POOL

Andrew Stoltmann and Hugh D. Berkson¹

Acknowledgements²

Introduction / Executive Summary

“What dollars do you actually collect when somebody has done you harm? Because you can have a really strong standard, but if there are no dollars there, that’s a problem.”³

1. Andrew Stoltmann is a Chicago based securities and investment fraud attorney. He is serving as the current President and a member of the Board of Directors for the Public Investors Arbitration Bar Association (PIABA), an international, not-for-profit, voluntary bar association of lawyers who represent claimants in securities and commodities arbitration and litigation. PIABA’s mission is to promote the interests of the public investor in securities and commodities arbitration by seeking to: protect such investors from abuses in the arbitration process; make securities arbitration as just and fair as systematically possible; and, educate investors concerning their rights.

Hugh Berkson is a Cleveland based securities and investment fraud attorney, and is a past president of PIABA. He is also serving on PIABA’s Board of Directors.

2. The Authors would like to thank Daniel Guernsey, and Andrew Zuckerman, of the University of Miami School of Law, and Valerie Hammel, of the St. John’s University School of Law, for their extensive efforts in analyzing the award history data, and broker registration data, utilized in this report. The students worked under the direction of the University of Miami School of Law Investor Rights Clinic Director Teresa Verges, and St. John’s University School of Law Securities Arbitration Clinic Director Christine Lazaro. Professor Lazaro is also PIABA’s executive vice president, and a member of its Board of Directors. Her help, as well as that of Michael Edmiston and Benjamin Edwards, in editing this Update is greatly appreciated by the Authors.

3. Crypto News, *Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission*, YOUTUBE (Feb. 6, 2018), https://www.youtube.com/watch?v=NGgg_dXBpq0 (SEC Chair Jay Clayton, testifying before the Senate Banking, Housing and Urban Affairs Committee).

Those words, uttered by Jay Clayton, SEC Chairman, summarized the long-running problem underlying unpaid FINRA arbitration awards. Regardless of how strong the investor protection rules, regulations, and laws are, they are meaningless absent an investor's ability to actually recover money when those rules, regulations, and laws are violated. Investors who fall prey to financial advisor misconduct all too often fall victim to a second abuse: the inability to collect an arbitration award issued against the financial advisor and/or firm found liable.

Chairman Clayton's comments of one month ago address an old problem – one first raised seventeen years ago by the U.S. Government Accounting Office. Unfortunately, little has been done over the past two decades to address the problem. In 2016, PIABA issued a report (the "PIABA Unpaid Awards Report") which assessed the problem and offered potential solutions, including a national investor recovery pool (a "Pool") to compensate those investors who otherwise would recover nothing.⁴ Almost two years later, on February 8, 2018, FINRA published a Discussion Paper (the "FINRA Discussion Paper"), a proposed rule, and updated statistics on unpaid awards. FINRA welcomed discussion on this long running problem, but did not indicate that it is pursuing any particular solution to the problem.

FINRA's newly updated statistics indicated that, in the five years from 2012 through 2016, a total of 268 awards (27% of the cases where investors were successful) or \$199 million in awards (29% of total damages awarded to investors) have gone unpaid. PIABA studied the 2017 award data, and found that the trend continues: 36% of the investors who won their cases collected nothing, and 28 cents of each dollar awarded have gone unpaid. The data reveal that the problem is not fixing itself, and the steps taken by FINRA thus far have not effectively addressed the problem.

The problem is not a hypothetical one – it has meaningful effects on people from all walks of life. Bruce Wilkerson, a former NFL star, was harmed by a brokerage firm's wrongful misconduct and awarded his full losses in arbitration. But, since the firm has gone under, Mr. Wilkerson has collected nothing and now must work far longer into his retirement years.

Of the potential solutions outlined by FINRA, several of which were previously discussed by PIABA, a Pool remains the viable and effective solution. FINRA is fully capable of funding the Pool out of fines levied on its members who violate its rules. FINRA member fines have been

4. See Hugh D. Berkson, *Unpaid Arbitration Awards, A Problem The Industry Created – A Problem The Industry Must Fix*, PIABA (Feb. 25, 2016), <https://piaba.org/piaba-newsroom/report-unpaid-arbitration-awards-problem-industry-created-problem-industry-must-fix>.

substantially larger than the unpaid awards for four of the last five years. Alternatively, a Pool could be funded from FINRA's profits, or an assessment on its members. An annual assessment of between \$23 and \$120 per FINRA-registered broker would have covered the unpaid awards for the last five years. A Pool's benefit to aggrieved investors would more than outweigh the modest cost to FINRA or its members. PIABA renews its call on FINRA to create such a Pool.

Background

The problem of unpaid awards was first addressed in the U.S. Government Accountability Office's June 2000 report.⁵ Given the absence of publicly available data, the GAO conducted its own study. It surveyed a random probability sample of 247 of the 855 investors who received monetary awards in cases decided in 1998. Nearly all of the awards were from the NASD (FINRA's predecessor) arbitration forum. Based on that sample, the GAO concluded that approximately 500 of the NASD awards to investors issued in 1998 were either unpaid, or only partially paid.⁶ It estimated that 64% of NASD awards were unpaid in 1998.⁷ The GAO also presented an estimate of the dollar amount of the unpaid awards: \$129 million.⁸ Unsurprisingly, the GAO found that the larger awards were less likely to be paid: 44% of the awards under \$100,000 were paid in full while only 5% of the awards in excess of \$1.15 million were paid in full.⁹

The GAO made several recommendations, including that the SEC: "require NASD to adopt procedures for monitoring the payment of arbitration awards;" "develop and publicize information to focus investor attention on the possibility of unpaid arbitration awards;" and, "require NASD to develop procedures addressing the problem of unpaid awards caused by failed broker-dealers to help reduce costs and increase options for investors."¹⁰ In addition, the GAO recommended that the SEC "periodically

5. *Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards*, U.S. GAO (June 26, 2000), <https://www.gao.gov/products/GGD-00-115>.

6. *See id.*

7. *See id.*

8. *See id.*

9. *See id.*

10. *Id.*

examine the extent of nonpayment of SRO arbitration awards to determine the effectiveness of actions taken to improve the payment of awards.”¹¹ The GAO stated that the SEC “should establish a process to assess the feasibility of alternative approaches to addressing this problem,” to the extent unpaid awards remain a problem.¹²

Over the next fifteen years, FINRA did not publicly disclose data relating to the number and dollar amount of awards that went unpaid, thwarting any independent analysis of the problem. In 2013, FINRA disclosed a portion of unpaid award data for 2011 to the Wall Street Journal, but did not offer any additional contextual information.¹³ FINRA simply disclosed that “\$51 million of arbitration awards granted in 2011 remain unpaid. That is 11% of the total awards that year, compared with the unpaid levels of 4% for 2010 and 2009.” No further context or methodology was provided for FINRA’s calculations.¹⁴ In 2015, FINRA provided unpaid award data for 2013 to its Dispute Resolution Task Force, which was made publicly available when the Task Force filed its report.¹⁵ The Task Force reported that, in 2013, “FINRA issued arbitration awards in 539 investor cases, of which 75 were not paid. The amount of damages awarded and not paid in these cases total \$62.1 million.”¹⁶

In 2016, PIABA issued its Unpaid Awards Report. Using the figures disclosed in the 2015 Task Force Report, PIABA recreated the data, and placed it in further context. PIABA found that one out of three awards went unpaid; and nearly 25% of the total amount awarded to investors went unpaid.¹⁷ Just hours before PIABA’s report was made public, the Wall Street

11. *Id.*

12. *Id.*

13. See Jean Eaglesham and Rob Barry, *More than 5,000 Stockbrokers From Expelled Firms Still Selling Securities*, WALL ST. J., Oct. 4, 2013.

14. See *id.*

15. *Final Report and Recommendations of the FINRA Dispute Resolution Task Force*, FINRA DISPUTE RESOLUTION TASK FORCE (2015), <https://www.finra.org/sites/default/files/Final-DR-task-force-report.pdf>.

16. *Id.* (FINRA noted that the statistics did not include 19 unpaid awards that were the subject of judicial motions to vacate.)

17. PIABA did request more detailed data directly from FINRA, but was told that “compiling the data would require a great deal of staff resources and time,” and that it would take months to determine whether additional data would be made available.

Journal again reported on unpaid awards, citing FINRA as its source, stating that in 2014, unpaid awards totaled more than \$34 million, which represented “15% of the total awards granted that year.”¹⁸

FINRA’s newly released comprehensive unpaid award data for the five year period from 2012 through 2016 puts the problem into focus. The table below summarizes FINRA’s data:

Summary of FINRA’s Unpaid Award Data 2012-2016

Year Award Issued	# Cases Awarded Damages	# Cases with Unpaid Awards	% Cases Awarded Damages that are Unpaid	Total Amount Awarded	Total Unpaid Award Amount	% Award Amount Unpaid
2012	255	76	30%	\$109,000,000	\$51,000,000	47%
2013	212	62	29%	\$181,000,000	\$75,000,000	41%
2014	177	44	25%	\$66,000,000	\$33,000,000	50%
2015	190	42	22%	\$203,000,000	\$26,000,000	13%
2016	158	44	28%	\$119,000,000	\$14,000,000	12%

In addition to FINRA’s newly released data, PIABA reviewed the arbitration awards issued in 2017, and determined that investor awards totaled \$73,280,880.¹⁹ PIABA then determined that \$20,649,164 of those awards were issued against brokers or firms which were no longer registered, a characteristic making it probable that the awards went unpaid.²⁰ Using this

However, FINRA did make additional data available to the Wall Street Journal at about this same time.

18. Jean Eaglesham, *Arbitration Awards Against Stockbrokers Go Unpaid*, Wall St. J., Feb. 25, 2016.

19. PIABA has not included awards that have been the subject of vacature motions.

20. In anticipation of drafting this report, and in the absence of data from FINRA, PIABA spent considerable time pulling every award issued in 2016 and 2017. FINRA has since reported the 2016 unpaid award experience, but the authors thought it important to describe the methodology used in PIABA’s analysis of the 2017 data.

rule of thumb, PIABA concluded that 35.92% of investor awards went unpaid (51 of 142 investor arbitration awards) and 28.18% of the dollars awarded to investors in 2017 were unpaid. PIABA anticipates these figures will be substantially similar to FINRA's official statistics for 2017, when those statistics are published.

Concerns about the Unpaid Award Problem

Shortly after PIABA released its Unpaid Awards Report, FINRA's then-CEO, Richard Ketchum, testified before a Senate subcommittee on Capitol Hill. When questioned by Senator Warren on the topic of unpaid awards, he acknowledged that "Something should be done about it."²¹ Senator Warren continued her questioning and Ketchum offered the following: "We are looking at whether, one way or another, there should be a fund to try to at least address the small investors that are terribly harmed."²²

The Securities Industry and Financial Markets Association ("SIFMA"), described as "the voice of the U.S. securities industry,"²³ has also expressed

All awards were pulled, and investor cases were then isolated for analysis and grouped into four categories: (1) those in which no respondent was suspended by or expelled from FINRA membership; (2) those in which all respondents were suspended by or expelled from FINRA membership; (3) those for which a motion to vacate the award was filed in court after the rendering of the award; and, finally (4) those in which some of the respondents were suspended/expelled and some were not.

FINRA promptly revokes the registration for respondents who fail to pay arbitration awards. With that in mind, if no respondent was expelled or otherwise lost its FINRA membership, we considered that award paid. If all the respondents were expelled, we considered that award unpaid. If only some of the respondents were expelled, we attempted to determine whether any collectible respondents remained. If there appeared that at least one collectible defendant maintained its FINRA membership, we considered that award paid (even though that respondent may have only paid the portion of the award attributable to it, and the balance of the award remained unpaid). Finally, we ignored all awards that were the subject of motions to vacate since no payment would be due while the award was under appeal. PIABA considered this the most conservative approach to the analysis.

21. Ann Marsh, *FINRA May Create Fund for Unpaid Arbitration Awards*, FINANCIAL PLANNING (Mar. 16, 2016), <https://www.financial-planning.com/news/finra-may-create-fund-for-unpaid-arbitration-awards>.

22. *Id.*

23. See generally SIFMA, www.sifma.org (SIFMA's home page).

its consternation over the availability of data related to unpaid awards. While SIFMA's principal concern appears to lie with brokers who are unable to repay the loans their firms made to them, the securities industry's trade group has suggested that FINRA publish and track annual data on unpaid arbitration awards.²⁴ Specifically, SIFMA stated that FINRA should publish the total number of cases in which claimants won awards, the total dollar amount of those awards, the total number of awards paid, and the total amount of the awards paid.²⁵ FINRA responded to SIFMA's concerns, with the statement that it had heard the industry's concerns "loud and clear," and was considering the best course of action.²⁶

Since PIABA published its Unpaid Awards Report, FINRA made some efforts to address concerns related to unpaid awards. For example, FINRA discussed unpaid arbitration awards at its May 2017 Board meeting.²⁷ The FINRA Board authorized the publication of a Regulatory Notice seeking comment on proposed arbitration rule changes that would allow an investor to pursue claims in court, rather than arbitration, when a member firm becomes inactive during a pending arbitration, or when a broker became inactive before or during an arbitration proceeding. The Board also discussed other changes to the arbitration rules that would increase the options available to investors if a firm or broker became inactive during the arbitration process like, for example, permission to amend pleadings to name additional parties.²⁸ The Board additionally approved a change to the Form U4 to elicit information regarding brokers who did not pay arbitration awards, settlements, or judgments in full. In October 2017, FINRA finally issued the Regulatory Notice seeking comment on those proposed changes to the arbitration rules.²⁹

24. Rita Raagas De Ramos, "Unpaid Finra Arbitration Awards are a Big Problem," Financial Advisor (Nov. 8, 2017), available at: <https://financialadvisoriq.com/c/1781883/208993>.

25. *See id.*

26. *See id.*

27. *Update: FINRA Board of Governors Meeting*, FINRA (May 11, 2017), <http://www.finra.org/industry/update-finra-board-governors-meeting-051017>.

28. *See id.*

29. *See* FINRA Regulatory Notice 17-33, *Amendments to the Code of Arbitration Procedure for Customer Disputes to Expand the Options Available to Customers if a Firm or Associated Person Is or Becomes Inactive*, FINRA (Oct. 2017), <http://www.finra.org/industry/notices/17-33>.

FINRA's measures called for greater transparency regarding associated persons who had not fully satisfied awards, settlements, or judgments; and provided investors with certain options if a broker or firm became inactive during the arbitration process. The measures did not, however, provide any relief to investors who went through the entire process and were given an award that went unpaid and therefore became worthless. The Board closed the "Unpaid Arbitration Awards" section of its May 2017 Board Meeting Update with the statement: "The Board also discussed additional steps to address unpaid arbitration awards that will be considered at a subsequent Board meeting."³⁰ No detail was provided, and no mention of *any* potential cure (i.e., increased net capital requirements, insurance requirements, or a national investor recovery pool) was made.

FINRA once again discussed "unpaid arbitration awards" at its July 2017 Board meeting; however, there appears to have been no discussion of any steps to get investors recovery if an award went unpaid. FINRA did focus on the "cockroaching" problem, looking to scrutinize more closely asset transfers that left behind a significant number of pending arbitration claims, unpaid arbitration awards, or settlements.³¹ In February 2018, FINRA filed a Regulatory Notice seeking comment on these proposed changes to the membership rules.³²

FINRA has reason to focus on these issues: unpaid awards undercut FINRA's legitimacy as a self-regulatory organization credibly committed to investor protection. Self-regulation works best when the industry bears the costs of industry misconduct. When the industry internalizes the costs of misbehavior, it is incentivized to police its own ranks efficiently. If the industry does not internalize the true cost of misbehavior and instead allows arbitration awards to go unpaid, FINRA itself may not be incentivized to devote sufficient resources to address the issue.³³ Conceptually, each unpaid

30. *Update: FINRA Board of Governors Meeting*, FINRA (May 11, 2017).

31. "Cockroaching" is the term commonly used to describe a situation in which a brokerage firm gets in trouble thanks to the improper conduct of its brokers and those supervising them. The firm is shut down, and the brokers scurry to find employment at other firms.

32. See FINRA Regulatory Notice 18-06, *FINRA Requests Comment on Proposed Amendments to Its Membership Application Program to Incentivize Payment of Arbitration Awards*, FINRA (Feb. 2018), <http://www.finra.org/industry/notices/18-06>.

33. See Edwards, Benjamin, *The Dark Side of Self-Regulation* (September 14, 2016). UNIVERSITY OF CINCINNATI LAW REVIEW, Forthcoming. Available at SSRN:

award is an instance where FINRA failed to fully achieve its stated investor protection mission.

Initiatives To Promote Payment

FINRA's efforts to date focused on increasing investor awareness of the potential for an unpaid award, as well as increasing investor litigation options if there is an increased likelihood of an unpaid award. Unfortunately, FINRA continues to avoid addressing the GAO's recommendation to improve award payments themselves if unpaid awards remained a problem. Based on FINRA's own data, the problem has continued.

FINRA's Discussion Paper identifies three possible initiatives to discourage unpaid awards: greater disclosure on the firm's Form BD, changes to the "statutory disqualification" definition, and Bankruptcy Code changes.³⁴ PIABA encourages all efforts to promote broader disclosure of unpaid awards. PIABA also supports the efforts to end the practice of brokers moving from firm to firm to avoid the import of significant complaints against them and unpaid awards from their former firms. There is a meaningful problem of the concentration of brokers with a long history of complaints concentrating in certain firms, raising the risk for *all* customers of those firms.³⁵

Greater disclosure, while a good thing in the abstract, will not incentivize brokers and firms who are no longer registered to pay outstanding arbitration awards. PIABA applauds FINRA's focus on recidivist brokers, and its suggestion to strengthen its member rules to ensure principals are held accountable for the misconduct of failed firms. However, more must be done to ensure investors actually collect when somebody has done them harm.

<https://ssrn.com/abstract=2829592> or <http://dx.doi.org/10.2139/ssrn.2829592>
("When contractual relationships do not transfer the costs of misbehavior back to the industry, this incentive to self-police diminishes").

34. *Discussion Paper – FINRA Perspectives on Customer Recovery*, FINRA (Feb. 8, 2018), http://www.finra.org/sites/default/files/finra_persepectives_on_customer_recovery.pdf.

35. See Craig McCann, Chuan Qin, and Mike Yan, *How Widespread and Predictable is Stock Broker Misconduct*, SLCG (2016), <http://www.slcg.com/pdf/workingpapers/McCann%20Qin%20and%20Yan%20on%20BrokerCheck.pdf>.

Helping Investors Victimized By Industry Misconduct Recover

The PIABA Unpaid Awards Report spent considerable time addressing a number of possible remedies to the unpaid award problem: expanding SIPC coverage, increasing net capital requirements, imposing insurance requirements, and/or creating an investor recovery pool. FINRA's Discussion Paper addressed each of these, but did not discuss any in detail, and failed to make any recommendation as to the viability of any option.

Expanding SIPC:

Both PIABA and FINRA noted that SIPC, as it is currently statutorily constructed, does not have the power to combat fraud, or to address investment losses from negligence. Rather, its mission is to ensure that investors do not lose securities from their accounts when the brokerage firms holding those accounts close.³⁶ What FINRA's Discussion Paper did *not* note, however, is the problem associated with the concern that SIPC's fund is in constant jeopardy of depletion. SIPC has long been criticized for its refusal to pay investor claims.³⁷ It is unlikely SIPC will adequately address the problem of unpaid awards.

Insurance:

The FINRA Discussion Paper identifies "other insurance options" as a possible remedy to unpaid awards. FINRA simply states that insurance could be required, perhaps in the form of commercial insurance products or a captive insurance program. What FINRA's Discussion Paper omits, and what PIABA pointed out in its Unpaid Awards Report, is the fact that FINRA has gone on record a number of times stating that insurance is too expensive and is therefore not a viable option. FINRA also fails to address fundamental coverage issues: specifically, that intentional fraud cannot be covered by insurance. Thus, fraud, selling away, and Ponzi schemes would

36. *See generally* SIPC, <http://www.sipc.org/about-sipc/sipc-mission>.

37. *See* PIABA Unpaid Awards Report at 12 – 14 (contains more detailed discussion of the issues associated with SIPC coverage).

be nearly impossible to cover under insurance policies.³⁸ While insurance requirements would offer investors some additional protections, it is unlikely required insurance will solve the problem of unpaid awards.

Investor Recovery Pool:

PIABA spent considerable time discussing the details of a Pool in its Unpaid Awards Report. Now, two years later, FINRA indicates that a Pool is one possible remedy. In its Unpaid Awards Report, PIABA discussed possible ways to structure a Pool and addressed concerns that would likely be raised about a Pool. Of the options PIABA and FINRA have set forth, a Pool is the most viable option available to address the payment of awards. Accordingly, PIABA again recommends that FINRA establish a Pool.

Funding A Pool

Investors who have taken their cases all the way through the arbitration process, won at their arbitration hearing, confirmed their awards with a court of competent jurisdiction, and have been unsuccessful in their collection efforts would be entitled to a recovery from a Pool, after assigning the unpaid award to the Pool. These steps address the main objections to a Pool; that specious claims would be made and paid, and that firms would be incentivized to walk away from pending claims without any fear of being held responsible for those claims.

The question then arises: how would a Pool be funded? There are three ready sources to fund a Pool. They are, in decreasing order of appeal: FINRA's fines levied against its rule-breaking members; FINRA's profits; and, an assessment made against *all* FINRA members. Each of these options is addressed below.

The most appealing source of funds for a Pool is the fines FINRA levies against its members who violate its rules. There is an undeniable logic to using the fines assessed against FINRA's bad actors to ensure that investors who fall victim to those violations are made whole. Focusing on the data available since PIABA's Unpaid Awards Report was released, the fines

38. *See id.* at 19 – 21 (contains a full discussion of the issues surrounding an insurance remedy).

FINRA has collected are more than sufficient to fund a Pool. FINRA's report of unpaid awards and fines collected is summarized:

Year	Unpaid Awards (in millions)	Fines (in millions)
2014	\$33	\$132.6
2015	\$26	\$93.8
2016	\$14	\$173.8

The fines FINRA collected would have covered the unpaid awards, in full, sometimes by an order of magnitude.³⁹

FINRA is also capable of funding a Pool, and ensuring that every arbitration award is paid in full, simply out of its net profits. FINRA's report of unpaid awards and its annual net income is summarized:

Year	Unpaid Awards (in millions)	Net Income (in millions)
2014	\$33	\$129.0
2015	\$26	(\$39.5)
2016	\$14	\$57.7

FINRA's annual profits would have more than covered the unpaid awards for 2014 and 2016. While the SRO suffered a rare operating loss in 2015, the overwhelming profit from 2014 would have more than covered *all* the unpaid awards for 2014 through 2016. FINRA has not released its 2017 annual report, so PIABA is unable to determine whether it maintained a sufficient profit to cover the 2017 unpaid awards.

Finally, FINRA could fund a Pool with a modest assessment made on its members. FINRA boasts that more than 630,000 brokers are registered with the SRO.⁴⁰ Ignoring the administrative costs, a fee of \$23.24 per broker would ensure that a Pool covered every 2016 unpaid arbitration award. Turning to 2017, a fee of \$32.78 per broker would cover the unpaid

39. See *Statistics on Unpaid Customer Awards in FINRA Arbitration*, FINRA, <http://www.finra.org/arbitration-and-mediation/statistics-unpaid-customer-awards-finra-arbitration> (contains data concerning the unpaid awards); see also *Annual Reports & Financials*, FINRA, <https://www.finra.org/about/annual-reports-financials> (data concerning FINRA's fines levied against its members is found in its annual financial report).

40. See *Statistics*, FINRA, <http://www.finra.org/newsroom/statistics>.

arbitration awards. The highest amount of unpaid awards in the past five years was in 2013: \$75 million. Yet a fee of only \$119.05 per broker would cover that sum. Thus, based on the last five years of FINRA reported data, if FINRA chose to assess its brokers a fee to cover a Pool, that fee would not have exceeded \$120 per year, and could have been as low as \$23.25 per year.

While the Industry will undoubtedly claim it would be inequitable to force good brokers to pay for the wrongful conduct of bad brokers, the fact remains that the industry on the whole has chosen to require no safety net of any type thanks to its minimal net capital requirements and lack of insurance requirements for membership, leaving investors to bear the full risk of the industry's financial recklessness. A broker-funded Pool would serve to protect those investors where the industry has no other protection mechanisms.

Unpaid Awards Cause Real Harm to Investors

Investors suffering the dire effects of unpaid FINRA arbitration awards come from all walks of life. Take, for example, Bruce Wilkerson. Mr. Wilkerson, now 54 years old, is an accomplished former NFL player. After an All-SEC senior year at the University of Tennessee in 1986, he was drafted by the Los Angeles Raiders in the second round of the 1987 NFL Draft. He spent a decade playing football for the Raiders, the Jacksonville Jaguars, and the Green Bay Packers. After retiring from football, Mr. Wilkerson went to work as machinist at an Alcoa facility in Tennessee, where he has worked since.

Mr. Wilkerson trusted his hard earned life savings to his financial advisor, Robert A. Gist of Resource Horizon Group LLC. Gist gained Mr. Wilkerson's trust, and his investment portfolio, on the fraudulent pretense that he would invest conservatively in corporate bonds and other securities. In reality, Gist used the funds for a variety of improper purposes. He used Mr. Wilkerson's funds to pay his own personal expenses, to pay the expenses of a company he controlled, and to pay "dividends" and "proceeds" to other investors for false securities transactions he claimed to have made their behalf. In 2013, Gist entered into a \$5.4 million settlement with the SEC, after it alleged he converted funds from at least 32 investors.⁴¹

41. See SEC Litigation Release No. 22710, *Securities and Exchange Commission v. Robert A. Gist, et al.*, Civil Action No. 1:13-cv-01833-AT (N.D.Ga., May 31, 2013), <https://www.sec.gov/litigation/litreleases/2013/lr22710.htm>.

Mr. Wilkerson filed an arbitration claim against Resource Horizon for the actions of its broker, Gist.⁴² In March 2015, the arbitrators awarded Mr. Wilkerson his full losses of \$610,000, as well as other statutory damages.⁴³ Unfortunately, shortly before the award was issued, FINRA cancelled Resource Horizon's registration.⁴⁴ It turns out that it had already failed to pay another arbitration award related to the same misconduct affecting Mr. Wilkerson. No longer registered, Resource Horizon has failed to pay Mr. Wilkerson's award as well. Now 53 years old, Mr. Wilkerson, who thought he had smartly prepared for his golden years, has lost a substantial portion of his net worth. He will likely find himself working many years to make up those lost funds.

Conclusion

The landscape regarding unpaid arbitration awards remains largely unchanged since the GAO first addressed the issue in 2000. The publication of unpaid award data demonstrates that the figures are not improving. In 2013, nearly \$25 out of every \$100 awarded to investors went unpaid, and in 2017, more than \$28 out of every \$100 awarded to investors went unpaid. While 33 out of 100 investors who won their arbitrations in 2013 went unpaid, nearly 36 out of 100 investors who won their arbitrations in 2017 went unpaid.

42. One of Resource Horizon's principals escaped being named in Mr. Wilkerson's arbitration claim thanks to her personal bankruptcy filing. That principal, Kelly Miller, settled one arbitration claim brought by a Gist victim, and lost an arbitration filed by another Gist victim. She filed for bankruptcy roughly one month after the arbitration award was issued against her. Immediately following Resource Horizons' closing, and contemporaneously with her bankruptcy filing, Miller joined Kovack Securities. Kovack Securities' principal, Brian Kovack, was elected to FINRA's Board of Governors later that year. In June of 2017, Reuters reported that 34% of Kovack Securities, Inc.'s brokers had a history of FINRA red flags *See* Benjamin Lesser and Elizabeth Dilts, *Wall Street's Self-Regulator Allows Safe Havens for Tainted Brokers* (June 12, 2017) <https://www.reuters.com/article/usa-finra-brokers/wall-streets-self-regulator-allows-safe-havens-for-tainted-brokers-idUSL1N1J91C3..>

43. *See Wilkerson v. Resource Horizons Group LLC*, FINRA Case No. 14-00904 (Mar. 11, 2015).

44. *See* Resource Horizons Group LLC's BrokerCheck Summary, <https://brokercheck.finra.org/firm/summary/104368>.

While FINRA has stated it is “important to engage in a broader discussion with other regulators and policy makers, as well as other stakeholders in the issue, about investor recovery more generally,”⁴⁵ it is time for FINRA to take action. The best workable solution remains a simple one: a national investor recovery pool to be maintained and administered by FINRA. The SRO remains the best party to implement and maintain the system for several reasons: (i) it sets the standards for membership, including the financial responsibility required for its members; (ii) its members are the ones who are found to have engaged in the wrongdoing; (iii) it administers the arbitration system and has first-hand knowledge of the data generated by those arbitrations; and (iv) it is the one levying fines against its members for misconduct.

PIABA’s call for the creation of a Pool remains unchanged since its 2016 Unpaid Awards Report. Unpaid awards must be verified, and there must be measures in place to ensure fraudulent claims against firms are not eligible for payment by a Pool. It must be designed to avoid the hoarding problem that SIPC suffers, and therefore exhaust its resources on an annual basis (aside from the funds needed for ongoing operations.) A Pool should be funded out of FINRA’s fines it collects from its members, or FINRA’s profits. Alternatively, a Pool should be funded by levying an assessment against each of FINRA’s registered brokers.

PIABA welcomes FINRA’s invitation to discuss this issue further, however, little has been done since PIABA outlined the scope of this problem in 2016. PIABA is encouraged that FINRA is seeking active engagement on this topic; however, FINRA has had decades to study this problem. Investors’ experience collecting awards is not improving, and action must be taken without further delay. In the absence of any viable solution other than a national investor recovery pool, FINRA must be required to enact such a Pool either voluntarily or as a matter of legislative requirement.

45. FINRA Discussion Paper, at 19.

Notes & Observations

CHARACTERISTICS OF A WELL-CONSTRUCTED AND WELL-MANAGED INVESTMENT PORTFOLIO

Michael B. Engdahl, JD, MS, CFP®¹

INTRODUCTION

Attorneys representing investors often allege that a financial advisor breached his or her legal duty to the client by unsuitably or imprudently recommending, constructing, and/or managing an investment portfolio. Of course, in order to effectively represent his or her client, an attorney will need to prove to a court or arbitration panel that the client's investment portfolio was, in fact, improperly constructed and/or managed. Therefore, knowledge of the basic characteristics of a well-constructed and well-managed portfolio is crucial.

This article will list and describe ten basic characteristics of a well-constructed and well-managed investment portfolio. In particular, the article will explain that a well-constructed and well-managed investment portfolio (1) should have proper asset allocation, (2) should be properly diversified, (3) should have proper asset location, (4) should have a reasonable withdrawal rate when in the retirement distribution phase, (5) should not include stock market timing strategies, (6) should have low fees and expenses, (7) may be simple, (8) may or may not include foreign securities and alternative investments, (9) should ultimately increase in value for long-term investors, and (10) should not accelerate the depletion of the investor's money when in the retirement distribution phase. Support for these characteristics from creditable sources, such as regulatory agencies, academics, and financial journalists will be referenced.

1. Michael B. Engdahl, JD, MS, CFP® is an Associate Professor of Financial Services and Business Law at Edinboro University, a "fee-only" CERTIFIED FINANCIAL PLANNER™ certificant, and an attorney, who represents investors in their disputes with brokerage firms and the financial services industry. He holds a Juris Doctor degree from the State University of New York at Buffalo and a Master of Science in Personal Financial Planning degree from the College for Financial Planning. Michael has an office in Jamestown, NY and can be reached at (716) 485-6913 or mengdahl@edinboro.edu.

A WELL-CONSTRUCTED AND WELL-MANAGED INVESTMENT PORTFOLIO SHOULD HAVE PROPER ASSET ALLOCATION

Asset allocation involves the determination of the portion of an investment portfolio that should be allocated to various asset classes, such as stocks and bonds. It is often viewed as the first step in constructing an investment portfolio. Proper asset allocation should be determined after careful analysis of an investor's investment time horizon and risk tolerance.

In her book, titled *Making the Most of Your Money Now*, well-respected personal finance author, Jane Bryant Quinn, reported the results of her findings from her study to determine how often investors made money in major U.S. stocks from year 1926 through year 2008. Her findings are summarized below:

HOW OFTEN DID INVESTORS MAKE MONEY IN MAJOR U.S. STOCKS?*

Holding Period	The Percentage of Times Stocks Made Money			The Percentage of Time Stocks Lost Money
	0-10% Gain	10-20% Gain	Over 20% Gain	
1 year	16%	18%	37%	29%
5 years	28%	47%	11%	14%
10 years	43%	52%	1%	4%
15 years	38%	62%	0%	0%
20 years	33%	67%	0%	0%

*Standard & Poor's 500-stock average, 1926-2008, compounded annually with dividends reinvested.

Source: Ibbotson Associates, a Morningstar subsidiary.²

Based on her analysis of the data gathered in her study, Quinn concluded the following regarding investing in the stock market:

1. In any one-year holding period, stocks are dicey.
2. Over five-year holding periods, one's chance of loss is small.

2. JANE BRYANT QUINN, *MAKING THE MOST OF YOUR MONEY NOW* 697 (2010).

3. Over 15- and 20-year periods, one's chance of loss is zero, provided that dividends are reinvested.
4. The longer one holds stocks, the greater one's chance of making money and the smaller one's chance of losing it.
5. The longer one holds stocks, the greater one's chance of earning an average return rather than a spectacular one.³

Although Quinn's conclusions presuppose that future returns will be similar to past returns (which may or may not be the case), her data, findings, and conclusions provide some guidance regarding the percentage of one's portfolio that should be allocated to stocks based on investment time horizon.

It is important to note that an investor's time horizon is not the only factor to be considered when determining proper asset allocation. The investor's risk tolerance also needs to be considered. Therefore, it is possible that a portfolio with a 20-year time horizon heavily invested in the stock market may be suitable or prudent for an investor with a high-risk tolerance but unsuitable or imprudent for an investor with a low-risk tolerance.

A WELL-CONSTRUCTED AND WELL-MANAGED INVESTMENT PORTFOLIO SHOULD BE PROPERLY DIVERSIFIED

A well-constructed and well-managed portfolio needs to have proper asset allocation. It is also important to note that a well-constructed and well-managed investment portfolio should contain proper asset allocation both *across* asset classes and *within* asset classes. In other words, a well-constructed and well-managed investment portfolio should be properly diversified. Diversification can help to reduce the overall risk of an investment portfolio.

For example, investing the overwhelming majority of an investment portfolio with a one-year time horizon in the stock market may be unsuitable or imprudent since the asset allocation across asset classes (i.e., stocks, bonds, or cash and cash equivalents) is improper. Also, investing in only a handful of stocks or one narrow sector of stocks (i.e., technology stocks) within an investment portfolio with a 20-year time horizon may be unsuitable or imprudent since the asset allocation within the stock asset class is improper.

3. *Id* at 698.

The minimum number of investments within a particular asset class that is necessary to achieve proper diversification is a subject of considerable debate. After Enron Corporation's bankruptcy, the Financial Industry Regulatory Authority (FINRA) issued an Investor Alert that provides some insight into what FINRA considers to be an overly concentrated stock position.

Enron Corporation's bankruptcy focused the country's attention on the peril of investing too heavily in company stock. Approximately 58% of Enron employees' 401(k) assets were invested in Enron stock when it plunged almost 99%.⁴ In 2007, FINRA issued an Investor Alert, titled "Putting Too Much Stock in Your Company – A 401(k) Problem." FINRA issued the Investor Alert out of concern that many people were concentrating too much of their retirement savings in a single security. Of particular concern to FINRA were employees who held all or most of their 401(k) account assets in their employer's stock.⁵

In the Investor Alert, FINRA states that "the general consensus among financial experts is that an adequately diversified portfolio should have no more than 10 to 20 percent of the total investments in company stock." Also, in the Investor Alert, FINRA states that holding more than 10 to 20 percent of one's portfolio in company stock may expose an investor to more risk than he or she should bear.⁶ Although the Investor Alert references "company" stock, FINRA is conveying a message that, in its opinion, holding a position of more than 10% to 20% of one's investment portfolio in any one stock may result in an overly concentrated stock position and an improperly diversified portfolio.

A WELL-CONSTRUCTED AND WELL-MANAGED INVESTMENT PORTFOLIO SHOULD HAVE PROPER ASSET LOCATION

If an investor has both tax-deferred accounts (e.g., IRAs, 401(k) plan accounts) and taxable accounts, careful consideration must also be given to proper *asset location*. Proper asset location involves determining the most

4. FINRA, Investor Alert, *Putting Too Much Stock in Your Company—A 401(k) Problem* (Feb. 9, 2013), <http://finra.org/investors/alerts/putting-too-much-stock-your-company-a-401k-problem>.

5. *Id.*

6. *Id.*

tax-efficient placement of investments (e.g., stocks, bonds, etc.) in tax-deferred and taxable accounts.

For example, assume that an investor's portfolio totals \$1,000,000 and is equally divided between a tax-deferred IRA and a taxable individual account. (Therefore, \$500,000 is the value of the IRA, and \$500,000 is also the value of the taxable account.) Further assume that the investor's asset allocation target is 50% stocks and 50% bonds. Finally, assume that the investor's financial advisor is trying to determine which account(s) should hold the stocks and which account(s) should hold the bonds in order to ensure tax-efficiency. Below are three possibilities:

1. The IRA holds \$500,000 of stocks. The taxable account holds \$500,000 of bonds.
2. The IRA holds \$500,000 of bonds. The taxable account holds \$500,000 of stocks.
3. The IRA and taxable account each hold \$250,000 of stocks and \$250,000 of bonds.

According to the article, titled "Asset Location for Taxable Investors," by Colleen M. Jaconetti, CPA, CFP® of Vanguard Investment Counseling & Research, the most tax-efficient asset location strategy for the investor is most likely for the IRA to hold \$500,000 of bonds and the taxable account to hold \$500,000 of stocks.⁷ It is important to note that this asset location strategy assumes that the investor's stock portion consists of broad-market index equity mutual funds, broad-market index equity exchange traded funds (ETFs), or tax-managed stock mutual funds.

According to Jaconetti, "purchasing broad-market index equity funds/ETFs or tax-managed equity funds in taxable accounts has several advantages. First, it maximizes annual after-tax returns. . . . Second, it allows for the "shelf space" in tax-deferred accounts to be filled with taxable bond funds. . . . Finally, upon the death of the owner, the taxable assets that remain (the stock funds in the taxable account) will receive a step-up in cost basis." In addition, Jaconetti states that broad-market index funds/ETFs or tax-managed funds are tax-efficient in taxable accounts since they "provide minimum long-term capital gain distributions and little (or no) short-term capital gains."⁸

7. Colleen M. Jaconetti, *Asset Location for Taxable Investors*, VANGUARD INVESTMENT COUNSELING & RESEARCH, (2007), available at <https://personal.vanguard.com/pdf/s556.pdf>.

8. *Id.*

Placing the stock fund in the taxable account, rather than the IRA, also can facilitate the employment of tax harvesting in order increase the portfolio's tax efficiency. A taxpayer may deduct capital losses to the extent of capital gains if the capital loss occurred in a taxable account. If capital losses exceed capital gains, the taxpayer is also allowed a deduction from ordinary income up to \$3000 per year. If the taxpayer still has a net capital loss after taking the deduction from ordinary income, the net capital loss will be carried forward indefinitely into future tax years.

For example, suppose that an investor owns a stock mutual fund in his or her taxable account that has a cost basis of \$300,000 and a current value of \$210,000. The investor could sell the stock mutual fund, take the \$90,000 capital loss, use the capital loss to offset capital gains for the year, take a \$3,000 deduction from ordinary income assuming the investor's net capital loss before taking the deduction is at least \$3,000, and carry forward any remaining net capital loss into future tax years.⁹ This is true even if the sale proceeds were immediately used to purchase a new stock mutual fund provided that the new stock mutual fund purchased is not "substantially identical" to the stock mutual fund that was sold.

However, if the new stock mutual fund purchased is substantially identical to the stock mutual fund sold, the investor will run afoul of the wash sale rules, and his or her capital loss may be disallowed. The wash sale rules state that if an investor sells a capital asset, such as a mutual fund, at a loss and purchases the same capital asset or one that is substantially identical within 30 days before or after the sale, he or she cannot deduct the loss for tax purposes.¹⁰ Unfortunately, the wash sale rules tend to be somewhat ambiguous since the I.R.S. does not completely define the phrase "substantially identical."

It is important to note that, although placing stock investments in taxable accounts and fixed income investments in tax-deferred accounts to the extent possible may be suitable or prudent for many investors, it may not be suitable or prudent for all investors. However, all well-constructed and well-

9. MICHAEL A. DALTON, ET AL., PERSONAL FINANCIAL PLANNING THEORY AND PRACTICE 613 (9th ed. 2016).

10. U.S. Securities and Exchange Commission Office of Investor Education and Advocacy, *Wash Sale*, SEC.GOV (Nov. 17, 2016), <https://sec.gov/answers/wash.htm>. For more information about wash sales, see I.R.S., *Investment Income and Expenses (Including Capital Gains and Losses)*, PUBLICATION 550 (Apr. 9, 2018), available at <https://www.irs.gov/pub/irs-pdf/p550.pdf>.

managed investment portfolios should contain a well thought out strategy for enhancing the tax efficiency of the portfolio.

**A WELL-CONSTRUCTED AND WELL-MANAGED INVESTMENT
PORTFOLIO SHOULD HAVE A REASONABLE WITHDRAWAL
RATE WHEN IN THE RETIREMENT DISTRIBUTION PHASE**

More than two decades ago, Bill Bengen, a financial planner in Southern California, attempted to answer the following question: How much can a retiree withdraw from his or her investment portfolio each year without running out of money? After spending a considerable time on his computer, Bengen determined that “retirees who withdrew 4% of their initial retirement portfolio balance, and then adjusted that dollar amount for inflation each year thereafter, would have created a paycheck that lasted for 30 years.”¹¹ The portfolio Bengen tested was split evenly between stocks and bonds, and he tested every 30-year period dating from 1926.

Bengen’s findings became known as the “4% rule” and have been replicated, expanded, and refined. His original question has also been more recently answered using sophisticated computer programs such as Monte Carlo models. These models are powerful statistical tools that allow retirees to examine the potential performance of their portfolios under hundreds or thousands of different scenarios and, thus, increase the accuracy and reliability of financial projections. Monte Carlo models don’t offer a simple thumbs up or thumbs down on an retiree’s systematic withdrawal plan. Instead, the models focus on how *probable* it is that a retiree will deplete his or her investment portfolio before the end of his or her withdrawal period.¹²

Many subsequent studies have confirmed that Bengen’s original findings were either correct or close to correct and concluded that, in order to reduce the risk of prematurely depleting one’s retirement portfolio early, one’s initial withdrawal rate should be around 4%, and he or she should invest in a diversified portfolio consisting of both stocks and bonds. Also, in its 2006 Investor Alert, titled “Look Before Your Leave: Don’t Be Misled By Early Retirement Pitches That Promise Too Much,” FINRA states that, since

11. Tara S. Bernard, *New Math Rule for Retirees and the 4% Withdrawal Rule*, N.Y. TIMES, May 8, 2015, available at <https://nytimes.com/2015/05/09/your-money/some-new-math-for-the-4-percent-retirement-rule.html>.

12. Jonathan Clements, *Retirement Models That Let Reality Bite*, WALL ST. J., Feb. 20, 2001, available at <http://wsj.com/articles/SB98261836195546061>.

“many experts recommend initial withdrawal rates of no more than 3% to 5% per year,” one should be skeptical of claims that a retiree can withdraw a high percentage of his or her investment portfolio each year and never run out of money.¹³ Therefore, it is possible that a portfolio in the retirement distribution is unsuitable or imprudent if its initial withdrawal rate exceeds 5%.

In addition, it is important to include portfolio fees and expenses when calculating the true withdrawal rate. For example, if an investor receives \$40,000 this year from his or her \$1,000,000 investment portfolio and has \$20,000 deducted this year for mutual fund expenses and investment advisory fees, his or her true withdrawal rate is 6%.

A WELL-CONSTRUCTED AND WELL-MANAGED INVESTMENT PORTFOLIO SHOULD NOT INCLUDE STOCK MARKET TIMING STRATEGIES

Due to the significant volatility of the stock market over the past two decades, many investors are turning to “professional” financial advisors for advice on how to manage their investment portfolios. Unfortunately, some financial advisors lure new clients with promises that they can time the stock market. Timing the stock market has been proven by a large number of academic studies to be imprudent and counterproductive. For example, in the 2012 edition of his classic book, titled *A Random Walk Down Wall Street: The Time Tested Strategy for Successful Investing*, respected Princeton University economics professor Dr. Burton Malkiel stated the following:

Many professional investors move money from cash to equities to long-term bonds on the basis of their forecasts of fundamental economic conditions. Indeed, this is one reason many brokers give in support of their belief in professional money management. The words of John Bogle, founder of The Vanguard Group of Investment Companies, are closest to my views on the subject of market timing. Bogle said, “In 30 years in this business, I do not know anybody who has done it successfully and consistently, nor anybody who knows anybody who has done it successfully and consistently. Indeed, my impression is that trying to do market timing is likely, not only to not

13. FINRA, Investor Alert, *Look Before You Leave: Don't Be Misled By Early Retirement Pitches That Promise Too Much* (Sept. 14, 2006), available at <https://www.finra.org/file/alert-dont-be-misled-early-retirement-investment-pitches>.

add value to your investment program, but to be counter-productive.”¹⁴

In his book, Dr. Malkiel also revealed the following:

Over a fifty-four year period, the market has risen in thirty-six years, been even in three years, and declined in only fifteen. Thus, the odds of being successful when you are in cash rather than stocks are almost three to one against you... The professors [in a respected academic study concluded] that a market timer would have to make correct decisions 70 percent of the time to outperform a buy-and-hold investor. I’ve never met anyone who can bat .700 in calling market returns.¹⁵

Therefore, investors should be wary of any financial advisor claiming to be able to successfully and consistently time the stock market. Such a financial advisor is likely either dishonest or delusional. Dr. Malkiel provides significant compelling evidence on why attempting to time the stock market is imprudent and counterproductive in his widely popular classic book on investing.

A WELL-CONSTRUCTED AND WELL-MANAGED INVESTMENT PORTFOLIO SHOULD HAVE LOW FEES AND EXPENSES

It is imprudent to ignore the fees associated with buying, owning, and selling investments within an investment portfolio. According to the U.S. Securities and Exchange Commission (SEC), “an investment with high costs must perform better than a low-cost investment to generate the same returns for you.”¹⁶ In addition, the SEC recommends that “just like shopping around for the best price on any other product or service, you should consider how much you are paying for investing services.”¹⁷

14. BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET: THE TIME-TESTED STRATEGY FOR SUCCESSFUL INVESTING 185 (2012).

15. *Id.* at 186.

16. U.S. Securities and Exchange Commission, *Understanding Fees*, <https://www.investor.gov/research-before-you-invest/research/understanding-fees> (last visited May 24, 2018).

17. U.S. SECURITIES AND EXCHANGE COMMISSION OFFICE OF INVESTOR EDUCATION AND ADVOCACY, UPDATED INVESTOR BULLETIN: HOW FEES AND EXPENSES AFFECT YOUR INVESTMENT PORTFOLIO (Sept. 8, 2016), *available at* <https://www.investor.gov>.

On September 8, 2016, the SEC's Office of Investor Education and Advocacy issued an updated bulletin, titled "Updated Investor Bulletin: How Fees and Expenses Affect Your Investment Portfolio." The SEC issued the updated bulletin to educate investors about how the fees paid for investment services and products can impact the value of investment portfolios.

According to the SEC, "as with anything you buy, there are fees and costs associated with investment products and services. These fees may seem small, but over time they have a major impact on your investment portfolio."¹⁸ To illustrate this point, the SEC estimated the ending value of three portfolios. Each portfolio had a beginning value of \$100,000 and earned a 4% annual return for 20 years. However, one portfolio had an ongoing fee of 0.25%, a second portfolio had an ongoing fee of 0.50%, and a third portfolio had an ongoing fee of 1.00%. The SEC estimated that, in 20 years, 0.50% in annual fees reduced the portfolio by \$10,000 as compared with a 0.25% annual fee. The SEC also estimated that, in 20 years, 1.00% in annual fees reduced the portfolio by nearly \$30,000 as compared with a 0.25% annual fee.¹⁹

Furthermore, the SEC reported the output of another illustration in which it estimated the impact of a 1.00% ongoing fee on a \$100,000 investment portfolio that grows 4% annually over 20 years. According to the SEC's findings, in 20 years, the total amount paid for a 1.00% annual fee adds up to almost \$28,000 for a \$100,000 initial investment. In addition, the SEC states that "if you were able to invest the \$28,000, you would have earned an additional \$12,000."²⁰ Examples of ongoing fees include mutual fund annual operating expenses and annual fees charged by some investment advisors.

Additional research supporting the position that a well-constructed and well-managed investment portfolio should have low fees and expenses comes from distinguished scholars such as Dr. William Sharpe. Dr. Sharpe was the 1990 recipient of the Nobel Prize in Economic Sciences and is a professor emeritus of finance at Stanford University. He has been conducting research on mutual fund expenses since the 1960s and, in a 1966 article, wrote that

gov/additional-resources/news-alerts/alerts-bulletins/updated-investor-bulletin-how-fees-expenses-affect.

18. *Id.*

19. *Id.*

20. *Id.*

“all other things being equal, the smaller a fund’s expense ratio, the better the results obtained by its stockholders.”²¹

A few years ago, Dr. Sharpe had an article, titled “The Arithmetic of Investment Expenses,” published the *Financial Analysts Journal*. In his article, Dr. Sharpe concluded that “a person saving for retirement who chooses low-cost investments could have a standard of living throughout retirement more than 20% higher than that of a comparable investor in high-cost investments.”²²

Furthermore, John Bogle, founder and former chief executive of the Vanguard Group and president of the Bogle Financial Markets Research Center agrees with most of Dr. Sharpe’s findings. However, Bogle has concluded that Dr. Sharpe *underestimated* the gap in favor of low-cost investments. According to Bogle, when additional expenses, such as fund transaction costs, sales loads, and cash drag, are considered in addition to fund expense ratios, over time, no-load, low-expense mutual funds create extra wealth of 65% for retirement plan investors.²³

A WELL-CONSTRUCTED AND WELL-MANAGED INVESTMENT PORTFOLIO MAY BE SIMPLE

It is possible to properly construct an investment portfolio with only a couple of carefully selected no-load, low-expense index mutual funds or exchange-traded funds (ETFs). According to Consumer Reports and John Bogle, owning too many funds may actually decrease portfolio diversification and increase investment costs.

In an April 2015 *Consumer Reports Money Adviser* article, Consumer Reports explained the risk of owning a large number of stock funds as opposed to only one or two broadly diversified stock funds. According to Consumer Reports, the risk of owning a large number of stock funds “is that when there are so many equity funds in one portfolio, the investor is almost guaranteed to end up with a portfolio with similar holdings.” In addition,

21. William F. Sharp, *Mutual Fund Performance*, 39 J. BUS. 137 (Jan. 1966).

22. William F. Sharp, *The Arithmetic of Investment Expenses*, 69 FIN. ANALYSTS J. 34 (Mar./Apr. 2013), available at <https://www.cfapubs.org/doi/pdf/10.2469/faj.v69.n2.2>.

23. John C. Bogle, *The Arithmetic of “All-In” Investment Expenses*, 70 FIN. ANALYSTS J. 13 (Jan./Feb. 2014), available at <https://www.cfapubs.org/doi/pdf/10.2469/faj.v70.n1.1>.

Consumer Reports stated that “the thing to remember about being properly diversified is that it has little to do with quantity. Some of the most tried-and-true portfolios, with clever names such as ‘couch potato’ and less clever monikers such as ‘60/40 portfolio,’ can be built with as few as two or three funds.”²⁴

The idea of adhering to the principle of simplicity when building a prudent investment portfolio is not new. As a matter of fact, in a 1999 speech, titled “Investing with Simplicity,” John Bogle stated that many investors would fare well with a portfolio consisting of only two no-load, low-expense, broad based index mutual funds.²⁵ In addition, Bogle’s belief regarding a simple two fund portfolio was recently summarized by Laura Dogu in her *Forbes* article, titled “Vanguard Founder John C. Bogle – In Person With The Bogleheads.” According to Dogu, “Mr. Bogle believes that a simple portfolio including only two funds, the Vanguard Total Stock Market Index Fund and Total Bond Market Index Fund would be sufficient for many investors.”²⁶

Recently, I studied and evaluated Bogle’s simple two fund portfolio approach and reported my conclusions. In my May 2015 *Silver* article, titled “Simplifying, Balancing, and Reducing the Costs of Investment Portfolios,” I stated that “putting Bogle’s principals of simplicity, balance, and cost reduction into practice yields impressive results.”²⁷ For example, if one invested 60% of his or her portfolio in the Vanguard Total Stock Market Index Fund Admiral Shares, a broad-based U.S. stock index mutual fund, and 40% of his or her portfolio in the Vanguard Total Bond Market Index Fund Admiral Shares, a broad-based U.S. investment-grade bond index mutual fund, the portfolio would have the following characteristics.

24. Michael B. Engdahl, *The Advantages of Keeping an Investment Portfolio Simple*, SILVER, Jan. 2016, at 7.

25. John C. Bogle, *Investing With Simplicity*, The Personal Finance Conference, WASH. POST, Jan. 30, 1999, available at https://www.vanguard.com/bogle_site/lib/sp19990130.html.

26. Laura Dogu, *Vanguard Founder John C. Bogle – In Person with The Bogleheads*, FORBES (Oct. 23, 2011), <https://forbes.com/sites/thebogleheadsview/2011/10/23/vanguard-founder-john-c-bogle-in-person/2/#2eface156d89>.

27. Michael B. Engdahl, *Simplifying, Balancing, and Reducing the Cost of Investment Portfolios*, SILVER, May 2015, at 9.

1. The portfolio would contain almost 11,000 underlying investments. The stock mutual fund would be comprised of approximately 3,800 stocks, and the bond mutual fund would be comprised of over 7,100 bonds.
2. The weighted average expense ratio would be only 0.062%. (\$62 per year per \$100,000 invested). The average mutual fund has an expense ratio of approximately 1% (\$1,000 per year per \$100,000 invested).
3. The portfolio's one-year, five-year, and ten-year average annual rates of return would be 9.6%, 10.6%, and 7.1% respectively (as of 03/31/15).
4. In 2008, when the U.S. stock market declined by approximately 37%, the portfolio would have declined by only 20.13%. Also, in 2009, the portfolio would have increased by 19.72%.”²⁸

However, it is important to point out that financial advisors who create a well-diversified two fund portfolio for their clients will still need to properly select the portfolio's asset allocation in order for the portfolio to be suitable or prudent. As previously stated, proper asset allocation is largely determined by an investor's expected investment time horizon and risk tolerance.

A WELL-CONSTRUCTED AND WELL-MANAGED INVESTMENT PORTFOLIO MAY OR MAY NOT INCLUDE FOREIGN SECURITIES AND ALTERNATIVE INVESTMENTS

Those who adopt a Bogle two-fund investment portfolio philosophy may not need to be concerned that alternative investments are included in the portfolio. According to Consumer Reports, “when we add alternative investments to a ‘vanilla’ portfolio, such as commodities, international bonds, and real estate investment trusts (REITs), it doesn't always boost overall returns, and when it does, the difference isn't appreciable.”²⁹

Due to the recent lackluster performance of the foreign stock markets, many people are questioning whether an investment portfolio should include any foreign stocks or foreign stock mutual funds. U.S. stocks (as measured by the S&P 500 Index) have outperformed foreign stocks (as measured by the MSCI EAFE [Europe, Australasia, and Far East] Index) in seven of the past ten years. Below is the yearly return of each index over the past decade:

28. *Id.*

29. Michael B. Engdahl, *The Advantages of Keeping an Investment Portfolio Simple*, SILVER, Jan. 2016, at 7.

<u>Year</u>	<u>S&P 500</u>	<u>MSCI EAFE</u>
2017	21.83%	25.03%
2016	11.96%	1.00%
2015	1.38%	- 0.81%
2014	13.69%	- 4.90%
2013	32.39%	22.78%
2012	16.00%	17.32%
2011	2.11%	- 12.34%
2010	15.06%	7.75%
2009	26.46%	31.78%
2008	- 37.00%	- 43.38%

The debate regarding whether or not to include foreign stocks in investment portfolios is not new. Almost two decades ago, Jonathan Clements authored an article, titled “Investing Legends Clash on the Merits of Foreign Stocks,” which was published in *The Wall Street Journal* on May 18, 1999. In the article, Clements summarized the views of Dr. Burton Malkiel and John Bogle regarding investing in foreign stocks.³⁰ At the time, Malkiel was an economics professor at Princeton University and Bogle was the senior chairman of Vanguard Group.

Malkiel argued that investors should have as much as one-third of their stock portfolio in foreign stocks. Specifically, Malkiel stated that “you can add a risky investment [like foreign stocks] and reduce your overall portfolio risk.”³¹ The justification for including a small percentage of one’s stock portfolio in foreign stocks has, for years, been documented in Malkiel’s book, titled *A Random Walk Down Wall Street*. In a recent edition of the book, Malkiel illustrated how, from January 1970 – December 2009, a stock portfolio invested 83% in the S&P 500 Index and 17% in the MSCI EAFE Index produced a higher average annual return and experienced less volatility than a stock portfolio invested entirely in the S&P 500 Index.³²

However, Bogle argued that investors should not invest any more than 20% of their stock portfolio in foreign stocks and that a zero weighting in foreign stocks is fine. Clements stated that what worried Bogle was “the risks involved in venturing overseas. He frets about currency swings, which

30. Jonathan Clements, *Investing Legends Clash on the Merits of Foreign Stocks*, WALL ST. J. (May 18, 1999), <https://www.wsj.com/articles/SB92698493837176878>.

31. *Id.*

32. Malkiel, *supra* at 209.

makes foreign stocks behave so erratically. He also worries about the less-favorable political and legal environment found abroad.”³³

Bogle was not persuaded by evidence that including a small amount of foreign stocks in one’s stock portfolio can reduce the overall volatility of his or her stock portfolio. Specifically, Bogle reminded investors that, when they add a small amount of foreign stocks to their stock portfolio, they are “only reducing volatility by a very small amount.” Therefore, according to Bogle, including foreign stocks may be pointless.³⁴

A WELL-CONSTRUCTED AND WELL-MANAGED INVESTMENT PORTFOLIO SHOULD ULTIMATELY INCREASE IN VALUE FOR LONG TERM INVESTORS

Recently, I gave a presentation to attorneys as part of a continuing legal education program held at the Robert H. Jackson Center in Jamestown, NY.³⁵ My presentation, in part, focused on the fact that prudent investment portfolios should ultimately increase in value for long-term investors. To illustrate this point, I provided performance data for three portfolios beginning on January 1, 2008. I picked January 1, 2008 my starting date since the U.S stock market declined approximately 37% that year as a result of the 2008 Financial Crisis. The 2008 Financial Crisis is considered by many economists to be the worst financial crisis since the Great Depression. It began with a crisis in the subprime mortgage market and later developed into a full-scale international banking crisis.

The three portfolios used in my illustration included an index mutual fund that seeks to replicate the U.S. stock market, an index mutual fund that seeks to replicate the U.S. investment-grade bond market, and a portfolio that invests 50% in each of the aforementioned mutual funds. The stock mutual fund used in my illustration was the Vanguard Total Stock Market Index Fund Admiral Shares (TS). The fund invests in approximately 3,600 U.S. stocks and has an expense ratio of 0.05%. The bond mutual fund used in my illustration was the Vanguard Total Bond Market Index Fund Admiral Shares

33. Clements, *supra*.

34. *Id.*

35. Michael B. Engdahl, *Investment Losses - Does Your Client Have a Legal Claim?*, Robert H. Jackson Center (Oct. 20, 2015), presentation may be viewed at <http://youtube.com/watch?v+egpUAvmBzLk> (last visited Jan. 28, 2018).

(TB). The fund invests in approximately 8,700 U.S. investment-grade bonds and has an expense ratio of 0.06%.

Below are the annual returns of each of the three portfolios from 2008 through 2017:

Annual Returns

<u>Year</u>	<u>TS</u>	<u>TB</u>	<u>50/50</u>
2008	-36.99%	5.15%	-15.92%
2009	28.83%	6.04%	17.44%
2010	17.26%	6.54%	11.90%
2011	1.08%	7.69%	4.39%
2012	16.38%	4.15%	10.27%
2013	33.52%	-2.15%	15.69%
2014	12.56%	5.89%	9.23%
2015	0.39%	0.40%	0.40%
2016	12.66%	2.60%	7.63%
2017	21.17%	3.56%	12.37%

Below are the year-end values of a \$100,000 original investment in each of the three portfolios from 2008 through 2017:

Year-End Values (\$100,000 Original Investment)

<u>Year</u>	<u>TS</u>	<u>TB</u>	<u>50/50</u>
2008	\$63,010	\$105,150	\$84,080
2009	\$81,176	\$111,501	\$96,339
2010	\$95,187	\$118,793	\$106,990
2011	\$96,215	\$127,928	\$112,072
2012	\$111,975	\$133,237	\$122,606
2013	\$149,509	\$130,373	\$139,941
2014	\$168,287	\$138,052	\$153,170
2015	\$168,943	\$138,604	\$153,783
2016	\$190,332	\$142,208	\$165,516
2017	\$230,625	\$147,271	\$188,948

A review of the above year-end values, allowed me to make the following observations:

1. Investing all of one's portfolio in the U.S. total stock market index fund at the beginning of 2008 would have caused the investor's portfolio to decline significantly by the end of 2008. However, the portfolio would have more than doubled by the end of 2017.
2. Investing 50% of one's portfolio in the U.S. total stock market index fund and the other 50% in the U.S. investment-grade bond index fund would have caused the investor's portfolio to decline by the end of 2008. However, the portfolio would have increased by over 88% by the end of 2017.
3. Investing all of one's portfolio in the U.S. investment-grade bond index fund would have caused the investor's portfolio to *increase* in 2008. Also, the portfolio would have increased by over 53% by the end of 2017.

A review of the above year-end values reveals that long-term investors with well-constructed and well-managed investment portfolios should have experienced significant portfolio value increases from January 1, 2008 through December 31, 2017. If this was not that case for an investor, as I stated in my CLE presentation, "it is likely that something went awry."³⁶ Of course, the specific asset allocation chosen for an investor is determined by several factors including the investor's expected investment time horizon and risk tolerance.

It is important to note that the U.S. stock market experienced unprecedented growth since its significant decline in 2008. Therefore, it is not reasonable to expect that U.S. stocks will experience such an expedited recovery after a future market decline. However, well-constructed and well-managed portfolios should always ultimately increase in value for long-term investors. The values of such portfolios may go down from time to time. However, their values should never permanently stay down.

**A WELL-CONSTRUCTED AND WELL-MANAGED
INVESTMENT PORTFOLIO SHOULD NOT ACCELERATE
THE DEPLETION OF AN INVESTOR'S MONEY WHEN
IN THE RETIREMENT DISTRIBUTION PHASE**

Although a well-constructed and well-managed investment portfolio should ultimately increase in value for long term investors, it may ultimately

36. *Id.*

decrease in value for investors in the retirement distribution phase. Many retirees do not desire complete protection of their principal during the retirement distribution phase. Instead, they simply do not want to run out of money before they pass away. As previously stated, following the 4% rule and investing in a low-cost, well-diversified, and balanced portfolio has helped to reduce the risk of premature portfolio depletion during the retirement distribution phase.

However, it is important to note that a well-constructed and well-managed investment portfolio should not accelerate the depletion of a portfolio in the retirement distribution stage. For example, assume that a new retiree has \$1,000,000 and desires to take withdrawals of \$40,000 per year. If the retiree places his or her \$1,000,000 in a non-interest-bearing checking account and withdraws \$40,000 per year, his or her money will last for exactly 25 years ($\$1,000,000 / \$40,000 = 25$). However, if the money is invested and depletes prior to 25 years, the portfolio may be imprudently constructed and managed since it accelerated the depletion of the investor's money.

CONCLUSION

Having adequate knowledge of the basic characteristics of a well-constructed and well-managed investment portfolio can greatly assist an attorney with effectively representing an investor. It is important to note that it is possible a particular well-constructed and well-managed investment portfolio contains more or less characteristics than the ten described in this article. However, if a portfolio lacks several of the characteristics described in this article, there is a strong probability it is neither well-constructed nor well-managed.

PONZI VICTIMS: THE SKY IS FALLING UNDER TRUMP'S NEW TAX ACT

Kevin Diamond

Victims of Ponzi-like-schemes should be alarmed, as their sky is falling. President Trump's "Tax Cut and Jobs Act"¹ eliminates the "Theft Tax Loss" provisions of the Internal Revenue Code ("IRC"). And that will have a direct effect on such victims.

While investors are excited about many provisions of Donald Trump's Tax Act and its lower rates, when it comes to victims of Ponzi-like-schemes ... Chicken Little is screaming "the sky is falling, and the end is in sight!" It appears that these victims will no longer be able to file for these losses going forward and must act now or lose this great tax benefit. Having been harmed once, these victims are facing further damages.

For 50 years, the tax law allowed victims of Ponzi Schemes to use IRC Section §165(c)(2)² for claiming a "theft tax loss." This area of tax law was revised and enhanced³ in 2009 to help victims of Bernard L Madoff's \$68.4 billion Ponzi scheme.

However, Donald Trump's new tax act eliminates these beneficial provisions for victims of Ponzi schemes as of December 31, 2017, which must be claimed, for the last time, on their 2017 tax returns. Under the Act - effective for losses incurred in taxable years beginning after December 31, 2017 and before January 1, 2026 - a taxpayer may claim a personal casualty loss only if such loss was due to a *disaster* as declared by the President under the Stafford Disaster Relief and Emergency Assistance Act.⁴

Like human nature, the allure of significant returns on a steady basis is unlikely to change. Three newspaper articles point out just a few of the latest Ponzi schemes, which include:

- 1) The **Platinum Partners**⁵ and Mark Nordlicht were charged by the SEC in December 2016 with running a \$1 billion Ponzi scheme in New York;

1. Tax Cuts and Jobs Act, Pub. L. No. 115-97, enacted December 22, 2017.

2. 26 U.S.C. § 165(e) (2017).

3. IRS Rev. Rul. 2009-9, 26 C.F.R. § 1.165-8 (2017) and IRS Rev. Proc. 2009-20, 26 C.F.R. § 601.105 (2017).

4. Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 11044.

5. U.S. V. Nordlicht, No. 16-cr-640 (E.D.N.Y. filed December 14, 2016).

- 2) The **Woodbridge Group of Companies** and **Robert Shapiro**⁶ were charged by the SEC in December 2017 with running a \$1.2 billion Ponzi-scheme targeting thousands of elderly investors; and,
- 3) The **RMA Strategic Opportunity Fund**⁷ and **Raymond Montoya** of Boston were charged in November 2017 with running a multimillion-dollar Ponzi scheme.

For many years until the current administration, the benefit for taxpayers was that these Theft Tax Losses could be deductible from ordinary income. Further, the losses, if qualified, could be carried back three years and carried forward for 20 years under the prior tax system. With the loss of this section of the Internal Revenue Code, investors will not be able to take the Theft Tax Loss provisions of the IRC.

This is a very technical area of the federal tax law, with numerous legal requirements that, in this author's opinion, suggest that victims seeking tax relief are required to file a "Legal Opinion" to accompany the Victim's Tax Return and Amended Prior Years Tax Returns to provide the relief intended to be granted by the US Congress in implementing and amending the provisions of IRC §165(c)(2).

There are numerous legal requirements and a Ponzi victim's tax advisor should work with an experienced tax attorney who can help navigate the legal intricacies of the Investment Theft Tax Loss requirements.⁸ These include, but are not limited to such legal issues as: the tax basis; the timing of the loss; the definition of "theft" in the taxpayer's state of residency; whether there was "privity" for the Investor; and, whether there was "scienter" by the "lead figure" of the "specified fraudulent arrangement, etc."⁹

DISCLAIMER: This brief article is meant to sound the alarm of the urgency of action by victims of Ponzi like schemes. It is not meant to be scholarly analysis of Theft Tax Loss and/or the application of Internal Revenue Code §165(c.) (2); Revenue Ruling 2009-9; Revenue Procedure 2009-20 and the Safe Harbor Provisions contained therein. It is meant to advise the victim of the Ponzi scheme and their tax advisor (Attorney, CPA and/or Enrolled Agent) to contact an experienced tax lawyer to get a Legal Tax Opinion that

6. SEC v. Robert Shapiro, No. 17-cv-24624 (S.D. Fla. filed December 20, 2017).

7. U.S. v. Montoya, No. 17-mj-2228 (Dist. Mass. filed August 1, 2017).

8. Rev. Rul. 2009-9, 26 C.F.R. § 1.165-8 (2017), 2009-14 I.R.B. (April 6, 2009) and Rev. Proc. 2009-20, 26 C.F.R. § 601.105 (2017).

9. *Id.*

will meet the legal requirements and elements to allow for victim's federal tax refund.

Currently, victims of Ponzi scheme have several valuable tools:

1) Ponzi Victims Tools:

- a. Rev. Rul. 2009-9, 2009 I. R. B. (April 6, 2009)
- b. Rev. Proc. 2009-20
- c. Rev. Rul. 2009-9 and Rev. Proc. 2009-20 both outline the safe-harbor rules for qualified investors that are victims of fraud or embezzlement schemes may take a theft loss beginning with tax year 2008 and currently appear to be ending in 2017;
- d. Under the Safe Harbor,¹⁰ a taxpayer who transferred cash or property to a "lead figure" who promoted a "specified fraudulent arrangement" may use special rules to deduct the losses in the year the fraud is discovered without waiting for recovery;
- e. A "specified fraudulent arrangement"¹¹ is one in which a lead figure receives cash or property from an investor, purports to earn income for the investors, reports income amount to the investors that are partially or wholly fictitious, makes payments to some investors from amounts that other investors invested in the fraudulent arrangement and appropriates some or all of the investor's cash or property;
- f. Rev. Proc. 2009-20 provides for a two-pronged safe harbor deduction:
 - i. 95% of the net loss may be deducted, where the investor does not pursue any potential third-party recovery; or
 - ii. 75% of the net loss may be deducted, where a qualified investor is pursuing or intends to pursue any potential third-party actions for recovery.

The benefit of these tools is that the victim can apply for tax benefits now under the Safe Harbor provisions and still participate in any litigation and/or class actions attempts at recovery by accepting a lesser amount in refunds.¹² The amounts of recovery and future taxes will be adjusted when the litigation is finally resolved and the full amount of damages/recovery are fully known.

10. *Id.*

11. *Id.*

12. *Id.*

Hypothetical Analysis

In this hypothetical analysis, the value of the deduction can be seen in the projected \$1,000,000 loss in a Ponzi scheme. Assuming that the taxpayer made \$500,000 per year for the last three years and is taxed at 35% for federal tax purposes:

	<u>2015</u>	<u>2016</u>	<u>2017</u>
Income	\$500,000	\$500,000	\$500,000
Theft Loss	-0-	-0-	(\$1,000,000)
Fed. Tax @ 35%	\$175,000	\$175,000	\$175,000
Recovery	-0-	\$175,000	\$175,000 = \$350,000

The Loss of \$1,000,000 in a Ponzi scheme that qualifies for Theft Tax Loss under IRC §165(c.) (2) and filed using the Safe Harbor Provisions of Rev. Rul. 2009-9 and Rev. Proc. 20 could then potentially help the victim recover his/her taxes paid for this year and go back and recover his/her taxes for 2016.

So, while the Trump Tax Act is being hailed in many circles as a great achievement and benefit, for the victims of fraud, theft and Ponzi schemes will be best served by seeking a competent tax attorney to determine if they are eligible for the soon to disappear benefits of the Theft Tax Loss.

Don't let it be said that Chicken Little did not warn victims of Ponzi schemes, because the Theft Tax Loss Deduction and the sky are falling with the filing of your 2018 Tax Return.

Author is Attorney Kevin G. Diamond, CPA who has written about the Theft Tax Loss since 2007 and has a national tax practice representing victims of Ponzi schemes. He is a member of the US Tax Court. Questions and comments can find the author at kdiamond@rmdllp.com

CRYPTOCURRENCIES AND TOKENS: WHAT ARE THEY AND WHO REGULATES THEM?

*“Now this is not the end. It is not even the beginning of the end.
But it is, perhaps, the end of the beginning...”*
Great Britain Prime Minister, Sir Winston Churchill, 1942

Celiza P. Bragança, Esq.,¹ and Louis L. Straney²

Consider the following characteristics of an investment:

- a start-up, less than a decade in existence, with no operating history;
- subject to limited government oversight and regulation;
- documented incidents of outright theft of assets and system hacking;
- often associated with terrorism financing, money laundering and drug-related enterprises;³
- trading on unregulated and generally unaudited global exchanges;⁴

1. Celiza Bragança represents participants in the cryptocurrency/token space as well as investors in recovering losses. Lisa has been a Branch Chief for the U.S. Securities & Exchange Commission Division of Enforcement, a BigLaw litigator, and legal director of a disability rights organization. She has an M.B.A. and J.D. from The University of Chicago.

2. Louis Straney is a financial market historian, securities litigation consultant and expert witness. After his twenty-four year career as a Wall Street supervisor, he has authored several articles and books on financial crimes and is a frequent instructor for Canadian and U. S. market regulators, law enforcement and bar associations.

3. It was reported by CNN Tech/money.com quoting Lee Dongeun, in an article related to the South Korean Internet and Security Agency, “[w]e don’t know how much (Bitcoin) has stolen so far, but we do know that the police have confirmed the regime’s hacking attempts.” Sherisse Pham, *North Korea May be Making a Fortune From Bitcoin Mania*, CNN (Dec. 13, 2017), <http://money.cnn.com/2017/12/12/technology/north-korea-bitcoin-hoard/index.html>. On December 26, 2017, Pavel Lerner, the chief executive of a UK-based Bitcoin Exchange, EXMO, was kidnapped in the Ukraine. See Oscar Williams-Grut, *The CEO of a UK-registered bitcoin exchange has been kidnapped in Ukraine*, BUSINESS INSIDER (Dec. 29, 2017), <http://www.businessinsider.com/exmo-bitcoin-ceo-pavel-lerner-kidnapped-in-ukraine-2017-12>.

4. The Chicago Board Options Exchange (CBOE) initiated futures on bitcoin on 12/10/2017, which was followed by regulated trading on the CME and NASDAQ

- often promoted through unproven and exaggerated representations;
- not widely recognized as legal tender; and
- controlled by a small number of investors.⁵

The investment is bitcoin, one of the best performing investments of 2017.⁶ Bitcoin is the most used and well-known of the more than 1,300 virtual coins or tokens circulating today. Some refer to all of these virtual coins as cryptocurrencies.

Cryptocurrencies⁷ like bitcoin are front page news. Tokens like bitcoin are just some computer code created and maintained on a blockchain. For our purposes, a cryptocurrency is a particular kind of coin or token that some people use in lieu of government-issued currency. As of March 2018, there are disputes over whether most virtual coins or tokens are cryptocurrencies, commodities, or securities. The determination of whether a virtual coin is a security, commodity, or currency is critical to determining the applicable regulatory scheme.

exchanges. See Jesse Damiani, *CBOE Launches Bitcoin Futures Trading Dec. 10*, FORBES (Dec. 4, 2017), <https://www.forbes.com/sites/jessedamiani/2017/12/04/cboe-launches-bitcoin-futures-trading-dec-10/#14c87ee34d28>.

5. The Atlantic magazine reports that approximately 1,000 people or groups own 40% of all bitcoins in circulation. Derek Thompson, *Is Bitcoin the Most Obvious Bubble Ever?*, THE ATLANTIC (Dec. 9, 2017) <https://www.theatlantic.com/business/archive/2017/12/bitcoin-bubble/547952/>. A recent study by Cambridge University concluded that there were between 2.9 and 5.8 million cryptocurrency participants who own cryptocurrency “wallets.” GARRICK HILEMAN & MICHEL RAUCHS, GLOBAL CRYPTOCURRENCY BENCHMARKING STUDY 27 (2017), available at https://www.jbs.cam.ac.uk/fileadmin/user_upload/research/centres/alternative-finance/downloads/2017-global-cryptocurrency-benchmarking-study.pdf. A wallet, however, does not necessarily indicate asset ownership.

6. Assuming an efficient market and liquidity, bitcoin advanced 1,300% during 2017. See Charles Bovaird, *What Does Bitcoin’s Meteoric Rise Mean for Investors?*, FORBES (Dec. 7, 2017), <https://www.forbes.com/sites/cbovaird/2017/12/07/what-does-bitcoins-meteoric-rise-mean-for-investors/#6fa2ee143dd4>.

7. While bitcoin (BTC) is the most recognized example of a cryptocurrency, at the time of this article, there are more than 1,300 “coins” or “tokens” trading on various exchanges. Ethereum and Litecoin are also popular cryptocurrencies.

During 2017, the price of bitcoin defied gravity, rising from just under \$1,000 to over \$20,000.⁸ As of March 2018, bitcoin is trading below \$10,000. To some, this phenomenon is a reprise of the Beanie Baby craze of the 1990's.⁹ But to others, cryptocurrencies are simply the next generation of payment systems that started with PayPal, Apple Pay, and the electronic payment of your *grande Americano* through a Starbucks app. Without question, much of the bitcoin interest is driven by the long-recognized motivator -- the fear of missing out ("FOMO").

The sage of the futures markets, Chairman Emeritus of the CME Group Leo Melamed, has referred to cryptocurrencies as "an asset class" that can be controlled,¹⁰ while Jamie Dimon, JPMorgan Chase CEO, opined that bitcoin is a "fraud...stupid...and worse than tulip bulbs...it will blow up".¹¹ In the view of the authors, both Melamed and Dimon are correct. Virtual coins could revolutionize the way some financial services are delivered. At the same time, there will be many who use virtual coins to engage in fraud.

What is Bitcoin?

Bitcoin, the first virtual coin, was created in 2009 as open-source software by a person or group using the alias Satoshi Nakamoto.¹² The White Paper

8. Stan Higgins, *From \$900 to \$20,000: bitcoin's Historic 2017 Price Run Revisited*, COINDESK (Dec 29, 2017), <https://www.coindesk.com/900-20000-bitcoins-historic-2017-price-run-revisited>.

9. One optimistic seller currently has the Purple Princess Bear Beanie Baby listed on eBay for a solid \$350,000. *See Princess Bear/ Princess the Bear, a purple bear with a white rose on it chest*, EBAY, <https://www.ebay.com/itm/Princess-Bear-Princess-the-Bear-a-purple-bear-with-a-white-rose-on-it-chest/201958859916?hash=item2f05afa48c:g:s8sAAOSwMvtZRxko> (last visited May 25, 2018).

10. Reuters, Tomo Uetake & Hideyuki Sano, *CME's Melamed sees bitcoin becoming new asset class*, REUTERS (Nov. 7, 2017) <https://www.reuters.com/article/us-cme-group-bitcoin/cmes-melamed-sees-bitcoin-becoming-new-asset-class-idUSKBN1D712M>.

11. Thomas Heath, *Is bitcoin another tulip craze or a legitimate investment?*, WASHINGTON POST (Sept. 14, 2017), https://www.washingtonpost.com/news/get-there/wp/2017/09/14/is-bitcoin-another-tulip-craze-or-a-legitimate-investment/?noredirect=on&utm_term=.25bddae81837.

12. Sophie Bearman, *Bitcoin's creator may be worth \$6 billion — but people still don't know who it is*, CNBC (Oct. 27, 2017). Bitcoin was created with a possible issuance of 21 million coins. Currently, approximately 17 million coins have been

credited to Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, proposed a system that would skirt traditional regulatory and business channels and permits, allowing “two willing parties to transact directly with each other without the need for a trusted third party.”¹³ According to the White Paper, the initial objective of this cryptocurrency was to develop a peer-to-peer system that avoids the oversight of and transactional expenses imposed by non-stakeholder third parties.

To add to the mystery of bitcoin’s family tree, there is a body of unverified speculation that Jed McCaleb, who founded the now defunct cryptocurrency exchange, Mt. Gox, is Nakamoto. Mt. Gox was a major cryptocurrency/token broker until it shut down after being hacked multiple times.¹⁴ With Nakamoto, McCaleb, and others, the key modifier is “unverified.” On the world wide web, an alias or opaque user name is common.

Cryptocurrencies/tokens are based on blockchain technology. Unlike currency issued and backed by a sovereign nation (called “fiat” currency), the bitcoin you “hold” in your “wallet” (account) is just an entry on an electronic ledger (blockchain) that looks like this:

000000000000000000000000052138b6fe93e686b520bd1e99329890f6ec8cccf93da

While many representations of bitcoin depict a physical coin, that is misleading. Cryptocurrencies exist only in the electronic world – on distributed electronic ledgers.

Unlike a bank account that maintains *the* definitive record of your account, your bitcoin exists in thousands of separate identical ledgers around the world. The transaction entry listed above might reflect the transfer of one bitcoin from Lou to Mary. If you examined the transaction online – as anyone who knows the transaction number can do – you would see a number identifying Lou’s wallet as the transferor, a number identifying Mary’s wallet as the transferee,

issued with an estimate that issuance will cease in 2140. However, the coins can be subdivided, much like stock splits, making the potential ultimate float well above 21 million coins.

13. SATOSHI NAKAMOTO, *BITCOIN: A PEER-TO-PEER ELECTRONIC CASH SYSTEM* (2008).

14. Andy Greenberg, *Bitcoin's Price Plummets As Mt. Gox Goes Dark, With Massive Hack Rumored*, *FORBES* (Feb. 25 2014), [HTTPS://WWW.FORBES.COM/SITES/ANDY GREENBERG/2014/02/25/BITCOINS-PRICE-PLUMMETS-AS-MT-GOX-GOES-DARK-WITH-MASSIVE-HACK-RUMORED/#72c56deec1f](https://www.forbes.com/sites/andy-greenberg/2014/02/25/bitcoins-price-plummets-as-mt-gox-goes-dark-with-massive-hack-rumored/#72c56deec1f).

and the amount of bitcoin that was transferred. This exact same information would be recorded on a blockchain maintained on all ledgers.

There is a significant incentive for folks to maintain the distributed electronic ledgers – awards of bitcoin! If you are the first person to solve a complex problem, you are not only entitled to append the current bitcoin transaction to the blockchain, but you receive an award of bitcoin. To “earn” bitcoin, people get faster and faster computers that race to solve the problem first. Each time another bitcoin transaction needs to be recorded, the computers again race to solve the problem.

The people who maintain blockchain ledgers and earn bitcoin are called “miners.” Bitcoin mining has evolved from being something done by college kids in dorms to a process that requires highly specialized computer hardware, dedicated block-chain software¹⁵, and a huge amount of electrical power.¹⁶

The value of bitcoin in circulation is more than \$200 billion. As a currency, the value of bitcoin is currently exceeded only by the sovereign currencies of the United States, the European Union, and Japan.¹⁷ Bitcoin and other cryptocurrencies are gaining wider acceptance. The State of Nebraska, for example, recently announced that it would permit attorneys to accept payment from clients in bitcoin, as long as the bitcoin is immediately converted to U.S. currency.¹⁸ If cryptocurrency maps are accurate, many of the bitcoin ATMs are concentrated in the U.S. Northeast and metro Chicago.¹⁹ Initially, the ATMs were deposit only, but purchase, sale and exchange machines were

15. Blockchain, in this context, refers to open source ledgers that store transactional data.

16. Servers dedicated to currency mining run 24/7, require a controlled environment and reportedly create a high level of ambient noise. Due to the low cost of electric power, Iceland is a favored base for servers associated with cryptocurrency mining. See Alex Hern, *How Iceland became the bitcoin miners' paradise*, THE GUARDIAN (Feb. 13, 2018), <https://www.theguardian.com/world/2018/feb/13/how-iceland-became-the-bitcoin-miners-paradise>.

17. STATISTICS ON PAYMENT, CLEARING AND SETTLEMENT SYSTEMS IN THE CPMI COUNTRIES, BANK FOR INTERNATIONAL SETTLEMENTS, (Dec. 2016). When a currency lacks the direct backing of a commodity (such as the pre-1971 Gold Standard in the U. S.), and is only supported by a legal decree, it is referred to as “fiat currency.”

18. Joan C. Rogers, *Lawyers Can Accept Bitcoin—But Must Exchange ASAP, Nebraska Says*, BLOOMBERG (Sept. 12, 2017) (citing Nebraska Supreme Court Ethics Committee, Op. 17-03, (Sept. 11, 2017)).

19. See *Bitcoin ATM map*, <https://coinatmradar.com/> (last visited May 25, 2018).

quickly introduced. An actual tally of cryptocurrency machines is a moving target. For example, in Albuquerque, New Mexico, a bitcoin ATM was deactivated within weeks of being installed.

Does this mean that bitcoin can supplant the traditional role of a sovereign-backed currency or money? Money is something that (1) serves as a medium of exchange -- people tend to agree to accept it in exchange for goods and services; (2) serves as a measure of value -- it is a common language used to communicate in the marketplace; and (3) serves as a store of value -- you can put it under your pillow and use it two weeks from now. There is no requirement that money be issued by a government. On the Pacific island of Yap, stones weighing tons are used as money. Until recently, cigarettes were used as money by prisoners who are not permitted to have legal tender. Because of rampant hyperinflation, Venezuelans have recently been using eggs as money.²⁰ While cryptocurrencies are easier to use as money than eggs, cattle, and giant stones, they create a fertile ground for fraud. Advertisements similar to the following are quite common:

The Cryptocurrency Boom is a One-in-a-lifetime Opportunity

Search through your coat pockets...behind the
sofa cushions...the glove compartment of your car
Because all it takes is some spare change to capitalize
on the stock opportunity of a lifetime: cryptocurrencies.
If you make the right moves, you could find yourself
jumping for joy on top of an enormous pile of cash.
Ready or not, a growing number of economies, banks, and
billionaires are backing these new forms of tender.
And once you understand how easy it is to profit
from cryptocurrencies, it's easy to see why...
The cryptocurrency market is preparing to take off.
And the only time to buy is now.
Just one tiny investment – even one under \$100 – could soon put
you in a new class of “cryptocurrency millionaires.”

20. See Jacob Goldstein & David Kestenbaum, *The Island of Stone Money*, NPR (Dec. 10, 2010), <https://www.npr.org/sections/money/2011/02/15/131934618/the-island-of-stone-money>.

So sign up for your report below and see whether jumping on this moon-bound rockets is right for you.²¹

Who Regulates These Things?

Thus far, there has been a great deal of confusion about what law is applicable to cryptocurrencies/tokens. The Commodity Futures Trading Commission (CFTC) considers cryptocurrencies like bitcoin to be commodities. SEC Chairman Jay Clayton opined that all the initial coin offerings (ICOs) that he has seen are securities. Yet it is not clear whether many offerings of tokens are cryptocurrencies, commodities (like gold), or securities, or perhaps something else altogether. The lack of detail regarding ICOs does not seem to matter to purchasers who appear to have a voracious appetite for them. Many people jump at the chance to invest in a new token (ICO) based upon little more than a White Paper describing an idea.

The United States Treasury Department is leading a consortium of federal and state agencies to coordinate their approach to cryptocurrencies/tokens.²² Investors should not expect much clarity in the near term. The legacy regulatory system for securities, currency, and commodities is not a good fit for regulating cryptocurrencies/tokens. The federal securities laws are based on statutes from 1933, 1934 and 1940 that did not contemplate the possibility of a widely-accepted currency that was not backed by a sovereign.

Regulation of cryptocurrencies/tokens is primarily taking place through enforcement actions. In early 2018, the SEC launched a wide-ranging investigation into the issuance of cryptocurrencies/tokens. There are reports of as many as 80 SEC subpoenas having been served on entities involved in token offerings. Recipients of those subpoenas include some of the biggest players in the space like tZERO (Overstock.com's token) and Michael Arrington's \$100 million cryptocurrency hedge fund, TechCrunch.²³

21. *The Cryptocurrency Boom is a Once-in-a-lifetime Opportunity*, MONEY MORNING, <https://moneymorning.com/acq/aol/the-cryptocurrency-boom-is-a-once-in-a-lifetime-opportunity/> (last visited May 29, 2018).

22. OVERSIGHT OF AND APPROACH TO VIRTUAL CURRENCY FUTURES MARKETS, CFTC BACKGROUNDER (2018), available at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/backgrounder_virtualcurrency01.pdf.

23. Molly Zuckerman, *US: TechCrunch Founder's Crypto Fund Becomes Yet Another Target Of SEC Crypto Probe*, COINTELEGRAPH (Mar. 3, 2018),

A. Regulation of Tokens as Currency

To the extent that a token is solely a cryptocurrency, a purchaser has no more legal protection than a person who purchases Euros or pesos. It is up to the purchaser to determine whether holding (or “investing in”) a cryptocurrency like bitcoin is a good idea or not.

Investments in cryptocurrencies are significantly less regulated than investments in stocks and bonds. When an investment advisor or broker opens a new customer account, it is required to obtain information about the customer, including the customer’s investment objectives and her risk tolerance. When a money transmitter serves a customer it is required to collect far less information about the customer and, notably, is not required to collect any information about the customer’s investment objectives and risk tolerance.

A money transmitter selling a cryptocurrency is required to comply with federal and state laws applicable to a money transmitting business. At the federal level, the Financial Crimes Enforcement Network (FinCEN), a bureau of the Treasury Department, oversees registration and regulation of money transmitting businesses. In 2013, FinCEN issued guidance on the regulatory responsibilities of money transmitter businesses.²⁴ These regulations are primarily designed to detect and deter money laundering and other illegal activities.

A money transmitter that fails to comply with the anti-money laundering and “Know Your Customer” requirements may be subject to criminal prosecution for operation of an unlawful money transmitting business under 18 U.S.C. § 1960.²⁵ These requirements apply to transmitters of cryptocurrencies as well as sovereign-issued currencies:

Despite conflicting classifications by Federal regulators as to what Bitcoin actually is, the few Courts that have addressed this issue have held that 18 U.S.C. § 1960 covers Bitcoin because “[d]ictionaries,

<https://cointelegraph.com/news/us-techcrunch-founders-crypto-fund-becomes-yet-another-target-of-sec-crypto-probe>.

24. FinCEN, *Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies*, FIN-2013-G001 (March 18, 2013), available at <https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf>.

25. As of May 2018, money transmitters will be required to not only know the identity of their customer and to monitor for suspicious transactions but to inquire about beneficial ownership and the nature and purpose of the account in order to develop a customer risk profile. See Customer Due Diligence Requirements for Financial Institutions, 31 C.F.R. § 1010 (2016).

courts, and the statute's legislative history all point to the same conclusion: Bitcoins are funds." See *United States v. Murgio*, No. 15-cr-769, 2016 WL 5107128, at *4 (S.D.N.Y. Sep. 19, 2016); *United States v. Budovsky*, No. 15-cr-368, 2015 WL 5602853 (S.D.N.Y. Sep. 23, 2015); *United States v. Faiella*, 39 F. Supp. 3d 544 (S.D.N.Y. 2014).²⁶

These regulations are not designed to protect persons who purchase or hold currencies.

Only a few states including North Carolina and New York have enacted specific legislation addressing virtual currency money transmitters.²⁷ New York has implemented "BitLicense" regulations that apply to money transmitters doing business in New York.²⁸ New York's regulatory plan includes: (1) licensing rules and compliance provisions; (2) capital requirements; (3) custody and protection of consumer assets and other consumer protection provisions including a complaint procedure; (4) notices of material changes in business and of control and of mergers and acquisitions; (5) books and records; (6) examinations; and (7) the establishment and maintenance of anti-money laundering, cybersecurity, business continuity and disaster recovery programs. In 2017, the Uniform Law Commission issued the Uniform Regulation of Virtual Currency Act,²⁹ but to date, no state has enacted the uniform law.

State money transmitter laws generally cover cryptocurrency transactions. One notable exception is the State of Illinois. Although Illinois has invested

26. Joseph Evans, *Bitcoin, Money and Funds: the Application of the Unlicensed Money Transmitting Services Statute to Virtual Currency*, FORDHAM JOURNAL OF CORP. & FIN. LAW (Nov. 14, 2016), <https://news.law.fordham.edu/jcfl/2016/11/14/bitcoin-money-and-funds-the-application-of-the-unlicensed-money-transmitting-services-statute-to-virtual-currency/>.

27. For a current list, see the National Money Transmitters Association listing of state regulation which has links to state laws and regulations. *State-by-State Regulation*, THE NATIONAL MONEY TRANSMITTERS ASSOCIATION, <http://www.nmta.us/state-by-state-regulation> (last visited May 29, 2018).

28. 37 N.Y. Reg. 7 (2015).

29. UNIFORM REGULATION OF VIRTUAL-CURRENCY BUSINESSES ACT, NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS (2017), available at http://www.uniformlaws.org/shared/docs/regulation%20of%20virtual%20currencies/URVCBA_Final_2017oct9.pdf.

in a blockchain technology incubator³⁰ and is the home of two exchanges that trade bitcoin futures contracts, it does not regulate cryptocurrency brokers as money transmitters. In fact, the Illinois Department of Financial and Professional Regulation issued guidance that digital currencies are not money under the Illinois Transmitters of Money Act.³¹

B. Regulation of Tokens as Commodities

Investors in cryptocurrencies can look to the CFTC for some protection. In 2014, the CFTC declared virtual currencies like bitcoin to be commodities. While the CFTC does not directly regulate the sale of a commodity – for example the sale of a gold coin – it does regulate derivatives that are based upon the value of commodities, like swaps, futures, and options contracts.

The CFTC brought several enforcement actions related to cryptocurrencies. In September 2015, for example, the CFTC brought two settled cease-and-desist actions concerning cryptocurrencies. One was against a platform for trading bitcoin options contracts.³² The operator of the trading platform, Coinflip, Inc., and its CEO agreed to cease and desist from operating a platform and consented to the entry of an order finding that these options contracts were swaps under the Commodity Exchange Act. Coinflip ceased operations.

The other September 2015 action was against a provisionally registered swap execution facility for executing prearranged trades (wash trades) in bitcoin options.³³ TeraExchange executed prearranged trades of bitcoin swaps that it informed the CFTC and National Futures Association were designed to “test the pipes.” The next day, TeraExchange issued a press release

30. Michael del Castillo, *New Chicago Blockchain Center Launches With Government Backing*, COINDESK (Jun. 8, 2017), <https://www.coindesk.com/new-chicago-blockchain-center-launches-with-government-backing/>.

31. ILLINOIS DEPT. OF FIN. AND PROF. REGULATION, DIGITAL CURRENCY REGULATORY GUIDANCE (2017), available at <https://www.idfpr.com/Forms/DFI/CCD/IDFPR%20-%20Digital%20Currency%20Regulatory%20Guidance.pdf>.

32. *In the Matter of Coinflip, Inc.*, CFTC Docket No. 15-29 (Sept. 17, 2015), available at <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliporder09172015.pdf>.

33. *In the Matter of TeraExchange, LLC*, CFTC Docket No. 15-33 (Sept. 24, 2015), available at <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfteraexchangeorder92415.pdf>.

announcing that trading in bitcoin swaps had taken place – improperly characterizing these prearranged test trades as true market transactions.

Thus far, the CFTC has brought only one action against an exchange for virtual currencies like bitcoin. In 2016, the CFTC brought a settled action against Bitfinex, one of the major online cryptocurrency/token trading platforms for operating, as an unregistered futures commission merchant (FCM) and for facilitating the financing of transactions in bitcoin for participants who were not eligible under Dodd-Frank.³⁴ Bitfinex, a business formed in the British Virgin Islands and purportedly based in Hong Kong, has ceased doing business with customers it knows to be in the United States.

In September 2017, the CFTC filed its first anti-fraud action concerning a bitcoin investment scheme.³⁵ The CFTC alleged that a bitcoin pool that purported to engage in high-frequency algorithmic trading was, in reality, a Ponzi scheme.³⁶ More recently, the CFTC filed another anti-fraud action, obtaining a temporary restraining order halting the offering of a virtual currency called My Big Coin (“MBC”).³⁷ It is interesting that the CFTC brought this case rather than the SEC. The facts alleged in the complaint are consistent with what the SEC typically would call a security so it is surprising that the CFTC brought this case rather than the SEC.³⁸

The Chicago Mercantile Exchange and the Chicago Board Options Exchange began trading bitcoin futures contracts in late 2017.³⁹ These

34. *In the Matter of BFXNA Inc.*, CFTC Docket No. 16-19 (June 2, 2016), available at <http://www.cftc.gov/ids/groups/public/@lrenforcementactions/documents/legalpleading/enfbfxnaorder060216.pdf>.

35. Press Release, *CFTC v. Gelfman Blueprint, Inc. et al* (Sept. 21, 2017), available at <http://www.cftc.gov/PressRoom/PressReleases/pr7614-17>.

36. Complaint, *CFTC v. Gelfman Blueprint, Inc.*, No. 17-7181 (S.D.N.Y. Sept. 21, 2017), available at <http://www.cftc.gov/ids/groups/public/@lrenforcementactions/documents/legalpleading/enfgelfmancomplaint09212017.pdf>.

37. Order, *CFTC v. My Big Coin Pay, Inc. et al.*, No. 18-00077 (D. Mass. Jan. 16, 2018), available at <http://www.cftc.gov/ids/groups/public/@lrenforcementactions/documents/legalpleading/enfmybigcoinpayorder011618.pdf>.

38. Complaint *CFTC v. My Big Coin Pay, Inc. et al.*, No. 18-00077 (D. Mass. Jan. 16, 2018), available at <http://www.cftc.gov/ids/groups/public/@lrenforcementactions/documents/legalpleading/enfmybigcoinpaycomplt011618.pdf>.

39. CFTC, CFTC BACKGROUNDER ON OVERSIGHT OF AND APPROACH TO VIRTUAL CURRENCY FUTURES MARKETS (Jan. 4, 2018), available at http://www.cftc.gov/ids/groups/public/@newsroom/documents/file/backgrounder_virtualcurrency01.pdf.

exchanges operate under the supervision of the CFTC. While the exchanges used the self-certification process to approve and begin trading these contracts, the CFTC did not object to the trading of bitcoin futures contracts.⁴⁰

In 2017, the CFTC launched LabCFTC, an initiative designed to promote responsible Fin Tech innovation.⁴¹ The CFTC has provided significant guidance for investors, issuers, and brokers including through its “Backgrounder” and its “Primer on Virtual Currencies.”⁴²

C. Regulation of Tokens as Securities

The SEC has not proposed specific regulations for virtual coins. The SEC’s position is that existing law provides adequate guidance. The longstanding definition of a security is an investment of money in a “common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.”⁴³ But the devil is in the details – the question remains how is that definition to be applied to tokens created using blockchain technology.

In a December 11, 2017 statement, Chairman Clayton acknowledged that there are cryptocurrencies that are not securities. He offered some guidance as to his view of when a token might be classified as a security:

For example, a token that represents a participation interest in a book-of-the-month club may not implicate our securities laws, and may well

40. Contrast this with the position of the SEC Division of Investment Management on mutual funds holding cryptocurrencies. SEC, STAFF LETTER: ENGAGING ON FUND INNOVATION AND CRYPTOCURRENCY-RELATED HOLDINGS (Jan 18, 2018), *available at* <https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm>.

41. CFTC Launches LabCFTC as Major FinTech Initiative, CFTC Release No. 7558-17 (May 17, 2017), *available at* <http://www.cftc.gov/PressRoom/PressReleases/pr7558-17>.

42. CFTC, CFTC BACKGROUNDER ON OVERSIGHT OF AND APPROACH TO VIRTUAL CURRENCY FUTURES MARKETS (Jan. 4, 2018), *available at* http://www.cftc.gov/ido/groups/public/@newsroom/documents/file/backgrounder_virtualcurrency01.pdf; CFTC, CFTC PRIMER ON VIRTUAL CURRENCIES (Oct. 17, 2017), *available at* http://www.cftc.gov/ido/groups/public/documents/file/labcftc_primercurrencies100417.pdf.

43. *See* Jay Clayton, Chairman, SEC, Public Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017).

be an efficient way for the club's operators to fund the future acquisition of books and facilitate the distribution of those books to token holders. In contrast, many token offerings appear to have gone beyond this construct and are more analogous to interests in a yet-to-be-built publishing house with the authors, books and distribution networks all to come. It is especially troubling when the promoters of these offerings emphasize the secondary market trading potential of these tokens. Prospective purchasers are being sold on the potential for tokens to increase in value –with the ability to lock in those increases by reselling the tokens on a secondary market – or to otherwise profit from the tokens based on the efforts of others. These are key hallmarks of a security and a securities offering.⁴⁴

While the CFTC has acknowledged the challenges that cryptocurrencies and blockchain technology present to the existing regulatory scheme, the SEC appears committed to regulating the new technology through enforcement actions under existing law. It is unclear whether proposals like SAFT (Simple Agreement for Future Tokens) – a protocol developed by lawyers for lawfully issuing tokens as non-securities – will be widely adopted.⁴⁵ As time goes on, they look less promising.

Fraudulent offerings

Enforcement actions under existing law have worked well in protecting investors from fraudulent offerings. One of the earliest SEC actions was a 2013 federal court action against Trenton Shavers and Bitcoin Savings and Trust.⁴⁶ BTCST claimed that it was raising funds to engage in market arbitrage activity – including selling bitcoin to people who wanted to buy bitcoin “off the radar”. BTCST promised up to 7% interest per week. At least some BTCST investors may have known that the Internet name of the Shavers was “pirateat40” and BTCST was previously known as “First Pirate Savings & Trust.”

44. *Id.*

45. JUAN BATIZ-BENET, MARCO SANTORI, & JESSE CLAYBURGH, THE SAFT PROJECT: TOWARD A COMPLIANT TOKEN SALE FRAMEWORK (Oct. 2, 2017), available at <https://www.cooley.com/news/insight/2017/2017-10-24-saft-project-whitepaper>.

46. Complaint, *SEC v. Trenton Shavers, et al*, No. 4:13-cv-416 (E.D.Tex. July 23, 2013), available at <https://www.sec.gov/litigation/complaints/2013/comp-pr2013-132.pdf>.

Nevertheless, Shavers and BTCST raised 700,000 bitcoin – approximately \$4.5 million. In the end, they were ordered to pay \$40 million in disgorgement and \$150,000 in civil penalties.⁴⁷

In 2015, the SEC filed *SEC v. Homero Joshua Garza*, a federal court action halting the offering of interests in a bitcoin mining operation. Garza sold \$20 million of shares in a digital mining contract he called a “Hashlet.” Investors were told that they owned a share of computing power by investing in the Hashlet. Garza sold far more interests in the Hashlet than existed – promising to pay a return that far exceeded the actual return on the mining operations.⁴⁸ Garza used funds from new investors to make payments to earlier investors. He was charged in a parallel criminal case and ultimately pled guilty to one count of wire fraud.⁴⁹

In June 2017, the SEC obtained emergency relief halting a fraudulent scheme that raised over \$37 million.⁵⁰ Recidivist securities law violator and UK resident Renwick Haddow created an unregistered broker-dealer to sell securities in two companies that he created, Bitcoin Store (a purported cryptocurrency trading platform) and Bar Works (a purported chain of co-working spaces). Haddow is also facing criminal charges for his fraudulent activities.

In September 2017, the SEC obtained emergency relief halting another fraudulent scheme involving cryptocurrency.⁵¹ According to the SEC complaint, the offerors claimed that the REcoin token was backed by real estate and that they had hired a team of lawyers, professionals, brokers, and

47. Press Release, SEC, Final Judgment Entered Against Trendon T. Shavers, A/K/A/ "Pirateat40" - Operator of Bitcoin Ponzi Scheme Ordered to Pay More Than \$40 Million in Disgorgement and Penalties (Sept. 22, 2014).

48. Press Release, SEC, SEC Charges Bitcoin Mining Companies (Dec. 1, 2015), available at <https://www.sec.gov/litigation/litreleases/2015/lr23415.htm>.

49. Press Release, SEC, SEC Obtains Final Judgment Against Founder of Bitcoin Mining Companies Used to Defraud Investors (Oct. 4, 2017), available at <https://www.sec.gov/litigation/litreleases/2017/lr23960.htm>.

50. Press Release, SEC, SEC Files Fraud Charges in Bitcoin and Office Space Investment Schemes (June 30, 2017), available at <https://www.sec.gov/litigation/litreleases/2017/lr23870.htm>.

51. Press Release, SEC, SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds (Sept. 29, 2017), available at <https://www.sec.gov/news/press-release/2017-185-0>.

accountants who would invest the proceeds of the offerings in real estate.⁵² There is a parallel criminal action pending.

In December 2017, the SEC obtained emergency relief to halt the offering of the PlexCoin token by a repeat securities law violator as a fraudulent offering.⁵³ In January 2018, the SEC obtained a court order halting the AriseCoin offering, an offering to create the purported first-of-its-kind decentralized bank. The issuer, AriseBank, allegedly made false statements that it was able to offer FDIC-insured accounts and an AriseBank-branded VISA card to spend 700-plus cryptocurrencies. The SEC sought an emergency asset freeze and the appointment of a receiver to unwind what the SEC alleges is an “outright scam.” AriseBank is contesting the SEC’s allegations.

Unregistered securities offerings

The SEC brought its first action against an issuer for failing to register a token as a security in 2014.⁵⁴ As of March 2018, only one token has been registered with the SEC as a securities offering.⁵⁵ Others that do not register base that decision upon exemptions under the securities law such as crowdfunding and Reg D.

The first significant guidance from the SEC on how to determine whether a token is a security was issued in July 2017. At that time, the SEC issued a Section 21(a) report analyzing whether the sale of DAO (decentralized autonomous organization) tokens are securities, without bringing charges against DAO.⁵⁶ In the DAO Report, the SEC set out how, applying the *Howey*

52. Complaint, *SEC v. REcoin Group Foundation, LLC et al.*, 17 Civ. 5725 (E.D.N.Y. Sep. 29, 2017), available at <https://www.sec.gov/litigation/complaints/2017/comp-pr2017-185.pdf>.

53. Press Release, SEC, SEC Emergency Action Halts ICO Scam (Dec. 4, 2017), available at <https://www.sec.gov/news/press-release/2017-219>.

54. *In re Erik Vorhees*, Exchange Act Release No. 9592 (June 3, 2014), available at <https://www.sec.gov/litigation/admin/2014/33-9592.pdf>. Vorhees failed to register securities offerings apparently because he was only accepting payments in bitcoin.

55. Praetorian Group, Registration Statement (Form S-1), available at https://www.sec.gov/Archives/edgar/data/1721980/000137647418000045/pr_s1.htm.

56. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Rel. No. 81207 (July 25, 2017), available at <https://www.sec.gov/litigation/investreport/34-81207.pdf> (hereinafter the “DAO Report”).

test, it concluded that the DAO token was an “investment contract.” Although the DAO token was offered as something other than a security, the SEC stated “the emphasis should be on economic realities underlying a transaction, and not on the name appended thereto.”⁵⁷ The SEC found it significant that the DAO token purchasers would rely on the significant managerial efforts of others to earn profits. As a result, the SEC concluded that the offer and sale of the DAO securities must comply with the requirements of Section 5 of the Exchange Act that offers and sales of securities be registered or qualify for an exemption from registration.. The SEC noted in passing that the offer and sale of the DAO token did not qualify for exemptions under the crowdfunding provisions of the JOBS Act and expressly declined to consider whether DAO was an “investment company.”

Since the DAO Report was released, the SEC has signaled its intent to police virtual coins. The SEC set up a Cyber Unit to investigate activities in the cryptocurrency/token space that might violate federal securities laws.⁵⁸ There have been media reports that the SEC has issued eighty or more subpoenas to obtain information concerning ICOs.⁵⁹ In the coming months, we will likely see through enforcement actions which tokens the SEC considers to be securities.

The SEC Staff considers the cooperation and remedial efforts of offerors in determining what enforcement action it may take. For example, Munchee, issuer of the MUN token, consented to a cease-and-desist order in early December 2017.⁶⁰ In determining not to impose a civil penalty, the SEC took into consideration Munchee’s cooperation and prompt remedial actions. But, the degree of consideration for cooperation is within the SEC’s discretion. The consideration given for cooperation may differ significantly depending on the individual staff and supervisors handling the case, other investigations and cases the SEC is pursuing at the time, and SEC priorities and resources. Credit for cooperation is not a certainty.

57. *Id.* at 11.

58. <https://www.sec.gov/news/press-release/2017-176>.

59. Cryptocurrency Firms Targeted in SEC Probe, Feb. 28, 2018, WSJ, available at <https://www.wsj.com/articles/sec-launches-cryptocurrency-probe-151985626>.

60. *In the Matter of Munchee, Inc.*, Exchange Act Release No. 10445 (Dec. 11, 2017).

Unregistered securities exchanges

The SEC has also brought actions against operators of online trading platforms for failing to register as securities exchanges. In late 2014, the SEC brought an action against BTC Trading Corp and Ethan Burnside for operating two online platforms for trading securities that were not registered as securities exchanges.⁶¹ The SEC concluded that the tokens traded on those trading platforms were securities and sought disgorgement, a fine, and an industry bar.

In mid-2015, the SEC shut down an online trading platform for facilitating security-based swaps involving non-eligible persons and without an effective registration statement, which is prohibited under Dodd-Frank.⁶² Sand Hill was an entity created by two Silicon Valley entrepreneurs who were alleged to have made misrepresentations about their trading, operations, controls, and financial backing.

It remains to be seen what the SEC will do with virtual coin exchanges like Bittrex that may be operating as unregistered securities exchanges or unregistered broker-dealers.

D. Other Regulation

Other state and federal agencies are bringing actions to halt fraudulent offerings of virtual coins. Some of those actions have been brought by the Federal Trade Commission, the Texas Securities Department, and the North Carolina Securities Department.⁶³ Yet, people continue to pour money into virtual coins like “Ponzicoín” that clearly disclose the offering as a joke.⁶⁴ To

61. Order, *In the Matter of BTC Trading, Corp and Ethan Burnside*, Exchange Act Release No. 9685 (Dec. 8, 2014), available at <https://www.sec.gov/litigation/admin/2014/33-9685.pdf>.

62. 15 U.S.C. § 77e(e). *In Matter of Sand Hill Exchange*, June 17, 2015 Order, AP File No. 3-16598, available at <https://www.sec.gov/litigation/admin/2015/33-9809.pdf>.

63. See Press Release and related documents, *FTC v. BF Labs, Inc.*, 4:14-cv-00815-BCW (Sept. 23, 2014), available at <https://www.ftc.gov/enforcement/cases-proceedings/142-3058/bf-labs-inc>.

64. See Olivia Solon, *Bitcoin, titcoin, ponzi coin: jokes and scams fuel a cryptocurrency gold rush*, THE GUARDIAN (Feb. 2, 2018), available at <https://www.theguardian.com/technology/2018/feb/02/bitcoin-bananacoin-prodeum-cryptocurrencies>.

the extent that people are purchasing tokens for their amusement or novelty value, it would appear that tokens should be regulated by consumer protection agencies like the Federal Trade Commission. Perhaps people who purchase Ponzicoin do it for the same reason people purchase pet rocks or Chia pets and the law should merely require that they get what they want.

Conclusions & Recommendations

In the near term, investors will continue to respond to the attraction of virtual coins as currencies, commodities, and securities. That puts the retirement savings of millions of customers at risk. Broker-dealers and registered investment advisory firms should immediately:

- prohibit virtual coins in retirement accounts and any fiduciary account;
- require heightened supervision of any customer accounts invested in virtual coins; and,
- implement adequate training, revised protocols, and supervisory systems that specifically address the potential risks of virtual coins.

FINRA should implement, on an expedited basis, rules that specifically address the heightened risks of virtual coins as investments to retail investors. Member firms should not wait for others like the FINRA, the SEC, and state securities commissioners to provide specific guidance. Virtual coins have been growing in popularity since 2008. The current Chairman of the SEC considers this issue cut and dried – all tokens that he has seen are securities. Members should have specific supervisory policies and procedures in place to address the risks of financial advisors inducing or assisting customer virtual coin transactions.

While blockchain technology may be more transformative than the internet, FINRA and firms must take affirmative steps to mitigate the risk of investor losses – particularly potentially devastating losses of retirement savings.

CRYPTOCURRENCIES – INVESTMENT OR ELECTRONIC CURRENCY OF THE FUTURE¹

Douglas Schulz, Christopher Riley, and Tracy Pride Stoneman²

Introduction

Today it seems you cannot open a financial publication without seeing at least one article on bitcoins or other virtual currencies/cryptocurrencies. This article will attempt to clear up much of the misunderstandings that have governments, regulators, banks, and consumers confused. The authors will also posit what lies ahead for commerce, the global banking system, the unbanked without access to Finance, reserve currencies and central banking systems and that all have a ‘new player in town’.

Brief History of Currencies

Centuries before the time of Christ, individuals traded and bartered utilizing stones, beads, shells and almost anything of perceived value. The world’s first coins were either gold or silver and were minted by King Alyattes of Sardis, Lydia in approximately 610 BC. The first paper currency was utilized in

1. A more detailed version of this article that is more ‘investor friendly’ is available on the authors’ websites.

2. Douglas Schulz, CRCP (Certified Regulatory Compliance Professional), was a stockbroker, investment advisor, portfolio manager and licensed commodity trader. He currently trades in cryptocurrencies. His firm Invest Securities Consulting, Inc. based in Colorado does financial consulting and securities fraud expert witness work. www.securitiesexpert.com.

Christopher Riley, CEO Cutwater Shift, private equity and business optimization firm and Series 79 (Investment Banking) licensed. He was formerly in real estate development and management, has a Master’s in Organizational Psychology and has forensically helped shape the regulatory paths for the Payday Loan, Cannabis and Vehicle Service Contract industries. www.cutwatershift.com.

Tracy Pride Stoneman is a securities lawyer and co-authored the book BROKERAGE FRAUD - WHAT WALL STREET DOESN’T WANT YOU TO KNOW, (2002) with Douglas Schulz. She was a former Judge in Texas and served on The Board of Directors of PIABA. www.brokeragefraud.com.

China during the Tang dynasty over 1,000 years ago. The first European banknotes were issued in Sweden in 1661. As early as the 1800s in Europe, traders used something called a “tally stick” which in a sense was the first credit card; notches on a wooden stick indicated the amount of money lent or owed.

The exchanging of one country’s currency for another country’s currency is as old as the currencies themselves. One of the main reasons that in ancient times so many coins were either gold or silver is because there was little dispute over the value of an ounce of silver or gold compared to the value of a Roman coin that merely had the picture of an emperor stamped on it.

Why Cryptocurrencies - Anonymous Banking

It doesn’t seem feasible to have an anonymous global banking system with all the regulatory bodies across the world, but the cryptocurrency marketplace is trying. How the investment regulators collide with cryptocurrencies will determine the future of the crypto industry. Notwithstanding the investment issues, with the momentum of bitcoin ATMs, BitPay, LitePay debit cards in partnership with Visa³ that were abandoned⁴ but gave a hint to possibilities, and a full-court press on bitcoin/cryptocurrency wallets becoming mainstream, there is an epic battle about to ensue in the global banking industry.⁵ We believe that banks will inevitably maintain their position as the primary disseminator of currency. We also believe that cryptocurrencies are here to stay and will at least make a valiant run as an alternative to fiat currencies going forward, especially where the cryptocurrency platforms become mainstream.⁶

3. Wayne Duggan, *What You Need To Know About LitePay*, YAHOO! FIN. (Feb. 26, 2018), <https://finance.yahoo.com/news/know-litepay-194936452.html>. See also Tip Ranks, *Will LitePay Be the Game Changer that Takes Cryptocurrency Mainstream?*, NASDAQ (Feb. 8, 2018), <https://www.nasdaq.com/article/will-litepay-be-the-game-changer-that-takes-cryptocurrency-mainstream-cm918280>.

4. LITEPAY, <https://www.litepay.us/> (last visited June 8, 2018) (“LitePay, Inc has ceased operations due to an inability to source sufficient liquidity or financing.”)

5. Jamie Redman, *Bitpay Launches Bitcoin Cash Debit Card Top Ups*, BITCOIN.COM (Mar. 2, 2018), <https://news.bitcoin.com/bitpay-launches-bitcoin-cash-debit-card-top-ups>; see also LITEPAY, <https://www.litepay.us> (last visited June 8, 2018) (notice ceasing operations from lack of funding).

6. Some think of cryptocurrencies as a new asset class that will survive long term but is currently an asset bubble. “We are at the birth of a new asset class. As Andreessen

Banks will inevitably create their own cryptocurrencies and/or try to acquire or limit competitive cryptocurrencies that threaten their marketplace. Bank of America is already challenging this industry for existential reasons.⁷ On any particular holiday when banks are closed, “Bitcoin, as a peer-to-peer (P2P) settlement system, was able to process over \$1 bln [billion] worth of transactions, and more than \$7 bln [billion] worth of Bitcoin was traded on a single day. Regardless of holidays and weekends, users of Bitcoin and other cryptocurrencies like ether can freely transact on a peer-to-peer basis, through the

Horowitz puts it, 'cryptocurrencies are a new asset class that enable decentralized applications.' Or something like that. Some much smarter people than me like Chris Burniske and Adam White already wrote about the birth of the new asset class few years ago.” Etienne Brunet,

This is where we are in the life cycle of cryptocurrencies, MARKETWATCH (Dec 22, 2017), <https://www.marketwatch.com/story/this-is-where-we-are-in-the-life-cycle-of-crypto-currencies-2017-12-22>

Brunet delineates the 5 stages of a bubble from inception to post-crash and estimates the bitcoin market to be near the midpoint of the speculative phase with the next phase being the bursting of the bubble. “As of December 2017, we are right in the speculators phase.” *Id.*

On the other side, famed investor Warren Buffett denigrates cryptocurrencies, “(s)tay away from it. It's a mirage basically. It's a method of transmitting money. It's a very effective way of transmitting money and you can do it anonymously and all that. A check is a way of transmitting money too. Are checks worth a whole lot of money? Just because they can transmit money?” “I hope bitcoin becomes a better way to do it. But you can replicate it a bunch of different ways. The idea that it [bitcoin] has some huge intrinsic value is just a joke in my view.” Tae Kim, *Bitcoin up sevenfold since Warren Buffett warned digital currency was a 'mirage'*, CNBC (Sept. 7, 2017), <https://www.cnbc.com/2017/09/07/bitcoin-up-sevenfold-since-warren-buffett-warned-digital-currency-was-a-mirage.html>. “In similar fashion, billionaire investor Howard Marks told his clients to avoid high-flying digital currencies in July. ‘In my view, digital currencies are nothing but an unfounded fad (or perhaps even a pyramid scheme), based on a willingness to ascribe value to something that has little or none beyond what people will pay for it,’ Marks wrote in an investor letter. The manager then compared cryptocurrencies to the tulip mania of 1637, the South Sea bubble of 1720 and the internet bubble of 1999.” *Id.*

7. Evelyn Cheng, *Bank of America is worried about the threat of cryptocurrency to its business*, CNBC (Feb. 23, 2018), <https://www.cnbc.com/2018/02/23/bank-of-america-worried-about-threat-of-cryptocurrency-to-its-business.html>.

utilization of wallets.”⁸ For example, Business Insider reported a recent \$99 million litecoin transaction that cost 40 cents and took 2.5 minutes.⁹

This leads us to the Federal Reserve and the central banking system and we feel that it is also inevitable that some form of cryptocurrency will be present in both of those systems. “Some central banks are analyzing a cryptocurrency or other forms of digital currency that could be made widely available to the general public and serve as an alternative safe, robust and convenient payment, instrument, said the study by the group that includes the Federal Reserve and 59 other central banks for nations that account for about 95 percent of world gross domestic product.”¹⁰ Before Jerome Powell advises the primary Federal Reserve banks to choose a cryptocurrency, we have many years ahead of sifting through regulatory changes, vetting periods and the realization that cryptocurrencies are not evil. However, just like the credit card and payday loan industries, the “evildoers” need to be washed away before the industry can survive and be embraced by consumers.

There is one arena that makes logistical sense for cryptocurrencies and that surrounds the “unbanked” group which currently has very little or no access to any banking system. However, there are more caution flags waving in this arena to inject cryptocurrencies into than solution flags.

The first issues with outsiders bringing cryptocurrencies into a developing nation or an area that does not possess a sufficient banking system but whose recipients might not appreciate the intrusion. “As is the case with all efforts of outsiders attempting to better the lives of distant people, an uneasy awareness exists of the legacy of colonialism and the fine line between assistance and

8. Joseph Young, *Cryptocurrencies vs. Banks: Advantage of Decentralized Financial Systems*, COINTELEGRAPH (Mar. 10, 2018), available at <https://cointelegraph.com/news/cryptocurrencies-vs-banks-advantage-of-decentralized-financial-systems>.

9. Oscar Williams-Grut, *Someone transferred \$99 million in litecoin — and it only cost them \$0.40 in fees*, Business Insider, BUS. INSIDER (Apr. 23, 2018), <http://www.businessinsider.com/a-99-million-litecoin-trade-took-just-25-minutes-and-cost-040-2018-4>.

10. Ted Knutson, *Central Bank Cryptocurrencies Promising As Use Of Cash Disappears, Says Global Regulator Group*, FORBES (Mar. 12, 2018), <https://www.forbes.com/sites/tedknutson/2018/03/12/central-bank-cryptocurrencies-promising-as-use-of-cash-disappears-says-global-regulator-group/#4401dc8c30bd>.

paternalism.”¹¹ The real danger here is the volatility and insecurity of cryptocurrencies which could put the assets of those who can least afford a loss, at risk.

There are two schools of thought on the risks for the unbanked and they both reflect the immaturity of this innovation. One school believes that cryptocurrencies are the wave of the future and it would be foolish not to bring a solution to the unbanked so they can transact goods and services and participate in a broader form of commerce. The countervailing arguments point to the advisory and regulatory bodies that caution that cryptocurrencies require research, that a user be educated on the risks and cautions that users not ‘gamble’ with resources that they cannot afford to lose.

The authors of this piece advise the unbanked to avoid bitcoin, ethereum, Bitcoin Cash and all other public cryptocurrencies due to its extreme volatility. We would encourage some organization to specifically design and implement a cryptocurrency that would serve the unbanked and have a foundation behind it as a store of value. In fact, we believe that before 2019, there will be such an instrument and we believe, if done properly with proper vetting and due diligence, that this instrument will be a significant solution to bringing the unbanked into the 21st century!

No central bank or agency governs these new vehicles and thus when there is an irrevocable and untraceable trail of clues after a hack and theft of millions of dollars of cryptocurrencies, the investigators are unable to follow the money. This is a problem. In fact, this war between the cryptocurrency anonymity juggernauts and the traceable regulated banking is just about to begin. All of the thousands percent increases of these currencies could be wiped out with one regulation worldwide that would shatter the anonymity aspect of cryptocurrencies.

Ransomware criminals love anonymity. Their ability to have their victims pay in bitcoins has caused many companies to purchase bitcoins so the companies can retrieve their data via ransom if they are hacked.¹²

11. Paul Vigna & Michael Casey, *Bitcoin for the Unbanked*, FOREIGN AFFAIRS (Oct. 25, 2017), <https://www.foreignaffairs.com/sponsored/bitcoin-unbanked>.

12. Michael Baker, *How Cryptocurrencies Are Fueling Ransomware Attacks and Other Cybercrimes*, FORBES (August 3, 2017), <https://www.forbes.com/sites/forbes-techcouncil/2017/08/03/how-cryptocurrencies-are-fueling-ransomware-attacks-and-other-cybercrimes/>.

Let's explore how these platforms are intended to work and what happened to the second largest cryptocurrency, ethereum, that created a crisis and eventual split of its founders. The center of this technology is a Decentralized Autonomous Organization, or DAO. This is the foundation underpinning a good number of cryptocurrencies and is critical for all stakeholders to understand. Without going into detail, the largest cryptocurrency after Bitcoin embodies what is known as 'smart contracts'. "Basically, 'smart contract' is the term used to describe a computer code that enables the exchange of things of value, such as money, shares, property, and information."¹³ The uses for smart contracts are virtually endless. They are easier to implement, do not require intermediaries such as notaries and lawyers and are recorded on a ledger known as the blockchain.¹⁴

Several uses for smart contracts are:¹⁵

- raising capital through crowdfunding digitally and safely
- securely implementing insurance contracts, real estate contracts and other contracts that do not require lawyers, agents or other intermediaries
- controlling access to personal information in associations or public groups like country clubs or homeowner associations
- tracking supply chains so that the entire process is implemented through smart contracts and available on the blockchain for all to witness
- predictions on certain events like elections or winners of any time of sporting event where gambling or cash prizes are awarded to the winner

A DAO is an organization that uses these smart contracts for their transactions. For the most part, these are streamlining the way volumes of transactions are implemented. However, early on there were growing pains. There was an organization called Slock.it that used a DAO to make investment decisions. The problem came when the programmers of Slock.it allowed for a hole for hackers to corrupt the code and approximately \$50 million dollars was stolen from the company. The founders of ethereum decided to help the company and create a hard fork in the code, which goes against the entire decentralized

13. IKUYA TAKISHIMA, *ETHEREUM: THE ULTIMATE GUIDE TO THE WORLD OF ETHEREUM* 9 (2017).

14. Mike Orcutt, *Ethereum's smart contracts are full of holes*, MIT TECH. REV., (Mar. 1, 2018), <https://www.technologyreview.com/s/610392/ethereums-smart-contracts-are-full-of-holes/>.

15. Takishima, *supra* note 13, at 35-50.

credo of cryptocurrencies. The ethereum founders ended up helping the company get the \$50 million back, but the hardcore ethereum founders ended up splitting and forming ethereum Classic, which does not have the hard fork in the program to help locate thieves. Ethereum is alive and well with a price above \$900 per ether coin. Ethereum Classic's price is below \$50 per coin.

This one example is a very significant piece of data as to how the entire cryptocurrency industry is going to penetrate just about every two-party contract industry. Transaction driven industries like real estate,¹⁶ insurance,¹⁷ car rental, hotel, travel and law¹⁸ are beginning to embrace the ethereum smart contracts because if they are not already being used by your competitors, they are certainly investigating it. Just as investment advisors need to proceed with caution, so too should businesses and law because there are certainly issues with these smart contracts being 'smart'.¹⁹ "What are the requirements in today's world to be accepted as a legitimate currency used for the buying, selling and exchanging of products and services?" Answer: security, stability, size, volume, liquidity, and legitimacy.

Security and Hacking

Think for a moment if, during the climb of Google stock when it broke through the \$400 stock price in March 2013 that NASDAQ came out with a statement that five hundred million dollars (\$500,000,000) in Google stock was stolen and it can't identify who stole it, because NASDAQ uses an anonymous stock certificate tracking system.

This scenario happened to Mt. Gox's cryptocurrency exchange in February 2014 when five hundred million dollars (\$500,000,000) worth of bitcoins

16. DELOITTE, BLOCKCHAIN IN COMMERCIAL REAL ESTATE (2017), available at <https://www2.deloitte.com/content/dam/Deloitte/us/Documents/financial-services/us-fsi-rec-blockchain-in-commercial-real-estate.pdf>.

17. *How Will Smart Contracts Make Revolution in the Insurance Industry?*, ALTCOINTODAY.COM (Feb. 19, 2018), <https://altcointoday.com/will-smart-contracts-make-revolution-insurance-industry/>.

18. Michael del Castillo, *Legally Binding Smart Contracts? 10 Law Firms Join Enterprise Ethereum Alliance*, COINDESK (Aug. 14, 2017), <https://www.coindesk.com/legally-binding-smart-contracts-9-law-firms-join-enterprise-ethereum-alliance/>.

19. Andrew Glidden, *Should Smart Contracts Be Legally-Enforceable?*, BLOCKCHAIN AT BERKELEY (FEB. 27, 2018), <https://blockchainatberkeley.blog/should-smart-contracts-be-legally-enforceable-599b69f73aea>.

were stolen. The SEC, NYSE, NASDAQ and the Attorney General of the United States have no power over Mt. Gox since it is located in Tokyo, Japan, yet hundreds of millions of American dollars were lost. Now, four years later, it could happen again as smaller hacks are happening at various exchanges and companies across the globe.

The mining companies in the cryptocurrency exchanges have not rectified their security problems that have allowed for hundreds of millions of dollars to be hacked from the various systems. For legitimacy and acceptance broadly, these problems will need to be cleared up relatively quickly. The following are a few more examples of security breaches.

December 19, 2017 - “*A cryptocurrency exchange in South Korea collapsed on Tuesday after it suffered a second cyberattack in eight months and lost a large amount of its digital-currency reserves. Yopian, the company that operates a Seoul-based exchange called Yobit, suspended digital-currency trading and filed for bankruptcy after its systems were hacked in the predawn hours of Tuesday. The exchange trades 10 virtual currencies including bitcoin and ethereum. Yopian said in a statement that the latest security breach caused it to lose 17% of its total assets. The company didn’t specify the type of virtual currencies that were stolen or the financial value of its losses. The previous cyberattack, in April, also resulted in losses from its reserves.*”²⁰

January 27, 2018 - “*Japanese exchange Coincheck Inc. said Sunday it would spend up to ¥46.3 billion (\$426 million) to pay back customers after it was hacked and lost cryptocurrency worth some \$530 million two days earlier. In a release on its website, Coincheck said customers holding the cryptocurrency NEM would be paid back in Japanese yen at a rate of 88.549 yen per NEM. The company said it lost 523 million NEM after the cyberattack, meaning the payments would amount to ¥46.3 billion. It said about 260,000 customers hold NEM.*”²¹

February 10, 2018 - “*An Italian cryptocurrency exchange called BitGrail said on Friday that it lost about 17 million tokens of a cryptocurrency called Nano, with a market value of about \$170 million. In a note on its website, the*

20. Eun-Young Jeong & Steven Russolillo, *Hack Causes Exchange to File for Bankruptcy*, WALL ST. J. (Dec. 20, 2017); Eun-Young Jeong & Steven Russolillo, *Cryptocurrency Exchange Collapses, Files for Bankruptcy After Second Hack*, WALL ST. J. (Dec. 19, 2017), <https://www.wsj.com/articles/cryptocurrency-exchange-collapses-files-for-bankruptcy-after-second-hack-1513683519>.

21. Peter Landers, *Japanese Cryptocurrency Exchange Coincheck to Pay Back Customers*, WALL ST. J. (Jan. 27, 2018).

exchange said, “Internal checks revealed unauthorized transactions which led to a 17 million Nano shortfall, an amount forming part of the wallet managed by BitGrail.” It didn’t indicate exactly when the hack occurred. The exchange said that it has informed authorities, and that it didn’t believe any other currencies it holds were affected. It did say, however, that it was suspending all withdrawals and deposits temporarily.²²

Until the United States regulatory bodies come together to resolve these issues²³, it is entirely possible the cryptocurrency marketplace could look and operate a lot more like the cannabis industry where legal Colorado state entities do not violate state laws by conducting business, but the moment they pay federal 941 taxes, they are admitting to a federal crime. The solution in Denver is for the cannabis companies to haul duffle bags of cash to the Denver IRS office; federal banks won’t allow them to transact business because marijuana is still federally illegal. Thus, the cannabis companies are searching for ways to transact business without using fiat currencies and having to deposit monies in a bank. Welcome to the world of cryptocurrencies. “Technology companies like SinglePoint²⁴ and POSaBIT²⁵ are working to generate a payment method for dispensaries and consumers using bitcoin. In recent years, some cryptocurrencies have cropped up specifically for cannabis transactions,

22. Paul Vigna, *Cryptocurrency Worth \$170 Million Missing from Italian Exchange*, WALL ST. J. (Feb. 10, 2018).

23. The search for international standards is also progressing. “Some of the technologists at the meeting of the International Standards Organization were surprised when they learned that the head of the Russian delegation, Grigory Marshalko, worked for the F.S.B., the intelligence agency that is the successor to the K.G.B. They were even more surprised when they asked the F.S.B. agent why the Russians were devoting such resources to the blockchain standards. ‘Look, the internet belongs to the Americans — but blockchain will belong to us,’ he said, according to one delegate who was there.” Nathaniel Popper, *Blockchain Will Be Theirs, Russian Spy Boasted at Conference*, N.Y. TIMES (April 29, 2018), <https://www.nytimes.com/2018/04/29/technology/blockchain-iso-russian-spies.html>.

24. SINGLEPOINT, <https://www.singlepoint.com/> (last visited June 8, 2018).

25. POSABIT, <http://www.posabit.com/> (last visited June 8, 2018).

like PotCoin²⁶ and HempCoin.²⁷ This is just one example of how cryptocurrencies can exist well into the future.

The security issue still exists for consumers. The precious commodity backing up cryptocurrencies is a long alphanumeric code or integer that you most likely should only have one copy of on a removable storage device (cold storage)²⁸ where you can safely keep it. If you buy cryptocurrencies on an online exchange, they keep your code for you behind their firewall, which is why the Mt. Gox situation was so devastating. People who thought their currency was safe lost all their money. Cold storage is the advisable way to store your cryptocurrency. For those just coming into the cryptocurrency world, it must be somewhat shocking to think that in a world riddled with internet security issues and online banking that for a currency that exists solely online, the one sure way to secure it is to have a physical storage device stored under your mattress reminiscent of a bygone era.

Stability

Stability is the single biggest obstacle for cryptocurrencies. Most businesses based in the United States are rarely affected by currency fluctuations. Many international businesses have a major percentage of their businesses based on not only buying certain products from foreign countries but also selling their end product to foreign countries. If these international companies trade with countries that have currencies that are unstable, they can a) use the currency markets to hedge these exchange risks; b) force that country to both pay or sell their products and services in U.S. dollars, and c) use an intermediary to take the currency risk out of play based on currency exchanges that exhibit small incremental movements in deep markets.

Cryptocurrencies have been anything but stable. They were stable in the early years, but that was merely from the fact that there was little interest and very little volume. Ethereum traded at \$17.64 in April, 2017 and less than a year later it hit a high of \$1,338 (a 7,585% increase) before dropping 37% in only a few months down to \$845.56. If you received ten bitcoins in November

26. POTCOIN, <https://www.potcoin.com/> (last visited June 8, 2018).

27. Annie Nova, *Bitcoin Offers the Cannabis Industry an Alternative to Banks*, CNBC (Dec. 15, 2017), www.cnbc.com/2017/12/15/bitcoin-offers-the-cannabis-industry-an-alternative-to-banks.html.

28. Cold Storage is the slang term for a removable storage device that houses the codes that are unique to the owner of any amount of a cryptocurrency.

2017 for \$190,000 in services and held those bitcoins until January 18, 2018 (only 2 months) and then bought more inventory with your bitcoin, you would have lost 45% of your buying power and would have received 45% less product, because bitcoin lost 45% in two months. For this reason, the marketplace is going to have a difficult time embracing bitcoin, ether and all the other cryptocurrencies until some form of stability or hedging is present in this marketplace. The following are two recent examples of the volatility.

December 22, 2017 - *Bitcoin Plunges 25% in 24 Hours in a Cryptocurrency Market Rout. The price of bitcoin tumbled sharply Friday in Asia, wiping one-fourth of its market value in the past 24 hours alone, as a wave of selling hit the broader cryptocurrency market just before the Christmas holiday weekend. Bitcoin recently traded at \$13,758 after earlier falling as low as \$12,504, according to research site CoinDesk. The notoriously volatile digital currency started December at about \$10,000 and traded close to \$20,000 this past weekend but has been in retreat since. From its recent peak, the virtual currency has lost about \$121 billion of its total market value in less than a week or more than twice the market cap of Tesla Inc.*²⁹

January 17, 2018 - *Bitcoin prices fell below \$10,000 on Wednesday, marking a drop of about 50% from their December record and illustrating the degree to which the cryptocurrency remains a highly illiquid and volatile investment. Bitcoin fell as low as \$9,966, down around 6% on the day and nearly half from its Dec. 17 record of \$19,783.21, according to data from CoinDesk. A day earlier, the cryptocurrency plunged as much as 25%. Later in the U.S. morning, the price bounced back above the \$10,000 mark. Wednesday's drop spread quickly to other major digital currencies. Ether was down as much as 33%. XRP was down 47%. Litecoin was down 35%. Newer tokens like Cardano, EOS and Monero were down 35% or more.*³⁰

In the last year, the explosive growth of different cryptocurrencies and skyrocketing volume and dollar value of cryptocurrencies is not, we repeat, not due to the interest in cryptocurrencies becoming the trading currency of the future; it's because of the speculative trading fever of the underlying currency.

29. Steven Russolillo & Gregor Stuart Hunter, *Digital currency has lost \$121 billion of its total market value in less than a week*, WALL ST. J., Dec. 22, 2017.

30. Gregor Stuart Hunter, *Bitcoin Extends Rout, Dipping Below \$10,000 - Drop spreads to other cryptocurrencies, such as ether and litecoin*, WALL ST. J. (Jan. 17, 2018).

Size - Volume - Liquidity

We address the issue of currency gaining worldwide acceptance of size, volume and liquidity because they are interrelated. If the currency is going to be used for commerce, it must be available worldwide. The term used for this size/volume is referred to the amount of a specific currency in ‘circulation.’ There are a number of formulas for calculating circulation, but the more generally accepted, simplest formula is the number of coins, paper currency and banknotes that have been issued minus any that have been removed from circulation by a country’s central bank. The Bank for International Settlements listed the following numbers for the amount of currency in circulation as of December 31, 2016.³¹

(Converted to Billions of US Dollars)

1. United States	\$1,509
2. Europe – Euro	\$1,217
3. China	\$1,000 (estimated) ³²
4. Japan	\$915
5. Cryptocurrencies	\$467 ³³
6. India	\$196
7. Russia	\$145
8. United Kingdom	\$93
9. Switzerland	\$79

Don’t be fooled by the amount of money in circulation for established currencies as it pales in comparison when you consider the trillions of dollars that are traded in the currency markets daily, the best measure of liquidity and volume. The world’s largest trading market for currencies is the United States based Forex Market.

31. For volume in host country currency, *see* BANK FOR INTERNATIONAL SETTLEMENTS, STATISTICS ON PAYMENT, CLEARING AND SETTLEMENT SYSTEMS IN THE CPMI COUNTRIES (Dec. 2017), *available at* <https://www.bis.org/cpmi/publ/d172.pdf>; for comparison converting all to USD, *see* *Circulation (currency)*, WIKIPEDIA [https://en.wikipedia.org/w/index.php?title=Circulation_\(currency\)&oldid=826015376](https://en.wikipedia.org/w/index.php?title=Circulation_(currency)&oldid=826015376).

32. It is unknown how much renminbi (or Yuan) is in circulation, but estimates are approximately \$1,000 billion US dollars. *Id.*

33. *All Cryptocurrencies*, COINMARKETCAP, <https://coinmarketcap.com/all/views/all/> (As of early March 2018, the market cap of all cryptocurrencies was \$467 Billion).

According to the Bank for International Settlements, the preliminary global results from the 2016 Triennial Central Bank Survey of Foreign Exchange and OTC Derivatives Markets Activity show that trading in foreign exchange markets averaged \$5.09 trillion per day in April 2016. This is down from \$5.4 trillion in April 2013 but up from \$4.0 trillion in April 2010. Measured by value, foreign exchange swaps were traded more than any other instrument in April 2016 at \$2.4 trillion per day, followed by spot trading at \$1.7 trillion.³⁴ The \$5.09 trillion break-down is as follows:

- \$1.654 trillion in spot transactions
- \$700 billion in outright forwards
- \$2.383 trillion in foreign exchange swaps
- \$96 billion currency swaps
- \$254 billion in options and other products

“The most often traded currency pairs are the EUR/USD (approx. 28% of all volume), the USD/JPY (approx. 17% of all volume), and the GBP/USD (approx. 14% of all volume).”³⁵ In contrast the cryptocurrency market changes roughly \$50 billion a day, comparable to the New York Stock Exchange.³⁶

Cryptocurrencies Multiply

As any new product or concept that is embraced by consumers spawns countless copycats and competitors, cryptocurrencies have not only followed suit in this regard, but they have created an unprecedented threat of fraud and misdirection for consumers. Anyone with basic programming skills can create a cryptocurrency.

34. BANK FOR INTERNATIONAL SETTLEMENTS, TRIENNIAL CENTRAL BANK SURVEY: FOREIGN EXCHANGE TURNOVER IN APRIL 2016 (2016), *available at* <https://www.bis.org/publ/rpfx16fx.pdf>.

35. *The main forex currencies*, FOREX-CENTRAL.NET, <http://www.forex-central.net/main-currencies.php> (last visited June 8, 2018).

36. Oscar Williams-Grut, *The cryptocurrency market is now doing the same daily volume as the New York Stock Exchange*, BUS. INSIDER (Dec. 20, 2017), <http://markets.businessinsider.com/currencies/news/daily-cryptocurrency-volumes-vs-stock-market-volumes-2017-12-1011680451>.

The cryptocurrency pioneer, bitcoin, began in 2009. In 2018, there are more than 1,500 coins and tokens with a market capitalization of approximately \$500 billion U.S. dollars.³⁷ As the cryptocurrency market keeps growing, questions as to how the governments will control the money supply begin to creep into boardrooms and policy meetings. The answer is very concerning to traditional economists that are accustomed to fiat currency.

The above concerns sound a bit worse than actual reality, primarily because governments still have control over regulating this new industry. Although they cannot stop future cryptocurrencies from multiplying in number, they can control how they affect the buying and selling of goods and services.

We explore this concept a bit further, as this is one of the major concerns that is affecting the unknown future of this cryptic industry. Bitcoin is the clear leader as the pioneer and has the largest market cap at just under \$200 billion U.S. dollars. There is a total of 21,000,000 (twenty-one million) bitcoins available and once all of those bitcoins have been mined or have unlocked the code so that they can go into circulation, no more bitcoins can be generated. Unlike the U.S. dollar which, at the 'flick of a pen' from the Treasury Department, can kick out 5,000,000 one-hundred-dollar notes to add \$500 million of U.S. dollars into circulation, once the last bitcoin is thrust in to circulation, the only variable that can change is the price fluctuation of the cost of a bitcoin. In this manner bitcoin is akin to gold, though more gold can be found, the increments are small and thus gold functions as a fixed supply of value. This is why it is popular with some who fear inflationary pressures.

When will all bitcoins be in circulation? The designers set up the program so that there are a certain number of bitcoins that are awarded once a block formula is successfully solved. When bitcoin started, the number of bitcoins per block was 50. After 210,000 blocks of 50 bitcoins per block, the program is set to cut in half the 50 bitcoins to 25 bitcoins per successful block mined...and so forth. Every 210,000 blocks it will half again until the sum of bitcoins per block $(50+25+12.5+6.25\ldots) = 100$. $100 \text{ times } 210,000 = 21,000,000$ or twenty-one million bitcoins in circulation. This whole process will take almost 100 years to complete. Because of the halving system, almost 17 million of the 21 million bitcoins are already in circulation (approximately 80%) in the early months of 2018. All statistics, timing, bitcoins per block, when the blocks half again from 12.5 to 6.25 can all be found on the Bitcoinblockhalf.com website. The originators of a cryptocurrency wrote a computer program that requires other computers to try and guess a random

37. COINMARKETCAP.COM, <https://coinmarketcap.com/>.

integer from 0 to 4,294,967,296 called a nonce that will unlock a block of virtual coins that can be saved by the owner of the computer that cracked the code.³⁸ Many thousands of computers can be trying to crack the code for a block at the same time and only one of the fastest computers, or a lucky computer, will be the victor. All the other computers then have to move on to the next block. Since the originators wanted to release only portions of their currency every year, the program adjusts to make sure only a block is obtained every 10 minutes or so. For instance, bitcoin is going to be releasing portions of its 21 million coins until around the year 2140.

This is only how bitcoin, litecoin and several others of the blockchain technology cryptocurrency coins operate. litecoin has 84 million total coins with about 64% or 54 million in circulation for a market cap of \$12 billion dollars in the early months of 2018. Ethereum does not currently have a finite number that it will cap out at, but it is estimated that ether (the currency for the ethereum network) will cap out at around 100 million coins. It currently has about 97 million in circulation for a \$90 billion-dollar market cap. Ethereum has the smart contracts that are wrapped into its platform and will be one of the main focal points for how this industry moves forward. In the opinion of the authors, ethereum will be one of the survivors in this complex industry because the millions of transactions for basic needs such as real estate, insurance and car rentals can be done quicker and easier through the blockchain technology, which is what ethereum's smart contracts operate under.

The top five in market cap are bitcoin, ethereum, ripple, bitcoin cash and litecoin. The other coins of note are Cardano, Stellar, NEO, EOS, IOTA, Dash, and Monero. Each has unique aspects to them and prices range from .25 cents to over \$1,000 per coin. The top five in market cap account for 68.5% of the entire \$490 billion dollar market cap of the cryptocurrency world.³⁹ This is an amazing number, when you consider that, as shown above, only four economies (the United States, the European Union, China and Japan) have more currency in circulation than the collective market capitalization of cryptocurrencies.

This has risen the alert flags of regulators and governments across the world so much so that crackdowns, policy changes and bans have created an unstable, undulating price fluctuation for the most circulated cryptocurrencies. This investment instability has put a black mark on the investment aspect of

38. Noelle Acheson, *How Bitcoin Mining Works*, COINDESK, (Jan. 29, 2018), <https://www.coindesk.com/information/how-bitcoin-mining-works/>.

39. *All Cryptocurrencies*, COINMARKETCAP, <https://coinmarketcap.com/all/views/all/> (last visited June 8, 2018).

cryptocurrencies. As a pure investment, all investment advisors should warn every client that these are extremely volatile, complex investments and should not be purchased with anything but speculative, discretionary funds they are prepared to lose. This is unfortunate because, notwithstanding the prior warning to the public, the underlying platforms such as smart contracts and methods of payment for transactions are the true inherent value of cryptocurrencies. These components should be evaluated separately by consumers to improve the ease of transacting and by merchants for their value to increase the enterprise value of their company.

Regulators and Government Intervention

The following is a list of the current regulators of cryptocurrencies in the United States.

CFTC – Commodity Futures Trading Commission

The CFTC is responsible for recording and monitoring the trading of futures contracts on United States futures exchanges. The CFTC has the authority to fine, suspend, or sue the company or individual in federal court in cases of misconduct, fraud, or if a rule is broken. The CFTC also regulates commodity pools and commodity trading advisors. Many hedge funds operate as commodity trading pools. In December 2017, bitcoin futures began trading on the Chicago Mercantile Exchange (CME) and on the Chicago Board of Options Exchange (CBOE). The CBOE is now commonly referred to as Cboe Global Markets and thus comes under the watchful eye of the CFTC.⁴⁰

NFA - National Futures Association

The NFA is to the CFTC as FINRA is to the SEC. The NFA is a self-regulatory organization designated by the CFTC as a Registered Futures Association. The NFA was created by Congress in September 1981. The Dodd-Frank Wall Street Reform Act of 2010 created additional new reforms and

40. *See generally*, Comment Letter from William J. Brodsky, Chairman and CEO of the CBOE to Elizabeth Murphy, Secretary of the SEC and David Stawick, Secretary of the CFTC (Sept. 20, 2010), *available at* <https://www.sec.gov/comments/s7-16-10/s71610-46.pdf>.

requirements relating both to the CFTC and the NFA. Membership in the NFA is mandatory for those institutions trading for clients on U.S.-based future exchanges. The current NFA membership is roughly 4,000 firms and approximately 55,000 associates (licensed commodity brokers). One of the ways that the NFA regulates its members is through the publication of its NFA Rulebook containing rules, regulations, norms, and standards.⁴¹ The NFA's website provides warnings as it relates to trading virtual currencies.

SEC - Securities Exchange Commission

Many lay investors do not understand that the myriad of investments regulated by the SEC - stocks, bonds, mutual funds, stock options and other similar investments - does not include U.S. commodity futures and commodity options. Those are regulated by the CFTC and the NFA mentioned above.

FINRA - Financial Industry Regulatory Authority

FINRA regulates approximately 4,250 brokerage firms and approximately 629,000 registered securities representatives.

The U.S. Federal Reserve

Just in the last few months, there has been both a push and a prediction that in the relatively near future the Federal Reserve will create a United States based cryptocurrency.⁴² The Federal Reserve lists 7 purposes and functions that include regulating financial institutions, consumer protection and efficient safe payment and settlement system.⁴³

41. *See generally*, NFA RULEBOOK, NAT'L FUTURES ASS'N, available at <https://www.nfa.futures.org/rulebook/index.aspx>.

42. Jeff John Roberts, *5 Reasons the Fed Needs a Bitcoin-Style Currency*, FORTUNE MAGAZINE (December 26, 2017); Rakesh Sharma, *Federal Reserve May Introduce A Cryptocurrency in The Future*, INVESTOPEDIA (December 4, 2017).

43. *Purposes & Functions*, FEDERAL RESERVE, <https://www.federalreserve.gov/aboutthefed/pf.htm> (last visited June 8, 2018).

Examples of Governmental Intervention

It is almost a daily occurrence that some governmental agency or regulatory body worldwide files some warning to investors, new restrictions, or in some of the more severe cases, shutting down entire cryptocurrency exchanges or mining operations. The following is just a few examples in recent months.

December 6, 2017 - *“The Commodity Futures Trading Commission sent subpoenas Dec. 6 to virtual-currency exchange Bitfinex and its sister firm Tether Ltd., which issues tokens that it says are backed by a fund valued at about \$2.3 billion in U.S. dollars. That fund hasn’t been audited, and critics have questioned whether Tether can verify that it actually has those funds in reserve.”*⁴⁴

January 22, 2018 - Probably the biggest bombshell that the cryptocurrency markets were hit with was when South Korean financial regulators ruled they would no longer allow anonymous cryptocurrency trading accounts. The new regulations require anyone who is going to trade in cryptocurrencies to have a bank account that is linked to their cryptocurrency exchanges. Opening or utilizing a bank account already requires individuals to provide a laundry list of personal information. One of the motivations behind South Korea’s new regulation is its attempt to eradicate money laundering.⁴⁵

February 5, 2018 - *“Chinese authorities plan to block websites related to cryptocurrency trading and fundraising, state media reported, in the latest move to tighten controls over what Beijing deems as risky investments. Regulators are planning ‘a list of measures’ aimed at cryptocurrency trading, including ‘dealing with domestic and international websites,’ according to a report Monday by Financial News, a publication affiliated with China’s central bank.”*⁴⁶

Feb. 6, 2018 - *“U.S. regulators plan to ask Congress to consider imposing stricter federal oversight on trading of bitcoin and other cryptocurrencies, as market cops amplify alarms about an asset that is largely exempt from investor-protection laws. The chairmen of the Securities and Exchange Commission and the Commodity Futures Trading Commission plan to testify Tuesday that*

44. Gabriel T. Rubin & Paul Vigna, *U.S. Regulators Subpoena Bitfinex, Tether Over Digital Tokens*, WALL ST. J. (Jan. 31, 2018).

45. Eun-Young Jeong & Steven Russolillo, *Noose Tightens on Anonymous Cryptocurrency Trading in South Korea*, WALL ST. J. (Jan. 23, 2018).

46. Chao Deng, *The Latest Victim of China’s Great Firewall: Cryptocurrency Websites*, WALL ST. J. (Feb. 5, 2018).

cryptocurrency trading has outgrown the state-based regulation that covers many platforms. The aggressive tone adds to headwinds that bitcoin faces, including a crackdown in China and a move by U.S. banks to halt credit-card purchases of bitcoin. Bitcoin prices fell 11.6% on Monday, capping weeks of volatility. 'The currently applicable regulatory framework for cryptocurrency trading was not designed with trading of the type we are witnessing in mind,' SEC Chairman Jay Clayton said in prepared remarks for the Senate Banking Committee."⁴⁷

February 28, 2018 – The Wall Street Journal reported that “The Securities and Exchange Commission has issued dozens of subpoenas and information requests to technology companies and advisers involved in the red-hot market for cryptocurrencies.... The sweeping probe significantly ratchets up the regulatory pressure on the multibillion-dollar U.S. market for raising funds in cryptocurrencies. It follows a series of warning shots from the top U.S. securities regulator suggesting that many token sales, or initial coin offerings, may be violating securities laws. The wave of subpoenas includes demands for information about the structure for sales and pre-sales of the ICOs, which aren't bound by the same rigorous rules that govern public offerings, according to the people familiar with the matter. Companies use coin offerings to raise money for everything from file-sharing technology to pet passports. 'Many promoters of ICOs and cryptocurrencies are not complying with our securities laws,' SEC chairman Jay Clayton said earlier this year. In another speech he said he has instructed his staff to be 'on high alert for approaches to ICOs that may be contrary to the spirit' of those laws.”⁴⁸

March 2, 2018 - Jeremy Gardner, a co-founder of hedge fund Ausum Ventures, said in a tweet, With Australia set to introduce new legislation that will empower authorities to monitor and regulate the activities of cryptocurrency traders, many analysts are anticipating that the country's bitcoin investors will face a crackdown from the country's tax office. Australia's new cryptocurrency regulations will see anti-money laundering legislation extended in order to greater encompass the challenges posed by virtual currencies. Analysts are

47. Dave Michaels & Gabriel T. Rubin, *Patchy Bitcoin Oversight Poses Hazards for Investors, Regulators Say*, WALL ST. J. (Feb. 6, 2018).

48. Jean Eaglesham & Paul Vigna, *SEC Launches Cryptocurrency Probe*, WALL ST. J. (March 1, 2018).

*expecting that the Australian Tax Office (ATO) will launch a crackdown on Australian cryptocurrency traders once the new rules are in effect.*⁴⁹

March 7, 2018 – SEC policy statement: “Online trading platforms have become a popular way investors can buy and sell digital assets, including coins and tokens offered and sold in so-called Initial Coin Offerings (“ICOs”). The platforms often claim to give investors the ability to quickly buy and sell digital assets. Many of these platforms bring buyers and sellers together in one place and offer investors access to automated systems that display priced orders, execute trades, and provide transaction data. A number of these platforms provide a mechanism for trading assets that meet the definition of a “security” under the federal securities laws. If a platform offers trading of digital assets that are securities and operates as an “exchange,” as defined by the federal securities laws, then the platform must register with the SEC as a national securities exchange or be exempt from registration. The federal regulatory framework governing registered national securities exchanges and exempt markets is designed to protect investors and prevent against fraudulent and manipulative trading practices.”⁵⁰ Bitcoin immediately fell 10%, almost \$1,000 after the announcement.

March 8, 2018 – “Japan’s financial regulator punished several cryptocurrency exchanges on Thursday, including suspending operations at two of them for a month, part of new restrictions following an apparent \$530 million heist at one of its larger crypto platforms, Coincheck Inc. The Financial Services Agency said two of the country’s smaller exchanges, FSHO and Bit Station, had been ordered to halt operations for a month due to a lack of proper procedures to protect customers’ assets. The agency said the owner of Bit Station had improperly used customers’ bitcoin for personal use. It also asked Coincheck to better protect clients, take anti-money-laundering measures and overhaul operations.”⁵¹

49. Samuel Haig, *Aussie Crypto Traders Expect Tax Crackdown Ahead of New Regulations*, BITCOIN.COM (Mar. 2, 2018), <https://news.bitcoin.com/aussie-crypto-traders-expect-tax-crackdown-ahead-of-new-regulations/>.

50. Policy Statement, Statement on Potentially Unlawful Online Platforms for Trading Digital Assets, SEC Div. of Enforcement (March 7, 2018), *available at* <https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading>.

51. Steven Russolillo & Kosaku Narioka, *Japan Suspends Trading on Two Cryptocurrency Exchanges*, WALL ST. J. (March 8, 2018).

Mechanics of Investing and Trading Cryptocurrencies Today

There are various images associated with each cryptocurrency and most all of them are coin images. Many of them have ‘coin’ in its name such as bitcoin, litecoin, bytecoin, and dogecoin. Dogecoin was created as a joke and is named after a Japanese dog. Images of coins are created only to provide some sense of reality to these virtual coins.

How Do You Buy Goods and Services Using Cryptocurrencies?

To buy goods and services using cryptocurrencies is actually very easy and secure. Hundreds upon thousands of merchants across the world accept cryptocurrency as payment for goods and services. The direct way to purchase goods and services is to have what is known as an electronic wallet that stores your cryptocurrencies. There are many companies that offer apps that you can install on smartphones that store and facilitate payments using cryptocurrencies. The process is easy, merely copying destination addresses of the seller and then clicking buttons in your wallet to send the agreed upon amount of the cryptocurrency to the seller’s electronic wallet.

For those companies that do not have the ability to receive direct payments from an electronic wallet, there is the intermediary option, which is what many large companies are now using. For example, Expedia uses a popular and widely accepted cryptocurrency exchange, Coinbase, as its intermediary.⁵²

Venezuela has launched its own cryptocurrency called Petro to try and remedy its own debt crisis. The state of Georgia accepts bitcoin for the payment of taxes and governments across the world will shortly be following suit.

Now that one can buy a gift card with bitcoin called Gyft or use a third party app like purse.io and shop at Amazon.com and the fee is not much more than paying interest on your credit card, the world now has another form of payment with a market cap in the \$500,000,000,000 range. Skeptics who think cryptocurrencies are a fad destined to fail will need to see five hundred billion dollars disappear faster than it was created. Although Jamie Dimon, Chairman and CEO of JPMorgan Chase, once called bitcoin a fraud, his company now acts “as an agent for buyers and sellers of bitcoin XBT, an exchange-traded

52. *Bitcoin Terms and Conditions*, EXPEDIA.COM, <https://www.expedia.com/Checkout/BitcoinTermsAndConditions> (last visited June 8, 2018).

note designed to track the value of the cryptocurrency.”⁵³ This is indisputable evidence that the cryptocurrency bandwagon is gaining momentum.

Exchanges and Commerce

An Initial Coin Offering (ICO) is similar to an IPO where a company that has launched a cryptocurrency wants to raise money to grow. So far, only bitcoin has surfaced as a pseudo-currency. In fact, most of the other cryptocurrencies have what is known as a platform underlying their cryptocurrency. It is this fact that is critical to the argument as to whether cryptocurrencies will be a significant part of society in the future.

The commerce aspect of cryptocurrencies is the greater game, far above the investment component of how this new marketplace will unfold. Several industries are already morphing into a smart contract world using the blockchain technology. The question isn't whether these platforms will be a significant part of society, it is when will the 'bugs get ironed out' so that big business and governments embraces them.

Cryptocurrency Hedge Funds

As of mid-February 2018, the number of hedge funds specializing in cryptocurrencies rose to 226. This is incredible growth when you consider at the start of 2017 there were only 37 hedge funds focused on cryptocurrencies. The hedge funds tracked by the leading hedge fund database provider EurekaHedge showed a return of 1,477% in 2017 on average. Estimated current value of these cryptocurrency-based hedge funds is \$3.5-5 billion.⁵⁴ HFR is a separate entity that keeps track of fund managers investing in blockchain digital currency and distributed ledger technologies. HFR has created two blockchain indices: the HFR Block Chain Composite Index showed a 2,494% increase in

53. Reuters, *JP Morgan Helps Clients Buy Bitcoin Despite CEO Calling Bitcoin 'a Fraud'*, FORTUNE (Sept. 18, 2017) <http://fortune.com/2017/09/18/jpmorgan-buy-bitcoin-ceo-callingfraud>.

54. *Crypto Fund List*, AUTONOMOUS NEXT, <https://next.autonomous.com/cryptofundlist/> (last visited June 8, 2018).

the preceding 12 months through January 2018 and the HFR Cryptocurrency Index showed a 2,598% for the same period.⁵⁵

One of the more successful hedge funds has been Pantera Bitcoin Fund based in San Francisco. For the life of the fund which started in 2013, the total returns are a positive 25,004%.⁵⁶ It predominantly has been investing in bitcoins (this return was based on the bitcoin pricing of \$15,500) which far surpasses the highest performing non-cryptocurrency hedge fund which was up only 148% in 2017, whereas the average hedge fund was only up 8.83% 2017.⁵⁷ Pantera has a compounded annual rate of return of roughly 250% a year.

U.S. Publicly Traded Cryptocurrency Companies

These bitcoin Funds serve as examples of how investing in bitcoins works.

BITCOIN INVESTMENT TRUST (GBTC) NASDAQ

The Bitcoin Investment Trust - one of the most popular ways for retail traders to make bets on bitcoin. Essentially, the Bitcoin Investment Trust works like an exchange-traded fund (ETF). The fund owns bitcoins on behalf of its investors, which the fund's managers are responsible for keeping safe. Based on the current amount of bitcoins the fund owns, February 28, 2018, each share currently represents about 0.00100567 bitcoin^{58, 59}. Unfortunately,

55. *HFR Blockchain Indices Performance Tables*, HFR, <https://www.hedgefundresearch.com/family-indices/hfr-blockchain> (last visited June 8, 2018).

56. Nathaniel Popper, *A Bitcoin Hedge Fund's Return: 25,004% (That Wasn't a Typo)*, N.Y. TIMES, Dec. 20, 2017, at B4.

57. HEDGE FUND INDUSTRY PERFORMANCE REPORT – DECEMBER 2017, EVESTMENT (Jan. 10, 2018), available at <https://www.evestment.com/project/hedge-fund-performance-report-december-2017/>.

58. *Bitcoin Investment Trust*, GRAYSCALE, <https://grayscale.co/bitcoin-investment-trust/> (last visited March 3, 2018).

59. Matthew Frankel, *The Bitcoin Investment Trust's Stock Is Splitting: Here's What You Need to Know*, THE MOTLEY FOOL (Jan 16, 2018).

many GBTC investors don't fully understand exactly what it is they are buying, and the risks involved.

The GBTC trust is operated by Grayscale Investments... In May 2015, Grayscale gained regulatory approval to improve liquidity for its private investors by having shares of the trust trade on the U.S. OTC Market. Unlike the GLD ETF, which buys and stores physical gold, Grayscale has a unique challenge in storing and protecting its digital bitcoin holdings. "For GBTC, we have leveraged a third-party custodian, a firm called Xapo," Sonnenshein (the founder) said. "There is super intense cryptographic physical security as well as geographic dispersion such that their security model has no single point of failure." Unfortunately, due to the fact it's currently the only bitcoin trust of its kind out there for investors, traders have driven the price of the GBTC way above the value of the bitcoin it holds. In fact, the GBTC trust has consistently traded at a 50 percent premium to its assets under management... To make matters worse, analyst Ihor Dusaniwsky said short sellers have been paying 10 to 20 percent borrowing fees all year, and fees will likely continue to climb along with short interest. "Long GBTC holders may feel the pain of its 53% asset premium shrinking, while short sellers will probably be incurring a 50%+ stock borrow fee – both sides will be paying a premium in order to ride the Bitcoin rollercoaster once the CBOE futures start trading," Dusaniwsky said earlier this month.⁶⁰

GBTC had a 90 for 1 split for shareholders of record on January 22, 2018. Merrill Lynch has banned its roughly 17,000 advisers from executing client requests to trade in GBTC.

March 6, 2018 - *Grayscale Investments, the creator of the Bitcoin Investment Trust, is launching four new trusts today, doubling its number of products aimed at helping investors explore cryptocurrencies. The new trusts - which bring ethereum, litecoin, XRP and bitcoin cash to the offerings the firm provides - join Grayscale's existing bitcoin, ethereum classic and zcash investment trusts, as well as its Digital Large Cap Fund, a multi-crypto investment fund announced last month. Each of the newly announced cryptocurrencies is already part of the Digital Large Cap Fund, but were not previously available individually. Michael Sonnenshein, the managing director of Grayscale Investments, said "It is our belief that digital currencies as an asset class have not only arrived, but are here to stay. Consequently, we are committed to*

60. Wayne Duggan, *How the Bitcoin Investment Trust Actually Works*, BENZINGA (Dec. 21, 2017), <https://www.benzinga.com/analyst-ratings/analyst-color/17/12/10941281/how-the-bitcoin-investment-trust-actually-works>.

*providing investors with structures that enable them to participate in this exciting asset class." As of March 5, Grayscale had \$2.1 billion in assets under management, he said, up from \$208 million just a year ago.*⁶¹

The Securities and Exchange Commission has a pile of bitcoin ETF applications and institutional investors are lining up to get into the funds. Almost as soon as the first futures traded on the Cboe, the New York Stock Exchange filed for SEC approval for two ETFs based on bitcoin futures—one long and one short—to be managed by ProShares. Similarly, the Cboe has applied for approval for funds managed by fund families REX, First Trust and GraniteShares.⁶²

Some companies are working to adopt Blockchain and cryptocurrencies into their business model. In 2014, Overstock.com became the first major retailer to accept bitcoin for transactions. That same year, the e-tailer also began developing a small division called Medici Ventures that is focused on blockchain technology, the underlying tech that powers and protects bitcoin transactions. Despite the fact that Medici lost nearly \$12 million last year, Overstock shares have risen 260% since August, because a Medici subsidiary, tZero, announced it would begin trading digital coins and will seek to raise a record \$500 million through a digital coin offering. D.A. Davidson analyst Tom Forte has gone so far to say that if Overstock sold its e-commerce arm to home in on the blockchain, the stock would rise another 60%.⁶³ On March 1, 2018, the Securities Exchange Commission filed a request for information about tZero's initial coin offering (ICO) in December 2017.⁶⁴

Cryptocurrency Futures Trading

Cryptocurrency futures trading began in the United States in December 2017; currently, there is only one cryptocurrency being traded - bitcoin. The

61. Nikhilesh De, *XRP, BCH, LTC & ETH: Grayscale Adds 4 New Crypto Trusts*, COINDESK (Mar. 6, 2018), <https://www.coindesk.com/xrp-bch-ltc-eth-grayscale-adds-4-new-crypto-trusts/>.

62. Rob Curran, *What You Need To Know About Bitcoin Funds*, WALL ST. J. (Jan. 7, 2018).

63. Ryan Derousseau, *Three Stocks That Are Soaring Because Of Bitcoin*, MONEY MAGAZINE (Nov. 30, 2017), <http://time.com/money/5042272/stocks-investing-bitcoin/>.

64. Paul Vigna, *Overstock.com Shares Fall on CryptoProbe*, WALL ST. J. (Mar. 2, 2018).

bitcoin currency future is traded on two U.S. markets - CME Group and Cboe Global Market. The trading in bitcoin futures are very similar in both markets, the following is some of the basic similarities:

- you can be long or short the futures and contract months are quarterly
- unlike the cash for spot market for bitcoins, you can use margin and thus leverage your investment or hedging strategy
- settlement is a cash settlement - there is no physical delivery of bitcoin electronic currency
- both Chicago based markets are regulated by the CFTC, where many foreign virtual currency exchanges are to some degree unregulated
- Bitcoin futures can be used to hedge a physical ownership of bitcoins
- spreading futures is available, but currently, there are no bitcoin options traded
- it's not necessary to own bitcoin electronic currency and no "digital wallet" is necessary
- both markets currently contain "Contango"⁶⁵ the term for when further out contract months, trade at a premium to the current or closer in contract months.

The following are some of the specifics of the CME Group and Cboe Global Markets and some differences:

Cboe Global Markets – Cboe Bitcoin (USD) Future XBT

- XBT (the symbol) futures are cash-settled futures contracts that are based on the auction price of bitcoin in U.S. dollars on the Gemini Exchange
- the contract multiplier is one bitcoin (bitcoin closing price \$14,000 times 1 = futures contract of \$14,000)
- initial margin is 44% of the previous day's future settlement and maintenance margin is 40%
- minimum tick is \$10 per contract

65. Contango is the prevailing term structure for most futures markets much of the time. For instance, a well-supplied physical commodity market should remain in Contango. The pricing disparity between different delivery months should reflect the cost to store and insure the product over a given time frame. That's typically referred to as "cost of carry." A trader will pay more for the commodity at some future date to avoid incurring the costs of that commodity from now to that future date. In a normal market (Contango), there is a negative expected yield if a futures contract is rolled forward. *See generally, Contango*, INVESTOPEDIA, <https://www.investopedia.com/terms/c/contango.asp> (last visited June 5, 2018).

CME Group Bitcoin (USD) Future BTC

- BTC (the symbol) futures are cash-settled futures contracts that are based on the auction price of bitcoin in U.S. dollars on the Bitcoin Reference Rate (BRR)⁶⁶
- CME has one additional day of trading on Sunday
- initial margin is 43% for hedgers and 47% for speculators; maintenance margin is 43% for both hedgers and speculators.
- the contract multiplier is five bitcoins (bitcoin closing price \$14,000 times 5 = \$70,000)
- minimum tick is \$5 per contract

In January 2018, Ameritrade allowed investors to trade bitcoin futures contracts on the Cboe with a minimum deposit of \$25,000 in their account. Other broker-dealers that allow clients to trade in bitcoin futures are Interactive Brokers, E*TRADE, Wedbush, among others. As of March 2018, the millions that have thus far been traded on the two U.S. bitcoin futures markets is best described as muted when compared to the Asian cash/spot markets.

SEC, FINRA – Future Regulation

The SEC is already very actively regulating cryptocurrencies. The SEC's focus will mainly be on the fund-raising efforts/offerings by the cryptocurrencies companies and their reporting requirements. The bulk of SEC enforcement actions thus far on cryptocurrencies have related to private placements to raise funds, but that is expanding almost weekly. At SEC.gov, the SEC has extensive investor alerts and warnings for investors and potential participants relating to cryptocurrencies. As this article goes to press, the SEC has announced it will regulate the Cryptocurrency trading exchanges.

66. The BRR is calculated based on the relevant bitcoin transactions on all Constituent Exchanges between 3:00 p.m. and 4:00 p.m. London time. The price and size of each relevant transaction is recorded and added to a list which is portioned into 12 equally-weighted time intervals of 5 minutes each. For each partition, a volume-weighted median trade price is calculated from the trade prices and sizes of the relevant transactions across all the Constituent Exchanges. The BRR is then determined by taking an equally-weighted average of the volume-weighted medians of all partitions. See generally *CME CF Cryptocurrency Reference Rates*, CME GROUP, <http://www.cmegroup.com/education/bitcoin/bitcoin-reference-rate-methodology.html> (last visited June 8, 2018).

FINRA has had no enforcement actions relating to cryptocurrencies, but that day looms in the very near future. FINRA enforcement efforts will focus on the marketing, recommendations and sales efforts of their licensed registered representatives – stockbrokers and investment advisors. At FINRA.org there are likewise extensive investor alerts and warnings for investors as it relates to virtual currencies and cryptocurrencies. FINRA Rule 3110 Supervision certainly applies to the recommendation and sale of cryptocurrencies.

This article has provided ample evidence that investing in cryptocurrencies is not for the faint of heart. Every single regulatory agency has gone out of its way to make it quite clear that investing in cryptocurrencies is a highly speculative venture. If a licensed broker or advisor either makes a misstatement or omits telling an investor a material fact as it relates to a potential cryptocurrency investment, that individual is also in violation of the antifraud statutes.⁶⁷ FINRA RULE 2020 - Use of Manipulative, Deceptive or Other Fraudulent Devices could be violated in the recommendation of purchasing cryptocurrencies.

It's not as if brokers and advisers are bereft of a plethora of choices for high risk and speculative investments and strategies to recommend: options, leveraged ETFs, private placements, day trading, and shorting, to name a few. Virtual currencies/cryptocurrencies are the latest addition to these speculative investments and strategies, but they offer a unique challenge to professionals in the securities industry because they are the hottest game in town. Millions and even billions have been made in just the last few years, and just like the California gold rush of 1849, investors, speculators, scamsters, and "miners" are attracted to this get-rich fever.⁶⁸ In addition to the regulators, broker-dealers, managers, supervisors and compliance professionals will be faced with fast-moving, ever-changing virtual currency markets.

Conclusion

All indications point to a global future where cryptocurrencies will be mainstream across the world, and once stabilized, particularly in the Third World wherein the unbanked have no banking alternative.⁶⁹ The biggest issue

67. See 17 C.F.R. 240.10b-5 (2017).

68. *Prophets of Boom*, FORBES, Feb. 28, 2018, at 60.

69. See generally Vigna, *supra* note 11; Leigh Cuen, *Afghan Tech Entrepreneur Uses Bitcoin To Empower Women*, IBT (Aug. 8, 2017), <http://www.ibtimes.com/afghan-tech-entrepreneur-uses-bitcoin-empower-women-2575881>.

is that most of the attention has been focused on the investment aspect of cryptocurrencies which has cast a dark cloud over these cryptic virtual coins from regulators and investment professionals. However, where the attention should be focused is on the commerce aspects that are on the verge of changing the way the world transacts every-day activities.

The ease of transactions through the blockchain technology from ethereum and other cryptocurrencies could simplify consumer transactions and increase the volume of goods and services in a secure environment with less volatility. The irony here is that the investment component of cryptocurrencies is riddled with the word volatility, while the commerce component reduces volatility. Sooner or later a sustainable equilibrium will be found.

Notes & Observations

RETURN OF VOLATILITY HIGHLIGHTS EXPOSURES TO RISK ASSESSMENT

Tyler D. Nunnally, MLitt and Aradhana Gupta Kejriwal, CFA

Overview

Understanding the dynamics of market volatility is critical to effective investment strategy, portfolio construction and risk management. In the current regulatory environment, firms must address the poor state of risk profiling to better ensure that the tools they use meet fiduciary standards and suitability requirements. Risk measurement and quantitative tools are critical aids for supporting risk management, but they are not a substitute for judgment, expertise and Know Your Customer (KYC) obligations.

Article:

The Standard & Poor's historic declines in early 2018 are a stark reminder that stock prices rise – and fall. Everything that goes up, well, you know the rest. With a prolonged nine-year bull market that plays into behavioral biases like the recency effect, it is sometimes easy for investors and financial advisors to overlook that uncomfortable truth.

While everyone enjoys making money, financial loss (even unrealized) can be emotionally devastating. This is where risk tolerance becomes vitally important to investors. Risk tolerance is that sinking feeling you get in your stomach when you suffer a financial loss. That feeling often leads to such a strong sense of fear that it can trigger a state of panic. It's at that moment that the urge to "sell it all" conquers any sense of rational judgment. Advisors can try and talk a client off the financial ledge, but often it's too late. It's at the point of no return that damages are incurred. Selling at a loss can derail a financial plan, and, in turn, wreak havoc on an investor's dreams.

The purpose of risk tolerance assessment is for advisors to avoid putting clients in that position in the first place. Everyone has his/her limits and an investor's financial advisor has a duty of care to understand what those limits are. In the Broker-Dealer world, that is spelled-out clearly in FINRA Rule 2111 (Suitability).¹

1. FINRA, RULE 2111 (2014), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859.

A well-designed risk tolerance assessment is the foundation of that understanding. The results of the assessment are supposed to lead to a more in-depth conversation about risk, so advisors can construct a portfolio that accounts not only for returns, but their clients' behaviors as well.

One of the securities industry's worst kept secrets is that well-designed risk tolerance assessment tools are few and far between. After reviewing a significant numbers of risk tolerance assessments used in the U.S., we concur with Canadian² and British³ regulatory studies which found that the vast majority of such tools in use are "not fit for purpose." In fact, British regulators concluded that the leading cause of suitability failure was because "investment selection did not meet the customer's attitude to risk" and that flawed risk tolerance assessment was regularly at fault.⁴

These concerns extend beyond human financial advisory practices into the realm of digital investment advice delivered by robo-advisors (digital investment platforms that provide automated, algorithm-driven portfolio recommendations with little or no human supervision). In a March 2016 FINRA released - the Report on Investment Digital Advice⁵ - which raised the alarm that some robo-advisors may not be gathering enough information to understand client needs and risk tolerance. FINRA CEO Richard Ketchum made it clear that robo-advisors are subject to Rule 2111 Suitability obligations when he commented that:⁶

2. See PlanPlus, Inc., *Current Practices for Risk Profiling in Canada And Review of Global Best Practices* (Oct. 28, 2015), available at https://www.osc.gov.on.ca/documents/en/Investors/iap_20151112_risk-profiling-report.pdf.

3. See Financial Service Authority, *Guidance Consultation: Assessing suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection* (Jan. 2011), available at http://www.fsa.gov.uk/pubs/guidance/gc11_01.pdf.

4. Financial Service Authority, *Final Guidance: Assessing suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection* (Mar. 2011), available at <https://www.fca.org.uk/publication/finalised-guidance/fsa-fg11-05.pdf>.

5. FINRA, REPORT ON DIGITAL INVESTMENT ADVICE (Mar. 2016), available at <https://www.finra.org/sites/default/files/digital-investment-advice-report.pdf>.

6. Andrew Welsch, *Exclusive: FINRA CEO says fiduciary standard makes sense*, FINANCIAL PLANNING (Mar. 16, 2016), <https://onwallstreet.financial-planning.com/news/exclusive-finra-ceo-says-fiduciary-standard-makes-sense>.

"From FINRA's standpoint, the same requirements are in place. The same expectations that you understand your customer and both from the standpoint of what their risk appetites are and also that you have asked enough questions to really understand their financial situation and that they can accept risk and the risk of loss."

Those fears became a reality on February 5, 2018 when the S&P 500 Index dropped 4.1%. The websites of two of America's largest B2C robo-advisors crashed,⁷ apparently due to a deluge of anxious investors logging-in to view the impact on their portfolios. The robo-advisor sites of Fidelity, Vanguard and Schwab reportedly suffered outages as well.⁸ Whether those outages preempted frenzied selling is purely speculative, but there is little doubt that the market rout caused enormous anxiety that reflects risk tolerance.

Inadequacies in existing risk profiling approaches may well leave robo-advisors exposed to investor complaints. That should be of particular concern to robo-advisors that are asking too few or poorly constructed risk tolerance questions – or using scoring algorithms that neglect to account for risk tolerance at all.

Most robo-advisors match investors to a pre-packaged portfolio based on the risk profile. The construction of the portfolios and matching the risk profile raise concerns about risk in the portfolio. The FINRA report mentioned above compared the asset allocation models of seven different robo-advisors for a notional 27-year old person investing for retirement and found equity allocations ranging from a high of 90% to a low of 51%.⁹ To showcase the various pre-packed portfolio models, here are models from the Report:

7. See Brandon Kochkodin, et al., *Fidelity Reports Web Issues After Robo-Adviser Sites Crash*, BLOOMBERG (Feb. 5, 2018), available at <https://www.bloomberg.com/news/articles/2018-02-05/robo-adviser-websites-crashed-cutting-clients-off-from-accounts>.

8. *Id.*

9. *Report on Digital Investment Advice*, *supra* note 5.

Figure 1:

Asset Class	Digital Adviser A	Digital Adviser B	Digital Adviser C	Digital Adviser A	Digital Adviser D	Digital Adviser E	Digital Adviser F
Equity	90.1%	72.0%	51.0%	84.0%	60.0%	69.0%	72.2%
Domestic	42.1%	37.0%	26.0%	34.0%	30.0%	47.0%	28.9%
U.S. total stocks	16.2%	22.0%		34.0%		47.0%	13.0%
U.S. large-cap	16.2%		8.0%		19.0%		13.0%
U.S. mid-cap	5.2%						
U.S. small-cap	4.5%		18.0%		11.0%		2.9%
Dividend stocks		15.0%					
Foreign	48.0%	35.0%	25.0%	50.0%	30.0%	22.0%	43.3%
Emerging markets	10.5%	16.0%	13.0%	25.0%	9.0%	9.0%	17.0%
Developed markets	37.5%	19.0%	12.0%	25.0%	21.0%	13.0%	26.3%
Fixed Income	10.1%	13.0%	40.0%	10.0%	21.5%	11.0%	15.0%
Developed markets bonds			15.0%		2.5%		4.1%
U.S. bonds	4.9%	6.0%	25.0%	10.0%	12.0%		10.9%
International bonds	3.6%						
Emerging markets bonds	1.6%	7.0%			7.0%		
Other	0.0%	15.0%	9.0%	6.0%	10.0%	16.0%	12.8%
Real estate		15.0%	9.0%	6.0%	5.0%		12.8%
Currencies						2.0%	
Gold & precious metals					5.0%		
Commodities						14.0%	
Cash					8.5%	4.0%	

Asset Allocation Models for a 27-Year-Old Investing for Retirement, September 2015

Source: Cerulli Associates

Note: Columns may not total to 100% due to rounding.

Source: *FINRA Report on Investment Digital Advice, March 2016*¹⁰

For the sake of this article, we examined risk metrics of two portfolio allocations (Digital Adviser A and C from FINRA's model) for the same 27-year-old and observed a marked difference in the risk of the portfolios as shown in the table below.

Figure 2:

	Standard Deviation			Sharpe Ratio		
	3yr	5yr	10yr	3yr	5yr	10yr
Digital Adviser A	9.64	9.23	16.03	0.87	1.08	0.3
Digital Adviser C	6.5	6.5	11.56	0.92	1.01	0.44

Source: Morningstar Direct. Data as of 12.31.17. Past performance is no

10. *Id.*

guarantee of future results. Data is for illustrative purposes only and are not intended to represent the future performance.¹¹

Good governance of risk involves securities firms understanding the process for measuring investor's risk and tools used in assessing investor risk tolerance and ensuring consistency of the portfolio's allocation with the measured risk and goals of the investor. In this instance, the discrepancies in the range of portfolio risk are so vast that obviously both approaches cannot be suitable for an investor who shares the same profile in terms of age and investment objectives.

In an investor complaint, an expert would want to evaluate the characteristics that the robo-advisor used to define the investor's risk profile. That expert would look closely at the methodology used to assess the investor's risk tolerance. The expert would then examine the weights that were applied to that particular factor and the subsequent portfolio allocation recommendation to determine suitability.

Another major exposure facing financial advisory firms is how the results of assessment tools are actually used. Over-simplified methods - like using a risk tolerance score as the sole factor in portfolio selection - is downright dangerous. Since a substantial number of firms still use home-cooked risk tolerance questionnaires that are invalid and unreliable, this is particularly troubling – but not uncommon.

In another example, one popular tool that professes to be used by thousands of financial advisors maps a risk tolerance score to a portfolio of equal risk. For instance, if an investor has a risk tolerance score of 90 (out of 100) on the risk tolerance portion, the algorithm will recommend a portfolio risk score of 90 that consists almost entirely of high-risk assets.

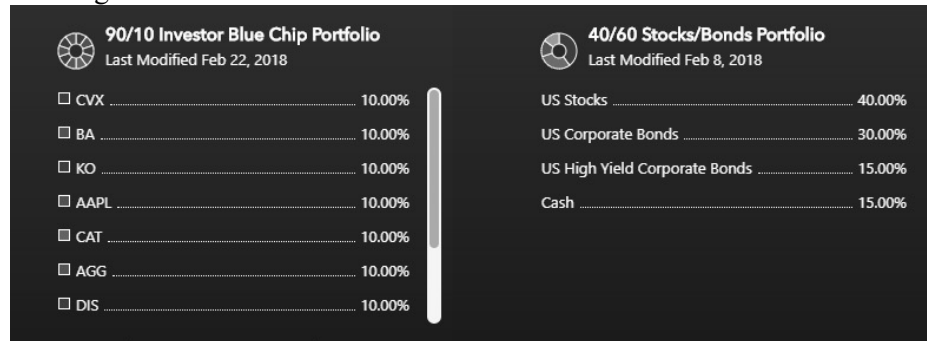
If you have a 65-year-old investor who is on the verge of retirement and invested in a typical 90/10 stocks/bonds portfolio, he could be potentially looking at a loss of upwards of 50% of the value of the portfolio during another Great Recession-like downturn. So much for a happy retirement! To showcase this, we walk through the example below:

A 65-year-old investor with \$500,000, retiring in 1 year, with income needs every year after retirement and is invested in 90/10 in stocks (9 blue chip US companies) and in bonds respectively. The 90/10 stocks/bonds portfolio matches the portfolio risk score of 90. Compare this to a diversified 40/60 portfolio in stocks/bonds. We used blue chip companies which are considered stable, high-quality companies in the stock portfolio.

11. Morningstar Direct, <https://www.morningstar.com/products/direct> (last visited May 25, 2018).

The analysis below shows a concentration in high-quality stocks can also be risky and unsuitable for a retiree:

Figure 3:



Source: Blackrock Investments, LLC, Past performance is no guarantee of future results. Hypothetical examples are for illustrative purposes only and are not intended to represent the future performance. See About the Analysis section for more details.¹²

Scenario Analysis: To test the risk in the portfolio, we ran the 90/10 Stocks (Investor Blue Chip)/Bonds Portfolio and the 40/60 Stocks/Bonds portfolio through various scenarios such as what happens when Global Stocks Fall, High Yield Bonds Spreads widen, Investment Grade Credit Spreads widen and if stock markets get volatile as they did in early February 2018.

Figure 4:

	Global Stocks Fall	High Yield Spreads Widen	Investment Grade Credit Spreads Widen	Stock Market Volatility Rises	Recession (2007-2009)
US Stocks	-19.57	-12.78	-10.90	-13.83	-49.17
Cash	+1.34	+1.33	+1.34	+1.33	+0.24
90/10 Investor Blue Chip Portfolio	-17.90	-11.53	-9.90	-12.55	-44.82
40/60 Stocks/Bonds Portfolio	-6.37	-3.35	-2.55	-4.16	-31.93

12. Blackrock Investments, LLC, <https://www.blackrock.com/us/financial-professionals/compliance/terms-and-conditions?targetUrl=%2Fus%2Ffinancial-professionals%2Fdashboard%3FredirectUrl%3D%2Finvesting> (last visited May 25, 2018).

Source: Blackrock Investments, LLC. Past performance is no guarantee of future results. Hypothetical examples are for illustrative purposes only and are not intended to represent the future performance.¹³

The scenarios depict higher negative returns for the high-quality 90/10 Stocks (Investor Blue-Chip)/Bonds Portfolio. For a retiree dependent on income, a loss of almost 20% can be significant.

During the recession of 2007-2009, the retiree's portfolio would have suffered a 45% loss, which would take years to recover, leaving the retiree with limited options of selling in a down market to meet their income needs. In a diversified portfolio, the retiree has an allocation to cash to help with income needs while the markets are turbulent. Such a scenario highlights the unsuitability of portfolio construction for a retiree based on one factor – the risk score.

Figure 5:
Risk-Return Characteristics:

	Standard Deviation			Sharpe Ratio		
	3yr	5yr	10yr	3yr	5yr	10yr
40/60 Stocks/Bonds Portfolio	4.67	4.47	6.40	1.28	1.60	1.34
90/10 Investor Blue Chip Portfolio	14.08	13.05	18.03	1.04	1.27	1.17
Russell 3000 TR USD	10.23	9.75	15.60	1.04	1.57	0.84

Source: Morningstar Data, Data as of 12.31.17. Past performance is no guarantee of future results. Data is for illustrative purposes only and are not intended to represent the future performance.¹⁴

To gauge the suitability of the portfolio, we looked at Standard Deviation which measures the risk of the portfolio return varying from its mean. Higher standard deviation means the portfolio is more volatile and its returns can swing in large proportion. The data above shows the 90/10 Stocks (Investor

13. *Id.*

14. Morningstar Data, *supra* note 11.

high-quality Blue Chip)/ Bonds Portfolio is more than 2.3 times more volatile than a diversified 40/60 stocks/bonds portfolio over a 10-year period.

Sharpe Ratio compares return and risk taken to earn that return - a higher Sharpe ratio means one is higher return for the same level of risk. Data above shows the 40/60 stocks/bonds diversified portfolio earning a higher Sharpe over a 10-year period with significantly lower risk.

The above example shows investors' portfolios *should be* constructed in line with *multiple* factors such as their time horizon, investment objectives, spending pattern, capacity for loss and risk tolerance. Advisors or brokers who fail to invest a customer's portfolio with an appropriate asset allocation and diversification within each asset class may be held responsible for a breach of fiduciary duty. This conduct may also constitute a failure to comply with the standard of care in the financial services industry.

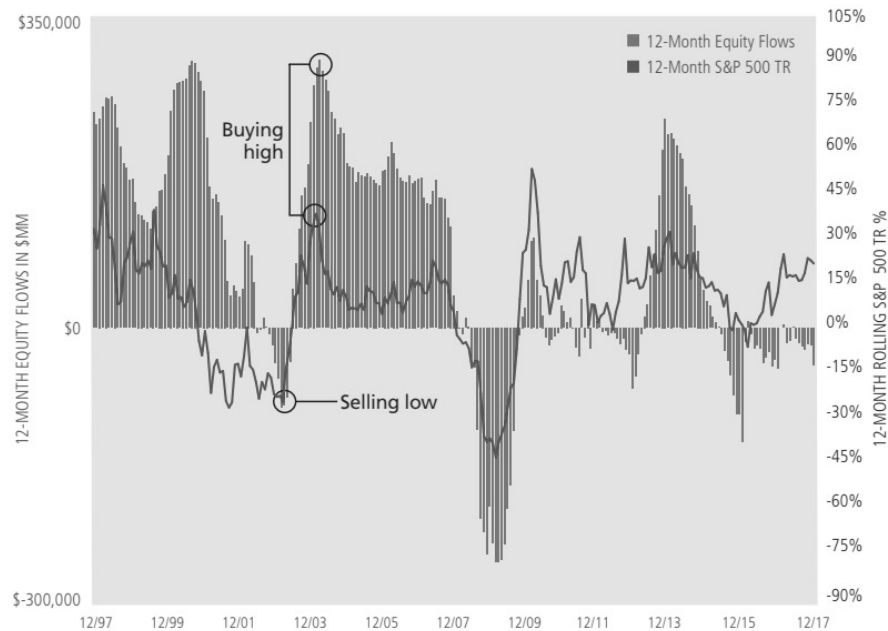
Using Short Time Frames To Measure Long-Term Portfolio Risks:

Some risk tools use algorithms based on outward projections of six months to derive the portfolio risk score. A probable outcome of using short-term horizons is that it may encourage investors to view short-term market volatility as risk and using their *perceived risk* in making portfolio allocation decisions can be a big mistake. *Perceived risk measures how risky investors think their own behavior might be.* The problem here is that investors generally are poor at judging the risk of their own behaviors, and gauging behavior over *short time* horizons for *long-term* life goals would therefore result in flawed decisions.

For example, an investor might say that she can handle 40% loss in a portfolio when asked in a bull market, however, in a bear market, she would suggest fleeing towards bonds and less risky investments. This might result in a portfolio low on equities at the end of a bear market and one heavy in equities at the top of a bull market.

The chart below shows the consequences of investors focusing on short-term market fluctuations in their decisions and making the classic mistake of "buying high and selling low." Re-allocation of a portfolio should be considered when life goals change along with consideration for risk tolerance and not due to a change in risk perception or misperceptions from short-term market performance.

Figure 6:

A track record of poor timingMonthly flows for U.S. stock mutual funds vs. stock market performance, 12/97 - 12/17¹

Source: MFS, Data sources: Strategic Insight Simfund/TD; SPAR, FactSet Research Systems Inc. Past performance is no guarantee of future results. Index charts are for illustrative purposes only and are not intended to represent the future performance.¹⁵

Another notable problem with this methodology is that investors are asked how much risk they can handle over six months. That means advisors need to re-assess clients' risk tolerance every six months. A failure to do so could lead to legal implications if an investor suffers a loss beyond the six-month timeframe they said they were comfortable with since risk tolerance is measured in six-month intervals.

15. MFS, EMOTION DRIVES INVESTOR DECISIONS (Feb. 2018), *available at* https://www.mfs.com/content/dam/mfs-enterprise/mfscm/sales-tools/sales-ideas/mfsp_stayin_sfl.pdf.

Conclusion

With a changing regulatory environment, the fiduciary stakes of the financial advisory community have been raised considerably. Regardless of how the SEC's April 2018 fiduciary rule¹⁶ is implemented, the risks to securities firms are immense. To mitigate the risks outlined in the article above, firms must address their exposures and the current state of risk profiling. A protracted bull market has insulated firms against poor practices for nearly a decade. As market volatility returns to the forefront, time is running out.

About the Authors:

Tyler D. Nunnally, MLitt is Principal at Nunnally International, Inc. As a risk tolerance consultant and expert witness, he has been retained in multibillion-dollar class action lawsuits in both state and U.S. federal courts.

Tyler began working in investment management in England with Oxford University spin-off consultancy, Oxford Risk Research & Analysis. He speaks frequently on risk-related matters and has been interviewed by the Wall Street Journal, Bloomberg, CNBC, Smart Money, Kiplinger, InvestmentNews, and multiple other media outlets. He has directed behavioral finance and risk tolerance research studies at Oxford University, Emory University, Georgia State University, SEI Investments and Capital One.

Tyler holds a Bachelor's degree from the University of Georgia and a Master's degree in International Business (MLitt) with Distinction from the University of St Andrews in Scotland.

Aradhana Gupta Kejriwal, CFA is Managing Partner at Practical Investment Consulting, Inc (PIC). As an Investment Consultant and Expert Witness, she has expertise in Investment and Portfolio Analysis, Suitability of investments, and Investor Risk Profiling.

Aradhana's investment acumen and financial experience includes her position as Chief Investment Officer of Behavioral Wealth Management firm, experience at major banks as Vice President of Prudential Financial, CIBC Mellon, TD Bank and has worked at Home Depot managing more than \$2 billion in short-term debt.

16. Press Release, Securities and Exchange Commission, *SEC Proposes to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships with Investment Professionals* (Apr. 18, 2018), <https://www.sec.gov/news/press-release/2018-68>.

Aradhana provides market insights through digital, print, TV and radio media and by professional panels and speeches, appearing in Atlanta's CBS46 TV, CNBC, The Atlanta Journal-Constitution, Seeking Alpha and 106.5 FM Radio.

Appendix:

About the Analysis:

The projections or other information in this report regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. Results may vary with each use and over time. Any information contained in or generated in this report should not be construed as or relied upon as investment advice, research or a recommendation by Practical Investment Consulting (PIC) and Nunnally International, Inc. regarding the use or suitability of any particular asset allocation, fund or overall investment strategy. Only an investor and his or her advisor know enough about the investor's circumstances to make an informed investment decision. Data shown is for informational purposes only, is subject to change and does not represent an actual account. Actual investment outcomes may vary.

Figure 1:

Source: *FINRA*¹⁷

Figure 2:

Allocations for Digital Adviser A and Digital Adviser C are taken from *FINRA*¹⁸ report. Allocations and Indexes used in the analysis for Digital Adviser A and Digital Adviser C:

Asset Class	Represented by	Digital Adviser A	Asset Class	Represented By	Digital Adviser C
US Total Stock	Vanguard Total stock Index- VITX	16.20%	US Large Cap	Russell 1000	8.00%
US Large Cap	Russell 1000	16.20%	US Small Cap	Russell 2000	18.00%
US Mid Cap	Russell Mid Cap Index	5.20%	EM	MSCI EM	13.00%
US Small cap	Russell 2000	4.50%	Developed Markets	MSCI EAFE	12.00%
Emerging Markets	MSCI EM	10.50%	US Bonds	Barclays Bloomberg US Aggregate Bond Index	25.00%
Developed Markets	MSCI EAFE	37.50%	Developed Market Bonds	S&P Global Developed Sovereign Bond Index	15.00%
US Bonds	Barclays Bloomberg US Aggregate Bond Index	4.90%	Real Estate	Wilshire US REIT Index	9.00%
International Bonds	Vanguard International Bond Index- VTIBX	3.60%			100.00%
Emerging Market Bonds	J.P. Morgan EMBI Global Diversified Index	1.60%			
		100%			

17. *Report on Digital Investment Advice*, *supra* note 5.

18. *Id.*

Analysis conducted using Morningstar Direct. Data as of 12.31.2017.¹⁹

Figure 3:

Analysis conducted using Adviser Tool by Blackrock Investments, LLC.²⁰ This analysis is strictly an illustration based on historical performance of particular asset classes. The results shown are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. The analysis shows how a portfolio would be impacted given the application of the selected scenario. The hypothetical performance returns are shown for illustrative purposes only and are not intended to be representative of the actual performance returns of any account, portfolio or strategy. The hypothetical performance returns are shown gross of all fees and expenses. If all fees and expenses were included, the returns would be lower. The hypothetical performance returns do not reflect the reinvestment of all dividends, interest and other income. It is not likely that similar results could be achieved in the future. Hypothetical performance returns have inherent limitations. Unlike actual performance returns, they do not reflect actual trading, liquidity constraints, fees and other costs. Hypothetical performance returns also assume that asset allocations would not have changed over time and in response to market conditions, which might have occurred if an actual account had been managed during the time period shown. No representation is being made that any account, portfolio or strategy will or is likely to achieve results similar to those shown.

Portfolio Summary

40/60 Stocks/Bonds Portfolio is represented by 40.00% US Stocks, 30.00% US Corporate Bonds, 15.00% Cash, and 15.00% US High Yield Corporate Bonds. Indexes used are: Cash: Represented by the BBG Barc T-Bill 1-3 Month Index, US Corporate Bonds: Represented by the BBG Barc U.S. Credit Index, US High Yield Corporate Bonds: Represented by the BBG Barc US Corp High Yield 2% Issuer Capped Index Investor, US Stocks: Represented by the Russell 3000 Index. Blue Chip Stocks Portfolio is represented by 30.00% Industrials Stocks, 20.00% Information Technology Stocks, 10.00% Consumer Discretionary Stocks, 10.00% Consumer Staples Stocks, 10.00% Energy Stocks, 10.00% Financial Stocks, and 10.00%

19. See Morningstar Data, *supra* note 11.

20. Blackrock Investments, LLC, *supra* note 12.

Materials Stocks. Information in the tool is as of December 31, 2017. Stocks used are randomly picked. Ticker symbols for the 90/10 allocation are: CVX, BA, BA, KO, AAPL, CAT, AGG, DIS, CSCO, DWDP, AXP.

Figure 4:

Analysis conducted using Adviser Tool by Blackrock Investments, LLC. About the scenarios: Global Stocks Fall: Defined as a 20% decrease in the MSCI World Index. Generally decreasing equity prices are reflective of a slowdown in economic growth. High Yield Spreads Widen: Defined as a 200 basis point (2%) increase in spreads between a benchmark high yield bond index and a US Treasury index. Typically, when high yield spreads widen it is function of an economic slowdown or risk-off environment as the underlying credit quality of the issuers decrease. Investment Grade Credit Spreads Widen: Defined as a 100-basis point (1%) increase in the spread between a benchmark investment grade bond index and a US treasury index. Typically, when investment grade spreads widen it is function of an economic slowdown or risk-off environment as the underlying credit quality of the issuers decrease. Recession (2007-2009): 2008 Recession - Assumes repeat of the 2008 Recession (12/3/2007-03/09/2009). Starting date for the scenario is the official beginning of the latest recession in the US. The end date is the lowest point of the S&P 500 in the recent decade. Stock Market Volatility Rises: Defined as 20% increase in the CBOE (Chicago Board of Options Exchange) VIX Index. The VIX typically serves as a gauge for volatility expectations in the market place. When it rises, investors are anticipating increased uncertainty and volatility. The scenario test results show a statistical estimate of a portfolio or asset class's reaction to a hypothetical market event. The scenario tester uses market indexes to represent portfolio exposures. The actual composition of specific investments entered vary from the market indexes used, sometimes significantly.

Figure 5:

Source: Morningstar Direct, Data as of 12.31.17. Past performance is no guarantee of future results. Data is for illustrative purposes only and are not intended to represent the future performance. Indexes used to represent 40/60 Stocks Bonds Portfolio: Cash: Represented by the BBG Barc T-Bill 1-3 Month Index, US Corporate Bonds: Represented by the BBG Barc U.S. Credit 2% Issuer Cap Index, US High Yield Corporate Bonds: Represented by the BBG Barc US Corp High Yield Index Investor, US Stocks: Represented by the Russell 3000 Index.

Figure 6:

Source: *MFS.com*,²¹ 1 Data sources: Strategic Insight Simfund/TD; SPAR, FactSet Research Systems Inc. Past performance is no guarantee of future results. Index charts are for illustrative purposes only and are not intended to represent the future performance. The Standard & Poor's 500 Stock Index measures the broad U.S. stock market. Index performance does not include any investment-related fees or expenses. It is not possible to invest directly in an index

Disclaimers and Disclosures:

The information provided herein is for general educational and entertainment purposes only, and should not be considered an individualized recommendation or personalized investment or financial advice; nor should the information provided herein be considered legal, tax, accounting, counselling or therapeutic advice of any kind. Any examples or characters mentioned herein are hypothetical in nature, purely fictitious, and do not reflect any actual persons living or dead. Practical Investment Consulting, Inc and Nunnally International, Inc. make no representations, whether express or implied, as to any expected outcome based on any of the information presented herein. Users assume all responsibilities or the use of these materials, including the responsibility of protecting the privacy of their responses. Practical Investment Consulting, Inc and Nunnally International, Inc does not accept any liability whatsoever for any direct, indirect or consequential damages or losses arising from any use of this document or its contents.

This material is intended for the personal use of the intended recipient(s) only and may not be disseminated or reproduced without the express written permission of Practical Investment Consulting, Inc and Nunnally International, Inc. The information contained in this message is being transmitted to and is intended for the use of only the individual(s) to whom it is addressed. If the reader of this message is not the intended recipient, you are hereby advised that any dissemination, distribution or copying of this message is strictly prohibited. If you have received this message in error, please immediately delete.

21. *Emotion Drives Investor Decisions*, *supra* note 15.

CASES & MATERIALS

Sara E. Hanley

Second Circuit Rejects Manifest Disregard of Law as a Basis for Vacating Arbitration Award

Pfeffer v. Wells Fargo Advisors, LLC, et al., No. 17-1819-cv (2d. Cir. Feb. 15, 2018)

A FINRA arbitration panel dismissed Claimant Pfeffer's state law claims arising from Wells Fargo Advisors failure to follow her late husband's instructions to transfer all assets from a trust naming his children as beneficiaries to a trust naming her as the beneficiary. Pfeffer testified that her now deceased husband requested the transfer because the Pfeffers became concerned about the management of the accounts. The Wells Fargo broker testified that he did not transfer the assets because he was worried that Mr. Pfeffer was not competent and was being unduly influenced by Mrs. Pfeffer. After receiving two letters from physicians confirming that Mr. Pfeffer was not capable of making financial decisions, Wells Fargo froze both trust accounts. After a five-and-a-half-day hearing, during which both parties presented testimony and other evidence, the Panel denied Mrs. Pfeffer's claim.

Mrs. Pfeffer filed a complaint challenging the arbitration award and Wells Fargo moved to dismiss the complaint and confirm the award. The district court confirmed the award and this appeal followed. On appeal, Mrs. Pfeffer argued that the award was procured by undue means, evident partiality, and misconduct because the Panel was intimidated by defense counsel and refused to consider relevant evidence. Pfeffer alleged that the Panel exhibited manifest disregard for the law and facts.

Under the Federal Arbitration Act, a district court may vacate an arbitration award if: (1) the award was procured by "corruption, fraud, or undue means"; (2) the arbitrators exhibited "evident partiality" or "corruption"; (3) the arbitrators were guilty of "misconduct" such as "refusing to hear evidence pertinent and material to the controversy" or "any other misbehavior" that prejudiced the rights of any party; or (4) the arbitrators "exceeded their powers." 9 U.S.C. § 10(a); *see also AT&T Mobility LLC v. Concepcion*, 563 U.S. 333, 350 (2011). The court reasoned that the second circuit does not recognize manifest disregard of the evidence as a proper grounds for vacating an arbitration panel's award, and will only

find a manifest disregard for the law where there is no colorable justification for a panel's conclusion. *Wallace v. Buttar*, 378 F.3d 182, 193 (2d Cir. 2004).

The court held that Mrs. Pfeffer failed to meet her "very high" burden to demonstrate that vacatur was appropriate. *Id.* at 103. The court found that the transcript of the arbitration reveals no suggestion that the award was produced by undue means, evident partiality, or misconduct. Mrs. Pfeffer's allegations that the Panel failed to abate defense counsel's abrasive manner and that it was intimidated by him are belied by the record. The court found that contrary to Mrs. Pfeffer's allegations, the transcript of the proceedings shows that the Panel considered her evidence, understood the issues underlying her claims, and afforded her latitude because she was *pro se*. Therefore, the court found no support for the conclusion that the panel had manifestly disregarded the law and affirmed the lower court's decision confirming the award.

Dismissal of a Counterclaim is an Appropriate Sanction for Flagrant Discovery Abuse

Simons vs. Fox, No. 17-1012 (7th Cir., February 1, 2018)

This appeal addresses the propriety of sanctions against a litigant for discovery abuses. In a highly contested dispute between the ex-CEO of a trading firm and its founder, the founder and defendant, asks the appellate court to vacate the dismissal of his counterclaim as a sanction for his discovery abuse. Simons sued Fox for firing him for uncovering Fox's alleged violations of corporate and securities laws. Fox then countersued Simons for defamation. Throughout the acrimonious litigation, Fox asserted that Simons lied in order to destroy Fox's companies. Rather than prove that assertion with evidence, Fox obstructed Simons's discovery. This led to sanctions and ultimately the dismissal of Fox's counterclaim. Fox appeals the orders leading up to the dismissal.

Fox repeatedly refused Simons's discovery requests, he refused to produce documents he possessed or controlled, and he was an uncooperative deponent. The district court judge directed the production of documents in at least three separate orders, yet Fox declined to produce discovery. The judge sanctioned Fox and he refused to pay the monetary sanction. Fox was then held in contempt of court and ordered to pay a fine for everyday he remained in contempt. Fox refused to pay the fine for contempt. After Fox asserted that he lacked funds to pay any fines, the judge entered an alternative sanction of

dismissing his counterclaim as the sanction for Fox's obstruction. The court found that when presented with the dismissal of claims as a sanction, "we weigh not only the straw that finally broke the camel's back, but all the straws that the recalcitrant party piled on over the course of the lawsuit." *Domanus*, 742 F.3d at 301 (quoting *e360 Insight, Inc. v. Spamhaus Project*, 658 F.3d 637, 643 (7th Cir. 2011)).

Similarly, the circuit court held that the trial court did not commit reversible error by allowing Simons to voluntarily dismiss the claims against Fox after Fox's counterclaim was dismissed. Federal Rules of Civil Procedure 41(a)(2) allows a Plaintiff to dismiss claims voluntarily at any time "on terms the court considers proper." The court reasoned that at the time of dismissal, Fox was in contempt of court, and he showed no prospect of respecting his long-ignored discovery obligations. Therefore, Fox cannot show prejudice from the judge allowing Simons to dismiss his claims voluntarily to end the case. Finally, Fox contended that the district judge was biased and should have disqualified himself. The court found that judicial rulings, even those that "are critical or disapproving of, or even hostile to" a party, do not constitute a valid basis for disqualification except in the "rarest circumstances" in which "deep-seated favoritism or antagonism" makes fair judgement impossible. *Liteky v. United States*, 510 U.S. 540, 555 (1994). The circuit court found that Fox presented no persuasive reason to disturb the district judge's fair and patient approach to managing the case and affirmed the decision.

Arbitration Award Will Be Upheld Unless Completely Irrational

Freedom Investors Corp. vs. Gantan, No. C 17-3914, 2018 U.S. Dist. LEXIS 57044 (N.D. Cal., April 3, 2018)

The court denied a petition to vacate a FINRA arbitration award and grants the cross-petition to confirm the award, holding that the petitioner failed to present any compelling grounds for vacatur. A FINRA arbitration panel rendered an award in favor of Claimant Gantan, and thereafter, Freedom filed a Petition to Vacate. As grounds for vacatur, the petition alleged arbitrator misconduct and that the arbitration panel exceeded its authority. The district court reasoned that "under the statute, confirmation is required even in the face of erroneous findings of fact or misinterpretations of law." *Kyocera Corp. v. Prudential-Bache Trade Servs., Inc.*, 341 F.3d 987, 997 (9th Cir. 2003). Judicial review under the FAA is "both limited and highly deferential." *Sheet Metal Workers' Int'l. Assn. Local Union No. 359 v. Madison Indus., Inc. of Ariz.*, 84 F.3d 1189, 1190 (9th Cir. 1996). The FAA creates "an extremely

limited review authority” that is “designed to preserve due process but not to permit unnecessary public intrusion into private arbitration procedures.” *Kyocera*, 341 F.3d at 998. “The burden of establishing grounds for vacating an arbitration award is on the party seeking it.” *U.S. Life Ins. Co. v. Superior Nat’l Ins. Co.*, 591 F.3d 1167, 1173 (9th Cir. 2010).

Freedom’s motion relied on section 10(b)(4), which applies to cases “where the arbitrators exceeded their powers.” 9 U.S.C. § 10(a)(4). A party seeking relief under section 10(a)(4) faces a “high hurdle”. *Stolt-Nielsen S.A. v. Animal Feeds Int’l Corp.*, 559 U.S. 662, 671 (2010). “It is not enough for petitioners to show that the panel committed an error- or even a serious error.” *Id.* Rather, a court must uphold an arbitrator’s decision unless it is “completely irrational...or exhibits a manifest disregard of law.” *Kyocera*, 341 F.3d at 997. The court held that the mere fact that the arbitration panel was unpersuaded by Freedom’s argument that it was not a successor to Merrimac, even if that decision was erroneous, does not warrant vacatur of the Award. The court further held that Freedom’s assertion that the Panel ignored controlling law is unsupported as is the contention that the panel exercised a manifest disregard for the law. The court concluded that Freedom’s arguments were nothing more than an invitation to reconsider the arbitration panel’s decision which it had no power to do. As a result, the court found that Freedom failed to present any compelling grounds for vacating the award, denied the Petition to Vacate and granted Gantan’s Cross Petition to Confirm.

Form U4 Amendments Supplement Rather than Supersede Initial Application

Hotvet vs. First Wilshire Securities Management, Inc., No. B271092, 2018 Cal. App. Unpub. LEXIS 1549 (Cal. App., 2Dist., March 6, 2018)

Hotvet (“Plaintiff”) sued her former employer, First Wilshire Securities Management, Inc. (“Defendant”), in connection with alleged wage theft occurring in 2010 and her alleged wrongful termination occurring in 2015. Defendant, a FINRA member until May 2012, petitioned to compel arbitration of Plaintiff’s claims, relying on Plaintiff’s Form U4 application, which contained an agreement to arbitrate any dispute between herself and Defendant in accordance with FINRA rules. Defendant further asserted that Plaintiff was acting in her role as a securities representative of a FINRA member subject to FINRA arbitration rules. Plaintiff opposed, arguing that the arbitration agreement was superseded by her subsequent Form U4 amendments, which did not contain arbitration agreements. Furthermore, Plaintiff argued that

FINRA rules compelling arbitration were inapplicable because Defendant was no longer a FINRA member and she was not an “associated person” because she was working as an investment advisor and not a securities representative. The trial court denied Defendant’s Petition, holding that the arbitration agreement was superseded by Plaintiff’s subsequent Form U4 amendments and that Defendant failed to prove it was a FINRA member or that Plaintiff was an “associated person.” Defendant appealed.

The appellate court reasoned that Defendant satisfied its burden of proving the existence of an arbitration agreement governed by FINRA, because Form U4 amendments supplement, rather than supersede, the initial application. Here, Defendant established that it was a FINRA member from the time it hired Plaintiff in 2003 through May 2012. The claims that indisputably arose after May 2012 – specifically, those relating to Plaintiff’s wrongful termination – fall outside the arbitration agreement. Accordingly, the court affirms the trial court’s denial of Defendant’s Petition as to these claims. However, the court finds that Defendant presented a *prima facie* showing that the remaining claims, those relating to the wage theft in 2010, are subject to arbitration because it is feasible, based on the allegations in the complaint and Petition, that Plaintiff was acting as a securities representative during the relevant time.

As a result, the appellate court reversed the denial of Defendant’s petition to compel arbitration regarding Plaintiff’s claims arising while Defendant was a registered FINRA member, and affirmed the denial as to the claims arising after Defendant had terminated its FINRA membership. The court held that the valid arbitration agreement set forth in Plaintiff’s Form U4 application was not superseded by Plaintiff’s subsequent Form U4 amendments. The court further held that Plaintiff failed to rebut Defendant’s *prima facie* showing that her claims fell within the arbitration agreement because she presented no evidence supporting that she was not an “associated person” of a FINRA member. Accordingly, because the trial court misallocated the appropriate burdens of proof, the court reversed the denial of Defendant’s Petition as to the claims arising before 2012, and remanded for further proceedings.

Virginia Stands Firm on Statute of Limitations

Snapp vs. Lincoln Fin. Sec. Corp., No. 5:17-cv-00059 (W.D. Va., March 2, 2018)

Plaintiffs brought an action asserting various claims arising from Defendants’ alleged securities fraud. Defendants argue that Plaintiffs’ claims

are time barred. Watts was a FINRA registered representative of Lincoln Financial Securities Corporation (“Lincoln”) and professional authorized to sell RiverSource variable annuities. Watts recommended that the Snapps invest their life savings in RiverSource variable annuities. Watts told them that the investment “would never go below the initial amount they would be investing” and that “it would be paid out in full as a death benefit”. The quarterly and annual statement received by the Snapps contradicted Watts’ representation that the value would never decline below the initial investment and that the death benefit would equal the initial investment. The Snapps asked Watts about the annuity and he repeatedly assured them that their investment would not decline.

Watts purportedly committed suicide after he was contacted by an investigator regarding thefts from customers. After his death, the Snapps called his office “and found out for the first time” that their death benefit had substantially declined. Thereafter, the Snapps filed a FINRA arbitration claim against Lincoln and RiverSource and the arbitration panel granted Defendants’ Motion to Dismiss based on FINRA’s six-year “eligibility” rule for the submission of claims.

The court held that the statute of limitations and statutes of repose are affirmative defenses that may be raised in a Motion to Dismiss under Federal Rule of Civil Procedure 12(b)(6). *United States v. Kivanc*, 714 F.3d 782, 789 (4th Cir. 2013). While a Rule 12(b)(6) motion “invites an inquiry into the legal sufficiency of the complaint, not an analysis of potential defenses to the claims set forth therein, dismissal nevertheless is appropriate when the face of the complaint clearly reveals the existence of a meritorious affirmative defense.” *Brockington v. Boykins*, 637 F.3d 503, 506 (4th Cir. 2011).

Defendants argued that the Snapps’ Virginia Securities Act claims were time-barred under the two-year limitation period. The fourth circuit has emphasized that the two-year limitation is “an absolute cutoff.” *Caviness v. Derand Res. Corp.*, 983 F.2d 1295, 1305-06 (4th Cir. 1993) (holding that the limitations period is not subject to equitable tolling because “we conclude from the plain meaning of the statute that the Virginia legislature intended to provide unqualifiedly that a claim must be brought within two years”). The court reasoned that in order to successfully maintain a claim for fraud, Plaintiffs “bear the burden to prove that [they] acted with due diligence and yet did not discover the fraud or mistake until within the statutory period of limitations immediately preceding the commencement of the action.” *Terry Phillips Sales, Inc. v. SunTrust Bank*. No. 3:13-cv-468, 2014 WL 670838, at 5 (E.D. Va. Feb. 20, 2014). The court found that because every quarterly and annual statement from RiverSource directly contradicted Watts’ representation that the annuity account values would never fall below the initial investment the Plaintiffs’

assertion that they did not discover the fraud until Watts death is not credible. The court then analyzed each cause of action asserted by the Plaintiffs and dismissed every cause of action.

Bring It in Arbitration

Sayre vs. JP Morgan Chase & Co., Nos. 17-449 & 17-2285 (S.D. Cal., February 26, 2018)

Sayre worked for JP Morgan as a financial advisor. Sayre argued that JP Morgan wrongfully terminated his employment after he complained about policies and protocols he contended were unlawful. Sayre was represented by attorneys, Mr. and Mrs. Mirch, who were a husband and wife attorney team. The case proceeded to arbitration and the parties participated in a morning hearing session. After lunch, Sayre's counsel became ill and went to the doctor. Sayre's attorneys requested a continuance of the hearing to the next day which was granted. The next morning, Mrs. Mirch appeared and requested a continuance because neither Mr. Mirch nor Mr. Sayre could be present. Mr. Mirch was in the emergency room and Mr. Sayre's wife was about to have a baby. The Panel denied the motion to continue the hearing. The hearing concluded and the Panel found in favor of JP Morgan. Sayre filed a Petition to Vacate or Modify the Arbitration Award.

The court reasoned that an arbitration award is generally upheld if there was "any reasonable basis" for denying the requested continuance. *Cortina v. Citigroup Global Markets, Inc.* No. 10Cv2423-L RBB, 2011 WL 3654496, at 5 (S.D. Cal. Aug. 19, 2011). Here the Panel cited the "reasonable basis" for its denial of a continuance. The Panel determined it could make an impartial decision with or without Mr. Sayer and Mr. Mirch's presence. The Panel reviewed the evidence submitted by both parties. The Panel reasonably found an indefinite postponement of the arbitration hearing was unnecessary given there was sufficient evidence available that would allow it to make a fair and impartial decision. The court found no "manifest disregard for law" in the Panel's denial of Mr. Sayre's request to continue the hearing. The Court found that the Panels decision was not arbitrary, but was based on a reasonable decision by the Panel. Therefore, the court denied Mr. Sayre's Petition to Vacate.

Mr. Sayre also filed a Complaint against JP Morgan in court alleging, *inter alia*, violations of the Dodd-Frank Act. JP Morgan moved to dismiss the Complaint. JP Morgan argued that res judicata bared Plaintiff's lawsuit due to the FINRA arbitration award. The court reasoned that "[a]n arbitration

decision can have res judicata or collateral estoppel effect.” *C.D. Anerson & Co. v. Lemos*, 832 F.2d 1097, 1100 (9th Cir. 1987). “Res judicata bars relitigation of all grounds of recovery that were asserted, or could have been asserted, in a previous action between the parties, where the previous action was resolved on the merits. It is immaterial whether the claims asserted subsequent to the judgment were actually pursued in the action that led to the judgment; rather, the relevant inquiry is whether they could have been brought.” *Id.*

The court found that it was undisputed that the claims in the FINRA Arbitration differ from the claims in the present suit. Defendant’s position was that Plaintiff waived his right to litigate the claims in court when he litigated claims based on the same underlying facts and alleged conduct in the FINRA Arbitration. The court examined the issue of whether the claims in Plaintiff’s Complaint arose out of the same nucleus of facts as the FINRA claims and “could have been brought” in the FINRA arbitration. The court held that Plaintiff was not barred from bringing his Dodd-Frank Act whistleblower claims in arbitration. Therefore, the Court concluded that the arbitration involved the same claim or cause of action as the current suit and the first element of res judicata was met. As a result, the court granted Defendant’s Motion to Dismiss.

Form U5 Filings Serve to Protect

Sullivan vs. SII Investments, Inc., No. 18-CV-00666-SI, 2018 U.S. Dist. LEXIS 28067 (N.D. Cal., February 20, 2018)

Plaintiffs Sullivan and Cuenca worked in the securities industry for approximately two decades. Plaintiffs were registered representatives of Defendant SII Investments. Defendant announced it was selling itself to another brokerage firm, LPL. Following the announcement, Defendant informed its stockbrokers that letters would be sent to clients advising them that their accounts would be transferred to LPL and the clients would be assigned a new registered representative if the client’s current SII broker elected not to register with LPL. Sullivan was told that LPL would not transfer his registration and subsequently another brokerage firm, IFG, hired both Plaintiffs. On the same day, Defendant terminated Plaintiffs and filed a Form U5 indicating the termination was “for cause”. When Plaintiffs notified IFG of the termination, it rescinded its employment offer to Plaintiffs. Plaintiffs subsequently found another brokerage firm, IAA, and obtained an employment offer, under terms that were “markedly less attractive.” Thereafter, Defendant

sent out a transfer letter to Plaintiffs' clients advising them that their accounts would be moved over to LPL unless they opted out. Plaintiffs filed a Complaint and a Motion for a Temporary Restraining Order asking the court to grant injunctive relief.

The court reasoned that "injunctive relief is an extraordinary remedy that may only be awarded upon a clear showing that the Plaintiff is entitled to such relief." *Wachovia Sec., LLC v. Raifman*, No. C 10-04573 SBA, 2010 WL 4502360 at 4 (N.D. Cal. Nov. 1, 2010). In order to obtain a temporary restraining order, Plaintiff must establish that he is likely to succeed on the merits, that he is likely to suffer irreparable harm in the absence of preliminary relief, that the balance of equities tips in his favor, and that an injunction is in the public interest. *Winter v. Natural Resources Defense Council*, 555 U.S. 7, at 20 (2008).

The court denied Plaintiffs' Motion for a Temporary Restraining Order because the Defendant's U5 filing is protected by absolute privilege and reasoned that U5 filings are an important mechanism for protecting customers, and therefore, serves the public interest. The court held that Plaintiffs must address their disputes with Defendant through arbitration because they are bound by their contract with Defendant and through their registration with FINRA to resolve any disputes in arbitration.

Arbitrability (Who Decides?)

Wells Fargo Advisors, LLC vs. Sappington, Nos. 16-3833 & 16-3854 (2nd Cir., March 7, 2018)

Former Wells Fargo employees filed putative class arbitrations before the American Arbitration Association seeking unpaid overtime from Wells Fargo. The employees were entry-level financial advisors in various Wells Fargo branch offices. Each entered into an employment contract with Wells Fargo that included an arbitration clause. Wells Fargo sought to compel bilateral rather than class arbitration. The district court denied Wells Fargo's petitions, holding that an arbitrator, rather than a court, must determine whether the arbitration clause in the employee's employment contract authorizes class arbitration.

The second circuit was therefore presented with (1) determining whether the question of arbitrability is for a court to decide and, if so, (2) determining, on a case-by-case basis, whether there is clear and unmistakable evidence of the parties' intent to let an arbitrator decide that question. The court's analysis began with the presumption that questions of arbitrability are for a

court to decide. The court further reasoned that the presumption that a court should decide a question of arbitrability is overcome when there exists “clear and unmistakable evidence from the arbitration agreement, as constructed by the relevant state law, that the parties intended that the question of arbitrability shall be decided by an arbitrator.” *Paine Webber Inc. v. Bybyk*, 81 F.3d 1193, 1198-99 (2d Cir. 1996).

In this case, the court concluded that there was clear and unmistakable evidence that the parties to the case intended to arbitrate all questions of arbitrability, including whether they agreed to authorize class arbitration. Accordingly, the second circuit affirmed the district court’s decision denying Wells Fargo’s petition to compel bilateral arbitration.

Cristo vs. The Charles Schwab Corporation, No. 17-1843 (S.D. Cal., April 11, 2018)

Over the years, Plaintiff Cristo opened various Schwab accounts and the account applications contained arbitration clauses. Plaintiff sued Schwab for violation of the Federal Right to Privacy Act because, in response to a subpoena from the IRS for records of Plaintiff’s 2002 transactions, Schwab supplied records of Plaintiff’s transactions from 1995 to 2006. Schwab moved to compel arbitration and stay or dismiss the court proceedings arguing that the arbitration clauses in the Schwab application control.

The Federal Arbitration Act sets forth a general policy favoring arbitration agreements and establishes that a written arbitration agreement is “valid, irrevocable, and enforceable.” 9 U.S.C. § 2. The FAA permits “a party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration may petition any United States district court...for an order directing that...arbitration proceed in the manner provided for in such agreement.” 9 U.S.C. § 4. In interpreting the validity and scope of an arbitration agreement, the courts apply state law principles of contract formation and interpretation. *Lowden v. T-Mobile USA, Inc.*, 512 F.3d 1213, 1217 (9th Cir. 2008). Arbitration agreements, “[l]ike other contracts...may be invalidated by generally applicable contract defenses, such as fraud, duress, or unconscionability.” *Rent-A-Ctr., W., Inc. v. Jackson*, 561 U.S. 63, 68 (2010). The party opposing arbitration bears the burden of showing that the agreement does not cover the claims at issue. *Green Tree Fin. Corp.-Alabama v. Randolph*, 531 U.S. 79, 91-91 (2000).

Charles Schwab argued that valid arbitration agreements exist because the arbitration provisions are “clear and unequivocal”. Plaintiff does not dispute that he signed the Schwab account applications, but he asserted that he merely signed where his investment advisor told him to sign. Plaintiff further argued that the applications were not binding contracts but were merely

applications. The Court held that failure to read or negotiate agreements prior to signing does not negate the offer or asset required for a binding contract, that binding contracts existed, including a valid arbitration agreement.

Next, Charles Schwab argued that the causes of action arose out of transactions covered by the arbitration agreements. Plaintiff argued that his allegations were not subject to arbitration as they do not stem from his account relationship with Schwab, but rather concern Schwab's allegedly unlawful acts in responding to IRS summonses. The arbitration provisions in the account applications state that it covers "any controversy" or "in any way arising from the relationship with Schwab." The Court reasoned that provisions that include such language are construed broadly. The Plaintiff's allegations concerned a dispute between the parties relating to Plaintiff's Schwab accounts and arose out of the relationship between the two parties. Accordingly, the Court concluded that Plaintiff's claims fell within the arbitration provisions.

Lastly, Plaintiff argued that even if there was a contract to arbitrate, it is procedurally and substantively unconscionable. The court disagreed and found that while Plaintiff has demonstrated some "oppression or surprise" in the application process there was not enough procedural or substantive unconscionability to meet the burden of proof. Therefore, the Court found the arbitration provisions enforceable. As a result, the Court granted Schwab's Motion to Compel Arbitration and stayed the court case pending arbitration.

Each Act is a Violation and a New Limitation Period Runs

SEC vs. Kokesch, No. 15-2087, 2018 U.S. App. LEXIS 616 (10th Cir., March 5, 2018)

Defendant Kokesch owned and controlled two SEC registered investment adviser firms. The SEC alleged that Defendant misappropriated over \$34.9 million and a jury found that Defendant had committed fraud. The district court ordered (1) that he pay a civil penalty of \$2,354,593; (2) that he be enjoined from violating securities laws in the future; and (3) that he disgorge \$34,927,329 (plus interest) holding that disgorgement does not constitute a penalty within the meaning of 28 U.S.C. Section 2462, and thus, Section 2462's five-year limitations period does not limit the amount of disgorgement claimed by the SEC. Defendant appealed.

The tenth circuit affirmed and Defendant sought Supreme Court review that the disgorgement claim was not subject to the five-year statute of limitations governing suits "for the enforcement of any civil fine, penalty, or forfeiture." The Supreme Court reversed, holding that "[d]isgorgement in the

securities-enforcement context is a ‘penalty’ and so disgorgement actions must be commenced within five years of the date the claim accrues.” *Kokesh v. SEC*, 137 S.Ct. 1635,1639 (2017). On remand, the SEC contended that Kokesh must still disgorge \$5,004,773 that was allegedly converted within Section 2462’s five-year limitations period.

Defendant argued that the limitations period begins “when the claim first comes into existence” and therefore, the SEC’s claims accrued when he first began his fraudulent schemes and concludes that the entire action is time-barred. The SEC responded that a new limitation period applied to each improper conversion of funds, so the limitations period had not expired for the conversion of \$5,004,773.

The court reasoned that a single violation continues over an extended period of time when the Plaintiff’s claim seeks redress for injuries resulting from a series of separate acts that collectively constitute one unlawful act, as opposed to conduct that is a discrete unlawful act. That is, a violation is a continuing one, when the conduct as a whole can be considered as a single course of conduct. However, in this case the court concluded that Defendant’s misappropriations of funds are properly viewed as discrete violations. Defendant’s misconduct was not a continuing omission to act in compliance with a duty. The SEC’s claim did not depend on the cumulative nature of Defendant’s acts. Defendant’s misconduct was taking funds without proper authority and without consent. The misappropriation constituted a series of repeated violations of an identical nature, with each unlawful taking being actionable for five years after its occurrence.

The court concluded that to hold that Defendant’s misappropriations constituted only one continuing violation would do much more than provide repose for ancient misdeeds; it would confer immunity for ongoing repeated misconduct. The court concluded that it cannot countenance such a result and found that a proper interpretation of § 2462 would not require such a result. Therefore, the circuit court held that the judgement of the district court is reversed and remanded with instructions to enter an order requiring Defendant to disgorge \$5,004,773.

RECENT ARBITRATION AWARDS

Christopher J. Gray

This issue's survey focuses on arbitration awards in favor of claimants in which the arbitrators granted rescission, prejudgment interest or costs. A frequent refrain from defense counsel, despite ample authority to the contrary, is that net out-of-pocket losses are the only or principal cognizable measure of damages in FINRA arbitration cases. The awards below demonstrate that arbitrators may (and sometimes do) award damages and relief other than or in addition to net losses in appropriate cases. The possibility of an award of prejudgment interest or rescission in a given case may have a significant impact on case evaluation in instances where the investment was held for several years and yielded distributions over the period during which it was held.

Shawn Scheuer, Claimant v. Steven Philip Anderson, and Morgan Stanley, Respondents

Case No. 16-02231¹

1. Claimant asserted the following causes of action against Respondents: breach of fiduciary duty; breach of implied covenant of good faith and fair dealing; and negligence. Claimant asserted the following causes of action against Anderson: fraud - nondisclosure of known facts; fraud - negligent misrepresentations; and violation of state securities law. The causes of action relate to Claimant's investment in Lord Abbott Floating Rate Fund, Class A; Black Rock High Yield Bond Fund, Class C; AIP Private Markets Fund VI LP (AIP"); The MS Real Estate Fund VIII Global ("G8"); and unspecified stocks, exchange traded funds, and mutual 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, Claimants requested:

1. Total damages in the amount from \$500,000.00 to \$1,000,000.00;
2. Market adjusted damages;
3. Rescission of the AIP and G8 private placement funds;
4. Disgorgement of Respondents' ill-gotten revenue;
5. Pre-judgment and post-judgment interest at the highest legal rate;

Reno, Nevada

Claimant's Counsel: Thomas C. Bradley, Esq., Reno, Nevada.

Respondents' Counsel: Joseph R. Coburn, Esq., and John S. Worden, Esq., Schiff Hardin LLP, San Francisco, California.

Arbitrators: Philip Aaron Tymon, Public Chairperson; Peter H. Daly, Public Arbitrator; Dennis Markham Smith, Public Arbitrator.

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

1. Respondents are jointly and severally liable for and shall pay to Claimant the sum of \$37,500.00 in compensatory damages.
2. Respondents are jointly and severally liable for and shall pay to Claimant the sum of \$90,500.00 in costs.
3. Morgan Stanley shall rescind Claimant's AIP and G8 private placement funds and return to Claimant his initial investment in the amount of \$535,898.00 by February 18, 2018, and not charge Claimant any surrender fees.
4. Respondents' request for expungement of Anderson's CRD record is denied.
5. Any and all claims for relief not specifically addressed herein, including Claimant's request for attorneys' fees, are denied.

This award is noteworthy given the fact Claimant was granted rescission of the sale on the private placement investments in AIP and G8. Furthermore, the Panel determined that Respondents were jointly and severally liable for costs in the amount of \$90,500. Finally, in addition to rescission and awarding costs, the Panel also held that Respondents were jointly and severally liable for compensatory damages in the amount of \$37,500.

6. Costs of the suit including attorneys' fees; and

7. Other and further relief the Panel deems just and proper.

In the Statement of Answer, Respondents requested:

1. The Statement of Claim be dismissed in its entirety and that Claimant be awarded nothing;
2. Expungement of this matter from Anderson's regulatory records;
3. All FINRA forum and hearing fees be assessed solely to Claimant; and
4. Such further relief as the Panel deems appropriate.

At the close of the hearing, Claimants requested final damages in the amount of \$1,898,874.00.

Jacqueline Peters, Claimant v. Morgan Stanley & Company, Incorporated, Helen Holmes Timpe, and Morgan Stanley Smith Barney LLC, Respondents

Case No. 17-00356²

San Diego, California

Claimant's Counsel: Claimant Jacqueline Peters appeared pro se.

Respondents' Counsel: For Respondents Morgan Stanley Smith Barney LLC ("MSSB") and Helen Holmes Timpe ("Timpe"), hereinafter collectively referred to as "Respondents," John S. Worden, Esq., Schiff Hardin LLP, San Francisco, California. For Respondent Morgan Stanley & Company, Incorporated ("MS"): Christine A. Kendrick, Esq., Morgan Stanley Wealth Management, San Francisco, California.

Arbitrators: John Scott Carter, Sole Public Arbitrator.

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

2. Claimant asserted the following causes of action: violation of California Corporations Code § 25401; negligence; breach of contract; breach of fiduciary duty; fraud, deceit, misrepresentation, and omission of material fact; suitability and failure to supervise. The causes of action relate to Claimant's investment in a SunAmerica Polaris Platinum III Variable Annuity ("SunAmerica Annuity").

Unless specifically admitted in the Statement of Answer, Respondents denied the allegations made in the Statement of Claim and asserted additional defenses and reservations of rights.

In the Statement of Claim, Claimant requested:

1. Rescission of her annuity;
2. Damages commensurate with the guarantees allegedly made by Timpe as a benefit of the bargain, in the amount of \$55,333.00;
3. Statutory damages as set forth in Corporations Code § 25501;
4. Interest on damages as set forth in Corporations Code § 25501; and
5. Punitive damages.

In the Statement of Answer, Respondents requested:

1. Claimant take nothing by reason of the Statement of Claim;
2. Expungement of any reference to this matter from Timpe's registration record maintained by the Central Registration Depository ("CRD"); and
3. Whatever relief the Arbitrator may deem appropriate.

1. MSSB shall rescind Claimant's annuity and return to Claimant her initial investment in the amount of \$200,000.00 by November 2, 2017, and not charge Claimant any surrender fees.
2. MSSB is liable for and shall pay to Claimant interest on the returned amount of \$200,000.00 at the statutory rate of 10% per annum from September 28, 2017 until the amount of \$200,000.00 is fully returned.
3. Claimant's claims against Timpe are denied.
4. Respondents' request for expungement of Timpe's CRD record is denied.
5. Any and all claims for relief not specifically addressed herein, including punitive damages, are denied.

The award is notable because the sole arbitrator denied the Claimant's request for damages of \$55,333, deciding in the alternative to rescind the sale of a SunAmerica Polaris Platinum III variable annuity purchased on November 14, 2013. In providing a written explanation underlying the Award -- the sole arbitrator indicated that based on certain documents presented at hearing and admitted into evidence -- it was not clear that the Respondents provided the variable annuity prospectus to the Claimant prior to its purchase. Finally, the arbitrator denied Claimant's claims against the named financial advisor, while simultaneously denying Respondent MSSB's request for expungement as to the financial advisor.

Bonnie Bolle, individually and as executor of the Estate of Byron Bolle, and Robin Richardson, Claimants v. Merrill Lynch, Pierce, Fenner & Smith Inc., and Carlos Miranda, Respondents

Case No. 15-02707³

3. Claimants asserted the following causes of action against Merrill Lynch: restitution after rescission and breach of fiduciary duty (supervision); and the following causes of action against all Respondents: breach of fiduciary duty; professional negligence and conversion. The causes of action relate to the change of beneficiaries on annuities issued by Midland National Life Insurance, Fidelity and Guaranty Life Insurance Company, as well as to the transfer of real property from the estate.

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, Claimants requested:

1. Rescission of the changes to the beneficiaries of the Midland and Fidelity annuities, and rescission of the changes to the Merrill Lynch account that were

San Francisco, California

Claimants' Counsel: Melinda Jane Steuer, Esq., Law Offices of Melinda Jane Steuer, Sacramento, California.

Respondents' Counsel: Eric A. Herzog, Esq., and Michelle L. Mello, Esq., Norton Rose Fulbright US LLP, Los Angeles, California.

Arbitrators: Ralph A. Cotton, Public Chairperson; Robert M. Smith, Public Arbitrator; Philip Ho, Non-Public Arbitrator.

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

1. Respondents are jointly and severally liable for and shall pay to Claimants the amount of \$627,041.00 in compensatory damages.
2. Respondents are jointly and severally liable for and shall pay to Claimants the amount of \$18,811.00 in interest.
3. Respondents are jointly and severally liable for and shall pay to Claimants the amount of \$39,727.26 in costs.

made on March 15, 2012, and restoration of the monies which Claimants would have received had those changes not been made, plus interest thereon;

2. Compensatory damages in an amount according to proof;
3. Pre-judgment interest;
4. Reasonable attorneys' fees pursuant to California Welfare and Institutions Code §15657.5;
5. Punitive and exemplary damages;
6. Costs of suit; and
7. Such other and further relief as this Panel may deem just and proper.

In the Statement of Answer, Respondents requested:

1. The Panel deny the Statement of Claim in its entirety;
2. Claimants take nothing by reason of their claims;
3. Costs;
4. Forum fees associated with this arbitration be assessed against Claimants; and
5. Expungement of all reference to this matter from Miranda's Central Registration Depository ("CRD") record.

At the close of the hearing, Claimants requested an estimated \$150,000.00 in attorneys' fees and costs, and \$50,000.00 in expert witness fees.

4. Any and all claims for relief not specifically addressed herein, including punitive and exemplary damages, and attorneys' fees, are denied.

This award is noteworthy in light of the damages awarded by the Panel. Specifically, Claimants sought compensatory damages in an amount according to proof and pre-judgment interest thereon, rescission as to changes to the beneficiaries of certain annuities, reasonable attorneys' fees and costs, as well as punitive damages. In rendering its Award, the Panel determined Respondents were jointly and severally liable in the sum of \$627,041.00 for compensatory damages, in addition to \$18,811 in interest. Moreover, the Panel also determined that Claimants were entitled to costs in the sum of \$39,727.26. While the Panel awarded compensatory damages and interest, as well as costs, Claimants' request for attorneys' fees and punitive damages was denied.

Elizabeth Jachles v. American Portfolios Financial Services, Inc., and LPL Financial LLC, Respondents

Case No. 15-00585⁴

Buffalo, New York

4. Claimants asserted the following causes of action: breach of fiduciary duty, violation of FINRA rules, negligence, breach of contract, aiding and abetting, unjust enrichment, and respondeat superior. The causes of action relate to variable annuities and real estate investment trusts.

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

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

In the Statement of Claim, Claimant requested compensatory damages; punitive damages; loss of income that would have been received if Claimant's accounts had been managed properly; attorneys' fees, pre-judgment and post-judgment interest; costs; and all sums Claimant is entitled to by law or equity.

In the Statement of Answer Respondent American Portfolios requested dismissal of the Statement of Claim with prejudice and such other and further relief that the Panel deems just, equitable, and proper.

In the Statement of Answer Respondent LPL requested dismissal of the Statement of Claim; attorneys' fees; costs and expenses; and such other relief that the Panel may deem appropriate.

Claimants' Counsel: Jason J. Kane, Esq. and Adam B. Wolf, Esq., Peiffer Rosca Wolf Abdullah Carr & Kane, Pittsford, New York.

Respondents' Counsel: For Respondent American Portfolios Financial Services, Inc. ("American Portfolios"): Richard Babnick, Esq., Sichenzia Ross Friedman Ference, LLP, New York, New York. For Respondent LPL Financial LLC ("LPL"): Jon D. Kaplon, Esq., LPL Financial LLC, Boston, Massachusetts.

Arbitrators: Krista Gottlieb, Public Chairperson; Thomas E. Webb, Jr., Public Arbitrator; Richard D. Rosenbloom, Public Arbitrator.

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

1. Respondent American Portfolios liable for and shall pay to Claimant the sum of \$338,450.00 (\$623,079.00-\$284,629.00) in compensatory damages.
2. Respondent American Portfolios is liable for and shall pay to Claimant interest in the amount of \$106,612.00 (at 9% for 3.5 years).
3. Respondent American Portfolios is liable for and shall pay to Claimant costs in the amount of \$15,950.15.
4. Respondent American Portfolios is liable for and shall pay to Claimant \$375.00 for reimbursement of the non-refundable portion of the filing fee.
5. Any and all claims for relief not specifically addressed herein, including punitive damages and attorneys' fees, are denied.

This award is noteworthy because, in addition to determining that Respondent American Portfolios was liable to Claimant in the amount of \$338,450.00 in compensatory damages, the Panel further held that Respondent American Portfolios was liable for interest (at 9% for 3 ½ year) in the amount of \$106,612.00. In addition to awarding compensatory damages and interest thereon, the Panel also found Respondent American Portfolios liable to Claimant for costs in the sum of \$15,950.15, in addition to reimbursement of \$375 to Claimant as to the non-refundable portion of the filing fee.

Joan D. Haydon, individually and on behalf of Christopher R. Haydon, and Chris Haydon, as power of attorney for Christopher R. Haydon, Claimants v. Royal Alliance Associates, Inc., Respondent

Case No. 17-00068⁵

Houston, Texas

Claimants' Counsel: David Miller, Esq. and Kirk Smith, Esq., Shepherd Smith Edwards & Kantas, Houston, Texas.

Respondents' Counsel: Martin Schexnayder, Esq. and Eron Reid, Esq., Winget, Spadafora & Schwartzberg, LLP, Houston, Texas.

Arbitrators: Donald K. Eckhardt, Public Chairperson; Pamela Marcell Carroll, Public Arbitrator; James A. Crouch, Public Arbitrator.

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

1. Royal Alliance Associates, Inc. is liable for and shall pay to Joan D. Haydon and Christopher R. Haydon the sum of \$186,538.00 in compensatory damages.
2. Royal Alliance Associates, Inc. is liable for and shall pay to Joan D. Haydon and Christopher R. Haydon the sum of \$28,925.00 in costs.
3. Royal Alliance Associates, Inc. is liable for and shall pay to Joan D. Haydon and Christopher R. Haydon the sum of \$65,288.00 in

5. Claimants asserted the following causes of action: breach of contract and warranties, promissory estoppel, unfair trade and deceptive practices, violation of state securities statutes, violation of state fraud statutes, intentional and negligent misrepresentations of material fact, unjust enrichment, breach of fiduciary duty, breach of the covenant of good faith and fair dealing, negligence, gross negligence, and unsuitable investment advice. The causes of action related to Claimants' allegations that Respondent and its agents reallocated Claimants' assets to a predominantly risky strategy, largely comprised of unspecified junk bonds and leveraged ETFs.

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 First Amended Statement of Claim, Claimants requested between \$100,000.00 and \$500,000.00 in damages, including all direct and/or consequential damages and statutory and/or punitive damages, plus interest and costs, including attorneys' fees.

In the Statement of Answer, Respondent requested dismissal of all claims asserted in the Statement of Claim, an award of attorneys' fees and costs, and expungement of all references to this matter from un-named party Bill Holubec's registration records maintained by the Central Registration Depository ("CRD").

attorneys' fees. The parties jointly submitted the issue of attorneys' fees for decision thereby creating a bilateral agreement to arbitrate the issue.

4. Royal Alliance Associates, Inc.'s request for attorneys' fees and costs is denied.
5. Royal Alliance Associates, Inc.'s request for expungement of unnamed party Bill Holubec's (CRD #1304064) CRD records is denied.
6. Any and all claims for relief not specifically addressed herein, including punitive damages, are denied.

This award is noteworthy given not only the significant recovery obtained, but also the fact that the Panel imposed liability for costs and attorneys' fees on Respondent Royal Alliance Associates, Inc. To begin, the Panel awarded Claimants \$186,538.00 in compensatory damages, in connection with allegations of unsuitable investment advice surrounding investments in unspecified junk bonds and leveraged ETFs. In addition to compensatory damages, the Panel determined that Respondent was liable for costs in the sum of \$28,925.00, as well as attorneys' fees in the amount of \$65,288.00. As enumerated in the Award, the issue of attorneys' fees was jointly submitted by the parties to the arbitration, thereby creating a bilateral agreement to arbitrate.

Notes & Observations

WHERE WE STAND

Historically, PIABA has commented on a number of issues,¹ on both a formal and an informal basis, which are directly applicable to our promotion of the interests of public investors in securities arbitration proceedings that are conducted before the Financial Industry Regulatory Authority (“FINRA”).

For example, among the issues that generated the most interest, from and/or on behalf of the members of our association, were proposed amendments to the rules concerning:

- Abusive pre-hearing dispositive motion practices; and
- The adoption of specific procedures that arbitrators will be required to follow before granting the extraordinary remedy of the expungement of prior customer complaints from the registration records of registered representatives.

In this section of the *PIABA Bar Journal*, we will share with our readers the comment letters and formal positions that have been submitted on behalf of our association, during the quarter, to the various regulatory authorities so that all of our constituents will know exactly where we stand.

1. To review all PIABA Comment letters, visit www.PIABA.org. For more information, contact Andrew Stoltmann at andrew@stoltlaw.com, Christine Lazaro at lazaroc@stjohns.edu or Robin S. Ringo at rsmingo@piaba.org for assistance.

(This page intentionally left blank)

The following PIABA Comment Letter regarding *Regulatory Notice 18-08 – Proposed New Rule Governing Outside Business Activities and Private Securities Transactions* was submitted to the Financial Industry Regulatory Authority by Andrew Stoltmann on April 27, 2018 (prepared with the assistance of Adam Weinstein).

Ms. Jennifer Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, N.W.
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 18-08 – Proposed New Rule Governing
Outside Business Activities and Private Securities Transactions

Dear Ms. Mitchell:

I write on behalf of the Public Investors Arbitration Bar Association (“PIABA”), an international bar association comprised of attorneys who represent investors in securities arbitration proceedings. 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 (hereinafter “FINRA”) related to investor protection.

FINRA Regulatory Notice 18-08 seeks comments concerning reforms to FINRA Rules 3270 and 3280. FINRA has proposed eliminating supervision requirements, including record keeping, for all registered representatives’ outside business activities, with two exceptions. First, if a member imposes conditions or limitations on participation in an investment-related activity, the member would be required to reasonably supervise compliance with those limitations, but the member would not have to actually supervise the underlying activities. Second, an approved private securities transaction would have to be supervised only where the person would otherwise need to register as a broker or dealer under the Exchange Act if not for the member’s registration.

FINRA proposes to exempt member firms from supervising:

- Investment related activities at third-party investment advisor firms (“IA”);
- Investment related activities at member affiliates including IAs, banks, and insurance companies;
- Non-investment related work and outside business activities; and,
- Personal investments.

PIABA strongly disfavors the proposed modifications to FINRA Rules 3270 and 3280.

PIABA’s position is that FINRA’s proposed rule changes would: result in member firms implementing supervisory procedures that would be deemed unreasonable under the Exchange Act; subject members to substantial reputational and litigation risks; and, increase investor exposure to harm through those who would exploit the rules. FINRA’s supervisory rules that deal with selling away and private securities transactions have serious consequences for investors and members alike. Despite the existing rules, each year FINRA members and their representatives engage in dozens of fraudulent schemes that cost investors millions of dollars.¹ For over 30 years, the NASD and now FINRA have emphasized that private securities transactions present “serious, regulatory concerns.” *See* Notice to Members (“NTM”) 85-84. The SEC has stated that:

[FINRA] Conduct Rule 3040 [prohibiting “selling away”] is designed not only to protect investors from unsupervised sales, but also to protect securities firms from liability and loss resulting from such sales. Such misconduct deprives investors of a firm’s oversight, due diligence, and supervision, protections investors have a right to expect.

In re Siegel, 2008 SEC LEXIS 2459 at *36 (Oct. 2, 2008), *aff’d Siegel v. SEC*, 592 F.3d 147, 156 (D.C. Cir. 2010) (citation omitted).

FINRA’s current efforts to limit supervisory requirements for registered representatives’ outside IA activities is a significant deviation from the NASD’s and FINRA’s former stated positions on the subject. Previously, NASD stated that its National Business Conduct Committee found Rule 3040 “should apply to all investment advisory activities” and “to conclude otherwise would permit registered persons to participate in securities transactions outside

1. <http://www.investmentnews.com/article/20111002/REG/310029969/selling-away-again-a-concern-for-regulators> (The North American Securities Administrators Association reported that in 2011 there were 54 enforcement actions involving selling away.)

the scope of the oversight and supervision of the employer member and of a self-regulatory organization to the potential detriment of customers.”² Accordingly, FINRA Rules 3270 and 3280 and NTMs 91-32, 94-44, and 96-33 are designed to assist members in reasonably achieving compliance with their supervisory obligations under the Exchange Act. Repealing existing guidance and rules will endanger member firms and remove guidance that is an essential foundation for firms to use in understanding their supervisory obligations under federal law.

Exchange Act Section 15(b)(4)(E) provides that the SEC can sanction or revoke the registration of any member firm “if it finds... that such broker or dealer... has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any person of any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Commodity Exchange Act, [the Securities Exchange Act of 1934], the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, *or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision.*” 15 U.S.C. § 78o(b)(4)(E) (emphasis added).

The Exchange Act was written with the understanding that those who commit securities fraud might use various entity affiliations, whether registered or not, to perpetrate their frauds. The Exchange Act requires broker-dealers to supervise a representative’s investment activities, no matter how the activity is executed, providing a prophylactic approach to supervision designed to prevent violations of the securities laws. Registration by a representative under the Investment Advisor Act or any other securities act in no way lessens a broker-dealer’s responsibility to reasonably supervise the activity of the representative, in order to prevent violations of securities laws.

FINRA’s proposed rule does not address how it reasonably complies with the Exchange Act’s explicit supervisory requirements. In addition, FINRA’s proposed rule contains confusing and inconsistent supervisory loopholes that create an avenue for wrongdoing. Ultimately, FINRA’s proposed rule leaves member firms defenseless to a charge of failure to supervise under the Exchange Act and unable to claim available statutory defenses.³

2. NASD NTM 91–32.

3. “[N]o person shall be deemed to have failed reasonably to supervise any other person, if (i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and (ii) such person has

FINRA's proposed rule states that it "would not impose a general supervisory obligation over the IA activities..." Regulatory Notice 18-08, pg. 8. It is unlikely that a rule limiting supervision of an activity that could lead to a violation of the securities laws could be deemed reasonable under the Exchange Act. Consequently, a member firm citing FINRA's guidance under the proposed rule when charged by the SEC with failing to supervise would be unable to show that following FINRA's guidance would lead to reasonable supervision of its registered representatives.

For example, a member that failed to supervise a registered representative that committed a violation of the Investment Advisers Act of 1940, through a third-party IA, would likely be unable to demonstrate reasonable supervision under FINRA's proposed rule. The SEC has sanctioned brokerage firms in the past for these types of failures. In the matter of *In re Commonwealth Equity Services, LLP*, Bleidt, a registered representative, misappropriated over \$31 million from more than 100 victims. SEC Rel. No. 56362, 2007 WL 3071391 (Sept. 6, 2007). Bleidt misappropriated client funds to fund his own radio station and to run other ventures. He was dually registered with Commonwealth and was the owner of an IA firm, which was "an independent investment adviser registered under the Advisers Act and not affiliated with or controlled by Commonwealth." *Id.* at *2. The SEC was clear in describing the applicable supervisory requirement: "[u]nder Section 15(b)(4)(E) of the Exchange Act, broker-dealers are responsible for reasonably supervising, with a view to preventing violations of the federal securities laws, persons subject to their supervision." *Id.* at *3. The SEC continued, finding that Commonwealth had "failed to establish reasonable policies and procedures for responding to red flags related to Bleidt's outside business activities." *Id.* There are other similar examples of firms being sanctioned for failing to supervise third-party IA activities.⁴

FINRA's only stated justification for the proposed rule is that "IA activities would continue to be subject to regulatory oversight by the SEC and

reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with." 15 U.S.C.A. § 78o(b)(4)(E).

4. *In re Signator Investors, Inc., et al*, SEC Rel. No. 75690 (Aug. 13, 2015) (finding that Signator failed to reasonably supervise both brokerage and advisory client activity of its representative leading to 125 clients being defrauded of \$13.5 million); *FINRA v. MidAmerica Financial Services, Inc.*, AWC No. 2012034475001 (FINRA, Jun. 2, 2014) (failing to supervise two brokers' IA activities); *FINRA v. VFG Securities, Inc.*, 2014038997601 (Jan. 26, 2017) (same); *NFP Advisor Services, LLC*, AWC No. 2011025618702 (Jul. 16, 2015) (same).

states under a different regulatory scheme.” Regulatory Notice 18-08, pg. 8. However, FINRA’s reasoning does not address the Section 15(b)(4)(E) of the Exchange Act, which imposes obligations on broker-dealers to supervise their representatives with a view of preventing violations of the securities laws. There are no exemptions to the supervisory obligations contained in the Exchange Act. As such, FINRA’s reliance on other statutory schemes as support for its proposed rule is misplaced.

In addition, FINRA’s proposed rule creates loophole issues that make it difficult, if not impossible to implement the rule. As proposed, “a member also must consider any ‘red flags’ indicating problematic activities” associated with its registered representatives’ activities. Regulatory Notice 18-08, fn. 15. If a registered representative ran his promissory note Ponzi scheme through an outside business that was not an investment advisory firm, his broker/dealer would be required to supervise the activity (and presumably prevent the Ponzi scheme from succeeding). If the same person registered himself as an IA, and ran his scheme through that IA operation, his broker/dealer would not be under the same obligation to monitor the conduct. When called to task, the member firm would surely claim it conducted FINRA’s nebulous and meaningless “risk assessment,”⁵ but was otherwise not required to supervise the activity. Registered representatives seeking to engage in violations of the securities laws will be incentivized to establish advisory practices in order to shield their activities from the supervision of their member firms.

To further illustrate the unworkable nature of the proposal, we will change the above fact pattern so that some Ponzi scheme victims never sign opening account forms with the IA and no accounts are established at the IA firm. The member firm would be unable to show that the Ponzi scheme, with respect to at least certain victims, was conducted through the IA. Accordingly, the registered representative would be engaging in promissory note sales outside the context of the IA firm, and that activity would accordingly have to be registered under the Exchange Act and subject to the supervision of the registered representative’s broker-dealer.

FINRA should not propose a private securities transaction rule whereby a Ponzi schemer’s ability or inability to complete paperwork has the effect of

5. FINRA’s stated “risk assessment” test is meaningless as a supervisory device because it merely requires a brokerage firm to approve an activity based upon unverified assertions of its registered representative and without any due diligence or subsequent supervision of the activity. Regulatory Notice 18-08, pg. 5 (the risk assessment would “ordinarily would not require the member to perform an analysis of the underlying outside business activity.”); *Id.* pg. 6 (no supervision required if no conditions are placed on the activity).

altering a member's supervisory responsibilities. A member's supervisory responsibilities stem from the Exchange Act - not from the ability of the firm's representatives to claim supervisory loopholes.

Beyond Ponzi schemes, FINRA's proposed rule would contradict multiple Notice to Members (hereinafter "NTMs") regarding topics as far reaching as suitability, record keeping, and branch audits. If the proposed rule were implemented, FINRA would have to spend years clarifying whether or not dozens of previously issued NTMs were intended to be modified by the proposed rule or how firms would be expected to comply with prior guidance.

For example, a recommendation to a registered representative's client to sell all of their assets held at a member firm to invest entirely in private placements through the registered representative's IA would be a recommendation or investment strategy that the registered representative's member would have to supervise under NTM 12-25. *See* pg. 6. Under the proposed rule, registered representatives would be incentivized to move assets from brokerage accounts to their IA in order to make recommendations in products and services that their member firm would not approve.

Yet, FINRA's rule proposal does not provide guidance on the supervision of a registered representatives liquidation and transfer of assets to institutions under the registered representative's control or how to comply with NTM 12-25's suitability requirements. *See also* NTM 12-25, pg. 8 (Similarly NTM 12-25 states that "[s]uitability obligations apply...to a broker's recommendation...to liquidate securities to purchase an investment-related product that is not a security" but it is unclear whether the proposed rule would require members to supervise these transactions occurring in part at other financial institutions).

Likewise, member firms are obligated under Rule 17a-4 to record and supervise communications of their registered representatives related to firm business. *See* SEC Rel. No. 34-38245 (Jan. 31, 1997). FINRA's proposed rule does not clarify FINRA's past guidance on member firms' requirements to record correspondence when "red flags" of misconduct are present through outside business activities, through affiliated firms, or third-party IAs that share joint clients with members. It is unlikely that FINRA would be able to devise a supervisory protocol that would achieve compliance with Rule 17a-4 without requiring firms to monitor and record all investment-related emails.

Finally, the proposed rule contradicts prior SEC guidance and fails to clarify whether or not FINRA is proposing to limit the scope of branch audits and its joint guidance with the SEC under NTM 11-54. FINRA's proposed rule states that "[i]f an activity is not investment related, the member has no [supervisory] obligation under the rule." Regulatory Notice 18-08, pg. 5. Yet the SEC has stated that "a firm should be alert to and investigate 'red flags'

indicating possible undisclosed outside business activities and ***assess all outside business activities by a representative, whether or not related to the securities business.***” Staff Legal Bulletin No. 17: Remote Office Supervision, SEC Rel. No. SLB-3A(CF), 2004 WL 5698359 (Mar. 19, 2004) (emphasis added). “The Commission has recognized that there is a risk that representatives will use outside business activities to carry out or conceal securities law violation[s].” *Id.*

The SEC’s position is completely in line with NASD’s. The NASD stated long ago that off-site employees who engage in other non-securities businesses “have a greater opportunity than on-site personnel to engage in undetected selling away. Consequently, firms that employ such persons are responsible for monitoring their activities in a manner reasonably intended to detect violations.” NTM 86-65. FINRA has also recommended that branch office inspections “identify the nature and extent of outside business activities of registered branch office personnel. Outside business activities conducted by registered persons may carry added risk because these activities may be perceived by customers as part of the member’s business.” NTM 11-54, pg. 2.

Regulatory Notice 18-08 has not provided evidence that outside businesses no longer pose a risk that registered representatives would use those businesses to conceal securities laws violations. Failing to supervise disclosed businesses or those discovered by “red flags” would subject member firms to charges of failing to supervise and increase the likelihood of investor harm.

PIABA members have seen, all too often, registered representatives establishing solo or small IA firms and using outside business activities in order to avoid member supervision, in order to engage in activities that harm of investors. Below are just some examples of investors losing hundreds of millions in investment frauds perpetrated by registered representatives through third-party IAs established by a registered representative:

Registered Representative	Securities Violation Details
Patrick Churchville (CRD#: 2245842)	Victims alleged that Churchville’s member firm failed to supervise Churchville’s private equity fraud conducted through his IA. Churchville’s fraud caused \$27 million in losses to more than 220 victims and was subject to an SEC action and criminal charges.

Dean Mustaphalli (CRD#: 2792038)	Victims alleged that Mustaphalli's member firm failed to supervise a hedge fund operated through his IA. Mustaphalli's fraud caused \$10 million in losses to 58 victims and was subject of an action by the New York Attorney General's office.
Cory Burnell (CRD#: 3260340)	Victims alleged that Burnell's member firm failed to supervise extraordinarily risky leveraged ETF trades conducted through Burnell's IA. Burnell's fraud caused about 30 investors more than \$2 million.
Tamara Steele (CRD#: 3227494)	Victims alleged that Steele's member firm failed to supervise private placement sales conducted through Steele's IA. Steele's sales caused approximately 100 investors more than \$7.5 million in losses.

Despite FINRA's stated intention to propose a single streamlined rule that addresses the outside business activities of registered persons, the proposal contained in Regulatory Notice 18-08 is unworkable. The proposal, if implemented, would clearly increase member firm's reputational and litigation risk as reduced levels of supervision would be unreasonable.

The current rules were issued in order to protect member firms from litigation risk and investors from unsupervised investment activity. FINRA's proposed rule only ensures that members will be exposed to increased litigation and increases the likelihood of investor harm. Moreover, FINRA's Regulatory Notice provides no justification for the rule proposal other than perceived confusion by members. Further, it creates an undue burden on other regulators, who would suffer increased supervisory obligations that are currently assumed by FINRA members.

In sum, PIABA is gravely concerned that FINRA's proposed rule will lead to industry non-compliance with the supervisory requirements of the Exchange Act and provide unscrupulous advisors with a clear road map to commit securities laws violations away from member supervision. PIABA thanks you for the opportunity to comment on this important topic.

Respectfully submitted,
Andrew Stoltmann
PIABA President

The following PIABA Comment Letter regarding *FINRA Regulatory Notice 18-06 – Program to Incentivize Payment of Arbitration Awards* was submitted to the Financial Industry Regulatory Authority by Andrew Stoltmann on April 9, 2018 (prepared with the assistance of Hugh Berkson and Aaron Isreals).

Jennifer Piorko Mitchell
Office of the Corporate Secretary FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 18-06 - Program to Incentivize Payment of Arbitration Awards

Dear Ms. Mitchell:

I write on behalf of the Public Investors Arbitration Bar Association (“PIABA”), an international, not-for-profit, voluntary bar association that consists of attorneys who represent investors in securities and commodities arbitration proceedings. Since its formation in 1990, PIABA’s mission has been to promote the interests of the public investor in arbitration proceedings by, amongst other things, seeking to protect such investors from abuses in the arbitration process, seeking to make the arbitration process as just and fair as possible, and advocating for public education related to investment fraud and industry misconduct. Our members and their clients have a fundamental interest in the rules promulgated by the Financial Industry Regulatory Authority (“FINRA”) that relate to investor protection.

We are writing in response to Regulatory Notice 18-06 and welcome the opportunity to comment on the FINRA’s proposals to incentivize payment of arbitration awards. To characterize unpaid arbitration awards as a *problem* would be a massive understatement. As discussed in more detail herein, at this time, nearly one in three arbitration awards are never paid in full. These numbers are staggering and are demonstrative of the fact that unpaid awards are not just a *problem*, they are an epidemic wreaking havoc on investors, while eroding public confidence in FINRA, its members, and the dispute resolution system, at the same time. PIABA continues to support FINRA’s efforts to incentivize the payment of arbitration awards; however, we continue to maintain that more can be done to assure that all awards are paid.

The unpaid award problem is very real and continues to grow worse. Two years ago, PIABA determined that the then-most recent data demonstrated that 33.3% of all awards in favor of investors went unpaid, and more than 24% of the dollars awarded to investors went unpaid. PIABA updated its analysis two months ago and found the most recent data, for 2017, showed that 36% of all awards in favor of investors went unpaid, with 28.18% of the dollars awarded to investors went unpaid. Clearly, the crisis is not resolving itself and something must be done to stop it.

Unpaid awards often follow a troubled firm closing its doors, at a time when it is without assets or insurance to satisfy the award(s). This practice is permitted under the FINRA Rules and can result in firm leadership either starting a new firm, or moving on to another firm, with impunity and without ever making any contribution to the corresponding award. Further, unpaid awards frequently arise in situations where an award is entered against an individual, such as a registered representative, an officer, or a control person. However, under the current system, troubled brokers are free to jump from one troubled firm to another, prior to the resolution of their claim and prior to satisfaction of the award. These practices need to be stopped; FINRA needs to institute stronger policies to ensure that the awards entered in its dispute resolution system have strong ramifications.

Regulatory Notice 18-06 requests comments on a series of specific topics, each of which is addressed in detail below.

1. Should FINRA consider proposing to apply a presumption of denial in connection with pending arbitration claims and CMAs? If so, under what circumstances?

PIABA supports a presumptive denial of continuing member applications (CMAs) when associated persons or members are subject to numerous pending arbitrations claims. PIABA understands that not all arbitration claims jeopardize the financial stability of a member firm or a registered representative of that firm, and further, that not all arbitration claims are in fact meritorious. However, PIABA members frequently encounter situations where the conduct of control persons, principals, registered representatives, and firms affects a large class of investors. In these situations, investor claims often involve similar products, individuals, and types of misconduct, which often arise during similar periods of time. These are the situations when the presumptive denial should come into play.

PIABA believes that the presumptive denial should be triggered when more than five claims are pending against any control person, principal,

registered representative, or other associated person of the firm. If any of these parties are subject to five or more claims, it is clearly indicative of a problem within the firm, or with the corresponding individual, that warrants additional scrutiny by FINRA. After all, only .0055% of all registered representatives have 5 to 9 disclosable events on the CRD report.¹ Further, unresolved arbitration claims are strong indicators of the potential for future investor harm.²

Given these statistics, it is highly unlikely that an individual with five or more claims could argue that the claims pending against them are isolated or non-meritorious claims. When any control person, principal, registered representative, other associated person is subject to five or more claims, the presumptive denial of the CMA should apply, requiring the applicant to rebut presumption with evidence of their ability to satisfy the claims, if the claims were in fact successful.

With respect to member firms, a presumptive denial based upon a fixed number of pending arbitration claims is likely not the answer. The presumptive denial needs to apply when the pending claims are posing a realistic threat to the continuing viability of the member firm. Accordingly, PIABA feels that the presumptive denial, as it relates to pending arbitration claims against a member firm, should be applied based upon the aggregate amount of damages pleaded in all pending arbitration claims, taking the nature and quality of those claim into account, compared to the value of cash assets and insurance held by the member. If this ratio tends to suggest a substantial risk of insolvency or simply a present inability to pay all pending legitimate claims in full, then the presumption should apply.

PIABA is mindful of the fact that damages are not always easy to ascertain and *pro se* parties often lack the sophistication necessary to properly compute their potential losses. To this end, FINRA should be permitted to look beyond damages stated in a statement of claim, and discuss the issues related to damages directly with investors, their representatives, and the FINRA members and their counsel, in confidential sessions, prior to applying a presumptive CMA denial. PIABA feels that FINRA should weight the

1. See Wall Street Journal, *FINRA is Cracking Down on 'High Risk Brokers'*, November 21, 2013.

2. "The improved performance of the model with all customer disputes suggests that not only the brokers disputes leading to award or settlement above a threshold amount, but also those pending, denied, or closed without action are useful in determining the likelihood of future investor harm." See *How Widespread and Predictable is Stock Broker Misconduct*, Securities Litigation and Consulting Group, April 21, 2016, Page 18.

claimant's information more heavily than the member's, but FINRA should be free to develop its opinion based on all available information. Obviously, FINRA should keep in mind that the investor will present one biased view and the member, cognizant of its fight against both the claim and the possible loss of its membership status, will present a different and likely more vigorous biased view.

If a firm can overcome the presumptive denial of a CMA, and it still desires to onboard or continue the employment of individuals with five or more pending arbitration claims, those individuals with such claims pending against them should be subject to heightened supervision immediately and not be permitted to serve in a supervisory capacity until all pending arbitration claims against them have in fact been resolved, and the corresponding awards or settlements, if any, have been paid in full. Following the conclusion of such proceedings, the decisions related to an individual's supervision or supervisory capacity, should rest with the firm. Again, as statistics show, individuals with five or more pending arbitration claims represent some of the most problematic brokers in the country and pose a significant threat to the public investor. FINRA's Rules should be modified to ensure that these individuals are not permitted to move from one firm to another without regard to problems that occurred at their former firms.

2. *If an applicant designates a clearing deposit or the proceeds from an asset transfer for purposes of demonstrating its ability to satisfy a pending arbitration claim, unpaid award or unpaid arbitration settlement, should FINRA require the applicant to provide some form of guarantee that the funds would be used for that purpose?*

PIABA believes that it is of the utmost importance to assure that assets used to demonstrate a firm's ability to satisfy pending arbitration claims should be earmarked for payment of the corresponding claims. To this end, PIABA feels that a written guarantee that the funds would be for that purpose is important, but it might not be enough to truly protect the arbitration claimants in question. If a guarantee is put into place to use the funds for a particular purpose, there needs to be strict penalties in the event of a breach of that guarantee. An appropriate penalty would likely be the immediate suspension of a member's broker-dealer license.

Special care must be taken when the member firm in the process of closing and winding up its affairs. A firm knowing its membership is already ending must still be incentivized to ensure the funds supposedly earmarked to satisfy awards are not directed elsewhere. The guarantee under those circumstances

must be secured by a lien in favor of FINRA or the investor and be enforceable against other FINRA members. For example, if a clearing deposit was being used to demonstrate ability to pay, that deposit could be secured by statutory lien and notice could be provided to the clearing firm. If the clearing firm knew that it could be liable to FINRA or an investor for disbursing the funds to a member firm, it is highly unlikely that the funds would ever be used for any purpose other than satisfying the corresponding claim. And, if the funds were diverted elsewhere, the investor and/or FINRA would then have a right of recovery against the clearing firm. The same logic would work in the event of an asset sale: if the purchaser knew of the lien, they would likely hold the funds pending resolution of the lien, to avoid further liability. While a guarantee that funds would be used to pay pending claims is important, there needs to be a way to secure the funds, to prevent them from being depleted for other purposes.

A better solution would be to hold funds in an escrow account, with clear instructions to the third-party escrow agent (who would be unaffiliated with the closing member firm) to disburse the funds only under very particular circumstances.

3. *The proposed amendments would not permit any direct or indirect acquisitions or transfers of a member's assets or any asset, business or line of operation where one or more of the transferring member's associated persons has a covered pending arbitration claim, unpaid arbitration award or unpaid settlement related to an arbitration, unless the member first seeks a materiality consultation for the contemplated acquisition or transfer and the Department has determined that the member is not required to file a CMA for approval of the acquisition or transfer. Should the proposed amendment be limited to principals, control persons or officers? Please explain.*

PIABA believes that limitations on transfers of member's assets, business assets or lines of operation should not be limited to instances where principals, control persons or officers have a covered pending arbitration claim, but rather, the restriction should include scenarios where an associated person also has a covered pending arbitration claim. PIABA's members often experience situations where a firm's solvency can be jeopardized by one broker, who is not necessarily a control person, a principal, or an officer. This is particularly common in cases involving a broker who is selling away from his or her firm.

In these cases, a particular broker could be running a large scheme, without the knowledge of the control persons, principals, or officers.

In cases of smaller or mid-size broker-dealers, a scheme run by a representative could be large enough to threaten the viability of the firm and its ability pay the corresponding awards. Control persons, principals, or officers are often not added to proceedings like this, particularly at the onset of the arbitration case. To permit an asset transfer under circumstances like these, simply because the control persons, principals, or officers were not named in the proceeding, would result in a manifest injustice to investors and potentially foreclose on their right to a meaningful recovery.

4. *Are there any material economic impacts associated with the proposed definition of a “covered pending arbitration claim”? Should FINRA include in the definition only those pending arbitration claims filed prior to a specified time period or event? For example, should FINRA limit the definition of a covered pending arbitration claim to those claims filed prior to public announcement of the contemplated transaction? Please explain.*

PIABA feels that the definition of “covered pending arbitration claims” should be drafted in a broad manner, and should not include a limitation related to claims filed prior to a specific date. If the limitation is added, related to claims filed prior to a specific date, it would again, unjustly enrich a firm who was in the process of shifting assets prior to a claim being filed. Firms would therefore be incentivized to announce a transaction upon the learning of bad conduct by a broker that could lead to potential arbitration hearings. In adopting such an amendment, FINRA would be, possibly inadvertently, establishing a troubling policy that promotes its members’ depletion of their assets rather than preserving them to pay investors who have fallen victim to the firm’s and its associated persons’ wrongdoing.

If FINRA does choose to include a limitation related to claims filed prior to a specific date, FINRA should also require that any funds received in consideration for the transaction assets be frozen or subject to a lien in favor of the investor, pending the resolution of all pending arbitration claims filed within a certain period following the transaction closing. This way, the hasty transaction can close, but assets would still be available to satisfy claims of aggrieved investors. While the assets should not be held indefinitely, a set time should be established to bring a claim against the firm – perhaps a year after the transaction closes.

5. *Are there any material economic impacts, including costs and benefits, to investors, issuers and firms that are associated specifically with the proposed amendments? If so: a) What are these economic impacts and what are their primary sources? b) To what extent would these economic impacts differ by business attributes, such as size of the firm or differences in business models? c) What would be the magnitude of these impacts, including costs and benefits?*

Paragraphs 5 and 6 will be addressed together below.

6. *Are there any expected economic impacts associated with the proposed amendments not discussed in this Notice? What are they and what are the estimates of those impacts?*

PIABA feels that the greatest economic impact associated with not adopting the above rules or other policies to ensure payment of arbitration awards will be borne by aggrieved investors. Unpaid arbitration awards leave investors penniless every day, and as written, the FINRA rules enable firms to onboard troubled brokers and shift assets when it is clear that pending claims may be larger than what the firm can afford to bear. Adding the above said restrictions to onboarding and asset transfers is a step in the right direction to protecting investors, and will likely help address the pervasive cockroaching problem, but FINRA needs to do more.

The time has come for FINRA to create an unpaid arbitration award pool, paid for by the financial industry. The unpaid awards pool is the only way to ensure that aggrieved investors are compensated for losses when a firm or registered representative fails to pay an award entered in favor of an investor.

Respectfully submitted,
Andrew Stoltmann
PIABA President

(This page intentionally left blank)

The following PIABA Comment Letter regarding *File No. SR-FINRA-2018-012* was submitted to the Securities & Exchange Commission by Andrew Stoltmann on April 4, 2018 (prepared with the assistance of Nicole Iannarone).

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

Re: *File No. SR-FINRA-2018-012*

Dear Mr. Fields,

I write on behalf of the Public Investors Arbitration Bar Association (“PIABA”), an international not-for-profit, voluntary bar association that consists of attorneys who represent investors in securities and commodities arbitration proceedings. Since its formation in 1990, PIABA’s mission has been to promote the interests of the public investor in arbitration by, amongst other things, seeking to protect such investors from abuses in the arbitration process, seeking to make the arbitration process as just and fair as possible, and advocating for public education related to investment fraud and industry misconduct. Our members and their clients have a fundamental interest in the rules promulgated by the Financial Industry Regulatory Authority (“FINRA”) that relate to the investor experience in the arbitration process.

We appreciate the opportunity to comment on the proposed changes to FINRA’s arbitration codes to eliminate the \$400 fee for explained arbitration decisions. While FINRA began waiving the fee on January 3, 2017, and only two explained decisions were requested thereafter, PIABA nevertheless supports FINRA’s decision to permanently eliminate the fee from the consumer code. PIABA supports transparency in the arbitration process and eliminating a fee for an explained award could potentially increase transparency in the arbitration process by revealing the arbitrators’ thought process. We similarly applaud FINRA’s decision to compensate arbitrators for explained awards even though the parties would not be charged for this service. Finally, we appreciate FINRA’s efforts to make it easier to obtain explained awards and reduce barriers to parties who seek them.

PIABA supports the proposed changes to the rules concerning explained decisions. Thank you for this opportunity to provide comments on the rules relating to the FINRA securities arbitration forum.

Respectfully submitted,
Andrew Stoltmann
PIABA President

The following PIABA Comment Letter regarding *File No. SR-FIRNA-2018-003* was submitted to the Securities & Exchange Commission by Andrew Stoltmann on March 6, 2018 (prepared with the assistance of Benjamin Edwards and William Young, Jr.).

Mr. Brent Fields, Secretary
Securities and Exchange Committee
100 F Street NE
Washington, D.C. 20006-1009

Re: Comment on Amending the Code to include a Special Proceeding for Simplified Arbitration (SR – FINRA 2018-003)

Dear Mr. 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 arbitration proceedings. 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") related to both investor protection and disclosure. As such, PIABA frequently comments on proposed rule changes in order to protect the rights and fair treatment of the investing public. PIABA submits this comment letter in response to SR - FINRA 2018-003 ("the Proposed Rule"). While PIABA believes the Proposed Rule is a positive step in advancing the rights of the public investor, it stresses that the Proposed Rule lacks features that would serve to further improve the simplified arbitration process.

For matters involving claims valued at \$50,000.00 or less, FINRA is proposing to amend the rules to include a special proceeding for Simplified Arbitration ("Special Proceeding"). The Special Proceeding would be limited to two hearing sessions, exclusive of prehearing conferences, with parties being given time limits for their presentations. Parties with claims involving \$50,000 or less are currently limited to a decision based on the pleadings and other materials submitted by the parties, or a full hearing that typically takes place in-person and is not limited in duration.

PIABA generally supports the amendment because it is important to have additional options related to simplified arbitration. As presented, there does not seem to be a downside for public investors under the proposed process. Under the current system, a party may desire to present his or her case to an arbitrator in person, but the travel and expenses associated with a full hearing could result in the deprivation of that opportunity. Also, allowing an arbitrator to see and hear the Claimant in person will add value to the process in terms of weighing witness credibility.

PIABA understands that the prospect of cross-examination by an opposing party might act as a deterrent for Claimants seeking to avoid a direct confrontation with their opponents. However, PIABA is concerned that the value of cross examination must be balanced against that apprehension. Given the fact that cross examination is often one of the most effective means of eliciting evidence during a hearing, the provision of a limited cross examination should be considered for any proposed amendment to the simplified arbitration rules. One such boundary could be time limits applied to cross examinations so that the overall goal of efficiency in adjudicating smaller cases is preserved.

In summary, PIABA generally supports FINRA's proposed amendment allowing for the option of a limited live hearing for simplified arbitrations. However, PIABA would urge FINRA to consider including in the Proposed Rule a mechanism for limited cross-examination of one or two key witnesses. PIABA thanks FINRA for the opportunity to comment on this proposal.

Very truly yours,
Andrew Stoltmann
PIABA President

The following PIABA Comment Letter regarding *FINRA Regulatory Notice 17-42 – Expungement of Customer Dispute Information* was submitted to the Financial Industry Regulatory Authority by Andrew Stoltmann on February 2, 2018 (prepared with the assistance of Benjamin Edwards, Christine Lazaro, Darlene Pasieczny and Lance McCardle).

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 17-42 - Expungement of Customer Dispute Information

Dear Ms. Asquith:

I write on behalf of the Public Investors Arbitration Bar Association (“PIABA”), an international, not-for-profit, voluntary bar association that consists of attorneys who represent investors in securities and commodities arbitration proceedings. Since its formation in 1990, PIABA’s mission has been to promote the interests of the public investor in arbitration by, amongst other things, seeking to protect such investors from abuses in the arbitration process, seeking to make the arbitration process as just and fair as possible, and advocating for public education related to investment fraud and industry misconduct. Our members and their clients have a fundamental interest in the rules promulgated by the Financial Industry Regulatory Authority (“FINRA”) that relate to investor protection.

We welcome the opportunity to comment on the proposed changes to the procedures for expungement of customer dispute information from an associated person’s Central Registration Depository (“CRD”) record. PIABA has studied this issue extensively over the past decade.¹ In its October 2015

1. See, e.g., “PIABA Study: Stockbroker Arbitration Slates Wiped Clean 9 out of 10 Times When “Expungement” Sought in Settled Cases,” October 2013, <https://piaba.org/piaba-newsroom/piaba-study-stockbroker-arbitration-slates-wiped-clean-9-out-10-times-when-0>; “Update to the 2013 Expungement Study of the Public Investors Arbitration Bar Association,” (“PIABA 2015 Study”), October 2015, <https://piaba.org/piaba-newsroom/piaba-study-stockbroker-arbitration-slates-wiped-clean-9-out-10-times-when-0>.

study, PIABA found that cases involving stipulated awards or settled customer claims between 2012 and 2014, expungements were granted in 87.8% of such cases.² These findings are consistent with FINRA's own review of cases filed between 2014 and 2016, where expungement was granted in 88% of settled cases.³

FINRA has taken steps to attempt to ensure that customer dispute information only be expunged when it has "no meaningful investor protection or regulatory value"⁴ and that expungement of customer dispute information be awarded solely as an extraordinary remedy. To this end, FINRA has increased arbitrator guidance and training related to expungement requests.⁵ FINRA has also prohibited firms from preventing customers from participating in the expungement proceedings.⁶ Notwithstanding FINRA's actions, expungement is granted far too frequently for it to be considered an extraordinary remedy.

In setting standards for expungement, FINRA should proceed carefully to ensure the protection of the public's interest in relevant information.⁷ FINRA's embrace of widespread pre-dispute arbitration agreements currently acts to conceal public access to information about many disputes because records from FINRA proceedings are not available to the public on the same terms as public court proceedings.⁸ As such, FINRA must only promulgate rules and

org/piaba-newsroom/report-update-2013-expungement-study-public-investors-arbitration-bar-association.

2. See PIABA 2015 Study at 3.

3. See FINRA Regulatory Notice 17-42 at 14, http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-42.pdf.

4. See FINRA, "Notice to Arbitrators and Parties on Expanded Expungement Guidance," ("Notice on Expanded Expungement Guidance"), updated September 2017, <http://www.finra.org/arbitration-and-mediation/notice-arbitrators-and-parties-expanded-expungement-guidance>.

5. See PIABA 2015 Study at 2, *supra* n. 2.

6. See *id.*

7. See Christine Lazaro, *Has Expungement Broken Brokercheck?*, 14 J. BUS. & SEC. L. 125, 149 (2014) ("FINRA has a statutory obligation to ensure that the information it provides through BrokerCheck is accurate and complete. It can only meet that obligation if the expungement process is handled with integrity and if expungement is granted as a remedy only in extraordinary circumstances").

8. Cf. *Union Oil Co. of California v. Leavell*, 220 F.3d 562, 568 (7th Cir. 2000) ("People who want secrecy should opt for arbitration. When they call on the courts,

policies that facilitate the removal customer complaints from the CRD in the most extraordinary circumstances, because that removal diminishes the ability of reputation to police business misconduct.⁹ If a lax expungement process removes information customers could use to protect themselves, more customers will be harmed by associated persons they could have avoided if the complaint information had not been suppressed through FINRA's expungement process.

PIABA applauds FINRA for continuing to examine this issue and attempting to find solutions to the issues PIABA has previously identified. PIABA looks forward to FINRA taking further steps to ensure that customer dispute information is not improperly expunged from associated persons' public records.

Below, PIABA comments on the questions specifically raised by FINRA:

1. FINRA Rules 12805 and 13805 provide, in relevant part that, in order to grant expungement of customer dispute information under Rule 2080, the panel must comply with the requirements stated in the rule. FINRA notes, however, that if a panel issues an arbitration award containing expungement relief, the award must be confirmed by a court of competent jurisdiction and FINRA could decide to oppose the confirmation. Thus, as the associated person is required to complete additional steps after the arbitrators make their finding in the award before FINRA will expunge the customer dispute information, FINRA believes the word "grant" may not be an appropriate description of the panel's authority in the expungement process. FINRA is considering changing the word to "recommend." Please discuss whether the rule should retain "grant" or change to "recommend" or some other description to more accurately reflect the panel's authority in the expungement process.

PIABA agrees that the operative word in FINRA Rules 12805 and 13805 should be changed from "grant" to "recommend." As an initial matter, PIABA notes that this change is appropriate based on the plain meaning of the two words. Merriam-Webster defines "grant" in this

they must accept the openness that goes with subsidized dispute resolution by public (and publicly accountable) officials.").

9. See Benjamin P. Edwards, *Conflicts & Capital Allocation*, 78 OHIO ST. L.J. 181, 209 (2017) ("Even if a retail investor becomes dissatisfied and brings an arbitration proceeding against a financial advisor, the financial advisor will often be able to remove the complaint from public records, further inhibiting the reputation consequence").

context as follows: “to consent to carry out for a person; allow fulfillment of.”¹⁰ It defines “recommend” as follows: “to suggest an act or course of action.”¹¹

FINRA rule 2080 does not confer upon the Panel the power to “grant” or “allow fulfillment of” an expungement request on its own. Rather, the Panel only has the authority to “recommend” or “suggest” expungement. If the Panel issues an award with a recommendation for expungement, the member or associated person subsequently “must obtain an order from a court of competent jurisdiction...confirming an arbitration award containing expungement relief.”¹² The member or associated person must then take the Court order to FINRA, which actually “carries out” the expungement.

PIABA further notes that this change would be consistent with language used in FINRA’s *Notice to Arbitrators and Parties on Expanded Expungement Guidance*, which states:

FINRA adopted FINRA Rules 12805 and 13805 to establish procedures that arbitrators must follow before **recommending** expungement of customer dispute information related to arbitration cases or customer complaints from a broker’s Central Registration Depository (CRD) record.

* * * * *

Expungement is an extraordinary remedy that should be **recommended** only under appropriate circumstances.

* * * * *

Arbitrators have a unique, distinct role when deciding whether to **recommend** a request to expunge customer dispute information from a broker’s CRD record.

* * * * *

Given this significant role, arbitrators should ensure that they have all of the information necessary to make an informed and appropriate **recommendation** on expungement.

* * * * *

Arbitrators **recommending** expungement should ensure that the explanation is complete and not solely a recitation of one of the

10. See Merriam-Webster’s online dictionary, available at <https://www.merriam-webster.com/dictionary/grant>.

11. See Merriam-Webster’s online dictionary, available at <https://www.merriam-webster.com/dictionary/recommend>.

12. See FINRA Rule 2080.

Rule 2080 grounds or language provided in the expungement request. Specifically, arbitrators should identify in the award the reason(s) for and any specific documentary or other evidence relied on in *recommending* expungement.¹³

For these reasons, PIABA agrees that the word “grant” should be replaced with “recommend.”

2. Would named associated persons request expungement in every case to preserve the right to have the expungement claim heard and decided, either in the Underlying Customer Case or as a new claim under the Industry Code? If so, what would be the potential costs and benefits of a named person requesting expungement in every case?

According to FINRA’s own statistics, it appears associated persons make expungement requests in approximately 20% of the cases filed.¹⁴ PIABA does not believe that the number of expungement requests made will increase following a change in the rules. With heightened standards applicable to expungement requests, and a clear process for requesting an expungement following the close of the customer case, associated persons may be more deliberate in making expungement requests.

3. Should FINRA consider bifurcating the expungement request from the customer’s claim in all cases relating to customer disputes? What would be the costs and benefits of such an approach?

FINRA should consider bifurcating expungement requests from customer claims. The decision a panel is asked to make with respect to expungement is different than deciding whether or not to find liability on a customer claim. For example, a panel may determine that a customer has not provided sufficient evidence to win on the merits of her underlying case for various reasons. However, expungement may still be inappropriate because the associated person may not have

13. See Notice on Expanded Expungement Guidance, *supra* n. 4.

14. FINRA Regulatory Notice 17-42 states that 2,232 customer cases filed between 2014 and 2016 contained requests for expungements. See, Regulatory Notice 17-42 at 13, *supra* n. 3. According to FINRA statistics, 10,938 customer cases were filed between 2014 and 2016. See, FINRA Dispute Resolution Statistics, <http://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics>.

established that the claim was “factually impossible or clearly erroneous,” or “false,” or that the associated person was “not involved” in the alleged conduct at issue¹⁵

Moreover, FINRA proposes to establish a specially trained arbitrator pool to consider expungement requests, referred to as Expungement Arbitrators. If expungement requests are not bifurcated from the underlying customer case, some expungement requests may be considered by arbitrators who are not Expungement Arbitrators. Failing to bifurcate the proceeding potentially undermines the benefits of creating a pool of Expungement Arbitrators.

4. What are the costs and benefits of requiring the unanimous consent of a three-person panel to grant all requests for expungement of customer dispute information?

As stated above, expungement should be an extraordinary remedy which is only granted when “it has no meaningful investor protection or regulatory value.”¹⁶ Unanimous consent will help ensure that this standard is met. If one of the arbitrators believes the customer dispute information has some meaningful investor protection or regulatory value, the information should remain on the associated person’s record.

5. Is the one-year limitation on being able to request expungement of customer dispute information appropriate? Should the time period be longer or shorter? Please discuss.

PIABA strongly supports a definite cut-off date for requests for expungement. A customer is far more likely to participate in an expungement hearing when it takes place in close proximity to the resolution of the underlying arbitration proceeding. A more stringent timeline will also lead to a higher quality of evidence for the Panel to consider, both in terms of testimony and documentary evidence, both which become less reliable and available with the passage of time. In cases where the arbitration panel in the underlying customer arbitration does not decide an expungement request as part of the award, FINRA proposes a one-year deadline as follows: In cases

15. See FINRA Rule 2080 (b)(1).

16. See Notice on Expanded Expungement Guidance, *supra* n. 4.

where a complaint is made but no arbitration is initiated, expungement requests would be permitted to be filed up to one year from the time a customer complaint is submitted to the CRD. In cases where an arbitration is initiated and no award is issued (e.g. settlement of the case, or withdrawal), expungement requests would be permitted to be filed up to one year from the time the underlying case closes.

PIABA believes that, *at a maximum*, a one-year time frame is acceptable for the above-described situations. But for those situations in which an arbitration is carried through an evidentiary hearing, and an award is issued, PIABA believes a shorter time frame of *90 days* from the resolution of the case is appropriate. Not only is 90 days reasonable, but it is more in line with adjudicatory procedures already familiar to litigants under the Federal Arbitration Act, and would result in a more transparent and meaningful proceeding.

The one-year time limit also poses a real danger of the arbitrators' understanding of the underlying facts going stale. According to FINRA statistics through November 2017, the average time that passes from a customer initiating a FINRA arbitration proceeding to receiving a hearing decision is 16.9 months (and 6.5 months in simplified cases).¹⁷¹⁸ Many cases settle near the time of the scheduled hearing. This means that customers may be litigating a case for over a year, and *then* have *another* year to wait to see if an associated person named (or not named but required to submit information to the CRD) in the case will submit a request for expungement. Likewise, customers in a simplified arbitration may have a faster resolution, either through early settlement or an award issued on average in six months. It is fair to require customers to wait a full *year* for a potential expungement request when an expedited resolution has taken place.

The Federal Arbitration Act, 9 U.S.C. § 12, provides that notice of a motion to vacate an arbitration award must be served and the motion filed in court *within 3 months* after the award is filed or delivered. This three month deadline is also a reasonable amount of time for a party to decide whether or not to move to vacate an award, and provides

17. The ABA has adopted model time standards for disposition of cases – 90 percent of all general civil cases should be tried or disposed within 12 months after filing. A number of states have adopted standards consistent with the ABA model. *See* National Center for State Courts, “Model Time Standards for State Trial Courts,” at 12, August 2011, <http://www.ncsc.org/Services-and-Experts/Technology-tools/~media/Files/PDF/CourtMD/Model-Time-Standards-for-State-Trial-Courts.ashx>.

18. *See* FINRA Dispute Resolution Statistics, *supra* n. 14.

certainty to the litigants that an arbitration award is final and that the corresponding proceeding is resolved. Surely a similar 90-day deadline for an associated person to request expungement is a reasonable amount of time. PIABA urges FINRA to consider a shorter deadline of *90 days* following the award or settlement for filing the expungement request in cases where an arbitration claim has been initiated.

6. Should the associated person who is requesting expungement be required to appear in person or by videoconference, rather than by phone, at the expungement hearing?

FINRA should require associated persons to appear either in person or by videoconference at expungement hearings. Telephonic appearances diminish the arbitrators' ability to observe the associated person and effectively gauge his or her credibility and veracity. Recent research found that the type of communication technology used affects how often persons will lie. Notably, one study found that persons "are more likely to lie (and to be lied to) on the telephone than in any other medium."¹⁹

Allowing associated persons to appear telephonically introduces additional risks into the expungement hearing. With a telephonic appearance, the arbitrators cannot observe whether the associated person is reading prepared remarks or looking to another person for coaching and signals about how to answer questions. These risks diminish with in person or videoconference appearances.

Requiring videoconference appearances for an associated person does not create an undue burden because videoconference technology is widely available at a low cost. When an associated person seeks extraordinary relief, and it is not unreasonable to require that person to "appear."

FINRA should also ensure that customers associated with the underlying complaint or arbitration have the right to participate in expungement hearings. Although it would be inappropriate to name customers as parties in expungement proceedings, legitimate expungement processes must notify customers of the proceedings and

19. Jeffrey T. Hancock, *et al*, *Deception and Design: The Impact of Communication Technology on Lying Behavior*, Proceedings of the 2004 Conference on Human Factors in Computing Systems (pp. 129-134), <https://pdfs.semanticscholar.org/7ac6/4e54d377d2e765158cb545df5013e92905da.pdf>.

facilitate their ability to provide information to arbitrators. As FINRA modifies its rules, it should also enshrine the rights provided in its current guidance.²⁰ FINRA's current guidance provides that customers should be allowed to appear with counsel at any expungement hearing and provide testimony telephonically, in person, or by any other method.²¹ The guidance also makes clear that customers should be able to introduce documents, cross-examine witnesses, and present opening and closing arguments on the same terms as any other person appearing at the expungement hearing.²²

7. Should the arbitrators on the Expungement Arbitrator Roster have specific qualifications? If so, are the proposed additional qualifications appropriate or should FINRA consider other qualifications?

FINRA proposes that only chair-qualified public arbitrators, with the following additional qualifications, be included on the Expungement Arbitrator Roster: (1) completed enhanced expungement training; (2) admitted to practice law in at least one jurisdiction; and (3) five years' experience in any of the following (a) litigation; (b) federal or state securities regulation; (c) administrative law; (d) service as a securities regulator; or, (e) service as a judge.

As proposed, the Neutral List Selection System (NLSS) would randomly select three names from the Expungement Arbitrator Roster, with no strikes by the parties permitted, but allowing the parties to challenge an arbitrator for cause.

PIABA supports the FINRA Dispute Resolution Task Force's recommendation that arbitrators on a special expungement hearing panel be chair-qualified public arbitrators, with additional training on expungement. The training should emphasize the importance of the CRD and BrokerCheck and their relationship to investor protection. As FINRA itself has stated, "[e]nsuring that CRD information is accurate and meaningful is essential to investors, who may rely on the information when making decisions about brokers with whom they may conduct business; to regulators, who rely on the information to fulfill their regulatory responsibilities; and to prospective broker-

20. Notice on Expanded Expungement Guidance, *supra* n. 4.

21. *Id.*

22. *Id.*

dealer employers, who rely on the information when making hiring decisions.”²³

PIABA is concerned, however, that some areas of the country would have difficulty filling the proposed Expungement Arbitration Rosters with *local* chair-qualified arbitrators. PIABA has previously identified the “traveling arbitrator” problem in general panel selection, resulting in arbitrators assigned to cases unfamiliar with local securities laws and complicating case scheduling. PIABA in no way suggests reducing the additional qualifications proposed by FINRA, but FINRA must continue to make significant efforts in recruiting chair-qualified arbitrators in underserved areas to bolster the local Expungement Arbitration Roster.

In addition, PIABA supports FINRA’s proposal that the Expungement Arbitrator panel be randomly selected. Random selection will reduce the risk of arbitrators being concerned about ruling against an associated person for fear they may not be selected for another panel.

8. Should the arbitrators on the Expungement Arbitrator Roster be lawyers only or could the experience of serving on three arbitrations through award be a sufficient substitute?

PIABA believes that Expungement Arbitrators should be licensed attorneys. This is a practical consideration – requiring service on three arbitrations through award would likely reduce the number of arbitrators qualified to be on the Expungement Arbitration Roster, exacerbating the issue of “traveling arbitrators” in certain areas of the country and as such, it would not be a sufficient substitute to an attorney-only roster.

Because the Rule 2080 grounds for expungement require a different weighing of evidence than deciding the merits of the underlying claim, arbitrators with legal training may be better equipped to make the distinction. For example, as mentioned above, even though a panel may determine that a claimant has not provided sufficient evidence to win on the merits of his or her underlying case, the evidence presented may still be insufficient to prove that the claim was “factually impossible or clearly erroneous,” or “false,” or that the associated person was “not involved.”²⁴ Legal training may assist the arbitrator

23. Notice on Expanded Expungement Guidance, *supra* n. 4.

24. See FINRA Rule 2080 (b)(1).

in understanding the differences in these evidentiary burdens, and be a benefit to protecting the integrity of the CRD and BrokerCheck systems.

9. How would the proposed amendments affect the granting or denying of expungement requests? Which aspect of the proposed amendments would have the largest impact on expungement determinations? Why?

FINRA's codification of its own guidance on expungement is very important to improving the expungement process. Currently, FINRA Rule 12805 requires that the arbitrators "[i]ndicate in the arbitration award which of the Rule 2080 grounds for expungement serve(s) as the basis for its expungement order and provide a brief written explanation of the reason(s) for its finding that one or more Rule 2080 grounds for expungement applies to the facts of the case." However, FINRA Rule 2080 does not set forth expungement standards; it sets forth standards that must be met if an associated person is requesting that FINRA waive the obligation within the rule to name FINRA as a party in a court action to confirm an arbitration award recommending expungement.

PIABA supports amendments to the rules that would clarify that an arbitration panel may not recommend expungement on grounds other than those set forth in Rule 2080, and that the panel must also determine whether the customer dispute information has any meaningful investor protection or regulatory value before recommending expungement.

Clarifying the standards governing expungement in the rules, in conjunction with training a special pool of arbitrators to consider the requests, may lead to some success in ensuring expungement is only recommended when appropriate. In addition, ensuring that expungement requests are made in a timely fashion encourage customer participation in the process, allowing the arbitrators to make a more informed decision.

10. The proposal would establish a one-year limitation period for associated persons to expunge customer dispute information that arose from a customer complaint. The limitation period would start on the date that the member firm initially reported the customer complaint to CRD. Should the one-year limitation period be based on a different milestone? If so, what should it be?

PIABA has concerns about commencing the limitation period on the report date because FINRA's member firms and associated persons control the date when reports are made. This liberal commencement date introduces risks that member firms or associated persons might benefit from delaying the reporting of complaints to the CRD. PIABA believes that the one year limitation period should run from the shorter of (i) a month after the associated person received notice of the customer complaint or (ii) from the date the member firm initially reported the customer complaint to the CRD.

11. The proposal would clarify for arbitrators that the standard for granting the permanent removal of customer dispute information from CRD is a finding that at least one of the Rule 2080(b)(1) factors applies and that the customer dispute information has "no investor protection or regulatory value." Are there specific factors that arbitrators should consider when making a finding that the customer dispute information has "no investor protection or regulatory value"?

The current factors set forth in Rule 2080 may help inform the arbitration panel as to whether or not customer dispute information has any investor protection or regulatory value. Unfortunately, in practice, it appears that arbitration panels often believe the Rule 2080 standards are easily met. There seems to be some confusion amongst arbitration panels as to the burden of establishing whether a claim was "factually impossible or clearly erroneous," or "false," or that the associated person was "not involved."²⁵ Further, it seems that Panels often do not grasp the fact that a customer may not have met his or her burden for purposes of establishing liability, or that an affirmative defense was available to limit liability, but this does not mean the claim is factually impossible or false. Yet, that is often the reason used by arbitration panels to support their recommendation of expungement. It must be clear that the standards set forth in Rule 2080 are high standards, distinct from those employed to determine liability.

Requiring that an arbitration panel to find that customer dispute information does not have any investor protection or regulatory value because it fits into one of the categories set forth in Rule 2080 emphasizes the notion that arbitrators' actions have significant repercussions on investor protection. Moreover, enhanced training should further reinforce the importance of the disclosure of customer

25. See FINRA Rule 2080 (b)(1).

dispute information, regardless of the outcome of the underlying arbitration.

12. In a simplified arbitration case, if a customer requests a hearing, should the single arbitrator be permitted to decide an expungement request, if a request is filed?

PIABA supports FINRA's proposal to require that a request for an expungement in a simplified case not be considered during the underlying arbitration, but rather that a claim be filed pursuant to proposed Rule 13805(a). FINRA's proposal addresses flaws in the current process, whereby a hearing is held to consider the expungement request even though the customer chose not to elect a hearing under Rule 12800. It will also eliminate delays in securing an award in the simplified case because the arbitrator is considering the request for expungement.

However, PIABA contends that a single arbitrator should not be permitted to decide an expungement request in a simplified arbitration case. The proposed amendments regarding expungement recognize, among other things, that expungement of CRD information is "an extraordinary measure" and that "the integrity and reliability of CRD information is *critical* to the needs of the stakeholders," including investors, the SEC, FINRA, employers, and state and other regulators.²⁶ The proposed amendments are designed, in part, to make the stakeholders "more confident in the reliability" of CRD information and to make the CRD information "more meaningful and valuable" to stakeholders.²⁷

These goals should not be affected—and the proposed amendments should not be diminished—simply because a given incident of misconduct involved \$50,000 or less (and therefore was governed by FINRA's Simplified Arbitration procedure).²⁸ If FINRA were to permit a single arbitrator to decide an expungement request, that request would not be decided with the benefit of the additional safeguards put in place by the proposed amendments, including:

26. See FINRA Regulatory Notice 17-42 at 3, 13, *supra* n. 3.

27. See FINRA Regulatory Notice 17-42 at 15, *supra* n. 3.

28. See FINRA Rules 12800 and 13800.

- (1) that the request be decided unanimously by a three-person, randomly selected, panel of public chairpersons;²⁹ and
- (2) that the members of the panel be selected from FINRA's Expungement Arbitrator Roster, which ensures that the panel members have certain qualifications, including:
 - a. completed enhanced expungement training;
 - b. admitted to practice law in at least one jurisdiction; and
 - c. five years' experience in any one of the following disciplines:
 - i. litigation;
 - ii. federal or state securities regulation;
 - iii. administrative law;
 - iv. service as a securities regulator; or
 - v. service as a judge.³⁰

That the amount in dispute in an arbitration proceeding is \$50,000 or less should not have any effect on the manner in which a member's or associated person's request for expungement is handled. There must be uniformity in the expungement process to ensure that all stakeholders maintain their confidence in the system.

Generally, PIABA supports the proposed changes to the expungement rules. However, PIABA believes that expungement requests would be best handled separate from the arbitration process. Whether customer dispute information should be disclosed is a determination that should be made by FINRA itself, in conjunction with its oversight of the CRD system. It is not a determination that should be made by an arbitrator, whose purpose is to determine whether an associated person is liable to a customer. While the proposed changes should improve the process, PIABA is hopeful that FINRA will continue to examine these issues and consider other means by which expungement requests may be considered.

Respectfully submitted,
Andrew Stoltmann
PIABA President

29. *See* proposed FINRA Rule 13806(b)(1).

30. *See* proposed FINRA Rule 13806(b)(2).

The following PIABA Comment Letter regarding *FINRA Regulatory Notice 17-38 – Remote Branch Inspections* was submitted to the Financial Industry Regulatory Authority by Andrew Stoltmann on January 11, 2018 (prepared with the assistance of Stefan Apotheker and Benjamin Edwards).

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, N.W.
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 17-38: Remote Branch Inspections

Dear Ms. Mitchell:

I write on behalf of the Public Investors Arbitration Bar Association (“PIABA”), an international, not-for profit, voluntary bar association that consists of attorneys who represent investors in securities and commodities arbitration proceedings. Since its formation in 1990, PIABA’s mission has been to promote the interests of the public investor in by, amongst other things, seeking to protect such investors from abuses in the arbitration process, seeking to make the arbitration process as just and fair as possible, and advocating for public education related to investment fraud and industry misconduct. Our members and their clients have a fundamental interest in the rules promulgated by the Financial Industry Regulatory Authority (hereinafter “FINRA”) that relate to investor protection.

FINRA Regulatory Notice 17-38 seeks comment on proposed amendments to FINRA Rule 3110, which requires FINRA member firms to maintain a system of supervision that is reasonably designed to achieve compliance with FINRA rules and applicable securities laws and regulations. FINRA Rule 3110(c) requires FINRA member firms to review, at least annually, the business in which they engage. FINRA has interpreted this rule to require that inspections take place “on-site.” *See* FINRA Regulatory Notice 11-54 (“A broker-dealer must conduct on-site inspections of each of its office locations.”) (Emphasis added.)

FINRA’s proposal would relieve its member firms of their obligation to conduct annual in person inspections of certain “qualifying” offices, which

FINRA has defined as, amongst other things, those with “not more than three associated persons” designated to the location.

PIABA opposes the proposed amendments to FINRA Rule 3010, as they would significantly weaken the minimum required oversight of a high-risk category of registered representatives. Small, geographically remote branch offices, by their very nature, create significantly heightened opportunities for unscrupulous brokers to engage in a variety of illicit conduct including, but not limited to, unapproved outside business activities and engaging in unapproved private securities transactions (e.g. “selling away”).

The Securities and Exchange Commission (SEC) has repeatedly emphasized that these small remote branch offices require vigilant supervision. For example, SEC Staff Legal Bulletin No. 17 *Remote Supervision* (March 19, 2004) provides:

Some broker-dealer firms have geographically dispersed offices staffed by only a few people, and many are not subject to onsite supervision. Their distance from compliance and supervisory personnel can make it easier for registered representatives (representatives) and other employees in these offices to carry out and conceal violations of the securities laws. The supervision of small, remote offices, therefore, can be especially challenging...

Inspections are a vital component of a supervisory system. The Commission has determined that broker-dealers that conduct business through remote offices have not adequately discharged their supervisory obligations where there are no inspections of those offices. Effective inspections can detect misconduct in its infancy, deter future wrongdoing, and prevent or mitigate investor harm. An effective supervisory system employs a combination of *onsite* and offsite monitoring, including the use of unannounced inspections and mechanisms for verifying that deficiencies are corrected...

Onsite inspections usually take one of two forms: routine or "for cause." Routine inspections are conducted in the ordinary course of business, while "for cause" inspections are conducted upon learning about a specific event or potential violation. We suggest that all inspections include at least... *in-person* questioning of the representative by the supervisor about business activities, including inquiry about any unusual activity; and (6) *in-person* interview by the supervisor of the representative's assistant or support staff, if any, about the remote office's business and any unusual activity. If, during the course of the examinations, deficiencies are identified, examiners should consider the need to conduct a more in-depth review. (Emphasis added.)

The proposed amendments to FINRA Rule 3110 do not address the SEC's well-founded concerns regarding the inherent risks associated with small, geographically remote branch offices with no direct on-site supervision. Electronic inspections will not reveal any of the hallmark indicators of misconduct, such as documents related to unapproved outside businesses or sales literature and marketing materials for unapproved outside investments. These are just a few examples of the types of misconduct which will go undetected with an electronic branch inspection, but would have been easily detected through an in-person inspection.

FINRA itself has repeatedly emphasized the importance of *in-person* branch inspections. For example, FINRA Regulatory Notice 11-54 provides:

The branch inspection provides the firm with the opportunity to validate its surveillance results from branch offices and to gather *on-site* intelligence that supplements the ongoing management and surveillance of the branch...

Branch office inspections provide an opportunity for oversight that should enhance the firm's routine surveillance and supervisory activities. For instance, branch office inspections may allow a firm to better identify the nature and extent of outside business activities of registered branch office personnel. Outside business activities conducted by registered persons may carry added risk because these activities may be perceived by customers as part of the member's business. Confirming that the scope of outside business activities of registered branch office personnel conform to those activities authorized by the firm is an important component of the branch office inspection, and addresses a risk that may be more difficult to monitor. For much the same reasons, unannounced inspections (which do not provide an opportunity to hide, alter or destroy documentation or other information reflecting such activities) are a critical element of any well designed branch office inspection program and should constitute a significant percentage of all exams conducted.

FINRA's proposed amendments to Rule 3110 do not address FINRA's stated goals and objectives for effective branch office inspections. For example, FINRA Regulatory Notice 11-54 states that an important component for an in-person branch office inspection is "procedures to uncover use of unauthorized computers or other electronic devices..." The electronic branch office inspections contemplated in Regulatory Notice 17-38 cannot meaningfully address or supervise the use of unauthorized devices at remote branch office locations.

As clearly illustrated above, FINRA and the SEC have repeatedly emphasized the importance of in-person branch inspections, especially in connection with remote branch offices. FINRA, without any explanation, now suggests a serious deviation from the supervisory structure both it and the SEC have strongly promoted in the past. The risks and problems identified by both the SEC and FINRA have not disappeared and there is simply no good reason to modify the current compliance structure. A decision to do so would surely allow these problems to manifest more frequently. It is inexcusable that U.S. investors have been, and continue to be, the victims of Ponzi schemes, selling away, and other illicit conduct occurring at remote branch office locations, which could have been easily detected and prevented through the use of more vigorous in-person branch inspections.

PIABA believes that rather than weakening the oversight of these high risk branch office locations, FINRA require stronger oversight of remote branch office locations by implementing more vigorous in-person branch office inspection requirements.

PIABA thanks FINRA for the opportunity to comment on this proposal and welcomes the opportunity to have further dialogue on this important issue.

Very truly yours,
Andrew Stoltmann
PIABA President