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THE PRE-HEARING CONFERENCE IN ARBITRATION – AN ARBITRATOR'S PERSPECTIVE

Philip S. Cottone, Esq.[1]

FINRA calls it the Initial Pre-Hearing Conference and the AAA the Preliminary Hearing, but despite the subtle differences in nomenclature, this first meeting among counsel, the arbitration panel and the case manager - usually by phone and without the parties present - is a critical part of the process because it lays the foundation for all that will follow. It is not just about setting dates, for if that is all that is accomplished an opportunity has been wasted to establish the proper tone for the subsequent proceedings and for the arbitrators to take control of and begin to manage the process. Simply put, it's the opportunity for all present to make a good first impression.

This article will describe the:

- customary procedures in what I call the Pre-Hearing Conference and
- do's and don'ts for counsel and arbitrators to help ensure an arbitration that respects party choice and is fair and attentive to conserving time and money where possible.

Who Should Attend?

Especially in larger commercial cases, General Counsel or senior in-house counsel for each of the parties should be present either on the phone or in person because many decisions will be made that affect the costs to be incurred and the speed with which the matter will proceed. The presence of in-house counsel commits the client more directly to the philosophy to be discussed and hopefully subscribed to by everyone present - that arbitration is not litigation, and the objectives of cost and time efficiencies as well as fairness and party choice are to be respected. At best, especially for the larger cases, this should be done in person, because developing agreement and cooperation to the extent

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1. ***This article is based on a similar one that was copyrighted in 2012 by the Practising Law Institute (NY) and was originally published in the course manual for PLI's Securities Arbitration 2012.*** Phil Cottone is an attorney and an experienced arbitrator and mediator for FINRA, AAA (commercial and real estate panels) and The Counselors of Real Estate. He is also certified by the International Mediation Institute at The Hague. His website and contact information are at www.philcottone.com.

possible among counsel and the parties and getting a commitment to achieving the shared objectives that should be articulated at the Pre-Hearing Conference, is much better accomplished face-to-face than by phone.

The Protocols for Expeditious, Cost-Effective Commercial Arbitration published in 2011 by the College of Commercial Arbitrators (the "CCA Protocols") devote eight pages to recommended choices for business users and in-house counsel to ensure cost and time saving in dispute resolution.[2] They note:

"Sophisticated in-house counsel know that it is absolutely essential for business principals and senior in-house counsel to stay actively involved throughout the dispute resolution process … In-house counsel should attend the first case management conference as well as all important subsequent conferences and hearings during the arbitration process in person or by telephone, should require periodic status reports from outside counsel, and should partner in the management of the arbitration rather than relinquishing such control to outside counsel … In-house counsel are a vital part of the effort to distinguish the tone of an arbitration process from that of litigation." (At pages 29-30).

Introductions and Preliminaries

After roll call has been taken and the parties have introduced themselves, it is appropriate for the Chair to ask the panel if there are any additional disclosures to those previously made. After that, the FINRA script has the Chair ask if counsel accepts the composition of the panel. I believe that is good practice in all cases, namely, to get an affirmative representation on the record from counsel that they have no problem with the designated arbitrators proceeding, notwithstanding any disclosures made. But this is not without controversy because some feel such a representation should not be requested because it is better for any party wishing to raise an objection to an arbitrator's service to raise it privately with the provider.

In FINRA cases, the panel will have the pleadings and often other documents to review prior to the Pre-Hearing Conference, so the arbitrators will have some idea what the controversy is all about. That is usually not the

2. Edna Sussman and Christi Underwood, *Time and Cost Solutions for Commercial Arbitration: Highlights from the College of Commercial Arbitrators' Four Protocols for Parties, Counsel, Arbitrators, and Arbitral Institutions,* DISPUTE RESOLUTION JOURNAL, Feb/April 2011 available at https://sussmanadr.com/docs/CCA%20time%20and%20cost%20solutions%204-2011.pdf.

case with AAA and private matters where panels might have only a Demand for Arbitration, if anything at all. In those cases, it is a good idea to ask Claimant's counsel to briefly review the causes of action that have been asserted (what the AAA calls Statements of Claims and Issues) and to ask the Respondent's counsel to respond. The FINRA outline then has the arbitrators confirm the documents they have received; I think this is also good practice. Occasionally, it turns out that the panelists do not all have the same materials, and this is a good time to find out and get everyone on the same page.

Dates

Sometimes it feels like it was easier scheduling the Normandy Invasion. The AAA Preliminary Hearing Checklist proceeds directly to establishing dates for the substantive hearing. The FINRA checklist does the same, but after having the Chair remind the parties of its highly successful, voluntary mediation program. I think encouraging mediation is a good idea in all arbitrations.

As a Chair my practice at this juncture is to ask the attorneys if they had a discussion about dates in preparation for the call. Often they have - about trial dates and/or discovery dates - and in that case I hear them out. It is always best for counsel to confer privately *before* the Pre-Hearing Conference and to agree where possible on how they would like the arbitration to be conducted. In the letter I send to all counsel before the Conference suggesting an Agenda I always encourage counsel to confer about the Agenda items, including dates. Asking if they did that, and maybe saying a few words to encourage that kind of dialogue between counsel as we proceed, is always useful. The best way for parties to protect themselves against arbitral rulings they might not like is to work it out themselves if they can. If they have not talked, I ask if they want to discuss dates for exchanging information first, and then trial dates, or the other way around.

I do it this way to see what the parties have in mind and to let them steer the discussion based on what is most important to them. Some counsel start talking about the need for prompt trial dates and may suggest hearing dates a number of weeks or months out; others are more concerned with getting on with discovery and setting dates for the filing of requests, subpoenas and, if necessary, Motions to Compel. This is the parties' process, after all, and letting them direct the discussion at the Pre-Hearing Conference does not at all mean the arbitrators are giving up control but, rather, that they are listening to the concerns of counsel to help them structure a calendar that will accomplish their objectives.

Discovery

"The expansion of discovery stands out as the primary contributor to greater expense and longer cycle time (in arbitration)" concluded a poll of participants in the 2010 National Summit on Business to Business Arbitration.[3]

Historically, discovery in arbitration was not an entitlement beyond the exchange of the most basic documents between the parties. As years have gone by and arbitration is increasingly used for larger commercial cases, discovery has increased accordingly, and institutional rules have developed to include Information exchanges (e.g. see AAA Commercial Rules; JAMS Comprehensive Rules; FINRA Discovery Guides).[4]

The FINRA Initial Pre-Hearing Conference script calls for discovery cut-off dates, responses to motions and a hearing date to handle discovery disputes, with dates to be specified for submissions in connection with that hearing. The AAA Preliminary Hearing Outline specifies "Exchange of Information" and, in one sentence, discusses resolving issues and establishing a method and schedule for exchanges and production, including reports from experts if needed. AAA Commercial Rule R-21 states that the arbitrator may direct the production of documents and other information "consistent with the expedited nature of arbitration."

Managing the discovery process is absolutely essential for a just, expeditious and comparatively inexpensive arbitration. The panel has to control the process to stop the increasing "litigitization" of arbitration and to make sure proportionality is achieved so the parties get what they need and no more, and at a reasonable cost in terms of money and delay.

The CCA Protocols note, "Discovery is the chief culprit of current complaints about arbitration morphing into litigation."[5] Discovery in arbitration is generally much more limited than under the Federal Rules of Civil Procedure or state discovery rules, and an out-of-control discovery process is certain to derail any arbitration. Limits need to be discussed and agreed to at the Pre-Hearing Conference.

If it is a large case, the parties can be encouraged to meet and confer on

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3. See Thomas J. Stipanowich, Curtis E. von Kann, Deborah Rothman, *College of Commercial Arbitrators Protocols for Expeditious, Cost Effective, Commercial Arbitration,* at 6, available at https://www.ccaarbitration.org/resources/cca-protocols/.

4. www.adr.org/commercial; www.jamsadr.com/rules-comprehensive-arbitration; www.finra.org/arbitration-and-mediation-discoveryguide.

5. *See* Stipanowich, von Kass, and Rothman, at 22.

limits themselves and come back with recommendations to the panel. If subpoenas have to be used, there must be a limitation on how many for both sides, and if depositions need to be conducted to save time at the substantive hearing, they also should be limited in both number and in the time allotted for each (or overall). Whenever possible, depositions must be agreed to by the parties and not compelled by the arbitrators.

For example, JAMS Rule 17 - "Exchange of Information" - calls for each party to take only one deposition with additional depositions determined by the arbitrator based upon "reasonable need." The JAMS Discovery Protocols for Domestic, Commercial Cases ("JAMS Protocols") says that each side may take only three depositions, which shall consume no more than a total of 15 hours. There are to be no speaking objections at depositions, except to preserve privilege, and the total period for taking depositions shall not exceed six weeks, with discretion for the arbitrator to change the numbers as circumstances dictate.

In a recent AAA commercial case that I chaired, the parties agreed - during the Preliminary Hearing - to a limitation of no more than five depositions and a total of 15 hours of total deposition time, with all of them to be completed by a date certain. Similarly, the New York State Bar Association Guidelines for the Arbitrator's Conduct of the Pre-Hearing Phase of Domestic Commercial Arbitrations ("NY State Guidelines")[6] calls for soliciting agreement on language such as the following:

Each side may take *** discovery depositions. Each side's depositions are to consume no more than a total of *** hours. There are to be no speaking objections at the depositions except to preserve privilege. The total period for the taking of depositions shall not exceed *** weeks.[7]

It is usual for the Chair to handle any discovery disputes and to rule on Motions to Compel, and for a date to be fixed for another Pre-Hearing Conference to deal with discovery issues. Many experienced arbitrators believe that it is important for a careful balance to be struck and that concerns about cost and time do not unfairly restrict a party's ability to get relevant and material information that will be essential to its case. Moreover, there are no hard-and-fast rules applicable to all cases; one size does not fit all. The panel

6. *See* DISPUTE RESOLUTION SECTION, NEW YORK STATE BAR ASSOCIATION GUIDELINES FOR THE ARBITRATOR'S CONDUCT OF THE PRE-HEARING PHASE OF DOMESTIC COMMERCIAL ARBITRATIONS AND GUIDELINES FOR THE ARBITRATOR'S CONDUCT OF THE PRE-HEARING PHASE OF INTERNATIONAL ARBITRATIONS, (April 2009) available at: http://www.nysba.org/Sections/Dispute_Resolution/Reports_and_White_Papers/Other_Publications_of_the_Dispute_Resolution_Section.html.

7. *Id.* at 14.

must consider the unique circumstances of the case before them and work with the parties to tailor discovery limitations in a manner that is fair and equitable and achieves the cost and time objectives that are appropriate. [8]

In the troublesome area of electronics documents (ESI), there should be agreement:

1. That, absent compelling reasons, production will be limited to sources in the ordinary course of business, not back-up information;
2. That only generally available technology will be used; and,
3. That where the cost and burden of production is great, the Chair will consider cost-shifting to the requesting party, subject to the allocation of costs in the final Award.[9] Here, too, the concept of proportionality is critical. "The burdens and costs for preservation of potentially relevant information should be weighed against the potential value and uniqueness of the information."[10]

Motions

Sixty-five percent of those polled at the National Arbitration Summit by CCA concluded that excessive, inappropriate or mismanaged motion practice was "moderately" to "very much" responsible for failing to meet their desires for arbitration efficiency and economy.[11] Like discovery, the panel must manage and control motion practice.

Some motions - such as those based upon statutes of limitation, release, contractual limits on damages, statutory remedies and other legal limitations on causes of action - may be entirely in order early on if there are no major questions of fact to be decided. Ruling on them would potentially save time and money by limiting the scope of the arbitration and disposing of matters that more quickly advance the case to resolution. However, if there are factual issues which require extensive discovery or testimony, and which would

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8. *See Id.* Exhibit A at 19 – 21.

9. *See* ARBITRATION DISCOVERY PROTOCOLS, JAMS RECOMMENDED ARBITRATION DISCOVERY PROTOCOLS FOR DOMESTIC, COMMERCIAL CASES (January 6, 2010) available at https://www.jamsadr.com/arbitration-discovery-protocols ; *See also* New York State Protocols at 9-11.

10. *See* Irene C. Warshauer, *Electronic Discovery,* THE NEUTRAL CORNER, Volume 2---2011, *available at* http://www.finra.org/sites/default/files/Publication/p123 535.pdf.

11. *See* Sussman and Underwood, at 8.

require the arbitrators to reserve decision perhaps until the end of the arbitration hearings, such motions should not be permitted by the arbitrators.

Under the Revised Uniform Arbitration Act ("RUAA"),[12] it is clear the arbitrators have the authority to manage the process, including the ability to dispose of claims by motion as long as they give the opposing party notice and a reasonable opportunity to respond, either by legal argument or by showing there are material issues of fact in dispute. Most institutional rules also either expressly or by implication confer that power on the panel.[13]

It has been suggested in the CCA Guide that if motions are to be considered, they should be fleshed out at the Pre-Hearing Conference and not be presented without advance permission from the arbitrators. Oral argument without written submissions is preferred, as well as requiring counsel to confer about whether the motion is really necessary.

JAMS Protocols and NY State Protocols require any party wishing to make a dispositive motion to first submit a brief letter - not to exceed five pages - explaining why the motion is necessary, with opposing counsel having five days to respond. Then the panel decides, and if they go forward with the motion they would place page limits on the briefs and set an accelerated schedule for argument, if any, and disposition. Some common types of motions include those for preliminary relief or interim measures; discovery; bifurcation; motions in limine (not favored under most circumstances); sanctions; and, continuance. In most cases, the criterion is whether granting the motion will reduce costs and streamline the process.

FINRA rules on dispositive motions have been very restrictive since early 2009 when the SEC approved new rules significantly limiting their use. For dispositive motions filed *before* the conclusion of a party's case-in-chief, the rule, among other things, limits the grounds to:

1. The non-moving party has signed a settlement and release;
2. The moving party was not associated with the account, security or conduct at issue;

12. *See, e.g.* Fla. Stat. Ann. §§ 682.01 to -.25 (2018); RUAA Section 15, *available at* http://www.uniformlaws.org/shared/docs/arbitration/arbitration_final_00.pdf

13. *See* Alfred G. Ferris and W. Lee Biddle*, AAA Handbook on Arbitration Practices, Second Edition*, Chapter 23, The Use of Dispositive Motions in Arbitration; *see also* Gary L. Benton, Joseph F. Canterbury, Jr., Deborah A. Coleman, Louise E. Dembeck, Eugene I. Farber, A. Holt Gwyn, Carroll E. Nessemann, Robert W. Wachsmuth, and Dana Welsh, *College of Commercial Arbitrators Guide to Best Practices in Commercial Arbitration, Fourth Edition*, 2017 — Chapter 7, Motions.

3. The claim does not meet the criteria of the eligibility rules.[14]

FINRA advises that from 2015 to 2018 Motions to Dismiss are trending down each year, and speculates that the provision of sanctions in the rule against those who engage in abusive motion practice may have had something to do with the decrease.

Hearing Preparation

The Pre-Hearing Conference must set dates, location and the first day starting time for the substantive hearing, and for the exchange of information regarding witness and exhibit lists, usually 15 to 20 days before the first day of the hearing. (It is good practice to specify whether "days" means business or calendar days so that everyone knows exactly what is required.)

As to the hearing dates, it is prudent, after asking counsel how many days they will need and reaching agreement, to consider adding one extra day for safety and/or for the panel to meet and have an initial conference on the case. This is especially important if the panelists are from different cities. You don't want an adjourned hearing if you can avoid it because it is disruptive to an orderly hearing and to the decision-making process. On the other hand, because the presentation of evidence often expands to fill the time available, it is important that counsel understand that the dates are firm and that counsel will be held to their estimates of time. ("An attorney's hour" should be equivalent to a layman's hour.) Moreover, it should be made clear to the attorneys that the trial dates will not be changed unless there is good cause shown. Some arbitrators and arbitration providers specify in their agreements that arbitrators will be paid in full for scheduled time if a cancellation is not requested and approved within 30 or more days in advance.

The AAA Pre-Hearing Checklist[15] specifies that witness lists must include the name and title of the witness and a short summary of anticipated testimony, together with a CV of expert witnesses. Exhibits have to include everything that is to be offered at the hearing (reports, summaries, diagrams and charts, says the AAA Checklist), pre-marked for identification. To avoid "arbitration by ambush," *all exhibits* include those that could be used on direct examinations and cross examinations. The parties should be encouraged and directed to confer on the preparation of joint exhibits as well.

14. *See* FINRA, Rule 12504(a) (2018) and FINRA, Rule 12206(a) (2018).

15. www.adr.org/commercial/preliminaryhearingprocedures/checklist.

In my experience, though some arbitrators and counsel disagree, I find a Stipulation of Uncontested Facts to be unnecessary and rarely ask for it unless counsel or my fellow panelists think it is desirable. I have not seen it used at FINRA arbitrations, but when used elsewhere it occasionally leads to contentious disagreements between and among counsel, and in my view has limited value, and often requires a lot of work and time by counsel that can be put to better use. The panel usually learns very quickly what facts are disputed and what are agreed without such a Stipulation. And, from my experience, in most arbitrations there are only a handful of dispositive issues.

While FINRA provides for digital recording of hearings, in other fora there must be a discussion of the need and cost for a stenographic record. In many instances, the decision on that subject is reserved until closer to the time the substantive hearings begin. It is good practice to specify a firm date by which the parties will advise the panel of their decision on the subject.

The form of Award should be discussed and definitions for each - Standard, Reasoned, or Findings of Fact and Conclusions of Law - should be reviewed by the Chair to make sure everyone knows exactly what they will be getting. It is common practice that AAA arbitrators issue reasoned or explained Awards and for parties in a FINRA arbitration to receive an Award without an explanation as to how the arbitrators came to their conclusion, unless both parties request it.

FINRA has a voluntary direct communication provision in the Code of Arbitration Procedure permitting written materials to be exchanged between the parties and the arbitrators without going through a case manager.[16] The Case Management Order usually specifies the types of documents that may be sent and how they shall be sent, and the procedure can be terminated by any party or arbitrator at any time. From my experience, Chairs in FINRA Initial Pre-Hearing Conferences often skip this provision in the script or rule, without discussion, so direct communication will not be permitted in the case, and I really don't know why that is so. Yes, with the advent of and enhancements to FINRA's Portal, there is less of a need for direct communications, but it is still, a procedure that parties should be encouraged to consider since it is automatically done, and successfully so, at the AAA.

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16. *See* FINRA, RULE 12211 (2018) and FINRA, RULE 13211 (2018).

Case Management Order

The Pre-Hearing Conference usually results in a Case Management Order that records the agreements reached and conclusions made. It is good practice for the Chair to circulate a draft of the Order to the co-panelists for review and comments, and when its contents are agreed to by all the panelists, it should then be forwarded to the Case Manager for distribution to the parties (unless it is the rare instance of a FINRA arbitration with direct communication). If the Order specifies a time line extending out over many months, the panel may want to consider scheduling additional Pre-Hearing Conferences if needed to check on the case's progress and make sure things are on track.

Closing Comments

This article and most contemporary commentary on best practices in arbitration emphasize the need for what has been characterized as "muscular" management by the arbitrators to make sure the objectives of party autonomy and choice are balanced by those of fairness and cost and time control, and that a litigation mindset does not take control of events. The place to lay the foundation for that is the Pre-Hearing Conference.

While this article has not been about management of the hearing, experienced practitioners know that arbitrators have the ability to assert control at all times regarding deadlines and commitments made during the Pre-Hearing Conference. As noted in the NY State Guidelines, "The arbitrator has many tools that can be used both to enforce the fairness of the proceedings and to prevent disruption in the rare case. Those tools may include, for example, the making of adverse factual inferences against a party that has refused to come forward with required evidentiary materials on an important issue, the preclusion of proof, and/or the allocation of costs … it may be possible to award attorneys' fees and in extreme cases other monetary sanctions against an obstructing party … and possibly even against obstructing counsel. Sanctions may even include the resolution of a claim or defense against a party."[17]

While the theme at the Pre-Hearing Conference should be one of cooperation and respect between counsel, they must be reminded that all dates

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17. *See* NEW YORK STATE BAR ASSOCIATION GUIDELINES FOR THE ARBITRATOR'S CONDUCT OF THE PRE-HEARING PHASE OF DOMESTIC COMMERCIAL ARBITRATIONS AND GUIDELINES FOR THE ARBITRATOR'S CONDUCT OF THE PRE-HEARING PHASE OF INTERNATIONAL ARBITRATIONS, at 12 - 13.

and issues in the Case Management Order are to be kept unless there is good cause shown. If necessary - and usually it is not this early in the case - parties can also be reminded of the possible sanctions they will face if they do not meet their commitments.

FALSE CONFLICTS: A 50-STATE SURVEY OF BLUE SKY LAWS

Jesse Stewart, Esq.

Cross-jurisdictional disputes frequently involve questions regarding which state's (or states') laws should govern. Choice-of-law issues most obviously arise in multi-state class-action litigation, with class-action defendants asserting that differences among state laws defeat certification. Similar issues arise in other contexts, however (including arbitration) where the rule-maker's choice-of-law decision can materially impact a defendant's liability, as well as the claimant's opportunity to recover interest, costs, and attorneys' fees.[1]

The first step in every choice-of-law analysis (regardless of jurisdiction or venue) is to determine whether an *actual* conflict exists among the laws of the various states.[2] If the laws are materially the same, there is no actual conflict and the choice-of-law "issue" disappears.[3] Defendants raising choice-of-law challenges emphasize differences among state laws, but this focus obscures the reality, particularly as to Blue Sky Laws. In fact, *all* Blue Sky Laws are "additive"—i.e., intended to supplement other remedies available to defrauded investors.[4] Thus, for example, regardless of differences regarding the scope of

1. *E.g.*, In the Matter of the Arbitration Between: Claimant, Kirk A. Nelson, FINRA No. 17-00712, 2018 WL 2980927, at *2 (June 6, 2018) (decision whether to apply Nebraska's or Missouri's Blue Sky Law determined claimant's ability to recover interest, costs, and attorneys' fees).

2. Phillips Petroleum Co. v. Shutts, 472 U.S. 797, 816 (1985) ("We must first determine whether Kansas law conflicts in any material way with any other law which could apply. There can be no injury in applying Kansas law if it is not in conflict with that of any other jurisdiction connected to this suit.").

3. *Id.*; *see also* Hurtado v. Superior Court, 522 P.2d 666, 669 (Cal. 1974) ("The fact that two states are involved does not in itself indicate that there is a 'conflict of laws' or 'choice of law' problem. There is obviously no problem where the laws of the two states are identical.").

4. *E.g.*, Cromeans v. Morgan Keegan & Co., 303 F.R.D. 543, 556–57 (W.D. Mo. 2014)("[T]he putative Plaintiffs' claim under the Missouri Blue Sky Law is additive and does not diminish their rights under other security laws."); *see also e.g.*, Fed. Hous. Fin. Agency v. Deutsche Bank AG, 903 F. Supp. 2d 285, 291 (S.D.N.Y. 2012) (despite not providing a private right of action under New York's Blue Sky Law (the Martin Act), "New York has no interest in precluding claims" under other states' Blue Sky Laws).

aider liability under various Blue Sky Laws, there are no *actual* conflicts because every state's securities laws are intended to complement remedies available under other laws.[5]

Stated differently, Blue Sky Laws "do not present a conflict-of-laws problem"[6] because *all* states' securities statutes share the same interests of protecting consumers from fraudulent securities transactions *and* preventing their territories from becoming bases of operation "for purveyors of fraudulent securities."[7] Thus, the relevant inquiry for application of any given state's Blue Sky Law is simply whether that jurisdiction "has a significant contact or significant aggregation of contacts, creating state interests, such that choice of its law is neither arbitrary nor fundamentally unfair."[8]

This article provides a survey of U.S. Blue Sky Laws. First, it provides the statutory and caselaw citations establishing that all Blue Sky Laws are "additive" and intended to supplement other remedies available to investors.

Second, it provides a chart of the relevant statutes of limitations for all states' Blue Sky Laws. Arguably, an expired statute of limitations or repose may be an exception to the general rule that Blue Sky Laws do not present a conflict-of-laws problems.[9]

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5. *See Cromeans*, 303 F.R.D. at 556-57; *Deutsche Bank*, 903 F. Supp. 2d at 291.

6. Simms Inv. Co. v. E.F. Hutton & Co. Inc., 699 F. Supp. 543, 545 (M.D.N.C. 1988); *see also* In re BP p.l.c. Sec. Litig., No. 10-MD-2185, 2013 WL 5520067, at *9 (S.D. Tex. Sept. 30, 2013) (citing cases).

7. *Cromeans*, 303 F.R.D. at 556 (citing cases).

8. *Cromeans*, 303 F.R.D. at 556.

9. *Cf.* California Pub. Employees' Ret. Sys. v. ANZ Sec., Inc., 137 S. Ct. 2042, 2055 (2017) ("The 3–year time bar in § 13 of the Securities Act is a statute of repose. Its purpose and design are to protect defendants against future liability. The statute displaces the traditional power of courts to modify statutory time limits in the name of equity. Because the American Pipe tolling rule is rooted in those equitable powers, it cannot extend the 3–year period.").

<table>
<tr><td colspan="2"><u>50 State Survey I: Blue Sky Laws (Scope & Purpose)</u>
Blue Sky Laws supplement remedies available under other sources of law, are remedial in nature, and are intended to be given the widest possible construction.</td></tr>
<tr><th>State Savings clause</th><th>Construction</th></tr>
<tr><td colspan="2">Alabama</td></tr>
<tr><td>Ala. Code § 8-6-19(i) (“The rights and remedies provided by this article are in addition to any other rights or remedies that may exist.”)</td><td>Gilford Partners v. Pizitz, 630 So. 2d 404, 406-07 (Ala. 1993) (“[T]he general view is that blue sky laws, being enacted for the protection of the public, should be liberally construed to effectuate that purpose . . . .”)</td></tr>
<tr><td colspan="2">Alaska</td></tr>
<tr><td>Alaska Stat. Ann. § 45.55.930(i) (“The rights and remedies provided by this chapter are in addition to any other rights or remedies that may exist, but this chapter does not create a cause of action not specified in this section or AS 45.55.040(f).”).</td><td>Caucus Distributors, Inc. v. State, Dep’t of Commerce & Econ. Dev., Div. of Banking, Sec. & Corporations, 793 P.2d 1048, 1053 (Alaska 1990) (“The primary purpose of Alaska’s Blue Sky law is to protect the unwary and unsophisticated members of the general public from deceit and fraud in securities transactions.”)</td></tr>
<tr><td colspan="2">Arizona</td></tr>
<tr><td>Ariz. Rev. Stat. Ann. § 44-2005 (“Nothing in this article shall limit any statutory or common law right of any person in any court for any act involved in the sale of securities.”)</td><td>Sell v. Gama, 295 P.3d 421, 423-24 (Ariz. 2013) (“The legislature intended the [Arizona Securities Act] as a remedial measure for the protection of the public and therefore specified that the act be liberally construed. The ASA’s language confirms a broad intent to sanction wrongdoing in connection with the purchase or sale of securities.”)</td></tr>
<tr><td colspan="2">Arkansas</td></tr>
<tr><td>Ark. Code Ann. § 23-42-108 (“The rights and remedies provided by this chapter are in</td><td>Casali v. Schultz, 732 S.W.2d 836, 837 (Ark. 1987) (observing that the Arkansas Securities Act “is remedial</td></tr>
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addition to any other rights that may exist at law or in equity.”)	and should be liberally construed to afford protection to the public”).
California	
Cal. Corp. Code § 25510 (“**Nothing in this chapter shall limit** any liability which may exist by virtue of any other statute or under common law if this law were not in effect.”)	*People ex rel. Bender v. Wind River Mining Project*, 269 Cal. Rptr. 106, 111 (Cal. Ct. App. 1990) (“The purpose of [the California Blue Sky Law] . . . is to protect the public against spurious schemes, however ingeniously devised, to attract risk capital, and that goal cannot be permitted to be vitiated by inventive substitutes for conventional means of attracting risk capital. Consequently, as we have noted, in determining whether a transaction is a security courts must consider substance rather than form. The determination must be made on a case-by-case basis after consideration of all of the surrounding facts and circumstances and with attention to the regulatory purpose of the [Blue Sky] Law.”)
Colorado	
Colo. Rev. Stat. Ann. § 11-51-604(12) (“The rights and remedies provided by this article may be pleaded and proved in the alternative and **are in addition to** any other rights or remedies that may exist at law or in equity, but this article does not create any cause of action not specified in this section or section 11-51-602.”)	*People v. Pahl*, 169 P.3d 169, 185 (Colo. App. 2006) (“Because one of the goals of Colorado’s securities statutory scheme is to address all potential fraud, its provisions are interpreted broadly, like their federal counterparts.”)

Connecticut	
Conn. Gen. Stat. Ann. § 36b-29(j) ("The rights and remedies provided by sections 36b-2 to 36b-34, inclusive, **are in addition to** any other rights or remedies that may exist at law or in equity.")	*Connecticut Nat. Bank v. Giacomi*, 699 A.2d 101, 133 (Conn. 1997) ("The comprehensive statutory scheme of CUSA, commonly known as the 'blue sky law,' was adopted for the protection of investors in this state and they should be broadly and liberally construed so as to effectuate the purpose of protecting the investing public from fraud.")
District of Columbia	
D.C. Code § 31-5606.05(j) ("The rights and remedies provided by this chapter shall be **in addition to** any other rights or remedies that may exist at law or in equity, but this chapter does not create a cause of action not specified in this section or authorized under the bonding requirements of § 31-5602.03(h).")	D.C. Code § 31-5601.02(a) ("The purpose of this chapter is to protect investors and maintain public confidence in securities markets while avoiding unreasonable burdens on participants in capital markets. This chapter is remedial in nature and is to be broadly construed to effectuate its purposes.")
Delaware	
Del. Code Ann. tit. 6, § 73-605(h) ("The rights and remedies provided by this chapter **are in addition to** any other rights or remedies that may exist at law or in equity.")	*Hubbard v. Hibbard Brown & Co.*, 633 A.2d 345, 349 (Del. 1993) ("The purpose of the Delaware Securities Act is to prevent the public from being victimized by unscrupulous or overreaching broker-dealers, investment advisors or agents in the context of selling securities or giving investment advice." (quotation marks omitted)).

Florida	
Fla. Stat. Ann. § 517.241(2) ("**Nothing in this chapter limits** any statutory or common-law right of a person to bring an action in a court for an act involved in the sale of securities or investments, or the right of the state to punish any person for a violation of a law.")	*Arthur Young & Co. v. Mariner Corp.*, 630 So. 2d 1199, 1203 (Fla. 4th DCA 1994) ("The legislative purpose of the Florida Securities and Investor Protection Act was, as its title makes clear, to protect the public from fraudulent and deceptive practices in the sale and marketing of securities. As such, it is to be given a broad and liberal interpretation to effectuate its purpose.")
Georgia	
Ga. Code Ann. § 10-5-58(m) ("The rights and remedies provided by this chapter **are in addition to** any other rights or remedies that may exist, but this chapter does not create a cause of action not specified in this Code section or subsection (e) of Code Section 10-5-40.")	*Gilbert v. Meason*, 222 S.E.2d 835, 837 (Ga. Ct. App. 1975) ("[S]tate security laws are an expression by the General Assembly of a statutory policy affording broad protection to investors and are remedial in nature and should be liberally construed.")
Hawaii	
Haw. Rev. Stat. § 485A-509(m) ("The rights and remedies provided by this chapter **are in addition to** any other rights or remedies that may exist.")	*Am. Sav. Bank, F.S.B. v. UBS PaineWebber, Inc.*, 250 F. Supp. 2d 1254, 1257 (D. Haw. 2003) ("[T]he overriding purpose of Hawaii's Uniform Security Act [is] to afford greater protection to purchasers of securities by making available to them pertinent information concerning the security and the issuer thereof.")

Idaho	
Idaho Code Ann. § 30-14-509(m) ("Survival of other rights or remedies. The rights and remedies provided by this chapter **are in addition to** any other rights or remedies that may exist, but this chapter does not create a cause of action not specified in this section or section 30-14-411(e), Idaho Code.")	*Ashley & Rumelin, Bankers, v. Brady*, 238 P. 314, 315 (Idaho 1925) ("[T]he Blue Sky Law comes within the police power of the state, and the intent of the framers of the law was to protect the public.")
Illinois	
815 Ill. Comp. Stat. Ann. 5/14(C) ("**No prosecution for violation of any provision of this Act shall bar or be barred by any prosecution for the violation of any other provision of this Act or of any other statute** ….")	*People v. Bartlett*, 690 N.E.2d 154, 156 (Ill. App. 2d 1998) ("The objective of the Act is to protect innocent persons who may be induced to invest their money in speculative enterprises over which they have little control, and the Act must be liberally construed to better protect the public from deceit and fraud in the sale of securities.")
Indiana	
Ind. Code Ann. § 23-19-5-9(j) ("The rights and remedies provided by this article are **in addition to** any other rights or remedies that may exist.")	*Poyser v. Flora*, 780 N.E.2d 1191, 1193-95 (Ind. Ct. App. 2003) ("By legislative design, the Act protects the public by preventing dishonest promoters from selling financial schemes to unwary investors who have little or no knowledge of the realistic likelihood of the success of their investments. . . . Whether a security is involved or not depends upon the economic realities of the transaction in light of Congressional intent.")

Iowa	
Iowa Code Ann. § 502.509(13) ("Survival of other rights or remedies. The rights and remedies provided by this chapter are **in addition to** any other rights or remedies that may exist, but this chapter does not create a cause of action not specified in this section or section 502.411, subsection 5.")	*Midwest Mgmt. Corp. v. Stephens*, 291 N.W.2d 896, 901 (Iowa 1980) ("The general purpose of blue sky laws is to protect the public from deceit perpetrated in the sale of securities. Those laws should be liberally construed to effectuate their purpose.")
Kansas	
Kan. Stat. Ann. § 17-12a509(m) ("Survival of other rights or remedies. The rights and remedies provided by this act are **in addition to** any other rights or remedies that may exist, but this act does not create a cause of action not specified in this section or K.S.A. 17-12a411(e), and amendments thereto.")	*Taylor v. Perdition Minerals Grp., Ltd.*, 244 Kan. 126, 132, 766 P.2d 805, 809 (Kan. 1988) ("Blue Sky provisions are to be liberally interpreted in favor of purchasers to prevent fraud.")
Kentucky	
Ky. Rev. Stat. Ann. § 292.480(8) ("The rights and remedies provided by this section are **in addition to** any other rights or remedies that may exist at law or in equity.")	*First State Bank of Pineville v. Wilson*, 55 S.W.2d 657, 658 (Ky. 1932) ("No trick, device, subterfuge or pretense shall be allowed to evade the operation or defeat the purpose of [the Kentucky Blue Sky] law, and its provisions shall be liberally construed in order that the purpose and intention of the act to protect the public from fraud, deceit, and imposition in the sale of the securities referred to in this act, may be carried out.")

Louisiana	
La. Rev. Stat. Ann. 51:714(E) (“**Nothing in this Part shall limit** any statutory or civil right of any person to bring action in any court for any act involved in the sale of securities or the right of this state to punish any person for any violation of any law.”)	*Godair v. Place Vendome Corp. of Am.*, 648 So. 2d 440, 444, (La. App. 1 Cir. 1994) (“The central purpose of [the Lousiana Blue Sky law] is to protect investors through the requirement of full disclosure by issuers of securities.”)
Maine	
Me. Rev. Stat. tit. 32, § 16509 (“Survival of other rights or remedies. The rights and remedies provided by this chapter **are in addition to** any other rights or remedies that may exist, but this chapter does not create a cause of action not specified in this section or section 16411, subsection 5.”)	Me. Rev. Stat. tit. 32, § 11209 (“This chapter may be construed and implemented to effectuate its general purpose to protect investors, to prevent and prosecute illegal and fraudulent schemes involving commodity contracts and to maximize coordination with federal and other states’ laws and the administration and enforcement of those laws.”)
Maryland	
Md. Code Ann., Corps. & Ass’ns § 11-703(i) (“The rights and remedies provided by this title **are in addition to** any other rights or remedies that may exist at law or in equity, but this title does not create any cause of action not specified in this section or § 11-410 of this title.”)	Md. Code Ann., Corps. & Ass’ns § 11-804 (“This title shall be construed to effectuate its general purpose to make uniform the law of those states which enact it and to coordinate the interpretation and administration of this title with the related federal regulation.”) *Lubin v. Beneficial Assurance, Ltd.*, No. 24-C-02-006515, 2006 WL 5781983, at *17 (Md. Cir. Ct. July 21, 2006) (“The purpose of the [Maryland Securities] Act and the Division of Securities, like their federal counterparts, is to protect the investing public.”)

Massachusetts	
Mass. Gen. Laws Ann. ch. 110A, § 410(h) ("The rights and remedies provided by this chapter **are in addition to** any other rights or remedies that may exist at law or in equity, but this chapter does not create any cause of action not specified in this section.")	*Marram v. Kobrick Offshore Fund, Ltd.*, 809 N.E.2d 1017, 1025-26 (Mass. 2004) "(The [Massachusetts Securities Act's] thrust is both redressive and preventive. It aims, of course, to compensate the buyer for a loss. More importantly, it creates a strong incentive for sellers of securities to disclose fully all material facts about the security. . . . The act seeks not only to secure accuracy in the information that is volunteered to investors, but also, and perhaps more especially to compel disclosure of significant matters that were heretofore rarely, if ever, disclosed." Thus, the act provides strong protections for a buyer who received misleading information from a seller of securities.")
Michigan	
Mich. Comp. Laws Ann. § 451.2509(13) ("The rights and remedies provided by this act **are in addition to** any other rights or remedies that may exist, but this act does not create a cause of action not specified in this section or section 411(5).")	*Eichbauer v. U.S. Fid. & Guar. Co.*, 270 N.W. 829, 831 (Mich. 1937) ("[T]he Blue Sky Law should be liberally construed, its purpose being to prevent deception in the purchase of securities . . . .:)
Minnesota	
Minn. Stat. Ann. § 80A.76(m) ("Survival of other right or remedies. The rights and remedies provided by this chapter are **in addition to** any other rights or remedies that may exist, but this chapter does not create a cause of	*State v. Lorentz*, 22 N.W.2d 313, 315 (Minn. 1946) ("The [Minnesota Blue Sky] statute is liberally construed to effectuate its purpose.").

action not specified in this section or section 80A.66(e).")	
Mississippi	
Miss. Code. Ann. § 75-71-731 ("The rights and remedies provided by this chapter are **in addition to** any other rights or remedies that may exist at law or in equity.")	*First Mobile Home Corp. v. Little*, 298 So. 2d 676, 681 (Miss. 1974) (endorsing "the liberal interpretation generally given to the blue sky laws").
Missouri	
Mo. Ann. Stat. § 409.5-509(m) ("The rights and remedies provided by this act are **in addition to** any other rights or remedies that may exist, but this act does not create a cause of action not specified in this section or section 409.4-411(e).")	*Cromeans v. Morgan Keegan & Co.*, 303 F.R.D. 543, 557 (W.D. Mo. 2014) ("The Court liberally and broadly construes Missouri's Blue Sky law, to effect its intended remedial purposes of protecting investors in securities transactions and ensuring that the state's territory is not used as a basis of operation for purveyors of fraudulent securities.")
Montana	
Mont. Code Ann. § 30-10-102 ("Parts 1 through 3 of this chapter shall be construed to:(1) protect the investor, persons engaged in securities transactions, and the public interest;(2) promote uniformity among the states; and(3) encourage, promote, and facilitate capital investment in Montana."); Mont. Code Ann. § 30-10-307(1) ("Any person who offers or sells a security in violation of 30-10-202 or offers or sells a security by means of fraud or misrepresentation is liable to the person buying the security from	*State v. Duncan*, 593 P.2d 1026, 1033 (Mont. 1979) ("As we have stated, the Securities Act was enacted for remedial purposes and for that reason should be broadly construed.").

the offeror or seller, **who may sue either at law or in equity** to recover . . .")	
Nebraska	
Neb. Rev. Stat. § 8-1122 ("The Securities Act of Nebraska shall be construed as to effectuate its general purpose to make uniform the law of those states which enact it and to coordinate the interpretation and administration of the act with the related federal regulation.")	*State v. Jones*, 453 N.W.2d 447, 451 (Neb. 1990) ("In interpreting the Securities Act of Nebraska, § 8-1122 encourages reference to federal law and the law of other states that have adopted the Uniform Securities Act.").
Nevada	
Nev. Rev. Stat. Ann. § 90.700(2) ("The rights and remedies provided by this chapter are **in addition to** any other rights or remedies that may exist at law or in equity but this chapter does not create any claim for relief not specified in NRS 90.620 to 90.690, inclusive.")	*Sec'y of State v. Tretiak*, 22 P.3d 1134, 1140 (Nev. 2001) ("The underlying policy of the Nevada Uniform Securities Act is to prevent unnecessary loss to investors.")
New Hampshire	
N.H. Rev. Stat. Ann. § 421-B:25(XI) ("The rights and remedies promulgated by this chapter are **in addition to** any other right or remedy that may exist at law or in equity, but this chapter does not create any cause of action not specified in this section or RSA 421-B:8, V.")	N.H. Rev. Stat. Ann. § 421-B:32 ("This chapter shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it and to coordinate the interpretation of this chapter with the related federal regulation.")

New Jersey	
N.J. Stat. Ann. § 49:3-71(j) ("The rights and remedies provided by this act are **in addition to** any other rights or remedies that may exist at law or in equity, but this act does not create any cause of action not specified in this section or subsection (e) of section 10 of P.L.1967, c. 93 (C.49:3-57).")	*Fed. Ins. Co. v. Campbell Soup Co.*, 885 A.2d 465, 469 (N.J. Super. Ct. App. Div. 2005) (admonishing that "the overarching purpose of the securities laws . . . is to protect the investing public").
New Mexico	
N.M. Stat. Ann. § 58-13C-509(M) ("The rights and remedies provided by the New Mexico Uniform Securities Act are **in addition to** any other rights or remedies that may exist, but that act does not create a cause of action not specified in this section or Subsection E of Section 411 of that act.")	*State v. Kirby*, 70 P.3d 772, 778 (N.M. Ct. App. 2003) ("The Securities Act, as a whole, has remedial purpose. It is comprehensive. Its extensive regulatory and administrative provisions are aimed at protecting investors against unfair, deceptive, and fraudulent practices in the sale of securities. Lengthy regulations have been adopted to implement the Act. [] The Act was written with all encompassing strokes to protect the public, and to further the legitimate governmental purpose of protecting the public from the many means promoters may use to separate the unwary from their money. In enacting the Act, our Legislature undoubtedly shared the legislative intent behind the Securities Exchange Act of 1934, which was to insure honest securities markets and thereby promote investor confidence and to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.").

New York	
Fed. Hous. Fin. Agency v. Deutsche Bank AG, 903 F. Supp. 2d 285, 291 (S.D.N.Y. 2012) ("[T]he New York Court of Appeals has recently made clear that, although the Martin Act did not create a private right of action to enforce its provisions, it **does not preclude** a private plaintiff from bringing a securities-related claim rooted in some other source of law.") (citing *Assured Guar. (UK) Ltd. v. J.P. Morgan Inv. Mgmt. Inc.*, 962 N.E.2d 765, 770 (N.Y. 2011))	*All Seasons Resorts, Inc. v. Abrams*, 497 N.E.2d 33, 35 (N.Y. 1986) ("In construing section 352–e(1)(a), we are mindful that the statute, as part of New York's Blue Sky Law, should be liberally construed to give effect to its remedial purpose of protecting the public from fraudulent exploitation in the offer and sale of securities.")
North Carolina	
N.C. Gen. Stat. Ann. § 78A-56(j) ("The rights and remedies provided by this Chapter **are in addition to** any other rights or remedies that may exist at law or in equity, but this Chapter does not create any cause of action not specified in this section or G.S. 78A-37(d). If the requirements of Chapter 1D of the General Statutes are met, punitive damages are available to the extent provided in that Chapter.")	*State v. Heath*, 153 S.E. 855, 857 (N.C. 1930) ("The purpose of the [North Carolina Blue Sky Law] . . . is to protect the public against the imposition of unsubstantial schemes and the securities based upon them." (quotation marks omitted)).

North Dakota	
N.D. Cent. Code Ann. § 10-04-17(4) ("**Nothing in this chapter shall limit** any statutory or common-law right of any person in any court for any act involved in the sale of securities.")	*State v. Goetz*, 312 N.W.2d 1, 5 (N.D. 1981)"The purpose of the [North Dakota] Securities Act is not only to prevent fraud or deception but also to prevent the disposal of securities on unfair terms, or where the proposed plan of business appears to be unfair, unjust, or inequitable. Within the Act is a three-part framework for protecting investors and the public. The first part regulates securities. It is unlawful to offer for sale or to sell securities in North Dakota unless they are either registered with the Securities Commissioner or are within an exemption. The second part regulates the people who offer, sell, or provide security-investment advice. They must register with the Securities Commissioner unless a transactional exemption exists. The third part prohibits fraud when securities are offered for sale, sold, or purchased, or when security advice is given.")

Ohio	
Ohio Rev. Code Ann. § 1707.40 ("Except as provided in section 1707.261 of the Revised Code, sections 1707.01 to 1707.45 of the Revised Code create no new civil liabilities, and **do not limit or restrict common law liabilities** for deception or fraud other than as specified in sections 1707.042, 1707.043, 1707.41, 1707.42, and 1707.43 of the Revised Code, and there is no civil liability for noncompliance with orders, requirements, rules, or regulations made by the division of securities under sections 1707.19, 1707.20, 1707.201, and 1707.23 of the Revised Code.")	*In re Columbus Skyline Sec., Inc.*, 660 N.E.2d 427, 429 (Ohio 1996) ("The Ohio Securities Act, generally referred to as Ohio Blue Sky Law, was adopted on July 22, 1929 to prevent the fraudulent exploitation of the investing public through the sale of securities. Many of the enacted statutes are remedial in nature, and have been drafted broadly to protect the investing public from its own imprudence as well as the chicanery of unscrupulous securities dealers. In order to further the intended purpose of the Act, its securities anti-fraud provisions must be liberally construed.")
Oklahoma	
Okla. Stat. Ann. tit. 71, § 1-509(M) ("The rights and remedies provided by this act are **in addition to** any other rights or remedies that may exist, but this act does not create a cause of action not specified in this section.")	*Hornaday v. State*, 208 P. 228, 231 (Okla. Crim. App. 1922) ("The objects [of the Oklahoma Blue Sky Law] are to prevent fraud and unfair dealing in securities, as well as to prevent honest people, free from sinister influences, from investing in uncertain, ephemeral, 'get-rich-quick' stocks and securities. In other words, it is a statute designed in part to protect credulous persons against their own inherent weakness--a weakness akin to the gambler's hope of winning a prize. We think it is now well settled that both of these objects, within constitutional bounds, properly come within regulations prescribed by the police power of the state. Clearly the state

	has the right to protect its citizens against impositions and frauds.")
Oregon	
Or. Rev. Stat. Ann. § 59.365 ("**Nothing in the Oregon Securities Law limits** any statutory or common-law right of a person to bring an action in any court for an act involved in the sale of securities, or the right of the state to punish a person for a violation of any law.")	*Adams v. Am. W. Sec., Inc.*, 524, 510 P.2d 838, 842 (Or. 1973) ("[T]he Oregon Blue Sky Law . . . is to be liberally construed to afford the greatest possible protection to the public.")
Pennsylvania	
70 Pa. Cons. Stat. Ann. § 1-506 ("Except as explicitly provided in this act, no civil liability in favor of any private party shall arise against any person by implication from or as a result of the violation of any provision of this act or any rule or order hereunder. **Nothing in this act shall limit** any liability which might exist by virtue of any other statute or under common law if this act were not in effect.")	*Lenau v. Co-eXprise, Inc.*, 102 A.3d 423, 436 (Pa. Super. Ct. 2014) ("The Pennsylvania Securities Act is remedial legislation. Its primary purpose is to protect the investing public. . . . And the clear intent of the Act is not to be defeated by a too literal reading of words without regard to their context and the evils which the Act clearly was designed to correct.")
Puerto Rico	
10 L.P.R.A. § 890(h) ("The rights and remedies provided by this chapter **are in addition to** any other rights or remedies that may exist at law, but this chapter does not create any cause of action not specified in this section or § 862(e) of this title.")	10 L.P.R.A. § 895 ("This chapter shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it and to coordinate the interpretation and administration of this chapter with the related federal regulation."
Rhode Island	
R.I. Gen. Laws Ann. § 7-11-608(b) ("The rights and remedies provided by this chapter are **in addition to** any other rights or remedies that exist at law or in	*State v. Pullen*, 192 A. 473, 476 (R.I. 1937) ("In construing [the Rhode Island Blue Sky Law], we should, in view of the evil it seeks to eradicate and the public policy it is designed

equity, but this chapter does not create any claim for relief not specified in this part.”)	to promote, consider it primarily and essentially as remedial in its nature, and give to it a liberal construction.”)
South Carolina	
S.C. Code Ann. § 35-1-509(m) (“The rights and remedies provided by this chapter are **in addition to** any other rights or remedies that may exist, but this chapter does not create a cause of action not specified in this section or Section 35-1-411(e).”)	*McGaha v. Mosley*, 322 S.E.2d 461, 464 (S.C. Ct. App. 1984) (“Since the securities laws are remedial in nature, courts have uniformly held they should be liberally construed to protect investors.”)
South Dakota	
S.D. Codified Laws § 47-31B-509(m) (“Survival of other rights or remedies. The rights and remedies provided by this chapter are **in addition to** any other rights or remedies that may exist, but this chapter does not create a cause of action not specified in this section or § 47-31B-411(e).”)	*State v. Nagel*, 279 N.W.2d 911, 915 (S.D. 1979) (“The purpose of the Blue Sky laws is for the protection of the public. It is a public welfare statute. [] The statute is remedial in its nature, and was passed to protect the inexperienced, confiding, and credulous investor, and save him from his own foolish cupidity. It should therefore be liberally and sympathetically construed in order that its beneficent purpose may, so far as possible, be attained.”)
Tennessee	
Tenn. Code Ann. § 48-1-122(j) (“The rights and remedies under this part are **in addition to** any other rights or remedies that may exist at law or in equity.”)	*DeWees v. State*, 390 S.W.2d 241, 242 (Tenn. 1965) (“Securities acts, such as the one herein involved, popularly called ‘blue-sky laws’, prohibiting the unfettered sale of stocks, bonds, or other securities, are in effect in Federal jurisdictions as well as practically all State jurisdictions. Such acts are remedial in character, designed to prevent frauds and impositions upon the

	public, and consequently should be liberally construed to effectuate the purpose of the acts.”)
Texas	
Tex. Rev. Civ. Stat. Ann. art. 581-33(M) (“Saving of Existing Remedies. The rights and remedies provided by this Act **are in addition to** any other rights (including exemplary or punitive damages) or remedies that may exist at law or in equity.”)	*Flowers v. Dempsey-Tegeler & Co.*, 472 S.W.2d 112, 115 (Tex. 1971) (“Section 33 . . . is **remedial** in nature [and] should be given the widest possible scope.”)
Utah	
Utah Code Ann. § 61-1-22(10)(a) (“The rights and remedies provided by this chapter are **in addition to** any other rights or remedies that may exist at law or in equity.”)	*Mem’l Gardens of the Valley, Inc. v. Love*, 300 P.2d 628, 629 (Utah 1956) (recognizing “considerable merit” in “the . . . view . . . that the [Utah Blue Sky] statute should be liberally construed to effectuate its purposes”).
Vermont	
Vt. Stat. Ann. tit. 9, § 5509(m) (“The rights and remedies provided by this chapter are **in addition to** any other rights or remedies that may exist, but this chapter does not create a cause of action not specified in this section or subsection 5411(e) of this chapter.”)	*Powell v. H.E.F. P’ship*, 793 F. Supp. 91, 96 (D. Vt. 1992) (“Remedial statutes [including the Vermont Securities Act] are to be liberally construed.”).
Virginia	
Va. Code Ann. § 13.1-522(G) (“The rights and remedies provided by this chapter shall be **in addition to** any and all other rights and remedies that may exist at law or in equity.”)	*Andrews v. Browne*, 662 S.E.2d 58, 62 (Va. 2008) (“The Virginia Securities Act [is] intended to protect investors from fraud in the investment market. . . . [W]e have previously held that the Virginia Securities Act should receive

	"similar construction" as the 1933 and 1934 Acts.")
Washington	
Wash. Rev. Code Ann. § 21.20.900 ("This chapter shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it and to coordinate the interpretation and administration of this chapter with the related federal regulation.")	*Cellular Eng'g, Ltd. v. O'Neill*, 820 P.2d 941, 945 (Wash. 1991) ("The Securities Act of Washington, RCW 21.20, is remedial in nature, its primary purpose being to protect investors from speculative or fraudulent schemes of promoters. We construe the Act broadly in order to effectuate that purpose. The Act is modeled after the Uniform Securities Act of 1956, which has been wholly or substantially enacted in the great majority of states. The Washington Act explicitly provides that it 'shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it and to coordinate the interpretation and administration of this chapter with the related federal regulation.' Therefore we interpret the Act so as to achieve harmony between it, federal law, and the securities laws of those other states that have also modeled their law after the Uniform Securities Act.")
West Virginia	
W. Va. Code Ann. § 32-4-410(h) ("The rights and remedies provided by this chapter are **in addition to** any other rights or remedies that may exist at law or in equity, but this chapter does not create any cause of action not specified in this section or section 202(e).")	W. Va. Code Ann. § 32-4-415 ("This chapter shall be so construed as to effectuate the general purpose to make uniform the law of those states which enact the Uniform Securities Act and to coordinate the interpretation and administration of this chapter with the related federal regulation.")

Wisconsin	
Wis. Stat. Ann. § 551.509(13) ("Survival of other rights or remedies. The rights and remedies provided by this chapter are **in addition to** any other rights or remedies that may exist, but this chapter does not create a cause of action not specified in this section or s. 551.411(5).")	*Klatt v. Guaranteed Bond Co.*, 250 N.W. 825, 829 (Wis. 1933) ("When we consider that the entire purpose of the so-called 'Blue Sky Law' is to protect the investors of this state and to restrain the floatation and sale of improvident securities, it is apparent that the law should receive liberal construction for the purpose of carrying out that very manifest legislative intent.")
Wyoming	
Wyo. Stat. Ann. § 17-4-122(h) ("The rights and remedies provided by this act are **in addition to** any other rights or remedies that may exist at law or in equity, but this act does not create any cause of action not specified in this section or W.S. 17-4-104(e).")	*Gaudina v. Haberman*, 644 P.2d 159, 165 (Wyo. 1982) ("[Blue Sky Laws] are remedial legislation among the central purposes of which is full and fair disclosure relative to the issuance of securities. It is a familiar canon of legislative construction that remedial legislation should be construed broadly.")
U.S. Virgin Islands	
9 V.I.C. § 659(m) ("The rights and remedies provided by this chapter are **in addition to** any other rights or remedies that may exist, but this chapter does not create a cause of action not specified in this section or section 641(e).")	9 V.I.C. § 668 (b) ("In cooperating, coordinating, consulting, and sharing records and information under this section and in acting by rule, order, or waiver under this chapter, the Administrator shall, in the discretion of the Administrator, take into consideration in carrying out the public interest the following general policies:(1) maximizing effectiveness of regulation for the protection of investors;(2) maximizing uniformity in federal and state regulatory standards;

	and(3) minimizing burdens on the business of capital formation, without adversely affecting essentials of investor protection.")
Guam	
T.G.C.A. § 46410(h) ("The rights and remedies provided by this Act are **in addition to** any other rights or remedies that may exist at law or in equity, but this Act does not create any cause of action not specified in this section or § 46202(e).")	*Sec. Adm'r v. Coll. Assistance Plan (Guam) Inc.*, 533 F. Supp. 118, 120 (D. Guam App. Div. 1981) (construing the Guam Uniform Securities Act "broadly to effectuate the remedial purposes of securities legislation").
Federal Authority	
	Chadbourne & Parke LLP v. Troice, 134 S. Ct. 1058, 1069 (2014) (securities laws "should be construed not technically and restrictively, but flexibly to effectuate [their] remedial purposes.") *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972) (stating that securities legislation is meant to be flexibly construed to accomplish its remedial purpose) *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) ("[W]e are guided by the familiar canon of statutory construction that remedial legislation should be construed broadly to effectuate its purposes. [Blue Sky Laws] quite clearly fall[] into the category of remedial legislation. One of [their] central purposes is to protect investors through the requirement of full disclosure by issuers of securities . . . .").

<u>50 State Survey II: Statutes of Limitations (Blue Sky Laws)</u>
Most jurisdictions' Blue Sky Laws provide investors a 2-year statute of limitations.

	Years	States
Blue Sky Laws	**6**	• Florida, Fla. Stat. Ann. § 517.191(7); • New Hampshire: N.H. Rev. Stat. Ann. § 421-B:25(VII)
	5	• Arkansas, Ark. Code Ann. § 23-42-105; • North Dakota, N.D. Cent. Code Ann. § 10-04-17(5)
	4	• Massachusetts, Mass. Gen. Laws Ann. ch. 110A, § 410(e)
	3	• Alaska, Alaska Stat. Ann. § 45.55.930 (f); • Colorado, Colo. Rev. Stat. Ann. § 11-51-604; • District of Columbia, D.C. Code § 31-5606.05(f)(1); • Delaware, Del. Code Ann. tit. 6, § 73-605(e); • Illinois, 815 Ill. Comp. Stat. Ann. 5/14(C); • Indiana, Ind. Code Ann. § 23-19-5-9(g); • Kentucky, Ky. Rev. Stat. Ann. § 292.480(3); • Maryland, Md. Code Ann., Corps. & Ass'ns § 11-703(f); • Nebraska, Neb. Rev. Stat. § 8-1118(4); • North Carolina, N.C. Gen. Stat. Ann. § 78A-56(f); • Oregon, Or. Rev. Stat. Ann. § 59.137(6); • South Carolina S.C. Code Ann. § 35-1-509(j); • Texas, Tex. Rev. Civ. Stat. Ann. art. 581-33(H)(2)(a)–(b); • Washington, Wash. Rev. Code Ann. § 21.20.430(4)(b); • West Virginia, W. Va. Code Ann. § 32-4-410(e)
	2	• Alabama, Ala. Code § 8-6-19(f); • Arizona, Ariz. Rev. Stat. Ann. § 44-2004(C); • Connecticut, Conn. Gen. Stat. Ann. § 36b-29(g); • Georgia, Ga. Code Ann. § 10-5-58(j); • Hawaii, Haw. Rev. Stat. § 485A-509(j); • Idaho, Idaho Code Ann. § 30-14-509(j); • Iowa, Iowa Code Ann. § 502.509 (10);

		• Kansas, Kan. Stat. Ann. § 17-12a509(j); • Louisiana, La. Rev. Stat. Ann. 51:714(C)(1); • Maine, Me. Rev. Stat. tit. 32, § 16509(10); • Michigan, Mich. Comp. Laws Ann. § 451.2509(10); • Minnesota, Minn. Stat. Ann. § 80A.76(j) • Mississippi, Miss. Code. Ann. § 75-71-725; • Missouri, Mo. Ann. Stat. § 409.5-509(j); • Montana, Mont. Code Ann. § 30-10-307(5); • Nevada, Nev. Rev. Stat. Ann. § 90.670; • New Jersey, N.J. Stat. Ann. § 49:3-71(g); • New Mexico, N.M. Stat. Ann. § 58-13C-509(J); • Ohio, Ohio Rev. Code Ann. § 1707.41(D); • Oklahoma, Okla. Stat. Ann. tit. 71, § 1-509(J); • Puerto Rico, 10 L.P.R.A. § 890(e) • South Dakota, S.D. Codified Laws § 47-31B-509(j) • Tennessee, Tenn. Code Ann. § 48-1-122(h); • Utah, Utah Code Ann. § 61-1-22(7)(a); • Vermont, Vt. Stat. Ann. tit. 9, § 5509(j); • Va. Code Ann. § 13.1-522(D); • Wisconsin, Wis. Stat. Ann. § 551.509(2); • Wyoming, Wyo. Stat. Ann. § 17-4-122(e); • U.S. Virgin Islands, 9 V.I.C. § 659(j); • Guam, T.G.C.A. § 46410(e)
	1	• Pennsylvania, 70 Pa. Stat. Ann. § 1-504; • Rhode Island, R.I. Gen. Laws Ann. § 7-11-606
	NA	• New York (New York's Martin Act provides no private right of action)

NOP REDUX

Fred Rosenberg

The conundrum of NOP's (Net Out-Of-Pocket) in securities Arbitration is that its application has been a mishmash of rulings both supported and rejected by Claimants and Respondents alike. Over the past years of rising markets, Respondents typically claim NOP's to be the measure of damages, yet in falling markets (2008-2011), they argued for MAD (Market Adjusted Damages); Claimant's the reverse. MAD and NOPs often vary substantially, particularly if substantial time has elapsed between the losses and the Statement of Claim filing date. Finra Arbitration Panels have awarded both.

Assume a small but thriving Tee-Shirt Silk Screen company, TSSS, with an initial investment of $50,000 for equipment and materials. Over two years TSSS builds $200K in inventory, purchased $50,000 in additional silk screens, paid a 75,000 annual salary and expected to turn a $500,000 profit from World Cup licenses in 2018. Two months before the World Cup, the business manager defects to a competitor, sabotages the inventory triggering a bank foreclosure on the inventory loan permanently ending operations. Assume the Manager is fully liable and agrees to Arbitrate. What are the damages?

The Respondent says there are no damages, Claimant only invested $50,000 and took out $150,000 in salary over two years, which amounts to a net two- year profit of $100,000. This is cash basis accounting (NOP). TSSS on the other hand points to the lost Enterprise Value of the operation, the growth engine behind the business not reflected in NOPs. There is $200,000 in profits reinvested in inventory with a wholesale value of $400,000 lost and ignored by NOP and $50,000 in new equipment all internally financed. The business is scalable, low-cost and can withstand and adapt to market changes. Its capitalized risk-adjusted return indicates an Enterprise value of 2 X EBIDTA (earnings before interest, depreciation, taxes, and amortization) of $600k. Clearly NOPs are not a measure of damages for TSSS in commercial arbitration, but would the outcome be the same in Finra Arbitration?

A principal concern is the treatment of reinvested profits, dividends, and distributions. NOP's make no distinction between return on and return of investment. Yet income investors specifically take on lower market risk for income with the expectation of principal stability from a growing inventory of income producing shares. Valuation of income securities is closely correlated with interest rates, not the SP 500 and growth occurs primarily through dividend reinvestment that increases the inventory of stable producing securities. Every share or unit is an engine of growth, a small enterprise that generates income and growth at identified risk. In the case of TSSS, $250,000 of profits were retained and reinvested in tangible inventory and equipment all of which is recoverable. But, if TSSS invested in an income portfolio instead of silk screens and inventory and reinvested $250,000 in additional shares (DRIPS, dividend reinvestment plans), that $250,000 reinvestment is ignored by NOP and excluded from recovery. A case I am working on should illustrate NOP issues.

Claimants are 6 participants in a $1.5 million pension plan advised by Broker who sets up all accounts primarily for income. Over 8 years the portfolios, 90% C shares, generated $450,000 in dividends all of which was reinvested in additional shares. The Broker then liquidated $450,000 of shares and put them into bad reits and Ponzi offerings effectively losing 8 years of accumulated shares ignored by NOP. Still the overall performance was barely profitable, about 1%/yr. As is evident, there is a huge disparity between NOP and MAD, especially over an 8-year span.

NOP is also a net number, and netting of profits and losses, (if accurately reported) may be inappropriate in cases where defined abuses impair portfolio growth. Traditional account analyses provide two forms of analysis, a reconciliation of the cashflows and a trading account analysis. Both are expected to prove up the NOP and match. The trading P&L plus interest and dividends, less fees and margin should equal the Statement NOP. Both calculations ignore the destruction of a functioning portfolio set up to reinvest and grow organically through share accumulation over several years.

In growth portfolios income may be de-minimis, but income portfolios grow through compounding, reinvesting over time to build the portfolio. In portfolios invested primarily for income, DRIPs accurately measure portfolio return and provide a measure of damages independent of NOP or MAD. In my case, an analysis run only on the $450,000 DRIP cash flow over eight years using a 50/50 allocation grew to over $800,000, illustrating what the account value would have grown by in the absence of the NCI's and their $450,000 trading loss. Can squandering 95% of the accumulated income-producing shares be inoculated from liability by a 1/yr.% overall portfolio profit? If all you review are the NOP confirmation balances, then you ignore any destructive trading activity that specifically diminished returns, and effectively agree to netting losses with gains.

Next, consider that most NCI investments were originally carried at cost and transfers between accounts or out of a portfolio were frequently also reported at cost. NCIs substantially change portfolio risk and liquidity, impair credit, and increase costs. Many older account statements overstate NCI values for months if not years making retroactive adjustments nearly impossible. It also means that the ratios for turnover, fee%, costs, and NOP could be incorrect if based solely upon the statements. If the account analyst properly adjusts for true NCI's value, losses will increase, and trading activity no longer will confirm NOP. In my case, unit prices were retroactively adjusted from $10/sh to $4.00/sh resulting in an additional $250,000 loss not reported in the statements.

Fees and charges reduce return in two ways: 1) they reduce current returns annually, and 2) they reduce the number of shares added to the portfolio permanently impairing future compound growth under a DRIP. Assuming a $1 million investment in mutual fund "C" shares paying a 1% 12b fee, over twenty years it will cost approximately $550,000 of which $390,000 is fees and $160,000 is lost appreciation with average 6% yearly growth. Whether 12b fees on C shares, variable annuity charges, or excess management fees, the impact over time can be substantial even if the portfolio is properly allocated, profitable and suitable.

Claims based on recovery of fees and charges are entirely independent of market performance or portfolio allocation. NTM 03-47 confirms that "Refunds should be made regardless of the performance of the mutual fund purchased by the customer" with interest. Damages are calculable, unrelated to NOP, and should never be conflated with general suitability claims. In my case, excess fees with interest computed to over $90,000.

Class Settlements present another problem for account analysis. If an investor settles in a class action, the impact of those investments in the analysis should be adjusted to reflect actual value or eliminated entirely. In the recent case alluded to above, the claimants held $200,000 in Shale and Medcap investments that were never marked to market. The claimants accepted the class settlement for both and Medcap and Shale were removed from the matched trades analysis including all DRIPs, (dividend reinvestment program). Shale and Medcap values and income remained on the Statements at cost however, and analyses based on them should be adjusted for the class settlement.

Many of the claims I see focus on the suitability of NCI's, the low hanging fruit, to the exclusion of a thorough trading analysis that traces funds, provides support, and identifies potential independent claims such as for fees and costs, fund switching, variable annuities charges and disgorgement. None of those claims are market-based or subject to suitability defenses but are about the impairment of returns through excessive costs and fees, not NOP.

Finally, when reinvested income is a substantial driver of portfolio growth it should always retain its character as income. NOP treats all distributions as principal first when in fact investors believe distributions are income and are taxed as income, and are actually advised to spend them as income. Then, as is common in arbitration after years of living on "income" distributions, the investor first hears that he only "got his money back". As for undistributed and reinvested dividend contributions, those are simply ignored by NOP all of which raises the question, "where's the income?"

STATE-SPECIFIC FIDUCIARY DUTIES AND REGULATING FINANCIAL ADVICE IN THE FUTURE

Jacob Crawley

ABSTRACT

In June 2017, Nevada became the first state to enact statutes to impose a state-specific fiduciary duty to broker-dealers and investment advisers. The action has prompted heated debate as to the challenges that Nevada faces in enforcing these fiduciary duties, including preemption and conflict with the current federal securities law. This Article provides insight into the current fragmented federal regulatory framework of financial advice and posits that state-specific fiduciary duties are entirely permissible. This Article suggests that a uniform fiduciary duty will help retail investors save hundreds of millions of dollars.

I. Introduction

In 2014 Mr. and Mrs. Toffel of Lindenhurst, Illinois were basking in their golden years.[1] The Toffel's were especially fond of their local U.S. Bank branch, and relied on the bank's representatives to invest their lifetime savings of $650,000.[2] When their U.S. Bank financial planner recommended investment in a variable annuity, the elderly couple didn't question the suggestion.[3] Like many consumers throughout the country, the Toffel's believed that their financial planner was legally bound to suggest investment products in their best interest.[4] Like many U.S. consumers, they were wrong.

A financial planner's duties are dependent upon whether they act as a stockbroker ("broker") or a registered investment adviser ("investment adviser"). If the Toffel's financial planner was acting as a broker, he or she need only recommend "suitable" investment products. If acting as an

1. Tara Siegel Bernard, *Before the Advice, Check Out the Adviser*, N.Y. TIMES, Oct. 10, 2014, at BU13.

2. *Id.*

3. *Id.* This particular variable annuity charged a four percent yearly fee, in addition to further fees if the Toffels needed to withdraw their investment more immediately.

4. *Id.*

investment adviser, then the Toffel's financial adviser must recommend products in their "best interests." Was a variable annuity *suitable* for the Toffels? Perhaps. Was a variable annuity in the Toffel's *best interest*? Probably not.[5]

Financial planners, or individuals providing investment advice in exchange for compensation, are regulated dependent upon their registration and their actions. Investment advisers are bound to operate in the client's best interest as required by the Investment Advisers Act of 1940[6] ("Advisers Act"), whereas the Financial Industry Regulatory Authority's ("FINRA") Suitability Rule[7] compels brokers to provide suitable advice to clients. The difference in conduct standards may be the difference between whether a financial planner may recommend the Toffels a variable annuity.

The current financial planner federal regulatory regimes creates inconsistent enforcement and consumer confusion. The Securities and Exchange Commission ("SEC") struggles to define the advisory differences between brokers and investment advisers. Research indicates that even educated consumers often misunderstand the different conduct standards.[8] Consumers, largely unaware of these differences, often rely equally upon broker and investment adviser recommendations.[9]

In addition, mandatory arbitration creates a dearth of judicial precedent.[10] Brokerage or advisory accounts almost always contain mandatory arbitration

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5. The Toffel's investment objectives, due in large part to their age and investment time horizon, would likely be low risk, lower return. This would infer that the need for lower fees is greater. As stated above, this particular annuity charged a four percent yearly management fee. These high fees would erode the Toffel's low returns.

6. *See* Investment Advisers Act of 1940 § 202(11).

7. *See* FINRA RULE 2111 *available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859.*

8. *See generally* Angela A. Hung et al., INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS, RAND Institute for Civil Justice (2008).

9. Gary A. Varnavides, *The Flawed State of Broker-Dealer Regulation And The Case For An Authentic Federal Fiduciary Standard For Broker-Dealers*, 16 FORD. J. CORP. FIN. L. 203, 216 (2011).

10. *See* SEC & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALER, 94-96 (Jan. 2011), *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

clauses.[11] These mandatory arbitrations compel claimants to pursue damages in FINRA's arbitration forum and deprive courts from issuing well-reasoned decisions. The lack of common law precedent leaves little to define conduct standards of financial planners.

In response to continual investment fraud and consumer confusion, the Nevada Legislature enacted statutory law to impose a uniform fiduciary duty on brokers and investment advisers.[12] The legislation removed language that exempted brokers and investment advisers from state-specific fiduciary duties.[13]

This Article explores this first state-specific uniform fiduciary duty rule. Part I examines the possible motives for the Nevada Legislator's bold move in imposing a state regulated fiduciary duty and the challenges that Nevada will subsequently face. These challenges include the threat of preemption by federal law and possible conflicts. Part II analyzes whether other states should follow Nevada's example and impose a uniform fiduciary duty rule to all financial planners. This analysis includes: (1) consideration of the disparate federal regulatory standards between brokers and investment advisers and the fragmentation created therein; (2) the consumer protections available to states that apply a uniform fiduciary duty to brokers and investment advisers; (3) the case precedent dearth; (4) the possibility that a uniform fiduciary rule will create an advice gap; and (5) the SEC's recent proposed rule, Regulation Best Interest, and its impact upon investor protection.

A. Nevada's Regulation of Financial Planners

1. Nevada Revised Statute (NRS) § 628A.010

Towards the end of the twentieth century Nevada legislators sought to protect their citizenry from investment advice outside the consumer's best interest. In 1993 state legislators proposed a bill to apply a state-mandated fiduciary duty to financial planners.[14] The bill applied a higher duty of care to

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11. *Id.*

12. Nev. Legis. S. S.B. 383, 2017 Leg., 79th Sess. (Nev. 2017).

13. *See* Nev. Rev. Stat. § 628A.010 (Current professionals exempted from a fiduciary duty include attorneys, certified public accountants (CPAs), insurance consultant, etc.)

14. *Hearing on S.B. 545 Before the S. Comm. On Commerce and Labor*, 1993 Leg.,

financial planners, as well as a new, private cause of action against financial planners that violated the statute.[15] The proposed fiduciary duty rule required financial planners to provide investment advice in the consumer's best interest.[16] The bill passed unanimously, but not before legislators amended the definition of "financial planner" to exempt "those persons licensed under another chapter, such as attorneys and certified public accountants."[17] These defined exemptions included brokers, investment advisers, and insurance producers.

Nevada legislators were likely motivated to enact this change due to the burgeoning retirement population. From 1980 to 1990 Nevada realized the greatest national increase in its retirement population.[18] This trend continued well into 2010.[19] Individuals over the age of 65, likely in the beginning of their retirement, often seek financial planning advice to manage their lifetime savings.[20] Incidentally, they also vote in greater numbers than other age groups.[21] Finally, research indicates that financial planning misconduct occurs more frequently in counties with high retirement populations.[22] Nevada legislators likely viewed protecting retirement-age investors as a mutually beneficial arrangement.

67th Sess. (Nev. 1993).

15. *Id.*

16. *Id.*

17. *Hearing on S.B. 545 Before the S. Comm. On Commerce and Labor*, 1993 Leg., 67th Sess. (Nev. 1993).

18. U.S. Bureau of the Census, *65+ in the United States*, 94-95 (1996). Nevada realized a 92.5 percent population increase in the population over the age of 65 from 1980 to 1990. *Id.*

19. *See* U.S. Bureau of the Census, *The 65 Years and Over Population: 2000*, 4 (2001); *See* U.S. Bureau of the Census, *65+ in the United States: 2010*, 185 (2014).

20. According to a recent study done by RAND, 62 percent of surveyed respondents over the age of 40 stated they used a financial planner for retirement planning services. Angela A. Hung et al., INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS, RAND Institute for Civil Justice, tbl.G.4 (2008).

21. U.S. Bureau of the Census, *Who Votes? Congressional Elections and the American Electorate: 1978-2014*, 5 (2015).

22. Mark Egan, Gregor Matvos, and Amit Seru, THE MARKET FOR FINANCIAL ADVISER MISCONDUCT, 27 (September 2017).

In 2017, Nevada legislators removed "financial planner" definition exceptions to further protect Nevadan investors. Untouched since 1993, legislators altered the "financial planners" definition by eliminating exemptions afforded to brokers and investment advisers.[23] The statutory definition of "financial planner" now includes brokers and investment advisers, thereby applying a fiduciary duty to both classes.[24]

Opponents to the changes argued that releasing brokers and investment advisers from statutory exemption would (1) reduce consumer access to high-quality investment advice,[25] (2) confuse Nevada consumers,[26] (3) conflict with federal requirements assigned by the SEC and FINRA,[27] and (4) require brokers and investment advisers to maintain errors and omissions insurance.[28] As will be discussed later, these arguments have little merit.

Nevadans' increased vulnerability to financial adviser deception likely motivated Nevada legislators to enact these changes. Nevadans are especially vulnerable to deceptive financial advice because of their financial literacy in relation to their above-average earning capacity. A significant majority of Nevada's population has attained, at most, a high school education.[29] High school educated individuals are less likely to use financial planning services because they believe they do not have enough money to invest with a financial planner.[30] In Nevada, however, the hospitality and gaming industry employs

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23. Nev. Legis. S. S.B. 383, 2017 Leg., 79th Sess. (Nev. 2017).

24. *Hearing on S.B. 383 Before the S. Comm. On Commerce, Labor and Energy*, 2017 Leg., 79th Sess. (Nev. 2017) (statement of Nev. Sen. Aaron Ford, District No. 11).

25. *Hearing on S.B. 383 Before the Ass. Comm. On Commerce and Labor*, 2017 Leg., 79th Sess. (Nev. 2017) (statement of David T. Bellaire, Esq., Exec. Vice Pres. And Gen. Counsel for the Financial Serv. Ins.).

26. *Hearing on S.B. 383 Before the Ass. Comm. On Commerce and Labor*, 2017 Leg., 79th Sess. (Nev. 2017) (statement of Kimberly Chamberlain, Managing Dir. And Assoc. Gen. Counsel for Securities Industry and Financial Market Assoc.).

27. *Id.*

28. *Id.*

29. Nearly 70 percent of Nevadans' highest educational achievement is a high school education. U.S. Bureau of the Census, *U.S. Census Bureau, 2011-2015 American Community Survey 5-Year Estimates* (2017).

30. Angela A. Hung et al., INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS, RAND Institute for Civil Justice, tbl.G.3 (2008) (58 percent of respondents with no college degree reported that they did not use a

many high school educated individuals whose hourly wages are supplemented significantly by tip wages.[31] Therefore, Nevada high school educated individuals, who often do not understand the differences between brokers and investment advisers, have above-average incomes that permit them to use financial services.[32] Recent study further indicates that financial planning misconduct occurs more frequently in counties with fewer college educated consumers.[33] Nevadan's disproportionate income relative to their education makes them especially vulnerable to deceptive financial planning.

2. Financial Planners in Nevada

At its finest, the title "financial planner" is ambiguous. In fact, the financial industry generally considers "financial planner" as "a phrase that encompasses many types of services and skills."[34] Brokers, investment advisers, insurance producers, insurance consultants, and even some accountants permissibly use the financial planner title.[35] The shared title, however, does not equal identical regulation. Instead, state and federal agencies regulate financial planners according to the particular services they provide and not necessarily the titles they use.[36] For example, regulators often view financial planners that solely buy and sell securities as a broker, but may view a financial planner that solely prepares financial plans for clients as an accountant or investment adviser.

Below I shall discuss the differences between registered investment advisers, brokers, and insurance producers. This will include examining the new Nevada fiduciary duty and the current federal regulation of these three classes of financial planners.

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financial service provider because of "no money for investments.").

31. *How Gaming Benefits Nevada*, NEVADA RESORT ASSOCIATION, http://www.nevadaresorts.org/benefits/jobs.php (The entertainment and gaming industry in Nevada employs roughly 27.7 percent of Nevada's total workforce, and 31.5 percent of the private workforce.)

32. Angela A. Hung et al., INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS, RAND Institute for Civil Justice, tbl.G.1 (2008).

33. *See* Egan *supra* note 22.

34. *Financial Planners*, FINRA, http://www.finra.org/investors/financial-planners.

35. *Id.*

36. *Id.*

a. Registered Investment Advisers

Investment advisers include "any person who, for compensation, engages in the business of advising others…as to the value of securities or as to the advisability of investing in…securities."[37] Unlike other financial planners discussed, investment advisers have federally imposed fiduciary duties of care and loyalty.[38] These fiduciary duties require the investment adviser to act in the "best interest" of their client.[39] This includes fee and conflict of interest disclosures related to investment recommendations.

Under the Investment Advisers Act of 1940 ("Advisers Act"), investment advisers have a fiduciary duty to their clients and prospective clients.[40] In pertinent part, Congress enacted the Advisers Act to prohibit investment advisers:

(1) to employ any device...to defraud any client or prospective client;

(2) to engage in...course of business which operates as a fraud or deceit upon any client or prospective client;

(3) acting…for his own account, knowingly sell any security to or purchase any security from a client…without disclosing *to such client in writing before completion of such transaction the capacity in which he is acting*…; or

(4) to engage in any…course of business which is fraudulent, deceptive or manipulative.[41]

The U.S. Supreme Court interprets the above prohibitions to impose upon investment advisers "an affirmative duty of utmost good faith and full disclosure of all material facts, as well as…to employ reasonable care to avoid misleading" their clients.[42] In addition to a fiduciary duty of care, the U.S. Supreme Court interprets the Advisers Act to create a fiduciary duty of loyalty for advisers.[43] This duty of loyalty compels the adviser to fully disclose any

37. Investment Advisers Act of 1940 § 202(11).

38. *Id.*

39. *Id.*

40. Investment Advisers Act of 1940 § 201, 15 U.S.C. § 80b-1 through 15 U.S.C. § 80b-21.

41. Investment Advisers Act of 1940 § 202, 15 U.S.C. § 80b-6 (emphasis added).

42. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963).

43. *Id.*

conflicts of interest when recommending investment products.[44]

Nevada's recent uniform fiduciary duty rule applies a state imposed duty, but requires little additional compliance outside current federal regulatory requirements. Federal fiduciary duties under the Advisers Act imposed identical fiduciary duties upon Nevadan investment advisers long before these state-specific statutory changes.

b. Brokers

Brokers, or financial planners that receive commissioned compensation from the investment products they recommend, are required to recommend suitable investment products to their clients.[45] This suitability standard prevents the broker from categorically recommending investment products that ignore their client's age, economic situation, tax circumstances, etc.[46] This rule does, however, permit the broker to recommend different products within an investment classification.

Multiple entities currently regulate brokers. The SEC, FINRA, and individual states all permissibly regulate broker activities. Under the Securities Exchange Act of 1934 ("Exchange Act"), brokers must register with the SEC and a self-regulatory organization ("SRO").[47] FINRA is the only SRO with which brokers may register.

The SEC delegates much of its regulatory authority to FINRA, allowing FINRA to act as brokers' primary regulator.[48] FINRA scrutinizes broker transactions according to FINRA Rule 2111. In pertinent part, Rule 2111 states:

> A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on

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44. *See* Benjamin P. Edwards, *Fiduciary Duty and Investment Advice: Will a Uniform Fiduciary Duty Make a Material Difference?*, 14 MICH. ST. J. BUS. SEC. L. 105, 117 (2013).

45. *Id.* at 106 (Brokers must comply with FINRA Rule 2111, also known as "The Suitability Rule").

46. *See* FINRA RULE 2111 *available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859.*

47. 15 U.S.C. § 78o(b)(1) (West 2010).

48. *See* Edwards *supra* note 44 at 111.

> the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.[49]

FINRA's Rule 2111 mandates brokers to suggest "suitable" investment products after considering the client's entire financial profile.[50] FINRA does not explicitly define "suitability" and instead provides three suitability obligations: reasonable-basis, customer-specific, and quantitative suitability.[51] These obligations, however, do not apply a fiduciary duty to brokers. Instead, these obligations require a broker to (1) comprehend the security product they are recommending, (2) understand that the product is suitable to *some* investors, and (3) recommend a series of security products only where the series, as a whole, is suitable for the client.[52] But what meets the bar of "suitable?"

FINRA's interpretive guidance on the Suitability Rule requires brokers to "make only those recommendations that are ***consistent*** with the customer's best interest."[53] Consistent with the customer's best interest does not, however, rise to a fiduciary duty level. FINRA's Suitability guidance states that recommendations need not provide the least expensive securities product to be consistent with the best interests of the client.[54]

FINRA's suitability rule allows for more subjective investment recommendation analysis. To illustrate, suppose that a client comes to a broker with a desire to invest in a managed retirement account. The current suitability

49. *See* FINRA RULE 2111 *available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859.*

50. *Id.*

51. James S. Wrona, *The Best of Both Worlds: A Fact-Based Analysis of the Legal Obligations of Investment Advisers and Broker-Dealers and a Framework for Enhanced Investor Protection*, 68 BUS. LAW. 1, 56, 23-26 (2012).

52. *Id.*

53. *See* FINRA, Regulatory Notice 12-25, 2012 (May 21, 2012) (emphasis added).

54. See FINRA, FINRA RULE 2111 (SUITABILITY) FAQ *available at* http://www.finra.org/industry/faq-finra-rule-2111-suitability-faq (last visited May 12, 2018).

rule allows the broker to recommend a Vanguard index fund tracking the S&P 500 with an annual management fee of 0.05%, or a Rydex index fund, also tracking the S&P 500, with an annual management fee of 2.31%. The catch: both funds will provide identical net returns because both track the S&P 500. The Vanguard fund, therefore, ***will always*** outperform the Rydex fund because the Rydex fund charges an additional 2.26% management fee for the same return. In contrast, a broker with a fiduciary duty would likely recommend the Vanguard fund because its lower management fee will provide a greater gross return. There do exist other circumstances where a broker must act as a fiduciary, but the applicable case law is inconsistent.[55]

In addition, the Advisers Act exempts brokers from fiduciary duties.[56] This exception applies to brokers that provide both investment and brokerage advice. A broker is exempt where the investment advice provided is "solely incidental to the conduct of his business as a broker…and who receives no special compensation..."[57] The SEC struggles to define the "solely incidental" requirement for this exemption.[58] The SEC's most recent interpretive rule defines "solely incidental" where (1) a broker does not exercise investment discretion, (2) charges a separate fee for the investment advice, (3) does not receive "special compensation", and (4) does not provide services attributable to accounts subject to the Advisers Act.[59] Professor Arthur Laby points out, however, that this rule does not resolve the scope of advice exempted or the types of compensation outside exemption.[60]

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55. *See* Edwards *supra* note 44, at 113-116 (these extenuating circumstances include brokers bound by the Adviser's Act of 1940, states that impose a fiduciary duty on brokers, where brokers provide advice for discretionary investment accounts, and states that require brokers act as fiduciaries where the customer relies upon a broker's advice); *See also* Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 VILL. L. REV. 701, 704 (2010).

56. *See* Varnavides, *supra* note 9 at 207.

57. *Id.*

58. *See* Certain Broker-Dealers Deemed Not to Be Investment Advisers, Exchange Act Release No. 34-51523, 70 Fed. Reg. 240424-01 (Apr. 19, 2005) (This interpretive rule was overturned by the D.C. Circuit Court of Appeals in Fin. Planning Ass'n v. SEC, 482 F.3d 481 (D.C. Cir. 2007) on the grounds that the SEC had overstepped its regulatory authority).

59. *See* Interpretive Rule Under the Advisers Act Affecting Broker-Dealers, Exchange Act Release No. 2652, 17 Fed. Reg. 275 (Sept. 24, 2007).

60. *Id.*

Nevada's new uniform fiduciary rule imposes a higher standard never before statutorily applied to brokers. For example, California common law imposes a fiduciary duty upon brokers, but does not define the services where the duty applies.[61] To date, California has not statutorily imposed a fiduciary duty upon brokers, despite their common law precedent. In contrast, Nevada brokers now have a fiduciary duty to every client whom they give financial advice. This duty applies regardless of the scope of the advice the broker provides. In pertinent part, Nevada law states:

> A financial planner has the duty of a fiduciary toward a client. A financial planner shall disclose to a client, at the time advice is given, any gain the financial planner may receive, such as profit or commission, if the advice is followed. A financial planner shall make diligent inquiry of each client to ascertain initially, and keep currently informed concerning, the client's financial circumstances and obligations and the client's present and anticipated obligations to and goals for his or her family.[62]

To reiterate, Nevada adjusted its definition of "financial planner" to include brokers. The above fiduciary duty applies to all brokers and investment advisers, not the specific service offered. Borrowing from the above-mentioned example, it is unlikely that a Nevada broker could recommend a Rydex indexed fund over a Vanguard indexed fund. A higher fee for the same return is likely not in the client's best interest.

c. Insurance Producers

Each individual state is exclusively responsible for regulating insurance producers ("producers"), or financial planners that primarily assist consumers with their insurance needs in exchange for compensation.[63] Producers recommend insurance products that include life insurance, long-term disability

61. Hobbs v. Bateman Eichler, Hill Richards, Inc., 164 Cal.App.3d 174, 201 (Ct. App. 1985) ("The relationship between a broker and principal is fiduciary in nature and imposes on the broker the duty of acting in the highest good faith toward the principal.") (*quoting* Twomey v Mitchum, Jones & Tempelton, Inc., 69 Cal.App.2d 690, 709 (Ct. App. 1968)).

62. Nev. Rev. Stat. § 628A.020.

63. Christine Lazaro, Benjamin P. Edwards, *The Fragmented Regulation of Investment Advice: A Call of Harmonization*, 4 MICH. BUS. & ENTP. L. R. 47, 68 (2014).

insurance, annuities, and other insurance products. Many producers, however, market themselves as "financial planners" or "financial advisers" and seek to assist clients with the totality of their investment needs. Many producers hold registrations with their state as an insurance producer, and registration with FINRA and the SEC as an investment adviser. As a result, producers often act as investment advisers and may assist their clients with financial planning, including establishing individual retirement accounts (IRAs), trust accounts, and college savings plans (also known as 529 savings plans).

Where a producer is acting as an investment adviser, the producer has a fiduciary duty under the Advisers Act. A potential problem, however, is distinguishing when a producer is acting as a producer and when he or she is acting as an investment adviser. Given the difference in regulation between a producer, and an investment adviser enforcement of greater standards of conduct becomes difficult.

Interestingly, Nevada legislators chose to keep some producers as exempt from a fiduciary duty when they removed brokers and investment advisers from the defined exemptions.[64] Nevada law only permits this exemption, however, where the "advice upon investment…is incidental to the practice of his or her profession or business."[65] Given the fact that many producers market themselves as "financial planners" with the intent to assist clients with all of their financial planning needs, it makes practical sense that producer profession, or business is not, and cannot, be incidental to providing investment advice. This seems to imply a fiduciary duty but still remains unclear given the recent changes to Nevada law.

B. Potential Challenges

1. Field Preemption

Current federal regulatory law does not preempt Nevada's recent statutory fiduciary duty applied to investment advisers and brokers by field preemption. Federal law preempts state law according to field preemption, or where Congress intends to displace state law and occupy a specific regulatory field.[66] Congressional enactment of the Securities Act and Exchange Act included

64. Nev. Rev. Stat. § 628A.010.

65. *Id.*

66. Silkwood v. Kerr-McGee Corp., 464 U.S. 238, 248 (1984).

provisions preserving state regulatory authority within state borders.[67] These provisions preserved states' authority to enact laws regulating state securities, often called blue sky laws.[68]

All fifty states have long since enacted blue sky laws to regulate their state securities markets.[69] Blue sky laws allow each state broad regulatory power, including regulation of securities issuance, investment adviser and broker registration, and establishing actions against the fraudulent purchase or sale of securities.[70] This broad regulatory power also extends to providing "additional rights" to investors so long as the rights to do not conflict with federal law.[71]

Under the current regulatory nature of blue sky laws, Nevada's fiduciary duty rule is likely permissible. Congressional intention to preserve states' blue sky laws in the Securities Act and Exchange Act demonstrates that they did not intend to exclusively occupy the field of securities regulation.

2. Conflicts

Nevada's fiduciary duty rule does not conflict with federal securities law because investment advisers already have a fiduciary duty and brokers may comply equally with both Nevada and federal securities law. Furthermore, a state-specific uniform fiduciary duty does not obstruct the congressional purpose of the Securities Act or the Exchange Act.

Federal law may preempt state law where compliance with both state and federal law is impossible[72] or where state law obstructs congressional purpose in enactment of federal law.[73] A conflict does not exist between Nevada's fiduciary duty rule and the Advisers Act because the duty applied is identical.[74]

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67. *See* 15 U.S.C. § 77p; *See also* 15 U.S.C. § 78bb(a).

68. Christine Lazaro, Benjamin P. Edwards, *The Fragmented Regulation of Investment Advice: A Call of Harmonization*, 4 MICH. BUS. & ENTP. L. R. 47, 55 (2014).

69. William Alan II Nelson, *Broker-Dealer: A Fiduciary by Any Other Name*, 20 FORDHAM J. CORP. & FIN. L. 637, 660 (2015).

70. *Id.* at 660-61.

71. *Id.* at 661.

72. Florida Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132, 42-43 (1989).

73. Jones v. Rath Packing Co., 430 U.S. 519, 526 (1977).

74. *See* Investment Adviser's Act of 1940.

Both the Nevada fiduciary duty rule and the Advisers Act apply fiduciary duties of loyalty and care to investment advisers. In complying with the federal fiduciary duty, investment advisers would thereby also comply with Nevada's fiduciary duty rule.

The Nevada fiduciary rule applies a different, greater duty of care to brokers, but compliance with the Nevada rule and FINRA's suitability rule is possible. FINRA's suitability standard requires the broker to recommend products consistent with the client's best interest. By definition, Nevada's fiduciary rule requires a Nevada broker to recommend investment products *in* the client's best interest. Compliance with Nevada's fiduciary rule, therefore, likely results in compliance with FINRA's suitability rule.

Further, the Nevada rule does not obstruct the purpose of the Securities Act and Exchange Act. Congress intended transparent securities market in enactment of the Securities Act and Exchange Act. Congress surmised that transparency would allow investors to make educated and informed decisions when investing, which in turn, would crowd out fraudulent enterprises. Congressional purpose of these federal securities laws was primarily investor protection. As mentioned above, Congress also intended to preserve state authority in regulating securities within state borders.[75] Nevada's fiduciary duty rule seeks to protect investors from receiving investment advice outside their best interests. This purpose is consistent with the purpose of federal securities law. Finally, Nevada exercises its congressionally preserved blue state authority in enacting and enforcing a uniform fiduciary duty.

Opponents to Nevada's fiduciary duty allege that Nevada's rule conflicts with the National Securities Market Improvement Act of 1996 ("NSMIA"). NSMIA amended the Securities and Exchange Act of 1934, and provides:

> (h) Limitations On State Law. –
>
> (1) Capital, Margin, Books And Records, Bonding, And Reports.—No law…of any State…shall establish capital, custody, margin, financial responsibility, making and keeping records, bonding, or financial or operational reporting requirements for brokers…that differ from, or are in addition to, the requirements in those areas established under this title.[76]

Opponents argue that Nevada's rule establishes new "financial or operational reporting requirements for brokers" in addition to the reporting requirements imposed federally. NRS 628A.020, however, imposes only a fiduciary duty and does not include additional federal reporting requirements.

75. *See supra* note 67.

76. National Securities Markets Improvement Act of 1996 § 103(a).

Further, inquiry into NSMIA's legislative history reveals that Congress intended to preserve state authority over regulating broker sales practice abuses. An initial House of Representatives conference report reveals that "The Managers have preserved the authority of the states to protect investors through application of antifraud laws. This preservation of authority is intended to permit state securities regulators to continue to exercise their police power to prevent fraud and broker-dealer sales practice abuse, such as churning accounts or misleading customers. It does not preserve the authority of the state securities regulators to regulate the securities registration and offering process…"[77] This clearly demonstrates that the Congressional intentions of NSMIA's enactment included preserving state blue sky authority.

II. SHOULD OTHER STATES ACT?

On June 2, 2017, Nevada became the first state to statutorily impose a fiduciary duty upon both brokers and investment advisers. Should, or will, other states follow suit? This section explores why states should enact a state-specific uniform fiduciary duty. This analysis includes an examination of federal regulatory fragmentation, the possible creation of state-by-state fragmentation, a state-specific fiduciary duty's protective benefits, the current judicial inaction, and whether a state-specific fiduciary duty might limit investor access to financial advice. Ultimately, it is in the states' best interest to follow Nevada in adopting a uniform fiduciary duty.

A. Fragmentation

Fragmentation in broker and investment adviser federal regulation promotes consumer confusion and limits consumer protection. The significant differences between how FINRA and the SEC regulate brokers and investment advisers confuses and harms retail investors.[78] These different standards also effect broker and investment adviser behavior. This combination results in

77. H.R. REP. NO. 104-864, at 40 (1996) (Conf. Rep.).

78. Christine Lazaro, Benjamin P. Edwards, *The Fragmented Regulation of Investment Advice: A Call of Harmonization*, 4 MICH. BUS. & ENTP. L. R. 47, 61 (2014).

financial advice consumers who rely equally upon financial advice provided by a broker or by an investment adviser, despite the different conduct standards.

1. Fragmentation Creates Consumer Confusion

When Mr. and Mrs. Toffel visited their financial planner, is it likely that they asked for the financial planner's credentials? Was he or she a registered investment adviser, bound by the Advisers Act? Or was he or she a broker, bound by FINRA's Suitability Rule? The unfortunate reality is that the Toffels likely did not ask these questions, either because they didn't know the difference between a broker and an investment adviser, or they implicitly trusted their financial planner.

Differences in federal regulatory standards contribute to the confusion and financial illiteracy that exists among American investors. Recent study indicates that the average investor does not understand the differences in legal duties required by brokers and investment advisers.[79] Furthermore, investors barely understand the differences in the services provided by brokers and investment advisers.[80] Research indicates that investors seek investment advice from both brokers and investment advisers equally.[81] A majority of these same investors, however, mistakenly believe that brokers are legally required to disclose conflicts of interest.[82] Investors are therefore likely to seek investment advice from a broker with the mistaken belief that the broker must act in the investor's best interest. This misunderstanding decreases the chance that an investor will question a broker's suitable advice.

Investor reactions to marketing differences between investment advisory firms and dually registered firms (firms registered as both a brokerage firm

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79. Angela A. Hung et al., INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS, RAND Institute for Civil Justice, 112-13 (2008).

80. *Id.*

81. *Id.* at 113.

82. Angela A. Hung et al., INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS, RAND Institute for Civil Justice, tbl.6.14 (2008) (70 percent of respondents reported that the believe a broker is legally required to disclose a conflict of interest, and only 60 percent of respondents reported that they believe an investment adviser is legally required to disclose a conflict of interest).

and an investment advisory firm) further reveal investor financial illiteracy.[83] After reviewing marketing materials from both an investment advisory firm and a dually registered advisory firm, investors reported that they found the dually registered firm more appealing because of low account minimums and fees.[84] Respondents also stated that working with the dually registered firm would ultimately involve financial advice.[85] These findings demonstrate that investors may seek financial advice from brokers with the mistaken belief that the broker will act as a fiduciary.

Investor confusion is apparent by the above-mentioned investor behavior and financial literacy. States that choose to follow Nevada's example and impose a uniform fiduciary would assist in curing this confusion. A state-specific uniform fiduciary duty would bypass the fragmented federal regulation and allow investors to trust that any financial planner, whether broker or investment adviser, must provide advice in the investor's best interest.

2. Fragmentation: State-by-State Differences

While the current federal regulatory regime promotes fragmentation, differences in state defined fiduciary standards may also cause fragmentation. Nevada became the first state to statutorily impose a fiduciary duty on brokers and investment advisers. It is likely that other states will follow suit, but less likely that they will adopt a fiduciary duty identical to Nevada's. States interpret and implement legal concepts differently and will equally vary in defining a broker's duties as fiduciary. For example, California legislators might enact statutory law to impose a fiduciary duty upon brokers to act in the best interests of the consumer but choose not to impose a duty to disclose on brokers. Any number of variations might possibly exist from state-to-state.

This state fragmentation would place a greater burden on national brokerage and investment advisory firms to comply with varied state requirements. Prior to Nevada's statutory changes, national brokerage and investment advisory firms complied with federal regulations under the Advisers Act and FINRA's Suitability Rule within every operating state. A movement away from uniform federal regulatory compliance to compliance dependent upon differing state regulation would increase the costs to operate

83. *See id.* at 111-12.

84. *Id.*

85. *Id.*

in multiple states. An increase in costs could shrink the number of financial planning representatives available to the public. As will be discussed later, a smaller number of financial representatives does not significantly impact investor access to financial planning.

B. Protection

$17 billion dollars. This is the price tag of lost retirement savings, ***per year***, for unregulated conflicts of interest that arise between financial advisers and the American public.[86] The Economic Policy Institute illustrates that implementation of Nevada's new fiduciary rule should save Nevada retirement investors approximately $104 million ***per year***.[87] California, Texas, and Florida could likely save approximately $1.9 billion, $1.0 billion, and $971 million, respectively, in retirement savings by implementing a uniform fiduciary duty rule.[88]

These economic losses likely increase retirement aged investors' reliance upon social security benefits to live. The Social Security Administration reports that in 2015, 62% of all social security beneficiaries receive 50% or more of their income from their Social Security benefits.[89] Even more disheartening, 34% of social security beneficiaries receive 90% or more of their income from their Social Security benefits.[90] It is reasonable to suspect that investors who lose all or a majority of their lifetime savings due to conflicted advice must rely upon their Social Security benefits in retirement. A state specific uniform fiduciary duty would significantly help retirement investors preserve and grow their savings. Safe from conflicted advice, retired

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86. *See* White House Council of Economic Advisers (CEA), *The Effects of Conflicted Investment Advice on Retirement Savings* (Feb. 2015) (available at https://obamawhitehouse.archives.gov/sites/default/files/docs/cea_coi_report_final.pdf).

87. Heidi Shierholz and Ben Zipperer, *Here is What's at Stake with the Conflict of Interest ("Fiduciary") Rule*, ECONOMIC POLICY INSTITUTE (May 30, 2017), http://www.epi.org/publication/here-is-whats-at-stake-with-the-conflict-of-interest-fiduciary-rule/.

88. *Id.*

89. *See* Social Security Administration, *Fast Facts & Figures About Social Security, 2017* (Sep. 2017), 8 (available at https://www.ssa.gov/policy/docs/chartbooks/fast_facts/2017/fast_facts17.pdf).

90. *Id.*

Americans could depend on their earned lifetime savings, rather than on government subsidy. Relieving this dependency would likely have a significant ripple effect throughout the entire American economy.

A state specific uniform fiduciary duty would protect consumers from conflicted interest and decrease investor confusion. As mentioned above, investor confusion and financial illiteracy prevents investors from successfully identifying when their financial planner is not providing advice in their best interests. A uniform fiduciary duty rule will protect the Mr. and Mrs. Toffels throughout the country by requiring all financial planners operate in the investor's best interest.

C. Judicial Inaction

The lack of judicial common law makes a state imposed fiduciary duty all the more necessary. Opponents of a state fiduciary duty claim that many state and federal courts have already applied a fiduciary duty to brokers. For example, opponents point to California precedent that seems to apply a "best interest" duty to brokers.[91] This precedent, however, does not fully define the scope of brokers' fiduciary duties and is widely inconsistent.[92]

Professor Arthur Laby points out that a major reason for the common law inconsistency is due to the lack of litigated cases between financial advisers and their clients.[93] Instead, a majority of disputes are resolved through arbitration, often required by an arbitration clause in the account opening document's terms.[94] FINRA most often administers the forum for such arbitrations.

A dearth of judicial decisions prevents ambiguous aspects of the law, such as broker duties to clients, from fully developing. Unlike judicial decisions, FINRA appointed arbitrators issue case decisions that do not require well-reasoned analysis.[95] Additionally, parties to any settlements often agree to

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91. *See supra* note 61.

92. *See* Arthur B. Laby*, Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 VIL. L. REV., 701, 704 (2010).

93. *Id.* at 706.

94. *See* SEC & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALER, 94-96 (Jan. 2011), *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf

95. *Id.* at 706-707.

keep the settlement private in the settlement's terms, as firms wish to avoid negative publicity. Those few decisions that are not gagged by agreement often provide little in the way of reasoning. Without an infrastructure from which to base decisions, arbitrators are left to resolve decisions on a case-by-case basis.[96] This perpetuates a lack of well-reasoned common law.

Absent judicial reasoning, an authoritative body must define the scope of broker and investment adviser responsibilities. The reality is that arbitration agreements are enforceable and pervasive. This is unlikely to change. Authoritative bodies must then interpret the conduct standards of both brokers and investment advisers. As mentioned above, FINRA and the SEC offer guidance on broker duties to investors.[97] Without well-reasoned precedent, investor and broker confusion remains despite interpretive guidance. A simple remedy available to state legislatures is enacting a uniform fiduciary duty to explicitly define broker duties owed to investors.

D. Creation of an Advice Gap

A common argument against a state-specific fiduciary duty is that increased state regulation will create an advice gap. Proponents argue that as broker regulation increases the number of available brokers will decrease and deprive the public access to financial advice. Recent research comparing investor behavior contradicts this argument.[98] The researchers analyzed access to financial planning by comparing states with and without common law fiduciary duties for brokers.[99] The research suggests that financial adviser saturation is not statistically significantly different between states with or without a fiduciary duty.[100] This evidence casts doubt on the red herring argument that requiring brokers to operate in their client's best interest would reduce access to financial advice.

Furthermore, even if access to financial advice was slightly reduced, it is not necessarily true that the public would be better off with conflicted financial advice than with no advice at all. Recent study suggests that individuals who

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96. *Id.* at 707.

97. *See supra* note 53; *See supra* note 59.

98. Michael Finke and Thomas Langdon, *The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice* (March 9, 2012).

99. *Id.*

100. *Id.* at 22-23.

choose retirement funds on their own have significantly greater returns (due to lower annual fees) compared to the return from taking an adviser's financial advice.[101]

Finally, Professor Benjamin Edwards proposes that the rise of robo-advisers may fill the gap in supply should a fiduciary duty rule decrease financial adviser saturation.[102] Innovations in financial technology, including "Robo-advisers," simplify investor decision-making by providing portfolio choices that suit their risk and growth needs.[103] In addition to accessibility ease, these robo-advisers charge fees as low as 0.25% of assets under management.[104]

E. SEC Proposed Rule: Regulation Best Interest

The SEC issued proposed rule changes to resolve confusion created by the current federal regulatory framework. In early 2018 the SEC released Regulation Best Interest to remedy investor confusion, financial illiteracy, and financial fraud.[105] Concerned about documented investor financial illiteracy, Regulation Best Interest suggests applying a "best interest" standard to broker advice.[106] Under the best interest standard brokers have three obligations to investors: a Disclosure Obligation, a Care Obligation, and a Conflict of Interest Obligation.[107] Interestingly, the language used to explain these obligations echoes FINRA's current regulatory framework. For example, the Care Obligation requires the broker to:

> "(1) understand the potential risks and rewards associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the interest of at least some retail

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101. John Chalmers and Jonathan Reuter, *Is Conflicted Investment Advice Better than No Advice?*, 26-27 (Sep. 14, 2015).

102. Benjamin P. Edwards, *Conflicts & Capital Allocation*, 78 OHIO ST. L. J. 181, 221 (2017).

103. *Id.*

104. *Id.* Professor Edwards references the management fees charged by Wealthfront, a leading robo-advisory firm.

105. Regulation Best Interest, 83 Fed. Reg. 21574 (proposed May 9, 2018) (to be codified at 17 C.F.R. 240).

106. *Id.*

107. *Id.*

> customers; (2) have a reasonable basis to believe that the recommendation is in the ***best interest*** of a particular retail customer based on that retail customer's investment profile and the potential risks and rewards associated with the recommendation; and (3) have a reasonable basis to believe that a series of recommended transactions…is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile."[108]

These requirements are almost identical to FINRA's Suitability obligations: reasonable-basis suitability, customer-specific suitability, and quantitative suitability.[109] Regulation Best Interest simply replaces the term "suitability" with "best interest." The SEC suggests that the new, different "best interest" standard prohibits the broker from placing their interests ahead of the client's interest when recommending investment products.[110] At the same time, Regulation Best Interest's Disclosure Obligation requires brokers to disclose, but not necessarily eliminate, potential conflicts of interest to investors.[111] Furthermore, brokers need not recommend the least expensive or least remunerative product, so long as the broker places the investor's interest ahead of their own.[112] The result is a standard that is greater than suitability, but somehow less than a fiduciary duty.

The SEC chose not to suggest a uniform fiduciary rule because of the economic impact a fiduciary duty might have upon brokers. The differences in brokerage and advisory firm business models, the SEC reasons, requires two separate and distinct regulatory frameworks. A uniform fiduciary duty for brokers and investment advisers "could lead to the potential loss of differentiation between two important business models…"[113] The SEC additionally fears that a uniform fiduciary duty will create an advice gap and decrease investor choice.[114]

The reasons provided by the SEC against a uniform fiduciary standard

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108. *Id.* at 133 (emphasis added).

109. *See* FINRA, Regulatory Notice 12-25, 2012 (May 21, 2012).

110. Regulation Best Interest, 83 Fed. Reg. 21574, 21575 (proposed May 9, 2018) (to be codified at 17 C.F.R. 240).

111. *Id.*

112. *Id.* at 21612-13.

113. *Id.* at 21663.

114. *Id.*

seem unjustified. First, using different regulatory mechanisms to police brokerage and advisory firms is meaningful only when the business product is truly different. Once upon a time, brokers were primarily transaction-based businesses rather than advisers, but technology and industry norm have blurred these distinctions.[115] It is now common for brokers to offer investment advice. Brokerage and advisory firms lack product differentiation, making regulatory differences nonsensical.

The SEC's fear of an advice gap is additionally unjustified. As previously mentioned, financial adviser saturation is not significantly different in states with or without a common law fiduciary duty.[116] The SEC cites recent research ("SIFMA study') on industry response to the DOL Fiduciary Rule transition to infer similar response to an SEC fiduciary rule.[117] The SIFMA study reveals that only 24% of participants completely eliminated advice in their brokerage services, while 47% maintained advised brokerage services and 29% only limited advised brokerage services.[118] Furthermore, the market will likely fill any gaps in financial advice to investors. For example, robo-advisors provide cost-effective investment recommendations to investors based upon chosen investment portfolio criterion.[119]

The SEC's Regulation Best Interest is not as likely to decrease investor loss to conflicted advice as a state-specific fiduciary duty. Regulation Best Interest creates a vague standard somewhere between a suitability standard and a fiduciary duty standard. Such vagueness is likely to increase investor and broker confusion. A state-specific fiduciary duty establishes well-defined, precedent supported duties of care and loyalty that require the broker to always act in the best interests of the investor.

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115. *See* Edwards *supra* note 44 at 108.

116. *See* Finke and Langdon *supra* note 98.

117. *See* Regulation Best Interest, 83 Fed. Reg. 21574, 21642 (proposed May 9, 2018) (to be codified at 17 C.F.R. 240); see also *The DOL Fiduciary Rule: A study on how financial institutions have responded and the resulting impacts on retirement investors*, SIFMA AND DELOITTE (Aug. 9, 2017), *available at* https://www.sifma.org/wp-content/uploads/2017/08/Deloitte-White-Paper-on-the-DOL-Fiduciary-Rule-August-2017.pdf.

118. *The DOL Fiduciary Rule: A study on how financial institutions have responded and the resulting impacts on retirement investors*, SIFMA AND DELOITTE (Aug. 9, 2017), *available at* https://www.sifma.org/wp-content/uploads/2017/08/Deloitte-White-Paper-on-the-DOL-Fiduciary-Rule-August-2017.pdf.

119. *See* Edwards *supra* note 102.

CONCLUSION

Nevada's recent adoption of a uniform fiduciary duty for brokers and investment advisers is a victory for the protection of investors and other states should adopt similar standards. While significant demographic factors may have pushed Nevada to be the first to enact a state specific fiduciary duty, it is likely that other states will follow Nevada's lead. The multiple inconsistencies federal securities regulation confuse investors, further dampening investor financial literacy. A state specific fiduciary duty is within states' blue sky authority and will protect investors from financial advice adverse to their best interest. States need not fear federal field, conflict preemption, or the advice gap threat should they adopt fiduciary duties for all financial planners. Instead, state legislators can expect to preserve hundreds of millions of dollars in investor retirement savings formerly lost to conflicted advice. As investors retain their retirement savings, states with a state specific fiduciary duty will likely see a decrease in retiree dependence upon state and federal welfare programs. If you can't take my word for it, at least take the pope's.[120]

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120. Bruce Kelly, *Pope Francis wants financial advisers to work like fiduciaries*, INVESTMENTNEWS, May 18, 2018.

CONSIDERATIONS IN CASES AGAINST INDEPENDENT INVESTMENT ADVISORS – CASE REVIEW, PROCEDURES, CAUSES OF ACTION AND DISCOVERY CONSIDERATIONS

Jane L. Stafford[1]

This article presents considerations in cases against independent investment advisors who are not registered with FINRA and not subject to FINRA arbitration. It renders an overview of considerations in commencing cases. These cases present considerations based on the granted or de factor discretionary authority exercised by investment advisors, often with financial planning services, for asset-based fees.

1. Primer on Investment Advisor Regulation

This primer on investment advisor regulation renders basic parameters of the regulatory scheme. An investment advisor, as defined,[2] must register with the Securities and Exchange Commission (Commission) if its assets under management exceed $110 million. With assets between $110 and $90 million,[3] an adviser is eligible but does not have to register with the Commission. The registration requirements are subject to multiple exceptions and exclusions, depending on the type of advisor, as for example, an advisor to a registered investment company, a private fund advisor, and family offices.[4] Advisors ineligible for registration with the Commission register with their state securities administrator.

1. Jane L. Stafford has represented and commenced actions against investment advisors for almost 35 years, successfully navigating this industry segment requiring a knowledge of the law and underlying investment concepts used in this industry. Further information may be found at on the website of the firm she founded in 2004, at https://www.staffordassoc.com/.

2. Investment Advisors Act, Section 202(a)(11) Definitions. The Investment Advisers Act commences at 15 USC §80b-1, *at* http://legcounsel.house.gov/Comps/Investment%20Advisers%20Act%20Of%201940.pdf.

3. *Id.* Section 203A State and Federal Responsibilities; Rule 204A-1 Eligibility for SEC Registration: Switching to or from SEC Registration. Rules promulgated under the Investment Advisors Act commence at 17 CFR 275.0-2 *et seq., at* https://www.ecfr.gov/cgi-bin/text-idx?node=17:4.0.1.1.22&rgn=div5.

4. *E.g.*, Rule 202(a)(11)(g)-1 Family offices; Rule 203(m)-1 Private fund adviser

Registration with the Commission requires the completion and filing of a Form ADV. The Form ADV may be reviewed with comments issued by the Commission. Form ADV consists of two parts: Part 1 contains check-the-box answers, relating to statistical and other objective information; and Part 2 contains a narrative disclosure about the advisor's business, strategies, rendering of advisory services, and conflicts.

State securities administrators may require additional documents depending on the state, such as a copy of the client agreement, written supervisory procedures, the agreement with the custodian, and a balance sheet. Each state adopts its own securities statutes, and for the most part, follow a version of the Uniform Securities Act with modifications. Reference is made to the Uniform Securities Act (2005)[5] for ease and simplicity as representative of state laws, and to the Model Rules promulgated by the North America Securities Administrators Association.[6]

Individuals rendering advice on behalf of investment advisors are referred to as investment advisor representatives, and most states require these persons to register. An individual must file a Form U4 and pass a qualifying examination or have a professional designation recognized by the state as acceptable in lieu of the qualifying examination.

Regulations promulgated by the Commission and the state securities administrators vary little. Any variations occur in more sensitive areas, such as the custody rule and disclosure requirements particular to a state's own concern. Regulations are extensive. Interpretation of the regulations promulgated by the Commission emanates from a variety of sources, primarily enforcement actions, FAQ's and staff interpretative releases. The state securities administrators offer minimal interpretation of their rules, and reference is usually made to the Commission's interpretation of the regulatory requirements for clarification.

Although the Investment Advisors Act prohibits states imposing regulations on advisors registered with the Commission, the state securities administrators maintain authority to investigate and bring enforcement actions

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exemption; Rule 203A-2 Exemptions from prohibition on Commission registration., *supra* note 2.

5. Uniform Securities Act, *at* http://www.uniformlaws.org/shared/docs/securities/securities_final_05.pdf.

6. NASAA model rules may be found at http://www.nasaa.org/1325/adopted-model-rules/.

with respect to fraud or deceit against an investment advisor or person associated with an investment advisor.[7]

2. Case Selection and Review

Actions against investment advisors contain their own considerations, distinct and separate from actions against broker-dealers and registered representatives. Beyond a different set of statutes and regulations governing their conduct, the relationship as between the advisor and the client varies. Most relationships are longer-term and involve a high degree of trust and faith by the client in the advisor.

a. Parties

An action against an investment advisor involves an action against the entity and its registered investment advisor representatives. The control persons of the firm maintain liability for malfeasant conduct under state securities statutes, unless the control person sustains the burden of proof that the person did not know, and in the exercise of reasonable care could not have known, of the wrongful conduct.[8] However, given the requirements for supervisory policies and procedures, it becomes the obligation of control persons to detect and to deter wrongful conduct.[9]

Form ADV contains information about the investment advisor, its structure and practices. Disclosure requirements exist, but many firms make form disclosures or disclosures that differ from their actual practices. Certain basic information may still be found. Form ADV's may be found through the

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7. Investment Advisors Act, Section 203A(b)(3) State and Federal Responsibilities, Limitations, s*upra* note 1.

8. Uniform Securities Act, Section 509(g) Civil Liability, imposes joint and several liability on control persons, pp. 134-135, s*upra* note 4,

9. *E.g*., Rule 206(4)-7 Compliance procedures and practices; Rule 204A-1 Investment adviser codes of ethics, *supra* note 2; Subsection (19) of NASAA Recordkeeping Requirements for Investment Advisers Model Rule USA 2002 411(c)-1 Adopted 9/17/2008; Amended 9/11/2011, p. 19 *at* www.nasaa.org/wp-content/uploads/2011/07/IA-Model-Rule-Definition-Under-2002-Act.pdf.

Investment Advisor Public Disclosure, as well as Form U4's for investment advisor representatives if required to register.[10]

In most instances, an advisor maintains custody of client assets with a broker-dealer who maintains a "platform" for investment advisors. The broker-dealer provides custodial services, brokerage, and many back-office functions, including without limitation provision of account statements and other reports.

b. Damages

A reference to damages in case selection and review seems obvious, except with investment advisors the difficulty may arise because of the length of the relationship and the tendency for a damage review to be based on net out-of-pocket. With a longer relationship, unless extenuating circumstances exist, the net out-of-pocket may be minimal when measured over the life of the relationship, oftentimes being very lengthy.

c. Recovery Potential

Many advisory firms are smaller, with minimal if any net capital requirements. Some states impose minimum net capital requirements. Under the Uniform Securities Act, a rule *may* require an investment advisor that has custody of or discretionary authority to obtain insurance or post a bond, but the amounts are comparatively minimal.[11]

Advisors registered with the Commission have no net capital requirements. The Commission only requires disclosure in Form ADV if the financial condition of the advisor would be material to the advisory relationship.[12] This disclosure obligation goes beyond the enumerated list of

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10. Investment Adviser Public Disclosure website, *at* https://adviserinfo.sec.gov.

11. *See* NASAA Minimum Financial Requirements for Investment Advisers Model Rule USA 2002 411(a)-1 Adopted 9/17/2008; Amended 9/11/2011, *at* http://www.nasaa.org/wp-content/uploads/2011/07/IA-Model-Rule-Minimum-Financial-Requirements.pdf.

12. General Instructions for Part 2 of Form ADV, No. 3 Disclosure Obligations as a Fiduciary, p.1 *at* https://www.sec.gov/about/forms/formadv-part2.pdf.

financial matters that must be disclosed, such as bankruptcies within the last ten years.[13]

If an advisor maintains custody, additional financial disclosures exist, and may extend to audited financial statements and a surprise examination.[14] Most advisors avoid custody.

Despite their size as "smaller," firms who maintain sufficient assets should not be dismissed as uncollectible. For example, assuming a smaller firm maintains $50 million under management, if that firm charges 1% of assets under management, the firm would gross $500,000 annually. This gross is offset with minimal expenses, primarily salaries and rent. Most operational expenses are undertaken by the custodian, broker-dealer within the provision of services under its platform.

d. Insurance Considerations

Many firms maintain insurance, and some of the custodian, broker-dealer platforms require insurance as a precedent to allowing an advisor to use the platform and to custody its clients' assets. Also, with advisors acting as financial planners, they may place a higher value on insurance and will maintain insurance for claims. Some states require an advisor to disclose on its Form ADV if it maintains insurance.[15]

With insurance coverage, care should be exercised to avoid denial of coverage. Typical errors and omissions insurance exclude intentional acts, such as gross negligence and common law fraud.[16] Although these claims may

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13. Form ADV, Part 1, Item 11 Disclosure Information. The Form ADV may be found *at* https://www.sec.gov/about/forms/formadv.pdf.

14. Rule 206(4)-2 Custody of funds or securities of clients by investment advisors, *supra* note 2.

15. For example, the Kansas Securities Commissioner requires advisors to disclose whether they maintain liability insurance under Item 19 of Part 2 of Form ADV. *See supra* note 12.

16. Copies of form contracts of insurance are available through the state departments of insurance in the SERFF Filing website. SERFF (System for Electronic Rates and Forms Filing) is maintained by the National Association of Insurance Commissioners and made available through the state insurance departments. An insurance company is required to file all forms of insurance policies, and if the name of the insurance company is known, a form of the policy may be found. However, the system is difficult to navigate. *See* http://www.serff.com/.

be included in the causes of actions claimed, drafting of facts involving intentional acts and gross conduct must carefully avoid the potential for denial of coverage. These issues become accentuated when statutes of limitations issues exist, with a need to claim an affirmative defense of fraudulent concealment to toll the statute.

e. Exculpatory Clauses

Simply put, exculpatory clauses are void.[17] Any language that purports to create the impression that an individual has waived any rights is void as against public policy and further evidences a breach of fiduciary duty by the advisor.[18]

3. Prefiling Demands

A demand letter prior to filing may serve numerous purposes. It may attempt to determine if an arbitration agreement exists and to resolve a poorly drafted arbitration agreement that either fails to reference a forum or references a defunct forum. A prefiling demand may also garner information about insurance coverage, either from the type of law firm responding or upon hopeful inquiry of the law firm responding.

4. Causes of Action

An investment advisor's duties arise under the Investment Advisors Act of 1940 and state blue sky laws. The Investment Advisors Act was created to

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17. Investment Advisors Act, Section 215 Validity of Contracts, *supra* note 1; Uniform Securities Act, Section 215(l) Validity of Contracts; No contractual Waiver, *supra* note 4.

18. The use of a hedge clause or other exculpatory provision in an investment advisory agreement which is likely to lead an investment advisory client to believe that he has waived non-waivable rights of action against the adviser provided by federal or state law violates Sections 206(1) and 206(2) as a device, scheme, or artifice to defraud, or a transaction, practice, or course of business that operates as fraud or deceit on clients or prospective clients. *In the Matter of William Lee Parks*, Release No. IA-736 (Oct. 27, 1980); *In the Matter of Olympian Financial Services, Inc.,* Release No. IA- 659 (Jan. 16, 1979).

regulate investment advisors' actions and to protect investors. It is a remedial statute and interpreted accordingly.

a. Liability

i. Investment Advisors Act

Generally, the only remedy available under the Investment Advisors Act of 1940 is under Section 215 of the Act, which states that contracts that violate the Act "shall be void . . . as regards to the rights of the person who has violated the Act.[19] The U.S. Supreme Court in *Transamerica Mortgage Advisors, Inc. v. Lewis*[20] stated:

> When Congress declared in Section 215 that certain contracts are void, it intended that the customary legal incidents of voidness would follow, including the availability of a suit for rescission or for an injunction against continued operation of the contract and for restitution."

Therefore, only under §215 does the limited private right of action to void a contract against a violator of the Investment Advisors Act exist.

The Court in *Transamerica Mortgage Advisors, Inc. v. Lewis* also determined the phrase in Section 206 of the Investment Advisors Act, which makes it unlawful for an investment advisor "to employ any device, scheme, or artifice to defraud . . . [or] engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client," does not establish a private cause of action upon violation of the phrase; the words are merely "designed to protect investment advisor's clients."[21]

Due to the inadequacy of the federal statutory remedies under which an investor may bring a private cause of action against an investment advisor, most causes of action are brought under general common law rights of action or blue-sky laws. The most common suits are brought under the following theories under common law: breach of fiduciary duty, negligence, breach of contract and common law fraud.

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19. Investment Advisers Act of 1940, Section 215 Validity of Contracts, *supra* note 1.

20. *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 18-19 (1979).

21. *Id.* 19-24. *See also* Investment Advisor Act, Section 206 Prohibited Transactions by Registered Investment Advisors, *supra* note 1.

ii. Statue Securities Statutes

Most state statutes impose liability on investment advisors and prohibit conduct that operates as "a device, scheme, or artifice to defraud another person; . . . an act, practice, or course of business that operates or would operate as a fraud or deceit upon another person, or conduct defined by a rule."[22]

Rules adopted under the Uniform Securities Act are typically quite extensive in listing the conduct deemed to be prohibited. Generally, any malfeasant conduct will be covered by a rule if the state's securities administrator has adopted rules.[23]

Short statutes of limitations with state securities statutes cause this remedy to be less useful. Individuals engaging an investment advisor do so because they desire to have someone else manage their money, and they trust that person implicitly. These individuals infrequently review account statements and believe the investment advisor when assurances are rendered as to poor performance of an account.

iii. Employee Retirement Income Security Act of 1974

Under the Employee Retirement and Income Security Act of 1974 (ERISA), investment advisors fall within the definition of a fiduciary and are held to the standards imposed on fiduciaries in accordance with ERISA.[24] A fiduciary must discharge its duties solely in the interests of the client with the "care, skill, prudence, and diligence then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims."[25]

22. Uniform Securities Act, Section 502 Prohibited Conduct in Providing Investments Act, pp. 124 – 145, *supra* note 4.

23. *E.g.*, NASAA Model Rule on Unethical Business Practices of Investment Advisers, Investment Adviser Representatives, and Federally Covered Advisers (NASAA Model Rule 102(a)(4)-1), at http://www.nasaa.org/1325/adopted-model-rules/**.**

24. 29 USC §1002(21), at https://www.law.cornell.edu/uscode/text/29/1002. *See also* 29 CFR §2510.3-21.

25. 29 USC §1104, *at* https://www.law.cornell.edu/uscode/text/29/1104.

iv. Breach of Fiduciary Duty

A fiduciary relationship is defined in Black's Law Dictionary as one "in which one person is under a duty to act for the benefit of the other on matters within the scope of the relationship."[26] As a fiduciary, an investment advisor owes the client a fiduciary duty to act in the client's best interests and with the utmost care, integrity and loyalty, and the highest degree of care and loyalty.[27]

A fiduciary relationship is also described as a relationship where there is a duty of trust, utmost loyalty and good faith to another. When a fiduciary relationship is deemed to be present, the law imposes an obligation to act in the best interest of the party to whom the duty is owed and to place that person's interests above the fiduciary's own interests.

An investment advisor owes the client a duty to manage the accounts according to the individual investment needs, objectives, goals and desires for the accounts. This duty requires an advisor to have a reasonable basis for its recommendations meeting the client's investment needs, objectives and desires.[28] The advisor has a further duty to disclose all material facts relevant to its engagement.[29]

The Investment Advisors Act of 1940 indicates that Congress recognized the nature of a fiduciary relationship and intended to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser to act in his own interests rather than those of the investor. The Commission promulgates a series of rules establishing standards of care to which an investment advisor must adhere, including disclosures, conflicts of interests, compliance programs, codes of ethics and designating chief compliance officers.[30]

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26. Black's Law Dictionary p. 640 (7th ed. 1999).

27. *Cf. SEC* v. *Capital Gains Research Bureau, Inc.,* 375 U.S. 180 (1963); *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U.S. 11 (1979); *Santa Fe Industries, Inc.* v. *Stone*, 430 U.S. 462, 471, n. 11 (1977). *See also* Investment Advisors Act of 1940, Section 206 Prohibited Transactions by Registered Investment Advisors, *supra* note 1.

28. *In the Matter of Jamison, Eaton & Wood, Inc.*, Investment Advisors Act Release No. 2129 (May 15, 2003); *In the Matter of Mark Bailey & Co., and Mark Bailey*, Investment Advisors Act Release No. 1105 (Feb. 24, 1988); *In the Matter of Kidder, Peabody & Co., Incorporated, Edward B. Goodnow*, Investment Advisors Act Release No. 232 (Oct. 16, 1968).

29. *Id.*

30. *E.g.*, Rule 204A-1 Investment adviser code of ethics; Rule 206(4)-7 Compliance

v. Negligence

Actions may be brought based on negligence in providing advice. In doing so, reference may be made to a multitude of standards of care, including state statutes regarding unfair financial planning practices,[31] senior financial exploitation statutes,[32] and state regulations defining prohibited conduct by investment advisors.[33]

If an individual maintains a professional designation, the maintenance of that professional designation requires certain standards of care, as follows:

Designation	**Standards**
Chartered Financial Analyst (CFA®)	Code of Ethics and Standards of Professional Conduct[34]
Certified Financial Planner (CFP®)	Certified Financial Plan Board of Standards of Professional Conduct[35]
Certified Public Accountant (CPA®)	AICPA Code of Professional Conduct[36]

procedures and practices, *supra* note 2.

31. *E.g.,* Revised Missouri Statutes §375.936(12). Unfair practices defined, unfair financial planning practices, *at* http://revisor.mo.gov/main/OneSection.aspx?section=375.936&bid=20427&hl=.

32. NASAA Model Legislation or Regulation to Protection Vulnerable Adults from Financial Exploitation, at http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/07/NASAA-Model-Seniors-Act-adopted-Jan-22-2016.pdf.

33. NASAA Model Rule on Unethical Business Practices of Investment Advisers, Investment Adviser Representatives, and Federally Covered Advisers (NASAA Model Rule 102(a)(4)-1), at http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/07/NASAA-Model-Seniors-Act-adopted-Jan-22-2016.pdf.

34. https://www.cfapubs.org/toc/ccb/2014/2014/6.

35. https://www.cfp.net/about-cfp-board/ethics-enforcement/standards-of-professional-conduct.

36. https://www.aicpa.org/research/standards/codeofconduct.html.

These standards of care present exhaustive requirements. In addition to providing required standards of care as the basis for a negligence claim, the organizations granting these professional designations pursue disciplinary actions against individuals violating the standards. Given the difficulty in obtaining these designations, most individuals prefer to avoid the potential for a disciplinary action that may impede the use of these designations.

Unsuitable investment advice is indicia of breach of fiduciary duty, negligence and goes toward the element of causation. The Commission promulgated a suitability rule which was never adopted.[37] Instead, it pursues suitability claims under the general anti-fraud provisions of the Investment Advisors Act.[38] The only suitability rule is the one for broker-dealers.[13] Although investment advisors are not regulated by FINRA, FINRA's rule on suitability may be referenced as a minimum standard of conduct to make suitable recommendations.[39]

vi. Breach of Contract

Many investment management contracts contain language that the investment advisor will provide investment supervisory services. "'Investment supervisory services' means the giving of continuous advice as to the investment of funds on the basis of the individual needs of each client."[40] When a client experiences losses, in all likelihood, the advisor failed to provide the investment supervisory services promised. Additionally, investors may bring breach of contract actions if the investment advisor does not follow the

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37. Proposed Rule, Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406 (March 16, 1994), *cited by* Commissioner Louis A. Aguilar, Speech by SEC Commissioner: A Shared Responsibility: Preserving the Fiduciary Standard, note 6 (March 26, 2010), ("Investment advisers are fiduciaries who owe their clients a series of duties, one of which is the duty to provide only suitable investment advice. This duty is enforceable under the antifraud provisions of the Advisers Act, section 206, and the Commission has sanctioned advisers for violating this duty."), *at* https://www.sec.gov/news/speech/2010/spch032610laa.htm.

38. *Id. See* Investment Advisors Act, Section 206 Prohibited Transactions by Registered Investment Advisors, *supra* note 1.

39. FINRA Rule 2111. Suitability, at: http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=15663&element_id=9859&highlight=suitable#r15663.

40. Investment Advisors Act Section 202(a)(13) Definitions, *supra* note 1.

clients' instructions or if the investment advisor breaches the implied covenant of good faith and fair dealing.

vii. Common Law Fraud

Common law fraud, including misrepresentations and omissions, are common causes of action brought against investment advisors. The requisite elements in common include: false representation of a material fact, knowledge of the falsity, purpose of the falsity to induce the investor to act, the investor relies on the falsity and believes it to be true, and the investor acts on the falsity to his or her detriment.[41] The conduct must be intentional by the advisor.[42]

b. Statutory Damages

Statutory provisions provide for damages beyond a net out-of-pocket measure. These statutory provisions are contained in the state securities statutes and ERISA.

Section 509(f) of the Uniform Securities Act[43] provides for damages equal to the following:

> Consideration paid for the advice and the amount of any actual damages caused by the fraudulent conduct, interest [at the legal rate of interest] from the date of the fraudulent conduct, costs, and reasonable attorneys' fees determined by the court, less the amount of any income received as a result of the fraudulent conduct., interest at the legal rate, costs and reasonable attorneys' fees determined by the court, less the amount of any income received as a result of the fraudulent conduct.

The statutory remedies under ERISA[44] provide damages measured as follows:

- Losses incurred;
- Restoring profits made by the advisor;

41. *Golden Atlanta Site Dev. v. Nahai*, 683 S.E.2d 166, 171 (Ga. App.2009).

42. *See* Restatement (Second) of Torts § 531.

43. *Supra* note 4, pp 134-135.

44. 29 U.S.C. § 1132, *at* https://www.law.cornell.edu/uscode/text/29/1109.

- Reasonable attorneys' fees and costs; and
- Such other appropriate equitable relief to redress such violations or to enforce ERISA.

The Employee Benefits Security Administration, under the Department of Labor, has extensive materials delineating violations of ERISA and example violations. A multitude of articles exist on statutory remedies under ERISA.

5. Statute of Limitations

Because of the relationship of trust and confidence, however misplaced, statutes of limitations present themselves with possibly more frequency than a claim against a broker-dealer. If an individual engages an investment advisor to manage his assets on a discretionary basis, from the beginning, the engagement implies a high degree of faith and trust, as well as the lack of time to allot for investment management oversight. Consequently, claimants seem to realize their losses much later, or to act much later because they believe whatever the advisor tells them about the losses being experienced.

a. State Securities Statutes

Claims under state securities statutes are barred "unless the action is instituted within the earlier of two years after discovery of the facts constituting the violation and five years after the violation."[45] Seemingly this longer statute of limitations recognizes the unique nature of the advisory relationship. The typical antifraud statutory limitation of one-year/three-year does not govern. Notwithstanding, governing state law must be reviewed to determine the actual statute of limitations under that state's statute. State statutes may vary substantially.

b. ERISA

ERISA bars an action with respect to a fiduciary's breach of any responsibility, duty, or obligation, after the earlier of

> (1) six years after (A) the date of the last action which constitute a part of the breach or violation, or (B) in the case of an omission the

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45. Uniform Securities Act, Section 509(j), Civil Liability, Statutes of Limitations, *supra* note 4.

latest date on which the fiduciary could have cured the breach or violation, or

(2) three years after the earliest date on which the plaintiff had actual knowledge of the breach or violation; except that in the case of fraud or concealment, such action may be commenced not later than six years after the discovery of such breach or violation. [46]

c. Common Law Claims

Each state will have its own statute of limitations for common law claims of breach of fiduciary duty, negligence, breach of contract, fraud and similar claims. With these common law claims, tolling provisions may allow an extension of the statute of limitations, such as the continuing tort doctrine, fraudulent concealment and equitable tolling.

The "continuing tort doctrine" acts as a tolling provision. A continuing tort is one inflicted over a period of time. It involves wrongful conduct that is repeated until desisted.[47]

The doctrine of fraudulent concealment tolls or suspends the running of limitations after it has begun if the facts necessary to know that a cause of action has accrued is concealed. It tolls the statute until the fraud is discovered or could have been discovered with reasonable diligence.[48] Courts characterize fraudulent concealment as an affirmative defense and require it be pled accordingly.[49]

Some courts distinguish fraudulent concealment from the discovery rule, which may be applied categorically to instances in which the nature of the injury incurred is inherently undiscoverable and the evidence of an injury is

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46. 29 USC §1113 – Limitations of actions, *at* https://www.law.cornell.edu/uscode/text/29/1113.

47. *Dickson Const., Inc. v. Fidelity and Deposit Co. of Md*., 960 S.W.2d 845, 851 (Tex. App-Texarkana 1997).

48. *Shell Oil Co. v. Ross* 357 S.W.3d 8, 17 (Tex. App. 2010); *Sauceda v. Kerlin* 164 S.W.3d 892, 917 (Tex. 2005). *See also, DeLuna v. Burciaga*, 857 N.E. 2d 229, 242-43 (Ill. 2006).

49. *Arnold V KPMG LLP,* 543 F Supp. 230, 237 (S.D.N.Y. 2008); *Achee v. Port Drum Co.,* 197 F. Supp. 723, 737 (E.D. Tex. 2002).

objectively verifiable.[50] An injury is not inherently undiscoverable when it is the type of injury that could be discovered through the exercise of reasonable diligence.[51]

Additionally, the fiduciary relationship tilts application of the discovery rule, as an injury being inherently undiscoverable because of the relationship.[52] The courts will apply the discovery rule when it is otherwise difficult for the inured party to learn of the wrongful acts.[53]

Some courts apply an equitable tolling doctrine, which focuses on excusable ignorance of the wrongful conduct.[54] In limited instances, this equitable tolling may even toll statutes of repose.[55]

These concepts of fraudulent concealment, the discovery doctrine and equitable tolling depend highly on the jurisdiction and the court's inclination. The cases cited are for reference only. Further research on current law in any particular jurisdiction must be conducted and within the facts presents.

6. Forum Considerations

Forum considerations first depend on any contractual language to arbitrate. If an agreement to arbitrate exists, courts are highly likely to enforce

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50. *Computer Assoc. Int'l, Inc. v. Altai, Inc*., 918 S.W.2d 453, 455-56 (Tex. 1996).

51. *Wagner & Brown, Ltd. v. Horwood*, 58 S.W.3d 732, 734-35 (Tex.2001); *Hays v. Hall*, 488 S.W.2d 412, 414 (Tex.1972) (negligence in performing vasectomy confirmed by subsequent pregnancy; held discovery rule applies).

52. *West v. Proctor*, 353 S.W.3d 558 (Tex. App, 2011); *Hagney v. Lopeman,* 590 N.E.2d 466, 469 (Ill. 1992); *Vogel v. A. G. Edwards & Sons, Inc*., 801 S.W. 2d 746, 755 (Mo. App. E.D. 1990), *citing Burr v. Nat'l Life & Acc. Ins. Co*., 667 S.W.2d 5, 7 (Mo. App.1984) (relationship creates a sense of security which may be false, only actual discovery of the fraud serves to begin the period). *See also Cohen v. S.A.C. Trading Corp*., 711 F.3d 353, 363 (2d Cir. 2013) (reasonable diligence in discovery).

53. *S.V. v. R.V*., 933 S.W.2d 1, 6 (Tex. 1996).

54. *Cf., Rhodes v. Guiberson Oil Tools Div*., 927 F.2d 876, 878 (C.A.5 (La) 1991), *citing Felty v. Graves-Humphreys*, Co., 785 F.2d 516, 519 (4th Cir.1986).

55. *First Interstate Bank of Denver, N.A. v. Central Bank & Trust Co. of Denver*, 937 P.2d 855, 860 (Colo. App., 1996); *Cange v. Stotler and Co., Inc*., 826 F.2d 581, 587 (C.A. 7 (Ill.) 1991), *citing Glus v. Brooklyn Eastern Dist. Terminal*, 359 U.S. 231, 232-233 (1959) (not permit a party to assert a defense if the defense would enable the party to take advantage of his own wrongdoing).

such an agreement.[56] Of course if no agreement exists, the parties may proceed and file in local courts. In some instances, however, a party may prefer to arbitrate a matter, such as a successful businessperson who prefers the privacy of arbitration, or if the dynamics of a local forum may provide minimal sympathy for someone losing substantial sums while still having a considerable fortune left.

If an investment advisor is also a registered broker-dealer and member of FINRA, or another self-regulatory organization, FINRA rules allow a customer to request arbitration under the Code of Arbitration Procedures if the dispute arises in connection with the business activities of the member.[57] FINRA also allows disputes between investors and non-member registered investment advisors under certain conditions.[58] The consideration then shifts to the advantages, if any, of arbitration administered by FINRA over proceeding in court or another arbitration forum.

a. Arbitration

If the agreement to arbitrate fails to designate a forum or designates a defunct forum, the parties may proceed in private arbitration, such as JAMS or the American Arbitration Association (AAA). A private arbitration contains advantages of being able to select a qualified and knowledgeable arbitrator. However, some arbitrators may prefer the structure and assistance offered by JAMS or AAA. The costs of JAMS and AAA present a strong consideration to pursue a private arbitration.

With a private arbitration, the parties agree upon an arbitration and that the arbitrator determines the rules of arbitration, with reference to rules promulgated by FINRA, JAMS or AAA. Care needs to be taken in referencing any forum's rules because of the potential for dispositive motions, limited discovery, depositions, and other similar matters that denigrate the advantages

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56. *Gilmore v. Interstate/Johnson Lane Corp*., 500 U.S. 20, 26 (1991); *Rodriquez de Quijas v. Shearson/American Express, Inc*. 490 U.S. 477 (1989).

57. FINRA Code of Arbitration Procedure for Customer Disputes, Rule 12200 Arbitration Under an Arbitration Agreement or the Rules of FINRA, *at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4105.

58. FINRA, Guidance on Disputes between Investors and Investment Advisers that are Not FINRA Members, *at* https://www.finra.org/arbitration-and-mediation/investment_advisers.

of arbitration. One forum may favor dispositive motions, while another forum may not.

For example, JAMS arbitration rules allow at least one deposition and the arbitrator may determine the necessity of additional depositions.[59] Both JAMS and AAA allow dispositive motions, but AAA requires a showing of "substantial cause that the motion is likely to succeed and dispose of or narrow the issues in the case."[60]

b. Court

Proceeding in court will be an individual determination depending on the claims, the issues in controversy and similar matters. It is a debate unique to any individual case, the facts, and preferences of the parties and their counsel. Further considerations of federal and state court forum choices exist, depending on the parties and claims. Filing a case in court, whether state or federal, is a public filing and may involve time consuming and expensive motion practice, discovery processes, and the ability of either party to appeal even interlocutory matters has the potential to grind the proceeding to a halt. Filing in court may also be a tool to force settlement, as advisors fear the attendant adverse publicity and the possibility of additional lawsuits being filed.

7. Discovery Tools

The Commission and state securities administrators require investment advisors to maintain certain books and records.[61] The books and records rules are substantially similar and may form the bases for a discovery request.

59. JAMS Comprehensive Arbitration Rules & Procedures, Rule 17(b) Exchange of Information (July 1, 2014), *at* https://www.jamsadr.com/rules-comprehensive-arbitration/.

60. American Arbitration Association, Consumer Arbitration Rules (February 21, 2018), R-33 Dispositive Motions, *at* https://www.adr.org/sites/default/files/Consumer_Rules_Web.pdf.

61. Rule 204-2 Books and records to be maintained by investment advisors, *supra* note 2; NASAA Recordkeeping Requirements for Investment Advisers Model Rule 203(a)-2, amended 9/11/2011, at http://www.nasaa.org/wp-content/uploads/2011/07/IA-Model-Rule-Recordkeeping.pdf.

Form ADV's are maintained for the current year on the Investment Advisor Public Disclosure website. Prior years Form ADV's must be maintained by investment advisors, and if an advisor claims exculpatory disclosures in a prior year's Form ADV, the advisor must maintain that copy and produce it.

Advisor's websites provide a valuable resource, albeit limited, as well as general internet searches. Many financial planners advertise extensively, and oftentimes, their television advertisements or radio talk shows are captured on YouTube or a similar media. When investment advisors are seeking new clients, the representations they make if committed to writing in some format prove incredulous.

8. Conclusion

The number of registered investment advisors continues to increase, from 10,511 in 2012 to 12,172 in 2017.[62] In comparison, FINRA reports a decrease in registered representatives from 643,322 in 2015 to 635,902 in 2016, a net decrease of about 1.2%.[63]

The cases against investment advisors provide a distinct advantage of having a claim for fiduciary duty, without question. That same fiduciary duty may cause statute of limitations problems, in clients relying too much on their trusted advisor. Clients will believe the advisor's lulling representations that everything is okay with their accounts and often fail to review account statement regulatory or carefully, relying entirely on their trusted advisor.

The genesis of the shift in business models commenced on May Day, or May 1, 1975 when broker commission rates became de-regulated.[64] Since that date, market competition has continually diminished commission rates, resulting in shift away from commission business to asset-based fee business and many financial advisors entering the more lucrative investment advisory

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62. Number of Registered Investment Advisors (RIASs)* employed in the United States from 2012 to 2017, The Statistics Portal, Statista 2018, *at* https://www.statista.com/statistics/614815/number-of-rias-employed-usa/.

63. FINRA, Registered Representatives Statistical Review 2002 – 2016, *at* https://www.finra.org/newsroom/statistics#repsform.

64. Securities Acts Amendments of 1975, Public Law 94-29, **states in its preface: An Act to amend the Securities Exchange Act of 1934 to remove barriers to competition."** http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1970/1975_0604_1975Amendments.pdf.

business. Because of the relatively minimal barriers to entry in this industry, many unscrupulous, unknowledgeable and unqualified individuals have entered this field. Coupled with the complete control exercised over client assets, the resulting harm to investors continues increasing.

RECENT ARBITRATION AWARDS

Christopher Gray

This issue's survey highlights the extreme unpredictability of results in FINRA arbitration. On the positive side for Claimants, the awards below feature three make-whole awards including attorneys' fees, one of which also included an award of punitive damages. On the negative side, the awards include a dismissal that amounted to a pre-hearing grant of summary judgment in favor of a Respondent broker-dealer in a "selling away" case, seemingly based solely on the fact that it was a "selling away" case, as well as an award of $200,000 in attorneys' fees plus $75,000 costs against an unsuccessful Claimant pursuant to a contractual attorneys' fee-shifting provision contained in a subscription agreement.

Michael Joseph Briggs and Margarita Ramirez Briggs, Claimants v. BOK Financial Securities, Inc., Respondent
Case No. 17-03507[1]

1. Claimants asserted the following causes of action: breach of fiduciary duty, breach of contract, fraud, misrepresentation, unsuitable investment recommendations, violations of FINRA Conduct Rules, failure to supervise, negligent hiring, negligence, and negligent supervision. The causes of action related to Claimants' allegation that Respondent sold them an annuity without any explanation of how the investment worked.

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

In the Statement of Claim, Claimants requested compensatory damages in the amount of $55,000.00, punitive damages in an amount to be determined from the evidence accumulated during discovery, interest, costs, attorneys' fees, and such other damages the Arbitrator deems appropriate.

In the Statement of Answer, Respondent requested that the Arbitrator dismiss the Statement of Claim in its entirety and order that Claimants are not entitled to recover any sum of money from Respondent; award Respondent its costs, including reasonable attorneys' fees incurred in the defense of the Statement of Claim; award Respondent recovery for its forum fees, assessments, and charges imposed in connection with these proceedings; and award Respondent such other and further relief to which it shows itself entitled.

Houston, Texas

Claimants' Counsel: Kristian P. Kraszewski, Esq., Kyros Law Offices, Naples, Florida.

Respondent's Counsel: Jared M. Burden, Esq., Frederic Dowart, Lawyers, Tulsa, Oklahoma.

Arbitrator(s): Sherry R. Wetsch, Sole Public Arbitrator.

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

1. Respondent is liable for and shall pay to Claimants the sum of $22,071.92 in compensatory damages.
2. Respondent is liable for and shall pay to Claimants interest on the above-stated sum at the rate of 5% per annum, from and including thirty days after the Date of Service of this Award, through and including the date this Award is paid in full.
3. Other than forum fees which are specified below, the parties shall each bear their own costs and expenses incurred in this matter.
4. Any and all claims for relief not specifically addressed herein, including punitive damages, are denied.

The award is notable because the Sole Public Arbitrator issued an award in the amount of $22,071, thus fully satisfying Claimants' request at the hearing for compensatory damages of $11,638, as well as disgorgement of commissions totaling $10,433. At issue in this matter was the sale of an annuity product and Respondent's alleged failure to inform Claimants of how the investment worked.

Denise M. Fry Living Trust, Denise M. Fry, and Donna Sullivan, Claimants v. Comprehensive Asset Management and Servicing, Inc., and Tamara Rae Steele, Respondents and Comprehensive Asset Management and Servicing, Inc., Cross-Claimant v. Tamara Rae Steele, Cross-Respondent

Case No. 17-01767[2]

2. Claimants asserted the following causes of action: outside business activities and selling away; unsuitable investments and negligent account management; violations of the Indiana Securities Act; Violation of Registered Investment Advisor Section of Indiana Securities Act; sale of unregistered and non-exempt securities; breach of fiduciary duty; violations of the FINRA Conduct Rules and NYSE Board Rules; respondeat superior; and negligence and negligent supervision. The causes of action

Indianapolis, Indiana

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related to Claimants' purchase of promissory notes, common stock, preferred stock, and stock warrants of Behavioral Recognition Systems, Inc. ("BRS Labs").

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

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

In its Cross-Claim against Steele, Comprehensive asserted the following causes of action: indemnification and contribution. The causes of action related to Comprehensive's allegations that Steele entered into a Registered Representative Agreement with Comprehensive, which entitled it to contribution and indemnification for Steele's intentional and/or negligent acts.

Unless specifically admitted in her Statement of Answer to Cross-Claim, Steele denied the allegations made in the Cross-Claim and asserted various defenses.

In their Statement of Claim, Claimants requested $280,026.03 in compensatory damages, pre and post judgment interest, costs of arbitration, attorneys' fees, alternate damages measured by how Claimants' assets would have performed had they been managed in a manner consistent with their investment objectives, disgorgement, punitive damages, and other relief.

In its Statement of Answer, Comprehensive requested that Claimants' claims be dismissed, that it be awarded all reasonable costs and expenses including reasonable attorneys' fees, costs of suit and such further relief as the panel deems just and proper.

In her Statement of Answer, Steele requested dismissal, a reasoned decision in her favor denying Claimants' request for relief and other appropriate relief. Steele also requested that, if Claimants are awarded damages, that Claimants be required to transfer their BRS Labs investments and security interests to Steele, and that Fry be required to transfer her judgment against Giant Gray to Steele.

In its Cross-Claim, Comprehensive requested indemnification and contribution from Steele for all judgment amounts, settlement amounts, costs of defense, costs of prosecution, attorneys' fees, costs of suit including FINRA fees, and such other and further relief as the arbitration panel deems just and proper.

In her Answer to Cross-Claim, Steele requested that the relief requested in the CrossClaim be denied and that she be awarded other appropriate relief.

At the close of the hearing, Fry Trust and Fry requested $117,000.00 in compensatory damages.

At the close of the hearing, Sullivan requested $55,408.00 in compensatory damages.

Claimants' Counsel: Mark E. Maddox, Esq. and Thomas K. Caldwell, Esq., Maddox Hargett & Caruso, P.C., Fishers, Indiana.

For Respondent Comprehensive Asset Management and Servicing, Inc. ("Comprehensive"): Brian A. Carlis, Esq., Stark & Stark P.C., Lawrenceville, New Jersey.

For Respondent Tamara Rae Steele ("Steele"): Robert L. Hartley, Esq., Frost Brown Todd LLC, Indianapolis, Indiana.

Arbitrators: Lynn Hirschfeld Brahin, Public Chairperson; Julia Church Kozicki, Public Arbitrator; Jill Elise Vestal, Public Arbitrator.

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

1. Steele is liable for and shall pay to Fry Trust and Fry the sum of $111,700.00 in compensatory damages.
2. Steele is liable for and shall pay to Fry Trust and Fry interest on the sum stated in Paragraph 1 above at the rate of 8% per annum, from and including June 22, 2015, through and including July 25, 2018.
3. Steele is liable for and shall pay to Sullivan the sum of $55,408.00 in compensatory damages.
4. Steele is liable for and shall pay to Sullivan interest on the sum stated in Paragraph 3 above at the rate of 8% per annum, from and including February 5, 2016, through and including July 25, 2018.
5. Steele is liable for and shall pay to Fry Trust and Fry the sum of $750.00 in costs.
6. Steele is liable for and shall pay to Sullivan the sum of $750.00 in costs.
7. Steele is liable for and shall pay to Claimants the sum of $300.00 as reimbursement for the non-refundable portion of Claimants' filing fee.
8. Steele is liable for and shall pay to Claimants the sum of $58,000.00 in attorneys' fees, pursuant to the Indiana Securities Act 23-19-5-9.
9. Fry Trust and Fry are ordered to transfer all investments and security interests in BRS Labs (held in the name of "The Denise M. Fry Living Trust" or "Denise Fry Living Trust") to Steele upon full satisfaction of Paragraphs 1-8 above.
10. Sullivan is ordered to transfer all investments and security interests in BRS Labs to Steele upon full satisfaction of Paragraphs 1-8 above.
11. Fry is ordered to transfer any judgment against Giant Gray to Steele upon full satisfaction of Paragraphs 1-8 above.
12. Any and all claims for relief not specifically addressed herein, including punitive damages, are denied.

This award in this "selling away" case is noteworthy in light of the Panel's decision to award of full rescissionary damages to Claimants, pursuant to Indiana's Blue Sky law (Indiana Securities Act 23-19-5-9). The award was entered solely against a registered representative, Steele, as Claimants had previously settled their claims against Steele's broker dealer employer, Comprehensive Asset Management and Servicing, Inc.

John and Jane Fuchs, Claimants v. G.F. Investment Services, LLC, Madison Avenue Securities, LLC, Andrew M. Costa, and Christopher Grant Conness, Respondents

Case No. 18-01756[3]

Boca Raton, Florida

Claimants' Counsel: Gary S. Menzer, Esq., Menzer & Hill, P.A., Boca Raton, Florida.

For Respondent G.F. Investment Services, LLC ("GFIS"): Kimberly A. Koves, Esq., Wiand, Guerra, King, P.A., Tampa, Florida.

For Respondent Madison Avenue Securities, LLC ("Madison"): Lloyd R. Schwed, Esq., Schwed Kahle & Kress, P.A., Palm Beach Gardens, Florida.

3. Claimants asserted the following causes of action: breach of contract; fraud; negligence; breach of fiduciary duty; negligent supervision; suitability; misrepresentation; and, omission to state a material fact. The causes of action relate to Claimants' investment in Woodbridge Notes.

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

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

In the Statement of Claim, Claimants requested: compensatory damages of approximately $150,000.00; rescission; interest; punitive damages; and costs.

In its Statement of Answer, Respondent Madison requested dismissal with prejudice of all claims asserted against Respondent Madison in the Statement of Claim, attorneys' fees and costs.

In their Limited Statement of Answer, Respondents GFIS, Costa and Conness reserved their rights to supplement their Answer and to seek dismissal of the claims asserted against them.

For Respondents Andrew M. Costa ("Costa") and Christopher Grant Conness ("Conness"): W. Todd Boyd, Esq., Boyd Richards Parker & Colonnelli, P.L., Miami, Florida.

Arbitrators: Paul Weinberg, Public Chairperson; Gilbert A. Schnirman, Public Arbitrator; Will Murphy, Public Arbitrator.

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

1. Pursuant to Rule 12504(a)(6)(B) of the Code, Claimants' claims against Respondent Madison are dismissed, with prejudice.
2. Any and all claims for relief not specifically addressed herein, including Claimants' request for punitive damages, are dismissed with prejudice.

This award is noteworthy because the Panel effectively granted summary judgment in favor of one Respondent on a "selling away" claim concerning unregistered securities related to the Woodbridge Ponzi scheme. This unusual pre-hearing dismissal occurred after a state court in Palm Beach County, Florida had enjoined Claimants from pursuing claims in arbitration against he named registered representative Respondents, as well as the other named broker-dealer Respondent. Thus, Claimants were left without a remedy, recovery or even a hearing on the merits in FINRA arbitration, despite allegedly being sold unregistered securities by agents of a FINRA member firm.

George Mattson and GNM ICBC, LLC, Claimants v. J.P. Morgan Securities, LLC, Respondent

Case No. 17-01969[4]

4. Claimants asserted the following causes of action: negligence (failure to conduct due diligence and failure to supervise); common law fraud; breach of fiduciary duty; respondeat superior; and violations of state and federal securities laws, and FINRA rules. The causes of action relate to Claimants' investment in Jawbone, a San Francisco-based technology company.

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

In the Statement of Claim, Claimants requested: compensatory damages in the amount of $1,000,000.00; interest at the rate of 4.75% per annum; attorneys' fees; costs; punitive damages; and such other and further relief deemed just and appropriate by the Panel.

Boca Raton, Florida

Claimants' Counsel: Craig H. Kuglar, Esq., Law Office of Craig Kuglar, LLC, Atlanta, Georgia.

Respondent's Counsel: Tibor L. Nagy, Esq. and Anuja Thatte, Esq., Dontzin Nagy & Fleissig LLP, New York, New York.

Arbitrators: Gloria O. North, Public Chairperson; Daniel Joseph Chiodo, Public Arbitrator; Ronald W. Weissman, Public Arbitrator.

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

1. Claimants' claims are denied in their entirety.
2. Claimants are jointly and severally liable for and shall pay to Respondent the sum of $200,000.00 in attorneys' fees pursuant to the terms of the Subscription Agreement dated May 27, 2014.
3. Claimants are jointly and severally liable for and shall pay to Respondent the sum of $75,000.00 in costs.
4. Any and all claims for relief not specifically addressed herein, including Claimants' requests for punitive damages and attorneys' fees, are denied.

This award is noteworthy for two reasons. First, the Panel granted both of Respondent's motions at the hearing to disqualify two of Claimants' expert witnesses. Second, the Panel ultimately issued an award extremely adverse to Claimants, not only declining to award damages against Respondent but also holding Claimants liable for $200,000 in attorneys' fees pursuant to a subscription agreement, as well as $75,000 in costs. The award highlights the importance of discussing the worst-case scenario with prospective clients in cases in which there are fee-shifting or contractual indemnity provisions contained in a subscription agreement.

In the Statement of Answer, Respondent requested: denial of the Statement of Claim, with prejudice; attorneys' fees; costs; and such other and further relief deemed just and proper by the Panel.

At the close of the hearing, Claimants presented three different final damage calculations using various interest rates and rates of return. The first total was $3,450,525.63, the second total was $1,852,120.83, and the third total was $2,768,513.42.

Kathryn A. Schmierer, Claimant v. Wells Fargo Advisors, LLC, Respondent
Case No. 16-02832[5]
Tampa, Florida

Claimants' Counsel: Kalju Nekvasil, Esq. and Stephen Krosschell, Esq., Goodman & Nekvasil, P.A., Clearwater, Florida.

For Respondent Wells Fargo Advisors, LLC: Demian J. Betz, Esq., Wells Fargo Advisors Law Department, Charlotte, North Carolina.

Arbitrators: Russell W. Merriman, Public Chairperson; Frank Brenner, Public Arbitrator; Anne Marie Martin, Non-Public Arbitrator.

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

1. Respondent is liable for and shall pay to Claimant the sum of $172,000.00 in compensatory damages.
2. Respondent is liable for and shall pay to Claimant the sum of $68,800.00 in attorneys' fees pursuant to: a violation of federal

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5. In the Statement of Claim and in the Amended Statement of Claim, Claimant asserted the following causes of action: violations of federal securities laws; violation of the North Dakota Unlawful Sales or Advertising Practices Act; violation of the North Dakota Securities Act; breach of contract; common law fraud; breach of fiduciary duty; negligence; and gross negligence. The causes of action relate to the purchase of numerous investments, including but not limited to: Oasis Petroleum, Inc.; Ritchie Bros Auctioneers, Inc.; TCF Financial Corp.; Arts-Way MFG Co., Inc.; Monsanto Co New; James River Coal, Inc.; Intrepid Potash, Inc.; CNH Global NV; BP PLC SPONS ADR; and Pengrowth Energy Corp.

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

In the Statement of Claim and in the Amended Statement of Claim, Claimant requested: damages in the amount of at least $300,000.00; bargain damages; lost opportunity costs; model portfolio damages; pre-judgment interest; costs; reasonable attorneys' fees; non-economic damages; rescission; restitution; specific performance; statutory damages; punitive damages in an amount to be determined; and such other relief deemed necessary and proper.

In the Statement of Answer, Respondent requested the dismissal of the Statement of Claim, as amended, in its entirety.

At the close of the hearing, Claimant requested compensatory damages in the amount of $172,000.00.

securities laws that specifically provide for attorneys' fees; N.D.C.C. §51-15-09, §51-15-02, and §10-04-17; and any other relevant basis contained in the record.

3. Respondent is liable for and shall pay to Claimant the sum of $100,000.00 in punitive damages pursuant to: Sections 12(2) and 15 of the Securities Act, 15 U.S.C. §§ 771(2), 77o; and Sections 10(b) and 20 of the Securities Exchange Act, 15 U.S.C. §§ 78j(b), 78t and Rule 10b-5 thereunder and 17 C.F.R. §240.10b-5. The Panel also finds, based on record evidence of violations of common law fraud, breach of fiduciary duty and gross negligence that punitive damages are awardable, in addition to any other record evidence and argument or pleadings that support an award of punitive damages.
4. Respondent is liable for and shall pay to Claimant interest on the compensatory damages, attorney's fees and punitive damages awarded at the prevailing Florida statutory rate from September 26, 2018, and shall continue until this Award is satisfied or otherwise extinguished.
5. Respondent is liable for and shall pay to Claimant the sum of $20,000.00 in costs.
6. Any and all claims for relief not specifically addressed herein are denied.

This award is notable given the fact that the Panel found Respondent liable for compensatory damages of $172,000 (as requested at hearing). In addition, the Panel found Respondent liable for attorneys' fees of $68,000 pursuant to North Dakota statute governing Unlawful Sales or Advertising Practices (N.D.C.C. §51-15-09, §51-15-02, and §10-04-17), $100,000 in punitive damages, $20,000 in costs, as well as interest on compensatory damages, attorneys' fees, and punitive damages.

Danny J. Wrubel, IRA, Karen Fell, Julie Ferrario, Ferrario Family Revocable Trust, Shirely A. Maiuri, Marilynn L. Peterson, IRA, Marilynn L. Peterson Revocable Trust, Josephine A. Marion, Marion Family Living Trust, Marion Irrevocable Trust, Travis Peterson, Marilynn L. Peterson, Shirley A. Maiuri, IRA, Julie Vipond, Danny J. Wrubel, and Teresa K. Wrubel, Claimants v. IMS Securities, Inc., and Jackie Divono Wadsworth, Respondents
Case No. 18-02199[6]

6. In the Statement of Claim, First Amended Statement of Claim, Second Amended Statement of Claim, and Third Amended Statement of Claim, Claimants asserted the following causes of action: aiding and abetting fraud, aiding and abetting breach of

fiduciary duty, civil conspiracy, civil RICO, civil RICO conspiracy, and negligent supervision. The causes of action related to Claimants' allegations that a non-party under the supervision of Respondents induced Claimants to invest in unsuitable, high-risk, illiquid investments, including United Mortgage Trust ("UMT"), United Development Funding II ("UDF II"), and United Development Funding III ("UDF III").

Unless specifically admitted in the Statement of Answer and the First Amended Statement of Answer, Respondents denied the Claimants' allegations and asserted various affirmative defenses.

In the Statement of Claim, First Amended Statement of Claim, Second Amended Statement of Claim, and Third Amended Statement of Claim, Claimants requested an award of treble the amount of each Claimant's compensatory and exemplary damages, jointly and severally, against Respondents, pursuant to 18 USC 1964(c). Claimants further requested an award of attorneys' fees and costs.

In the Statement of Answer and the First Amended Statement of Answer, Respondents requested that the Panel dismiss all of the claims and causes of action asserted against them in Claimants' Statements of Claim, award Respondents their reasonable attorney's fees and costs incurred in defending this case, grant expungement, and grant such other and further relief, whether in law or in equity, to which Respondents may be justly entitled.

In a post-hearing submission, Claimants, collectively, requested attorneys' fees and costs under RICO in the amount of $50,000.00 for fees and $5,000.00 for costs. In addition, Claimants, individually, requested:

- Danny J. Wrubel and Teresa K. Wrubel requested $17,730.00 in compensatory damages or $53,190.00 in RICO Treble Damages.
- Josephine A. Marion requested $154,764.00 in compensatory damages or $464,292.00 in RICO Treble Damages.
- Julie A. Ferrario requested $71,100.00 in compensatory damages or $213,300.00 in RICO Treble Damages.
- Marilyn L. Peterson requested $143,270.00 in compensatory damages or $429,810.00 in RICO Treble Damages.
- Shirley Mauiri requested $234,594.00 in compensatory damages or $703,782.00 in RICO Treble Damages.
- Karen Fell requested $89,694.00 in compensatory damages or $269,082.00 in RICO Treble Damages.
- Julie Vipond requested $252,684.00 in compensatory damages or $758,592.00 in RICO Treble Damages.

Detroit, Michigan

Claimants' Counsel: Daniel J. Broxup, Esq., Mika Meyers, PLC, Grand Rapids, Michigan.

For Respondent IMS Securities, Inc. ("IMS"): Jackie Wadsworth, IMS Securities, Inc., Houston, Texas.

Respondent Jackie Divono Wadsworth ("Wadsworth") appeared pro se.

Arbitrators: Patrick R. Sughroue, Public Chairperson; Edward A. Porter, Public Arbitrator; Mark Gregory Brackon, Public Arbitrator.

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

1. Respondents are jointly and severally liable for and shall pay to Danny J. Wrubel and Teresa K. Wrubel $17,730.00 in compensatory damages.
2. Respondents are jointly and severally liable for and shall pay to Josephine A. Marion $154,764.00 in compensatory damages.
3. Respondents are jointly and severally liable for and shall pay to Julie A. Ferrario $71,100.00 in compensatory damages.
4. Respondents are jointly and severally liable for and shall pay to Marilyn L. Peterson $143,270.00 in compensatory damages.
5. Respondents are jointly and severally liable for and shall pay to Shirley Mauiri $234,594.00 in compensatory damages.
6. Respondents are jointly and severally liable for and shall pay to Karen Fell $89,694.00 in compensatory damages.
7. Respondents are jointly and severally liable for and shall pay to Julie Vipond $252,684.00 in compensatory damages.
8. Claimants are entitled to only a single satisfaction. As a result, to the extent any Claimant recovers any of their compensatory damages from a collateral source prior to recovery from Respondents, the prior recovery shall serve to offset the amount due under this Award. Possible collateral sources may include, without limitation, UDF II, UDF III, UMT, and any of the respondents from the Original Case.
9. Respondents are jointly and severally liable for and shall pay to Claimants the sum of $5,000.00 in costs.
10. Respondents are jointly and severally liable for and shall pay to Claimants the sum of $50,000.00 in attorneys' fees pursuant to RICO and Michigan law.
11. Respondents are jointly and severally liable for and shall pay to Claimants the sum of $375.00 as reimbursement for the non-refundable portion of the initial filing fee.

12. Any and all claims for relief not specifically addressed herein, including treble damages, are denied.

This award is noteworthy because the Panel found Respondents liable not only for compensatory damages in the full amounts requested at hearing by the eight (8) Claimants, but moreover, found Respondents liable under civil RICO and applicable Michigan law for $50,000 in attorneys' fees, in addition to $5,000 in costs and for reimbursement of the filing fee. This matter concerned investments in certain non-traded REIT vintages offered by United Development Funding (UDF) of Grapevine, TX.

CASES & MATERIALS

Sara E. Hanley

11th Circuit Defines Materiality in Connection with the Purchase or Sale of a Security

Brink v. Raymond James & Associates, Inc., No. 16-14144 (11th Cir., June 8, 2018)

This appeal addresses the preclusive effect under Title I of the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), which prohibits class actions alleging state law causes of action based on conduct that constitutes federal securities fraud. Appellant Brink disputed that her complaint against Raymond James & Associates ("RJA") alleged a "misrepresentation…of a material fact in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1)(A).

As an alternative to a traditional commission-based investment account, RJA offered a "Passport Account" program that charged customers an annual advisory fee based on the total value of qualifying assets in the account instead of a commission based on each individual trade. Passport Account customers were charged a flat fee per transaction. In its written agreement with each Passport Account customer, RJA described this flat fee as a "Processing Fee" for "transaction execution and clearing services" and stated that the Processing Fees were "not commissions". RJA's actual costs incurred in the execution and clearing of the transactions were much lower than the Processing Fees charged. RJA kept as profit any amount above the actual costs associated with transaction execution and clearing.

Brink filed a putative class action complaint alleging state law claims for breach of contract and negligence. Brink alleged that because Passport Account customers had agreed only to pay for "expenses incurred in facilitating the execution and clearing" of their trades, RJA's undisclosed profit built into the Processing Fees breached the Passport Agreement. Brink also claimed that RJA breached its duty of care owed to its customers, which she alleged included a duty to charge customers a reasonable fee for its services.

RJA filed a motion to dismiss for lack of subject matter jurisdiction, arguing that Brink's state law claims were disguised claims for federal securities fraud, and therefore, were precluded under SLUSA. The question before the appellate court was whether the representation by RJA to its

Passport Account customers that the Processing Fee covered only the actual costs of transaction execution and clearing constitutes a "misrepresentation or omission of a material fact in connection with the purchase or sale" of those securities. The court found that a reasonable investor would not have made a different investment decision had they known that some of the processing fee included a profit for RJA, and therefore, the hidden profit on the processing fee is not material under federal securities law. As a result, the court concluded that SLUSA did not prohibit Brink's putative class action because RJA's alleged failure to disclose the hidden profit built into the Processing Fee is not a misrepresentation of material fact for purposes of SLUSA.

3rd Circuit Rules on Forum Selection Clauses

Reading Health Sys. v. Bear Stearns & Co., 2018 U.S. App. LEXIS 21910,___ F.3d___ 2018 WL 3735206 (3rd Cir. 2018)

In this case the court addresses an emerging trend in the brokerage industry. Ordinarily, broker-dealers, as members of the Financial Industry Regulatory Authority (FINRA), are required by FINRA Rule 12200 to arbitrate all claims brought against them by a customer. Seeking to avoid this obligation to arbitrate, broker-dealers began inserting forum-selection clauses in their customer agreements, without mentioning the customer's right to arbitrate. This practice, which has been condoned by several circuits, deprives investors of the benefits associated with using FINRA's arbitral forum to resolve brokerage-related disputes.

This case concerns such a forum-selection clause. Over the course of several years, Bear Stearns & Co., now known as J.P. Morgan Securities LLC (hereinafter J.P. Morgan), a broker-dealer and FINRA member, executed several broker-dealer agreements with Reading Health System. The agreements were executed in connection with four separate offerings of auction rate securities (ARS), through which Reading issued more than $500 million in debt. Two of those contracts included forum-selection clauses providing that "all actions and proceedings arising out of" the agreements or underlying ARS transactions had to be filed in the District Court for the Southern District of New York.

After the ARS market collapsed, Reading filed a statement of claim with FINRA, alleging that J.P. Morgan engaged in unlawful conduct in connection with the ARS offerings and demanding that those claims be resolved through FINRA arbitration. J.P. Morgan refused to arbitrate, however, contending that

Reading had waived its right to arbitrate by agreeing to the forum-selection clauses. To resolve this standoff, Reading filed a declaratory judgment action to compel FINRA arbitration in the District Court for the Eastern District of Pennsylvania. In response, J.P. Morgan moved to transfer the action to New York, based on the forum-selection clauses in some (but not all) of the broker-dealer agreements.

In this appeal, the court sought to answer two questions: (i) whether J.P. Morgan, as a FINRA member, is obligated to resolve Reading's substantive claims through FINRA arbitration; and (ii) which court decides that question of arbitrability. The court held that the transfer question must be resolved before the question of arbitrability. The court reasoned that Reading's action to compel FINRA arbitration did not "arise out of" the broker-dealer agreements because Reading's sole claim for declaratory relief did not involve an assertion of Reading's contractual "rights or duties." The only right Reading sought to enforce in its complaint is its right to arbitrate its claims against J.P. Morgan. That right does not originate from the broker-dealer agreements, but rather from FINRA Rule 12200, which gives Reading the right to demand FINRA arbitration and imposes a corresponding duty on J.P. Morgan to arbitrate. Because the sole source for Reading's right to arbitrate is FINRA Rule 12200—without which Reading would not be entitled to compel arbitration, and J.P. Morgan would not have a duty to arbitrate—Reading's declaratory judgment action does not "arise out of" the broker-dealer agreements.

Reading's declaratory judgment action to compel arbitration is not one "arising out of" the broker-dealer agreements, therefore it does not fall within the scope of the forum-selection clause. The court found that the district court properly required J.P. Morgan to submit to FINRA arbitration because the forum-selection clause did not waive Reading's right to arbitrate under FINRA rule 12200. Therefore, the court affirmed the District Court's order denying J.P. Morgan's motion to transfer the action to the Southern District of New York. The court further reasoned that attempts to reconcile the tension between a broker-dealer's right to litigate pursuant to a forum-selection clause and a customer's corresponding right to arbitrate under FINRA Rule 12200 have divided our sister circuit courts. The Second and Ninth Circuit Courts of Appeals have held that a materially identical forum-selection clause require the parties to litigate in federal court, while the Fourth Circuit Court of Appeals has held that Rule 12200 requires the parties to arbitrate notwithstanding the presence of a forum-selection clause.

The court determined that it agreed with the Fourth Circuit that the question is one of waiver, and that the forum-selection clauses did not implicitly waive Reading's right to FINRA arbitration. The court held that

Reading's right to arbitrate is not contractual in nature, but rather arises out of a binding, regulatory rule that has been adopted by FINRA and approved by the SEC. The court reasoned that by condoning an implicit waiver of Reading's regulatory right to arbitrate, it would erode investors' ability to use an efficient and cost-effective means of resolving allegations of misconduct in the brokerage industry and thus undermine FINRA's ability to regulate, oversee, and remedy any such misconduct. Therefore, the court held that the District Court properly concluded that, under FINRA Rule 12200, J.P. Morgan is required to arbitrate Reading's claims regarding the ARS offerings.

Summary Judgement Grated Against Ramirez

SEC v. Ramirez, Civil No. 15-2365, 2018 U.S. Dist. LEXIS 74481(D.P.R. April 30, 2018)

Ramírez was a registered representative of UBS Financial Services Inc. of Puerto Rico. The SEC claims that from approximately 2006 through approximately 2013, Ramírez made material omissions and misrepresentations to customers and effected a fraudulent scheme that increased his compensation by soliciting customers to improperly use proceeds from lines of credit offered by a UBS-PR affiliate in order to purchase securities despite the fact that he knew UBS-PR's policy and the line of credit agreements prohibited customers from using loan proceeds to purchase securities.

The SEC filed a Motion for Partial Summary Judgment on the Issue of Liability and Accompanying Memorandum of Law and Ramírez opposed and filed a Motion to Strike. The court found that Ramírez was aware that UBS-PR policy did not allow customers to use LOC proceeds to purchase securities, and that UBS-USA's LOC loan agreement prohibited it. Despite those prohibitions, he presented customers a way to make additional money by using LOCs to increase their CEF holdings. In order to circumvent UBS-PR's policy against using LOCs to purchase securities, Ramírez directed his customers to request wire transfers or write checks from their LOCs to the customers' personal bank accounts in other banks. Afterwards, customers were instructed, to deposit the funds recently deposited in their outside bank accounts, into their UPS-PR brokerage accounts, to allow Ramírez to execute trades for additional CEF shares. The scheme avoided detection because UBS-PR did not have a procedure designed to catch transfers from LOCs to outside banks and from outside banks back to UBS-PR. Ramírez was a top performing registered representative at UBS-PR with regard to LOC business production. He received recognition as a "Banking Champion". His compensation was based, in part, on his LOC production and the amount of funds his customers withdrew upon their LOCs. He earned commissions on the CEFs his customers purchased, and from 2011-2013, he received over $12.9 million in total compensation, over $5.5 million of which was attributable to customer LOCs.

Ramírez disputes the SEC's statements of fact on Fifth Amendment grounds arguing that: (1) he invoked the Fifth Amendment; (2) no adverse inference may be derived from his invocation of the Fifth Amendment at the summary judgment stage; and (3) the SEC has not produced independent admissible evidence of wrongdoing. The court reasoned that the Fifth Amendment privilege against compelled self-incrimination applies in civil and criminal proceedings, however, the privilege operates differently in criminal and civil contexts. In criminal cases, no negative inference from the accused's silence may be made, but in civil cases adverse inferences are permitted against parties, when they refuse to testify in response to probative evidence offered against them. The court found that by solely relying on the Fifth Amendment, Ramírez failed to create a genuine issue of material fact.

The court further found that Ramirez's misrepresentations and omissions were material. A "misrepresentation is material if there is a substantial likelihood that the misrepresentation would affect the behavior of a reasonable investor." *Ficken,* 546 F.3d at 47 (so recognizing); *S.E.C. v. Fife*, 311 F.3d 1, 10 (1st Cir. 2002)("misrepresentations and omissions were material because a reasonable investor would want to know the risks involved"). The court found that the investors would have wanted to know the risks involved in the recommended strategy, including the risk of loss of principal, and the risk of maintenance calls in the event the value of LOC collateral decreased. The court also found that investors would have been interested in knowing that Ramírez's recommendations were in direct contravention of UBS-PR policy and of the LOC agreements.

The court concluded that the SEC established all the necessary elements to show that Ramírez violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5. As a result, the court granted Plaintiff's Motion for Partial Summary Judgment on the Issue of Liability and Accompanying Memorandum of Law and Ramírez's Motion to Strike was denied.

Importance of Beneficiary Designations

Cooper v. D'Amore, 881 F.3d 247 (1st Cir. 2018)

In 2003, decedent, an investment executive/bond trader at Mesirow Financial Inc., established an IRA through his employer. At the time, decedent was married to D'Amore and designated her as the beneficiary. In 2006, decedent and D'Amore divorced and entered into a Martial Settlement Agreement which provided, in part, that "[e]ach party shall continue to own as his or her own separate property any Individual Retirement Account (IRA), pension or retirement plan in his or her name, and each does hereby waive any claim to such account of the other." Notwithstanding the Martial Settlement Agreement, decedent did not revoke the beneficiary designation for the Mesirow IRA.

On August 18, 2011, decedent completed a TD Ameritrade "Account Transfer Form" in order to transfer his assets from the Mesirow IRA to a TD Ameritrade IRA. On July 21, 2012, decedent died. Thereafter, Mesirow distributed the assets that remained in the Mesirow IRA to D'Amore pursuant to the beneficiary designation. The Cooper's sued D'Amore, seeking to recover the assets distributed by Mesirow to D'Amore. The parties filed cross-motions for summary judgment. The district court granted summary judgment for the Coopers, finding that upon divorce, D'Amore's beneficiary designation was revoked pursuant to the Illinois Trusts and Dissolutions of Marriage Act. On November 20, 2015, D'Amore filed a motion for reconsideration. Thereafter, the court determined that its summary judgment decision was improper because Delaware law, not Illinois law, governed the IRA. The court then imposed sanctions on the Coopers' counsel for the failure to turn over an authenticated copy of the Delaware Charter Trust document, and granted D'Amore's motion for summary judgment. The Coopers appealed and the court vacated the district court's entry of summary judgment on behalf of D'Amore because it found that the Delaware Charter IRA Trust Agreement was not in effect at the time the assets were distributed. On remand, the parties again moved for summary judgment. This time, the district court granted summary judgment for the estate. The court explained that from 2006, when the couple divorced, until August 2011, when the decedent transferred his assets, D'Amore was the beneficiary, but when decedent requested a transfer of all of his assets in 2011, the beneficiary designation was automatically revoked and the account terminated. This appeal followed.

The court reasoned that an IRA is composed of a variety of assets and some of the assets may not be transferable in their current form. The court found that in completing his transfer request, decedent had the opportunity to transfer all of his assets out of the Mesirow account, but he chose to direct a transfer of only those assets that were transferable. The court found that the decedent is assumed to have known that certain assets in the IRA were transferable, while others were nontransferable in their current form. If decedent wanted to direct a transfer of "all assets," he had to authorize a change of the nontransferable assets so that they could be transferred. Rather than doing that, however, decedent chose to transfer only those assets that were transferable. Thereafter, his agreement with Mesirow continued for the remaining nontransferable assets in the account.

The court reasoned that while the Mesirow IRA statements post-transfer failed to list D'Amore as the beneficiary, the statements simply stated that the beneficiary was "not provided." This does not establish that the beneficiary designation was revoked. Furthermore, the Plaintiffs' basis for their claim is that when the Mesirow IRA terminated, D'Amore's beneficiary designation was revoked. The court found that the account did not terminate, and therefore, the Coopers' argument that the beneficiary designation was revoked by account termination necessarily fails. As a result, the court reversed the summary judgment for the Coopers. A request to transfer all assets was never made; therefore, the beneficiary designation was never revoked and D'Amore was entitled to the remaining assets in the account upon decedent's death. The court therefore remand the case to the district court with directions to enter summary judgment for D'Amore.

Brokers Sue FINRA and Federal Jurisdiction Argument Fails

Webb v. Fin. Indus. Regulatory Auth., 889 F.3d 853 (7th Cir. 2018)

Brokers Nicholas Webb and Thad Beversdorf were fired by their employer, Jefferies & Company, Inc. ("Jefferies"). They decided to challenge their termination, and, as their employment contracts with Jefferies demanded, they filed their claims in the Financial Industry Regulatory Authority's ("FINRA") arbitration forum. FINRA required them to sign an "Arbitration Submission Agreement," which they did, and their dispute with Jefferies proceeded in arbitration for the next two-and-a-half years, however they withdrew their claims before a final decision was rendered. Under FINRA's rules, that withdrawal constituted a dismissal with prejudice.

After the arbitration failed, Webb and Beversdorf sued FINRA in the Circuit Court of Cook County, Illinois, alleging that FINRA breached its contract to arbitrate their dispute with Jefferies. They faulted FINRA for a number of things, including failing to properly train arbitrators, failing to provide arbitrators with appropriate procedural mechanisms, interfering with the arbitrators' discretion, and failing to permit reasonable discovery. They sought damages "in an amount in excess of $50,000" and a declaratory judgment identifying specified flaws in FINRA's Code of Arbitration Procedure. FINRA removed the dispute to federal court, where it moved to dismiss on multiple grounds, including arbitral immunity. The district court held that FINRA was entitled to arbitral immunity and dismissed the suit. Webb and Beversdorf appealed.

After it removed the case to federal court, FINRA initially claimed that the amount in controversy was satisfied because Webb and Beversdorf sought more than $1,000,000 from Jefferies. The district court properly rejected this argument, because the amount at stake in an underlying arbitration does not count toward the amount in controversy in a suit between a party to the arbitration and the arbitrator. *Caudle v. American Arbitration Ass'n*, 230 F.3d 920, 922-23 (7th Cir. 2000). Jurisdiction turns on what is at stake between the parties to the suit—Webb and Beversdorf, the plaintiffs, and FINRA, the defendant.

Webb and Beversdorf paid FINRA $1,800 at the start of the arbitration; if that is all they lost, the amount in controversy is obviously far short of the jurisdictional mark. They also, however, seek to recover the legal fees that they incurred both in the course of arbitrating against Jefferies and in preparing this lawsuit against FINRA. Webb and Beversdorf say that these fees—which exceed $75,000—were a reasonably foreseeable consequence of FINRA's breach of the Arbitration Submission Agreement. The district court accepted this argument and concluded that it had authority to adjudicate the suit. The court reasoned that legal fees may count toward the amount in controversy if the plaintiff has a right to them "based on contract, statute, or other legal authority." *Ross v. Inter-Ocean Ins. Co.*, 693 F.2d 659, 661 (7th Cir. 1982). Webb and Beversdorf do not contend that FINRA assumed a contractual obligation to cover either the fees that they incurred in arbitration or those that they incurred in this lawsuit. Illinois generally adheres to the American Rule that each party bears its own litigation costs. Therefore, the court reasoned that it is clear that Webb and Beversdorf cannot recover the money spent preparing to litigate against FINRA.

Webb and Beversdorf also seek recovery of the legal fees they incurred arbitrating against Jefferies. The court found that this is a more plausible ground for recovery, because Illinois recognizes a "third party litigation exception" to the American Rule. The Illinois Supreme Court has held that "where the wrongful acts of a defendant involve the plaintiff in litigation with third parties or place him in such relation with others as to make it necessary to incur expense to protect his interest, the plaintiff can then recover damages against such wrongdoer, measured by the reasonable expenses of such litigation, including attorney fees." *Ritter v. Ritter*, 381 Ill. 549, 46 N.E.2d 41, 44 (Ill. 1943).

Webb and Beversdorf's effort to recover expenses incurred in an arbitration proceeding begun for its own purposes—to assert a wrongful termination claim against Jefferies—distinguishes this case from those in which Illinois courts have applied the exception. When a defendant removes to federal court, as FINRA did here, its plausible and good faith estimate of the amount in controversy establishes jurisdiction unless it is a "legal certainty" that the plaintiffs' claim is for less than the requisite amount. *St. Paul Mercury Indem. Co. v. Red Cab Co.*, 303 U.S. 283, 58 S. Ct. 586, 82 L. Ed. 845, 1938 U.S. LEXIS 295. Here, Illinois law makes it a "legal certainty" that Webb and Beversdorf's claim is for less than the requisite amount. Therefore, jurisdiction does not exist.

FINRA makes an additional argument for federal question jurisdiction. FINRA contends that because the plaintiffs' suit implicates FINRA's SEC-approved Code of Arbitration Procedure, the court is required to decide whether FINRA breached a duty it owed Webb and Beversdorf under the securities laws. However, FINRA fails to identify a single provision of federal law that the court would have to interpret to resolve this case. Instead, the question before the court is whether FINRA breached its arbitration agreement, and no "inescapable" provision of federal law drives that analysis. The court reasoned that FINRA is regulated by the SEC, and its duties under the federal securities laws might come up, but that does not make federal law the "cornerstone" of the plaintiff's complaint. The Supreme Court has emphasized that a "federal role" is not enough. The court concluded that this is a state-law contract claim, and FINRA's effort to pull it within federal question jurisdiction fails. As a result, the 7th circuit vacated the judgment for lack of jurisdiction and remanded the case to the district court with instructions to remand to state court.

Jurisdictional Issues Resolved by the 2nd Circuit

Gottlieb v. United States SEC, 723 Fed. Appx. 17, 2018 U.S. App. LEXIS 1889, 2018 WL 507172 (2d Cir. January 23, 2018)

Appellant Phyllis Gottlieb ("Gottlieb") appeals from the district court's judgment dismissing her civil suit against the Securities and Exchange Commission ("SEC") and First American Title Insurance Company ("First American"). In 2003, the SEC obtained a securities fraud judgment against

Gottlieb's husband, Allen, for over $2 million. Allen Gottlieb made no voluntary payments towards satisfying the judgment, and the SEC attempted to collect on the judgment from his assets. While the judgment against Allen Gottlieb was outstanding, Phyllis Gottlieb sold a family home in Florida, and First American held the proceeds. After ascertaining that Allen Gottlieb was the true owner of the home, the SEC sought turnover of the funds. In response, Phyllis Gottlieb filed suit in Florida state court, seeking to obtain the funds from the home sale. The action was removed to the Southern District of Florida, and then transferred to the Southern District of New York. In the Southern District, Gottlieb failed to comply with three court orders to appear for a deposition in Miami. The SEC moved for sanctions, and Gottlieb, through counsel, agreed that dismissal of the suit was an appropriate remedy. Gottlieb now appeals from that dismissal. She argues on appeal that the district courts erred by transferring and later dismissing her suit, and that the judge was biased.

The court reviewed the issues of venue transfer and the imposition of Rule 37 sanctions for abuse of discretion. The court reasoned that the New York forum was more convenient for the SEC; First American did not object; all the parties had to appear in New York; and the convenience of the Florida forum for Gottlieb was diminished by the fact that she had moved, first to the Bahamas, and then to Brazil. Furthermore, the "first-filed rule" provides a presumption in favor of the Southern District of New York, where litigation over the funds from the Gottliebs' home sale was first initiated. *See, N. Y. Marine & Gen. Ins. Co. v. Lafarge N.A., Inc.,* 599 F.3d 102, 112 (2d Cir. 2010). The court further reasoned that in regard to the sanction of dismissal, Gottlieb, through counsel, agreed that dismissal was a proper sanction and she is bound by her concession. See *Gomez v. City of New York*, 805 F.3d 419, 424 (2d Cir. 2015) (a client is generally bound by the acts of her attorney). The presumption that the attorney speaks for the client is rebuttable when an attorney undertakes settlement or dismissal on the client's behalf. The court found that Gottlieb did not argue that her attorney acted without her authority when he agreed that dismissal was an appropriate remedy.

Lastly, the court reviewed for plain error the district court judge's refusal to recuse herself *sua sponte*. A judge must recuse from "any proceeding in which h[er] impartiality might reasonably be questioned" by an objective observer. *SEC v. Razmilovic*, 738 F.3d 14, 29 (2d Cir. 2013). Claims of judicial bias generally must be based on extrajudicial matters. See *Chen v. Chen Qualified Settlement Fund*, 552 F.3d 218, 227 (2d Cir. 2009) ("[A]dverse rulings, without more, will rarely suffice to provide a reasonable basis for questioning a judge's impartiality."). The court reasoned that other than dismissal of this case, Gottlieb does not suggest that district judge made any statements or took any actions exhibiting bias; and the dismissal was clearly within the judge's discretion. Gottlieb's argument that she had no opportunity to object to the judge's appointment is unavailing because Gottlieb could have moved for recusal at any time and chose not to. The court considered Gottlieb's remaining arguments, found them to be without merit and accordingly affirmed the judgment of the district court.

Joint and Several Liability for Aiders in the Purchase of Illegal Securities Denied

Boyd v. Kingdom Trust Co., 2018-Ohio-3156 (Ohio 2018)

This case presents a certified question of Ohio law to the United States Court of Appeals for the Sixth Circuit. The question before the court is whether R.C. 1707.43, a provision of the Ohio Securities Act, imposes joint and several liability on persons who aided in the purchase of illegal securities but did not participate or aid in the sale of the illegal securities.

The Plaintiffs in this matter, are the alleged victims of a Ponzi scheme operated by a William Apostelos who formed Midwest Green Resources, L.L.C. and WMA Enterprises, L.L.C., as the vehicles for offering illegal securities to investors. Apostelos, allegedly pursued Plaintiffs to open self-directed individual retirement accounts ("IRAs") to invest in equity interests in Midwest Green Securities and promissory notes issued by WMA Enterprises. Once the accounts were established, Apostelos asked investors to direct the trust companies to purchase his securities or to execute powers-of-attorney giving him the ability to direct the trust companies to purchase his securities using the investors' IRA assets. Apostelos allegedly used the money raised from these investors to pay earlier investors and promoters and to fund his own personal expenses.

After the Ponzi scheme unraveled, Plaintiffs filed a class-action lawsuit seeking to hold the Trust companies liable for their alleged roles in the scheme. The complaint does not allege that the trust companies had any role in Apostelos's Ponzi scheme aside from purchasing the unlawful securities at the investors' direction. Furthermore, the complaint fails to allege that the trust companies knew or had reason to know that Apostelos was perpetrating a fraud. [1] The trust companies filed motions to dismiss for

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[1] Plaintiffs failed to state a claim for negligence or aiding and abetting breach of fiduciary duty which may have resulted in a different analysis by the court.

failure to state a claim. The district court granted the motions. On appeal the court addresses whether the Ohio Securities Act extends joint and several liability to persons who aided in the purchase of illegal securities.

The court reasoned that Ohio authority offers no support for Plaintiffs' position. To the contrary, Ohio courts have consistently construed R.C. 1707.43(A) as imposing liability only on persons who played a role in the sale of unlawful securities, such as acting in concert with the seller of an unlawful investment. *Federated Mgmt. Co. v. Coopers & Lybrand*, 137 Ohio App.3d 366, 392-393, 738 N.E.2d 842 (10th Dist. 2000) (bank that directly participated in underwriting of investment and acted as financial adviser to issuer can be held liable under R.C. 1707.43); *Boland v. Hammond*, 144 Ohio App.3d 89, 94, 2001- Ohio 2680, 759 N.E.2d 789 (4th Dist. 2001) (defendant who relayed proposed terms of sale to investors, arranged meetings between seller and investors, and distributed promissory notes to investors can be held liable under R.C. 1707.43).

Ohio courts have held that a financial institution's mere participation in a transaction, absent any aid or participation in the sale of illegal securities, does not give rise to liability under R.C. 1707.43(A). Therefore, the court concluded that R.C. 1707.43 does not impose joint and several liability on a person who, acting as the custodian of a self-directed IRA, purchases illegal securities on behalf of and at the direction of the owner.

Supreme Court Deems SEC In-House Judge Hiring Unconstitutional

Lucia v. SEC, 138 S. Ct. 2044, 201 L. Ed. 2d 464 (2018)

The Appointments Clause of the Constitution lays out the permissible methods of appointing "Officers of the United States," a class of government officials distinct from mere employees. Art. II, §2, cl. 2. This case required the court to decide whether administrative law judges (ALJs) of the Securities and Exchange Commission (SEC or Commission) qualify as such "Officers." The SEC has statutory authority to enforce the nation's securities laws. One way it can do so is by instituting an administrative proceeding against an alleged wrongdoer. By law, the Commission may itself preside over such a proceeding. See 17 CFR §201.110 (2017). The Commission also may, and typically does, delegate that task to an ALJ. The SEC currently has five ALJs and other staff members, rather than the Commission selected them all. An

ALJ assigned to hear an SEC enforcement action has extensive powers—the "authority to do all things necessary and appropriate to discharge his or her duties" and ensure a "fair and orderly" adversarial proceeding. §§201.111, 200.14(a). An SEC ALJ exercises authority "comparable to" that of a federal district judge conducting a bench trial. *Butz* v. *Economou*, 438 U. S. 478, 513, 98 S. Ct. 2894, 57 L. Ed. 2d 895 (1978).

This case began when the SEC instituted an administrative proceeding against petitioner Raymond Lucia and his investment company. Lucia marketed a retirement savings strategy called "Buckets of Money." In the SEC's view, Lucia used misleading slideshow presentations to deceive prospective clients. The SEC charged Lucia under the Investment Advisers Act, §80b-1 *et seq.*, and assigned ALJ Elliot to adjudicate the case. After nine days of testimony and argument, Judge Elliot issued an initial decision concluding that Lucia had violated the Act and imposing sanctions, including civil penalties of $300,000 and a lifetime bar from the investment industry. On appeal to the SEC, Lucia argued that the administrative proceeding was invalid because Judge Elliot had not been constitutionally appointed. The Commission rejected Lucia's argument and argued instead that the SEC's ALJs are not "Officers of the United States" but instead, they are "mere employees"—officials with lesser responsibilities who fall outside the Appointments Clause's requirements.

The sole question before the Supreme Court was whether the Commission's ALJs are "Officers of the United States" or simply employees of the Federal Government. The Appointments Clause prescribes the exclusive means of appointing "Officers." Only the President, a court of law, or a head of department can do so. See Art. II, §2, cl. 2. All parties agree, none of those actors appointed Judge Elliot before he heard Lucia's case; instead, SEC staff members gave him an ALJ slot. The court reasoned that the Commission's ALJs hold a continuing office established by law. The court further reasoned that the Commission's ALJs exercise significant discretion when carrying out important functions. Lastly, at the close of proceedings, ALJs issue decisions. Based on the forgoing, the court found that Commission's ALJs are "Officers of the United States," subject to the Appointments Clause. The court further found that Judge Elliot heard and decided Lucia's case without the appointment the Clause requires.

As a result, the court held that "one who makes a timely challenge to the constitutional validity of the appointment of an officer who adjudicates his case" is entitled to relief. *Ryder* v. *United States*, 515 U. S. 177, 182-183, 115 S. Ct. 2031, 132 L. Ed. 2d 136 (1995). Lucia made a timely challenge when he contested the validity of Judge Elliot's appointment before the Commission, and continued pressing that claim in the Court of Appeals and this Court. The court held that the "appropriate" remedy for an adjudication tainted with an appointments violation is a new "hearing before a properly appointed" official. Accordingly, the Supreme Court reversed the judgment of the Court of Appeals and remand the case for further proceedings consistent with this opinion.

Statute of Limitations Applied to the Martin Act

People v. Credit Suisse Sec. (USA) LLC, 2018 N.Y. LEXIS 1451 (N.Y. June 12, 2018)

The Attorney General commenced this action in November 2012 asserting that the issuance of residential mortgage-backed securities by defendants Credit Suisse Securities (USA) LLC and affiliated entities (Credit Suisse) in 2006 and 2007 violated the Martin Act. The complaint alleges that defendants committed multiple fraudulent and deceptive acts in connection with the creation and sale of residential mortgage-backed securities ("RMBS"). In particular, the Attorney General claimed that defendants led investors to believe that they had "carefully evaluated — and would continue to monitor" the quality of loans underlying the RMBS. However, the complaint asserts that defendants were aware of "pervasive flaws in the screening process" for such loans but failed to disclose them to investors. Further, defendants purportedly encouraged originators to deliver defective loans based on an "incentives" program. The Attorney General contended defendants misrepresented the quality of the mortgage loans underlying the securities as well as the due diligence process. After describing the alleged misconduct in some detail, the first cause of action states that defendants' acts and practices violated Article 23-A of the General Business Law (the Martin Act). In a second cause of action incorporating by reference the same allegations, the complaint alleges defendants engaged in repeated fraudulent or illegal acts in violation of the Martin Act.

Defendants moved to dismiss the complaint arguing, among other things, that the action was time-barred because the operative statute of limitations is three years. The Attorney General countered that the action was timely because Martin Act claims are governed by the six-year limitations period. Alternatively, the Attorney General asserted that a six-year limitations period was applicable here because the complaint plead the elements of common law fraud.

The first issue before the court was whether the Martin Act claims are governed by CPLR 214(2), imposing a three-year statute of limitations, or the six-year limitations period implied by CPLR 213(1) or 213(8). CPLR 214(2) generally imposes a three-year limitation period for an action to recover upon a liability, penalty or forfeiture created or imposed by statute. An action based upon fraud receives a six-year statute of limitations pursuant to CPLR 213(8). CPLR 213(1) is a residuary provision applicable to "an action for which no limitation is specifically prescribed by law."

The court reasoned that the Martin Act imposes numerous obligations or liabilities that did not exist at common law. Therefore, the court concluded that the three-year statute of limitations in CPLR 214(2) which is applicable to "a liability, penalty or forfeiture created or imposed by statute" governs Martin Act claims. Accordingly, the court held that the order of the Appellate Division should be modified by granting defendant's motion to dismiss the Martin Act claims as time barred and remitting the case to Supreme Court for further proceedings in accordance with this opinion.

INVESTORS, CORNERED: 10 YEARS AFTER THE MADOFF PONZI SCHEME– INVESTORS STILL FAILING TO LEARN FROM THE PAST

Jeffrey Sonn, and Ryan Cook[1]

On December 11, 2008, Bernard Madoff, the former President of the NASDAQ, was arrested and charged with running a $50 Billion "Ponzi scheme," the largest U.S. scheme to date. Thousands of investors were affected, resulting years of litigation. Investors allegedly earned 10% - 18% per year, even during the dot.com crash of 2000-2003. Incredibly, Barron's published an article titled, "Don't Ask, Don't Tell: Bernie Madoff Attracts Skeptics in 2001."[2] Television news coverage was a constant reminder and often reinforced the old adage, "if its too good to be true, it probably is." But, did investors really learn from the Madoff case? A review of media coverage of Ponzi scheme cases reveals that investors didn't really heed that timeless advice.

As aptly described by Judge Speer in the case *In re: Marroquin*, Ponzi schemes, although they come in many different forms, usually have a number of characteristics in common. To determine whether a Ponzi scheme exists, courts generally assess whether such common characteristics are present and, if present, the strength of the characteristic to the applicable situation.[3] These common characteristics are as follows:

First, the fraud of the Ponzi scheme will usually entail using funds contributed by subsequent investors to pay previous investors.[4] Second, in the typical Ponzi scheme, investors are promised high rates of return, usually over a short period of time.[5] Third, the promoter of the Ponzi scheme will generally

1. Jeffrey Sonn, Esq. is the founder of Sonn Law Group in Miami, Florida and a member of the board of directors of PIABA. Ryan Cook is the Editor in Chief of the PIABA Bar Journal and an attorney with Shepherd Smith Edwards and Kantas, Houston, TX.

2. *See* Arvedlund, E., *Don't Ask, Don't Tell: Bernie Madoff Attracts Skeptics in 2001*, BARRON'S (May 7, 2001), https://www.barrons.com/articles/SB98901966782 9349012.

3. 441 BR 586 (ND OH 2010).

4. In re M & L Business Mach. Co., 84 F.3d 1330, 1335 (10th Cir.1996), cert. denied, 519 U.S. 1040, 117 S.Ct. 608, 136 L.Ed.2d 534 (1996).

5. Donell v. Kowell, 533 F.3d 762, 767 fn. 2 (9th Cir.2008).

pay back the early investments on a timely and expedited basis so as to generate enthusiasm for additional contributions.

Fourth, the Ponzi business commonly has little or no legitimate business purpose.[6] As such, Ponzi schemes are subject to ultimate collapse when the promoter of the scheme is unable to attract more funds to pay for demands made on previous contributions.[7] Finally, the promoter of the Ponzi scheme typically lives a lavish lifestyle.[8]

In the past ten years, there have been many, many notable Ponzi schemes, many of which highlight the span of purported business ventures which fraudsters have used for Ponzi schemes. For example:

Joseph S. Forte from Broomall, Pennsylvania was charged by the SEC with masterminding a $50 million Ponzi scheme. He stole from more than 80 investors, many of which were close friends. Forte was a "complete fraud" according to the SEC. Forte stole, for personal purposes, over $28 million according to the uncovered records. Ultimately, he got a 15 year prison sentence.[9]

The United Kingdom Serious Fraud Office discovered an £80 million buy-to-let scheme being run by a Practical Property Portfolio. More than 1,750 investors were defrauded of £25,000 each by being promised a house in North East England. The directors—John Potts, Peter Gosling, Natalie Laverick, Peter Graham, and Eric Armstrong—pled guilty to charges of fraud and were ultimately sentenced in March 2009.[10]

Nicholas Cosmo, who founded Agape World, was arrested as a result of his suspected $380 million Ponzi scheme. Notably, this wasn't even Cosmo's

6. In re Vaughan, 429 B.R. 14, 27 (Bankr.D.N.M.2010).

7. *See* In re Rose, 425 B.R. 145, 153 (Bankr.M.D.Pa.2010).

8. *See* Christina Tkacik & Tim Prudente, *Feds say Towson millionaire funded lavish lifestyle with elaborate Ponzi scheme*, BALTIMORE SUN (Sept. 19, 2018), *available at* https://www.baltimoresun.com/news/maryland/crime/bs-md-ponzi-scheme-20180918-story.html.

9. *See* Complaint, SEC v. Joseph S. Forte and Joseph Forte, L.P., 09-cv-0063-PD (E.D.P.A., 2009), *available at* https://www.sec.gov/litigation/complaints/2009/comp20847.pdf.

10. Phillip Inman, *Buy-to-let tycoon jailed for conning millions from investors*, THE GUARDIAN (APR. 2, 2009), *available at* https://www.theguardian.com/money/2009/apr/02/property-serious-fraud-office.

first fraudulent enterprise, as he had been convicted of fraud roughly a decade before. He was sentenced to 50 years' imprisonment.[11]

Allen Stanford, and his Stanford International Bank, were accused of "massive fraud" by U.S. authorities. Stanford obtained over $8 billion of investor funds, including from many investors in Latin America. Stanford was arrested by the FBI, and received a sentence of 110 years' in prison on June 14, 2012.[12]

Scott W. Rothstein, a disbarred lawyer and the former managing shareholder, chairman, and chief executive officer of the now-defunct Rothstein Rosenfeldt Adler law firm was accused of funding his philanthropy, political contributions, law firm salaries, and an extravagant lifestyle with a massive $1.4 billion Ponzi scheme. A PIABA member and board director, Jeffrey Sonn, Esq., successfully petitioned the U.S. Bankruptcy Court to place Rothstein's law firm, Rothstein Rosenfeldt and Adler, into Chapter 11 bankruptcy. Scott Rothstein later turned himself in to federal authorities and was subsequently arrested on charges related to the Racketeer Influenced and Corrupt Organizations Act (RICO). Rothstein was denied bond by U.S. Magistrate Judge Robin Rosenbaum, who ruled that due to his ability to forge documents, he was considered a flight risk. Although his arraignment plea was not guilty, Rothstein cooperated with the Government and reversed his plea to guilty of five federal crimes on January 27, 2010. He was sentenced to 50 years, despite the prosecution asking for 40 years.[13]

Joseph Blimline got a 20 year sentence in federal prison for operating two oil and gas based Ponzi schemes. His first Ponzi scheme, which ran from 2003 to 2005 in Michigan, netted over $28 million. He then ran another one in

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11. Press Release, U.S. Attorney's Office for the EDNY, Largest Grossing Broker In Agape Ponzi Scheme Sentenced To 108 Months' Imprisonment (Feb. 24, 2016), *available at* https://www.justice.gov/usao-edny/pr/largest-grossing-broker-agape-ponzi-scheme-sentenced-108-months-imprisonment.

12. Sonia Smith, *Allen Stanford Sentenced to 100 Years for Ponzi Scheme*, TEXASMONTHLY (Jan 21, 2013), *available at* https://www.texasmonthly.com/articles/allen-stanford-sentenced-to-110-years-for-ponzi-scheme/.

13. Ted Scouten, *4 More Charged for Roles in Rothstein's $1.2B Ponzi Scheme*, CBS MIAMI (May 27, 2011), *available at* https://miami.cbslocal.com/2011/05/27/feds-four-people-involved-with-rothstein-fraud-to-turn-themselves-in/.

Texas, using a company called Provident Royalties, that lasted from 2006 to 2009 and netted over $400 million.[14]

Paul Burks and Zeek Rewards, which was based out of North Carolina, promised investors returns as high as 1.5% ***per day*** by sharing in the profits of Zeekler, an internet penny auction site. Investors were incentivized to recruit new investors in order to increase their own returns. New investors were charged a monthly "subscription" of up to $99/month and also had to make a starting investment of up to $10,000. The greater the initial investment, the more the returns appeared to be. While the Zeekler website did generate revenue, it was only tiny fraction of the amount investors were led to believe. It is believed that this Ponzi scheme obtained more than $900M in investor funds, and affected over 1 million investors by the time the SEC filed suit. This made Zeek Rewards one of the, if the the, single largest Ponzi scheme by the amount of investors defrauded, although a number of other schemes obtained more money.[15]

Trendon T. Shavers (aka "Pirate" and "pirateat40"), founded and operated "Bitcoin Savings and Trust" (BTCST), a purported company which advertised itself on an internet forum. Shavers convinced investors to entrust more than 700,000 Bitcoin into BTCST. BTCST ran by using Bitcoin, making it fairly unique among Ponzi schemes. This structure allowed Shavers to stay completely anonymous for a long time before he ultimately shut down the website and just disappeared with all of the investor money. By the time Shavers ran, the bitcoin he had stolen was valued at around $4.5 million.[16]

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14. *See* Press Release, FBI, *Dallas Man Sentenced in Half-Billion-Dollar Ponzi Scheme* (May 04, 2012), *available at* https://archives.fbi.gov/archives/dallas/press-releases/2012/dallas-man-sentenced-in-half-billion-dollar-ponzi-scheme.

15. *See* Press Release, U.S. Attorney's Office Western District of North Carolina, *Former ZeekRewards CEO Sentenced to More Than 14 Years For Operating $900 Million Internet Ponzi Scheme* (Feb. 13, 2017), *available at* https://www.justice.gov/usao-wdnc/pr/former-zeekrewards-ceo-sentenced-more-14-years-operating-900-million-internet-ponzi.

16. *See* Nate Raymond, *Texan gets one-and-a-half years in prison for running bitcoin Ponzi scheme*, REUTERS (July 21, 2016), *available at* https://www.reuters.com/article/us-bitcoin-fraud-texas/texan-gets-one-and-a-half-years-in-prison-for-running-bitcoin-ponzi-scheme-idUSKCN1012W8.

Telexfree was a multibillion-dollar Ponzi scheme which was supposedly operating as an internet phone service company which allowed free calls to Brazil and Latin America. It is in competition with the Zeke Rewards Ponzi scheme for the dubious distinction of being the largest fraud of all time in terms of the number of people affected—more than 1 million, with victims in various countries.[17]

The Woodbridge Group of Companies recently shut down with a $1 Billion judgment for Ponzi scheme run by real estate developer Robert H. Shapiro (not to be confused with Attorney Robert L. Shapiro).[18] Ultimately Woodbridge utilized 281 related entities to set up a massive and widespread scheme that the SEC found defrauded roughly 8,400 investors across the United States. Woodbridge actually provided investors different investment structures to choose from, but all of them were ultimately supposed to be protected by huge underlying real estate investments, while still paying investors returns between 5-10% annually.[19]

A review of these notable cases reveals that investors continue to fall privately placed investments that turn out to be Ponzi schemes. According to ponzitracker.com, which tracks Ponzi schemes, there were over 500 Ponzi schemes between 2008 and 2013 alone, that collectively involved over $50 Billion. In the authors' experience, the common themes of these Ponzi schemes include the appearance of a charismatic promoter who appears highly successful and wealthy; an investment that offers consistent, attractive returns; in a private, unregistered investment that almost always has little transparency and a lack of audited financials; and when coupled with a track record of paying attractive fixed returns on a timely basis, the number of investors expands exponentially until the charismatic promoter cannot raise money fast enough, resulting in the scheme collapsing under excessive demands and little

17. *See* Scott Cohn, *Want to work at home? Take a lesson from this $3 billion pyramid scheme,* CNBC (June 22, 2018), *available at* https://www.cnbc.com/2018/06/21/want-to-work-at-home-take-a-lesson-from-this-3-billion-pyramid-scam.html.

18. *See* Press Release, SEC, *Court Orders $1 Billion Judgement Against Operators of Woodbridge Ponzi Scheme Targeting Retain Investors* (Jan. 28, 2019), *available at* https://www.sec.gov/news/press-release/2019-3.

19. *See* Press Release, SEC, *SEC Charges Operators of $1.2 Billion Ponzi Scheme Targeting Main Street Investors* (Dec. 21, 2017), *available at* https://www.sec.gov/news/press-release/2017-235.

remaining liquidity to pay investors.[20] While many remember Madoff, many have not headed the lesson that if it is too good to be true, it probably is, so stay away. It is the hope of this author that readers review the Ponzi schemes that occurred post-Madoff, and remind themselves and others to protect their money from investments that lack transparency and appear to be just too good to be true.

20. *See* Jeff Sonn, *Ponzi Schemes—Picking Up the Pieces from a Fallen House Of Cards*. 1755 PLI/CORP. 443, 446 (2009); *see generally, In re: Marroquin*, 441 BR 586, 598 (ND OH 2010); *In re: Petters*, 455 BR 166 at fn. 20. (8th Cir, 2011).

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 Christine Lazaro at lazaroc@stjohns.edu, Samuel Edwards at sedwards@sseklaw.com or Robin S. Ringo at rsringo@piaba.org for assistance.

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The following PIABA Comment Letter regarding *Pre-Proposed Amendment N.J.A.C 13:47A-6.3, Fiduciary Duty* was submitted to the Bureau of Securities by Christine Lazaro on December 14, 2018 (prepared with the assistance of Jean-Pierre Bado, Celiza Braganca, Brent Burns, Brady Sparks, Matthew Thibaut and Teresa Verges)

Christopher W. Gerold
Bureau Chief
Bureau of Securities
PO Box 47029
Newark, NJ. 07101

Re: Pre-Proposed Amendment N.J.A.C. 13:47A-6.3, Fiduciary Duty

Dear Mr. Gerold:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules which govern the conduct of those who provide investment advice to investors.

On October 15, 2018, the Bureau of Securities issued a Notice of Pre-Proposal soliciting comments regarding amendments to its rules to require that broker-dealers, agents, investment advisers, and investment adviser representatives be subject to a fiduciary duty when recommending to a customer an investment strategy, or the purchase, sale or exchange of any security, or providing investment advisory services to a customer.[1] The Bureau recognized in its Notice that a uniform fiduciary standard would protect investors from the abuses that can result when financial professionals place their own financial interests ahead of their customers, and invited comment on "the legal and factual bases for applying a fiduciary standard to all financial services professionals; the scope of the duty in terms of duration

1. Notice of Pre-Proposal, 50 N.J.R. 2142 (Oct. 15, 2018).

and when it arises; the types of recommendations that would trigger the duty; and the scope of the duty in terms of to whom it is owed."[2]

PIABA has long advocated for a true fiduciary standard for all investment professionals (regardless of what they call themselves) who provide investment advice to their clients and fully supports the Bureau's proposed fiduciary rule. Consistent with numerous studies, including the Securities and Exchange Commission's ("SEC") findings in 2011, we believe that a uniform fiduciary duty applicable to all financial intermediaries who provide investment advice would eliminate confusion and best protect customers.[3] We therefore believe that the fiduciary duty should apply to all forms of financial advice, and to all customers. We also believe that the fiduciary duty should arise whenever a financial or investment recommendation is made, and that it should last throughout the duration of the advisor-customer relationship. Finally, we believe the Rule should explicitly provide for a private right of action. PIABA's suggestions are discussed in further detail below.

I. A Fiduciary Standard Should Apply to all Financial Professionals Who Are Compensated for Making Financial and/or Investment Recommendations

Under federal law, Investment Advisers who charge a fee for their services are fiduciaries to their clients. However, under current federal and New Jersey law, Brokers who provide investment advice and financial recommendations to New Jersey citizens are not considered to be fiduciaries. Instead, brokers are subject to a lower suitability standard. The suitability standard allows brokers to recommend products that benefit the broker or their firm financially, even if such recommendations are not in the best interests of their customers. The suitability standard is clearly riddled with conflicts of interest. Indeed,

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2. *Id.* at 2143.

3. SEC, *Study on Investment Advisers and Broker-Dealers* ("SEC Study") (Jan. 2011), available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf. The SEC reviewed two studies which it sponsored (the "Seigel & Gale Study" and the "RAND Report"), and a study conducted by Consumer Federation of America. The SEC Study found that, based on the comments, studies and surveys it had reviewed, investors did not understand the differences between investment advisers and broker-dealers. The SEC determined that this misunderstanding is compounded by the fact that many retail investors may not have the "sophistication, information, or access needed to represent themselves effectively in today's market and to pursue their financial goals." *Id.* at 101.

PIABA members have long represented many investors in New Jersey who have been harmed by conflicted advice which would not have been allowable if a fiduciary standard existed.

For example, one New Jersey couple from Middlesex County, in their late forties, opened an account with a broker to prepare for retirement. The broker placed their funds in a combination of private placements, Real Estate Investment Trusts, and other high risk alternative investments. The broker told the couple the investments were safe, and met their goals of preservation of capital and growth. The couple did not know that the recommended investments were highly risky. The customers also did not know that the recommended investments paid substantially higher commissions to the broker and the firm than other, safer investments. Had the broker recommended investments that were in the best interests of his clients, he and his firm would have earned much less. Unfortunately, the couple lost a significant amount of their investment and retirement savings as a result of this conflicted advice.

As another example, a New Jersey couple from Ocean Township opened several brokerage accounts. The couple has been married for over 50 years, and, after retiring, decided it was important to entrust their retirement savings – amassed after a lifetime of hard work – to a broker whom they could trust to take care of them. Unfortunately, once the broker had control of the couple's accounts, he purchased promissory notes and other illiquid private placement investments. The couple believed their broker had chosen investments which were safe, and would provide them with a steady stream of income to support them in their retirement. In fact, the investments were very risky. The broker never conveyed how much risk the couple had actually assumed. The broker and his firm benefited from the purchases, because they made substantial commissions on each of those investments. The couple was not so fortunate. They lost much of the retirement savings they had spent their lifetime acquiring.

By enacting a fiduciary rule, New Jersey is in a position to protect its residents from suffering the same or similar fate as the New Jersey residents in the cases described above. The enactment of such a standard is particularly important because customers usually do not understand the differences between investment advisers, who are subject to a fiduciary standard under federal law, and broker-dealers, who are not. As the SEC has concluded: "it is important that retail investors be protected uniformly when receiving personalized investment advice or recommendations about securities regardless of whether they choose to work with an investment adviser or broker-dealer. It is also important that the personalized securities advice to retail investors be given in their best interests, without regard to the financial or other interest of the financial professional, in accordance with a fiduciary standard."[4]

The importance of a fiduciary standard is borne out by the fact that most retail customers think their financial advisor – regardless of whether that advisor is a broker or an investment adviser – is a fiduciary.[5] The industry is well aware of this confusion. In a survey open to all brokers, investment advisers, and insurance consultants and producers, 97 percent of them said: "investors don't understand the differences between brokers and investment advisers."[6]

Many firms and their personnel are also "dually-registered," meaning that they operate simultaneously as broker-dealers and as registered investment advisers. Customers of such firms often open "brokerage" accounts and "investment advisory" accounts with the same person at the same time. The customers are typically given a sheaf of paperwork, much of it in small print, in which the firm attempts to disclaim its duties for brokerage accounts. Customers rarely read these materials. They do not understand that their financial advisor may claim to have one duty with respect to their brokerage account, and a separate and different duty with respect to their advisory account.

Customers are also frequently confused by firm advertising. In a study conducted by PIABA in 2015, PIABA examined the websites of nine different brokerage firms (the "PIABA Report"), many of which conduct business in New Jersey.[7] PIABA examined Allstate, UBS, Morgan Stanley, Berthel Fisher, Ameriprise, Merrill Lynch, Fidelity, Wells Fargo, and Charles Schwab and found that the firms' advertising presents the image that firms are acting

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4. *Id*.

5. *See* Spectrum Group, *Fiduciary – Do Investors Know What it Means* (2015), available at http://spectrum.com/Content_Whitepaper/fiduciary.aspx.

6. *See* fi360-ThinkAdvisor, *Trustworthy Advice and Individual Investors: Will Regulators Act in Investors' Best Interest?* (Aug. 2013), available at http://www.fi360.com/uploads/media/fiduciarysurvey_resultsreport_2013.pdf; *see also* fi360-ThinkAdvisor, *Seeking Trustworth Advice for Institutional Investors – Financial Intermediaries Indicate Strong Support for Fiduciary Standard* (Feb. 2015), available at http://www.fi360.com/uploads/media/2015fiduciarysurvey.pdf.

7. *See* PIABA, *Major Investor Losses due to Conflicted Advice: Brokerage Industry Advertising Creates the Illusion of a Fiduciary Duty; Misleading Ads Fuel Confusion, Underscore Need for Fiduciary Standard* (Mar. 25, 2015) (the "PIABA Study"), available at https://piaba.org/system/files/pdfs/PIABA%20Conflicted %20Advice%20Report.pdf.

in a fiduciary capacity.[8] Those firms have continued to aggressively promote themselves as offering all-encompassing financial advice with no differentiation between the firms' investment adviser services and brokerage services.

PIABA believes that the only reasonable way to address the investor confusion – which has been created by the financial service industry's misleading advertising and description of their services – is to hold both brokers and investment advisers to a fiduciary duty that encompasses both a *duty of care* and *duty of loyalty*.

***Duty of Care*:** The duty of care should require brokers to act with the care, skill, prudence and diligence, under the circumstances then prevailing, that a reasonably prudent person acting in a like capacity would use in connection with providing investment advice, based on the investment objectives, risk tolerance, financial circumstances, and needs of the investor, without regard to the financial or other interests of the broker. This duty would require the investment advice to not only be suitable, but to also be the best possible advice given the circumstances. Investment costs must be a factor in determining what investment is best for a client, as well as investment objectives, risk and liquidity. This standard is similar to the fiduciary standard which was enacted by the Department of Labor in 2016 with respect to retirement accounts, after several years of study.

***Duty of Loyalty*:** The duty of loyalty should require the mitigation or elimination of conflicts of interest. Incentives which encourage brokers to engage in conduct that they would not otherwise engage in should be prohibited. Brokers should not be paid differential compensation that is dependent on the product recommended. Commissions should be leveled so that the incentive to recommend one product over another is eliminated. This will ensure that a broker considers the needs of his or her clients, rather than in his or her own pecuniary interest. In addition, sales contests should be eliminated because they encourage brokers to put their own interests ahead of their clients'.

II. The Fiduciary Duty Should Apply to All Customers/Investors

PIABA believes that brokers who provide investment advice to investors should be held to a fiduciary standard regardless of the wealth, sophistication or legal personhood of the investor. Institutions such as pension funds,

8. *Id.* at 1.

municipalities and institutional investors that manage pools of capital on behalf of retail investor beneficiaries hold the retirement savings for millions of individual investors. Those individuals are often unsophisticated people of modest means who have minimal outside assets. As such, a broker who misleads an institutional investor representing thousands of individuals can do substantial damage, without the impacted individuals ever knowing or having control over what was done.[9]

Moreover, there are many investors in New Jersey who would qualify as an "accredited investor" under the federal securities laws because they hold assets with high value, such as their retirement account, or they have an income that is large on a national level, but not for someone living in New Jersey.[10] However, an individual's wealth does not mean that he or she has a high level of understanding of investments, or is in a financial position to put his or her money at risk.

Simply put, all investors benefit from and should be entitled to a heightened standard of conduct when receiving financial advice.

III. The Fiduciary Duty Should Apply to All Forms of Financial or Investment Advice

PIABA urges New Jersey to adopt a fiduciary duty that applies to all financial and investment advice offered to a customer, regardless of the type of advice, type of account, or manner in which the broker is compensated. Additionally, the fiduciary standard should always arise when a financial professional recommends a securities transaction *or* an investment strategy involving securities. This would simply require brokers and brokerage firms to live up to the promises which they routinely make to customers in their advertising and in one-on-one communications.

Specifically, brokerage firms give their "registered representatives" titles that sound trustworthy and suggest they are "Investment Advisers", like

9. Tamar Frankel, *The Regulation of Brokers, Dealers, Advisers and Financial Planners*, 30 Rev. Banking & Fin. L. 123, 129-30 (2011). Professor Frankel also observes that institutional investors are "not much better off than individuals with respect to understanding some complex investments." *Id.* at 130.

10. Rule 501 under Regulation D defines accredited investor as "[a]ny natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000" (exluding primary residence), or whose income exceeds $200,000 per year, or joint income with that person's spouse exceeds $300,000 per year. 17 C.F.R. §230.501 (a)(5) and (a)(6).

"Financial Advisor," "Retirement Consultant," and "Wealth Manager."[11] Brokers pay millions of dollars every year to tell investors that they put the interests of customers ahead of their own. Brokers encourage investors to *trust* them, saying they will provide *advice* and *guidance.* One leading broker, whose US headquarters is located in New Jersey, emphasizes the advice and guidance it offers:

> Advice that's all about you and what you need is what UBS does best. It starts with a plan that we develop together—as part of a strategy for managing your wealth and pursuing your personal goals for every part of your life, at every stage of your life. It's what we call: Advice. Beyond investing.[12]

Other brokerage firms make similar promises. For example, Charles Schwab tells investors, "Let us help plan your financial future."[13] Wells Fargo advertises that "Our Financial Advisors are committed to providing you with top-notch service and attention that you expect and deserve."[14] Merrill Lynch says, "Your advisor will help guide you, making adjustments as your needs change."[15] Brokers use the language of fiduciaries to gain the trust and confidence of customers.[16] As a result, when customers meet with a broker, they reasonably expect that they are being given advice that is for their benefit.

Consistent with the foregoing, PIABA believes that a fiduciary standard should apply, regardless of how a brokerage firm charges a customer. There is no valid reason why a broker's duty should be any less to a customer who pays a broker by commissions than it is to a customer who pays a management

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11. *See* Consumer Federation of America and Americans for Financial Reform, *Financial Advisor or Investment Salesperson? Brokers and Insurers Want to Have it Both Ways* (January 18, 2017), available at https://consumerfed.org/wp-content/uploads/2017/01/1-18-17-Advisor-or-Salesperson_Report.pdf.

12. UBS, *Wealth Planning*, available at https://www.ubs.com/us/en/wealth/planning.html (last visited Nov. 23, 2018).

13. Charles Schwab, *Investing Based on Your Goals*, available at https://www.schwab.com/public/schwab/investing/invest.html (last visited Nov. 11, 2018).

14. Wells Fargo Advisors, *Why Choose Wells Fargo Advisors*, available at https://info.wellsfargoadvisors.com/form.aspx?type=wellsfargoadvisorspacket&cid=WFA140043903&intcid=WFA140043903 (last visited Nov. 11, 2018).

15. Merrill Lynch, *Working with Us*, available at https://www.ml.com/working-with-merrill-lynchfinancial-advisor.html (last visited Nov. 11, 2018).

16. *See supra* n. 7.

fee. In either scenario, the customer is reasonably trusting and relying upon the broker's advice. Consequently, the broker should always be required to act in the best interests of its customers, regardless of how the broker is paid.

Similarly, the imposition of a fiduciary standard should not depend on the type of account the customer holds. Brokers and brokerage firms often argue that no account is a fiduciary account unless the customer has given the broker discretion to trade the customer's account without the prior approval of the customer. That argument fails to acknowledge the reality of broker-customer relationships. Our experience is that customers usually trust, rely upon and follow the broker's advice. Indeed, the reason why customers typically retain financial professionals such as brokers is for their advice.

Additionally, PIABA also believes that the Rule should recognize that other types of financial recommendations may trigger a fiduciary duty. Specifically, brokers sometimes recommend other financial courses of action preceding the recommendation of a particular security or investment strategy in order to earn the client's trust and cause the client to entrust their assets to the broker for management. A prime example of such a scenario is when a broker recommends to a prospective client that they retire early and/or elect a lump sum payment in lieu of a defined benefit pension which is then turned over to the broker for investment. Obviously, the broker has a financial incentive to recommend such a course of action. Another example of a situation where financial recommendations unrelated to a specific securities recommendation may properly give rise to imposing a fiduciary standard of conduct is when a brokerage firm's personnel provides generalized financial advice to prospective clients for an extended period of time before the customer has met with a broker, in order to induce the customers to open brokerage accounts with the firm.

In short, it is important to recognize that certain financial recommendations, including recommendations to elect a lump sum in lieu of a pension, although not securities recommendations per se, are a necessary precursor to a broker obtaining control of assets which can then be invested through the broker. As such, those recommendations should trigger the same duties as the specific securities recommendations which must inevitably follow.

It is equally essential to recognize that brokers do not merely pick investments or devise investment strategies. As set forth in the examples of firm advertising cited above, brokers and brokerage firms often purport to offer retirement planning advice and/or a wide spectrum of financial advice and services. The firms' advertising presents the image that the firms are doing far more than simply recommending a specific investment or investment strategy.[17]

Given the foregoing realities, PIABA believes that the Fiduciary Rule should: a) always apply to recommendations of any securities transaction or investment strategy involving securities; and b) also apply in any situation where the broker offers generalized retirement planning, financial or investment recommendations to a prospective customer which are designed to encourage the customer to open an account with the firm and/or to bring additional assets to the firm for investment. Such situations include, but are not limited to, recommendations to take early retirement, recommendations to elect a lump sum in lieu of a defined benefit pension, recommendations to refinance a property to use the equity in order to make an investment, and/or recommendations to meet with a broker from the firm.

IV. The Fiduciary Duty Should Continue Throughout the Duration of the Broker-Customer Relationship

PIABA believes that the fiduciary duty owed by a broker to a customer should last for the duration of the customer relationship, just as it does with Investment Advisers. There are several reasons why this is an appropriate standard.

First, as discussed above, brokers and broker-dealers hold themselves out as providing continuous advice, and being available to assist customers in planning and managing their wealth and investment goals. As UBS puts it, its advice is "part of a strategy for managing your wealth and pursuing your personal goals for every part of your life, at every stage of your life."[18] Charles Schwab says: "Let us help plan your financial future."[19] Merrill Lynch says it will provide guidance, "making adjustments as your needs change."[20] These firms, and many others, emphasize the continuing relationship they will have with customers. Requiring brokers to undertake an ongoing fiduciary duty is simply requiring them to live up to what they promise.

Further, brokers often continue to be compensated for investment transactions and investment advice after the sale has occurred. For example,

17. *See supra* n. 7.

18. *Supra* n. 12.

19. *Supra* n. 13.

20. *Supra* n. 15.

certain types of investments, such as variable annuities and mutual funds, continue to pay commissions to brokers for years after the investments are sold. This is because variable annuities and mutual funds are long term investments which require ongoing management, including the repositioning of assets. In other words, the management of a variable annuity or mutual fund, and the payment to a broker for such management, does not end when the customer purchases the product. Accordingly, it logically follows that the broker's fiduciary duties to a customer should continue for as long as the broker is continuing to be compensated for that recommendation.

An ongoing duty is also essential in order to ensure that recommended investment strategies remain in the customer's best interest. Customers often maintain their accounts with a broker for years or even decades. During that time, a customer's investment profile will change, sometimes dramatically. Likewise, the investment strategy that will be in the customer's best interests can also change. For example, a customer who initially invested while employed but has since retired will most likely need a more conservative investment strategy than what was originally recommended. Similarly, a customer who was single when he or she opened an account but has since gotten married and had children is likely to have different objectives and risk tolerances. For these reasons, an investment strategy cannot satisfy a fiduciary standard unless such a standard requires an ongoing assessment and update of the customers' situation to ensure that the strategy is still in the customer's best interests.

V. The Rule Should Specifically Include a Private Right of Action

PIABA strongly believes that the Bureau should clearly provide for a private right of action in its rule, so that investors can take action on their own behalf against financial professionals and their firms who violate the Rule. There are several reasons why PIABA believes the inclusion of a private right of action is important.

First, allowing for a private right of action is consistent with the overarching goal of state and federal securities laws and regulations – which is to protect the investing public. A private right of action would provide firms with a strong incentive to adopt and implement policies and procedures to ensure that financial professionals are adhering to a fiduciary duty and to carefully police conflicts of interest.

Further, a private right of action can, and regularly does, supplement the state and federal agencies' public enforcement efforts, including in States which hold brokers to a fiduciary standard.[21] For example, customers may bring an action under Sections 11[22] and 12[23] of the Securities Act of 1933; and under Sections 21D,[24] 21F,[25] and 29[26] of the Securities Exchange Act of 1934. Investors can also arbitrate a broad range of state, federal and regulatory securities violations under the rules promulgated by the Financial Industry Regulatory Authority, if the underlying contract so provides or the customer demands it.[27] The New Jersey rule should recognize these well-established means of protection for private investors. Indeed, limiting remedial measures to actions brought by the State would be inefficient and burdensome upon the State.

Finally, a fiduciary relationship is that of the highest trust and confidence. Whenever that trust is broken, customers should have their own ability to pursue a private right of action in order to prevent the fiduciary standard from becoming meaningless. This is especially important because customers often lack the information and bargaining power necessary to protect their rights. Without a private right of action, customers would be deprived of their primary means to remedy abuses.[28]

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21. *See* Richard B. Stewart and Cass R. Sunstein, *Public Programs and Private Rights*, 95 Harv. L. Rev. 1193, 1214 (1982).

22. 15 U.S.C. § 77k (civil liabilities on account of false registration statement).

23. 15 U.S.C. § 77l (civil liabilities arising in connection with prospectuses and communications).

24. 15 U.S.C. § 78u-4 (private securities litigation).

25. 15 U.S.C. § 78u-6 (securities whistleblower incentives and protection).

26. 15 U.S.C. § 78j (manipulative and deceptive devices).

27. FINRA Rules 12200 *et seq*.

28. *See* Stacy-Ann Evy, *Contracting in the Age of the Internet of Things: Article 2 of the UCC and Beyond* 44 Hofstra L. Rev. 839, 893–94 (2016) (on information asymmetry); *see generally*, Albert Choi and George Triantis, *The Effect of Bargaining Power on Contract Design*, 98 Va. L. Rev. 1665 (2012) (on how bargaining power asymmetry impacts contract design of nonprice terms).

VI. The Industry's Arguments Against the Imposition of a Uniform Fiduciary Standard Lack Merit

A. The Fiduciary Duty Rule will help, not harm, small investors.

The securities industry has frequently protested, and continues to promote the argument, that the adoption of any fiduciary standard will harm small investors by preventing them from obtaining personalized financial advice. This begs the question of why any investor would be better off receiving conflicted financial advice, or advice that is not in their best interest, than in receiving no advice at all? We simply do not understand how or why continuing to allow brokers to recommend costly products which primarily benefit the brokers rather than the customers serves the needs of any investor, regardless of the size of their accounts.

Small investors have just as much of a right to be protected from financial abuse as larger investors. Indeed, many smaller investors have a greater need to preserve the money that is invested and cannot afford to lose their money. These investors are also at a disadvantage if they do lose money, because they are often not able to afford counsel, or to obtain any meaningful recovery against the advisor or the firm. Most importantly, the industry's argument that adoption of a fiduciary standard will drive brokers out of business, or result in the cessation of financial services for smaller investors, is not borne out by reality.

California, Florida, Georgia, Missouri, Puerto Rico, South Carolina, and South Dakota have all long considered brokers to be fiduciaries under state common law. Investors in those states have full access to investment advice and services. This was confirmed by a 2012 study which examined whether there were differences in the services available to investors in states that have fiduciary standards and those that do not. The study found no statistical difference between the two types of states when it came to servicing lower wealth clients, including the ability to provide a broad range of products such as those that provide commission based compensation.[29]

The costs of compliance associated with a fiduciary duty standard are also not meaningfully different from those associated with a mere suitability rule. The same 2012 study discussed above found that there is no statistically

29. *See*, Michael Finke and Thomas P. Langdon, "The Impact of the Broker-Dealer Fiduciary Standard on FinancialAdvice" (Mar. 9, 2012), available at https://www.onefpa.org/journal/Pages/The%20Impact%20of%20the%20Broker-Dealer%20Fiduciary%20Standard%20on%20Financial%20Advice.aspx.

significant increase in compliance costs in states in which there is a clear fiduciary standard and ones in which there is no fiduciary standard.[30]

Indeed, when the industry was moving towards the implementation of the Department of Labor's Fiduciary rule, the benefits to investors large and small were readily apparent. In examining those efforts, a report by the Consumer Federation of America determined that:

(i) The DOL rule had begun to eliminate the most harmful conflicts associated with commission-based advice without eliminating access to commission-based advice;

(ii) Despite dire predictions to the contrary, most firms continued to offer commission-based retirement investment advice; and

(iii) Far from driving up investors' costs, the DOL rule was responsible for significant cost reductions.[31]

The anticipation of the DOL Rule did not result in any meaningful reduction of commission-based products. It did not cause any decline in the products or services that are available for small investors. In fact, it did exactly the opposite. As a result of the anticipation of the DOL Rule, brokerage firms offered more services and investment products to small investors than they did prior to the enactment of the DOL Rule. If New Jersey adopts a similar rule, the firms will again innovate and small investors will benefit.

In short, there is substantial evidence that small investors have not suffered any disadvantages when fiduciary rules have been enacted by the states or when the fiduciary rule was enacted by the Department of Labor. There is also no evidence that a fiduciary rule will hurt small investors or prevent them from obtaining financial services. Simply put, a fiduciary rule benefits all investors. The only "harm" it does is to those in the securities industry who wish to continue to be able to take advantage of their customers to their own benefit.

30. *See id*.

31. *See*, Consumer Federation of America, *The Department of Labor Conflict of Interest Rule is Already Delivering Benefits to Workers and Retirees: Delay Puts Those Benefits at Risk* (Jan. 31, 2017), available at https://consumerfed.org/in_the_media/department-labor-conflict-interest-rule-already-delivering-benefits-workers-retirees/.

B. Disclosure of conflicts is not enough.

Several in the industry have argued that greater disclosures of conflicts would be sufficient to protect investors. However, these arguments ignore the fundamental nature of a client's relationship with his or her broker: one of trust. Clients do not believe they have to negotiate with their brokers to receive solid advice, nor do they think their brokers are trying to squeeze every last bit of compensation from their accounts. Simply put, clients do not think their brokers are lying to them and that it is their job to find the lies.

The foregoing is borne out by recent studies which show that disclosures do not lead to greater understanding, even when read. For example, a Rand Corporation study commissioned by the SEC revealed that, after reviewing disclosures regarding the differing duties of investment advisers and brokers, many individuals still remained confused about when firms owed them fiduciary duties and when they did not.[32] This finding was confirmed by another study of the effect of such disclosures which was conducted by the American Association of Retired Persons, the Consumer Federation of America, and the Financial Planning Coalition.[33] In short, disclosure of differing duties does not adequately put investors on notice that they should not trust their broker, or that a "buyer beware" standard applies.

Providing greater disclosure also does not appropriately mitigate the conflicts of interest inherent in the relationship between financial advisors and customers. Instead, it places the burden on the customers to fully understand the impact of those conflicts on the future of their retirement savings. However, the financial advisors have held themselves out to be professionals who are there to offer guidance to investors on important, life decisions. They should accept the responsibility that comes with the profession and with the trust they have sought to earn by managing the life savings of an individual.

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32. SEC, *Investor Testing of Form CRS Relationship Summary*, 46 (Nov. 2018), available at https://www.sec.gov/about/offices/investorad/investor-testing-form-crs-relationshipsummary.pdf.

33. AARP, Consumer Federation of America, and Financial Planning Coalition, *Final Report on Testing of Proposed Customer Relationship Summary Disclosures*, 12 (Sept. 10, 2018), available at https://consumerfed.org/reports/report-on-testing-of-proposed-customer-relationship-summary-disclosures/.

C. New Jersey retirement savers and investors cannot afford to wait for the SEC to promulgate rules.

New Jersey retirement savers and investors are losing $610 million every year due to conflicted advice from financial advisors.[34] Despite that sobering statistic, many in the industry continue to argue that New Jersey should delay the implementation of its own rule until such time as the SEC releases its final rule. However, the SEC has had almost eight years since it issued a report recommending the consideration of rulemaking that would apply to brokers providing personalized investment advice.

The White House Council of Economic Advisors concluded that this conflicted advice costs Americans $17 billion each year.[35] Likewise, the Department of Labor concluded that the cost to investors of investing based on conflicted advice is about $1.4 billion a month.[36] In the past eight years since the SEC study, New Jersey retirement investors have lost over $4.8 billion ($610 million x 8 years). New Jersey investors cannot wait any more. It is imperative that New Jersey retirement investors receive these protections as soon as possible.

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34. *See*, Economic Policy Institute, *Here is what's at stake with the conflict of interest ('fiduciary') rule* (May 20, 2017), available at https://www.epi.org/publication/here-is-whats-at-stake-with-the-conflict-of-interest-fiduciary-rule/.

35. *See*, White House Council of Economic Advisers, *The Effects of Conflicted Investment Advice on Retirement Savings* (Feb. 2015); available at https://obamawhitehouse.archives.gov/sites/default/files/docs/cea_coi_report_final.pdf.

36. *See*, "Regulating Advice Markets; Definition Of The Term "Fiduciary"; Conflicts Of Interest - Retirement Investment Advice; Regulatory Impact Analysis for Final Rule and Exemptions" (April 2016) ("RIA"), available at https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/completed-rulemaking/1210-AB32-2/conflict-of-interest-ria.pdf.

VII. Conclusion

PIABA supports the Bureau's efforts to heighten the duty of brokers who provide investment advice to their customers. PIABA urges the Bureau to adopt a broad, uniform fiduciary standard applicable to all financial professionals who provide investment advice to investors. PIABA thanks the Bureau for the opportunity to comment on this important issue.

Very truly yours,
Christine Lazaro
PIABA President

The following Testimony regarding FINRA Unpaid Arbitration Awards was submitted to the U.S. Securities and Exchange Commission Investor Advisory Committee by Christine Lazaro on December 13, 2018.

Thank you for the opportunity to speak today on the important topic of unpaid arbitration awards. My name is Christine Lazaro, and I am the President of the Public Investors Arbitration Bar Association (PIABA), and a Professor of Clinical Legal Education and the Director of the Securities Arbitration Clinic at St. John's University School of Law. PIABA is a national bar association whose mission is to promote the interests of the public investor in securities arbitration; to make securities arbitration as just and fair as systematically possible; and to create a level playing field for the public investor in securities arbitration. PIABA has almost 400 member attorneys who practice across the country and have represented thousands of investors in arbitration cases.

Investors place their trust in their financial advisor. Often, an investor will turn over her life savings to a broker, in an attempt to do the right thing and ensure a secure retirement. And often, the broker will do the right thing, and properly advise the investor. But sometimes, a broker will act improperly. A broker may act negligently, by not properly assessing an investor's risk tolerance or investment objectives. We have seen brokers focused wholly on generating income for investors by placing them in complex, illiquid investments, like non-traded REITs or structured products. Unfortunately, the broker may not fully understand the risks associated with the investment, meaning he or she could never explain those risks to the investor, who ends up suffering the losses when those risks manifest themselves. Other times, brokers may act fraudulently, by engaging in excessive trading intended to increase the broker's compensation, or by placing the investor in fraudulent investment schemes, like a ponzi scheme.

Whether the broker has acted negligently or fraudulently, the result is the same. An investor who tried to act responsibly to secure her retirement is left financially insecure. The broker's misconduct leaves the investor to figure out whether she will eat, or take her medicine that day, because she doesn't have enough money to do both.

Investor protection goes farther than simply making arbitration available. It is not enough that an investor be told by an arbitration panel that the broker did in fact act improperly. This leaves the investor no better off financially. Protection means the investor is able to recover the funds lost because of the broker's misconduct.

Unfortunately, far too often, investors who have gone through the very arduous arbitration process, receive an arbitration award that is never paid. An unpaid award is as worthless to the investor who just lost her life savings as was the poor advice and conduct that caused the losses in the first place. Unpaid arbitration awards have been a concern for some time, with the GAO first examining the issue in 2000. PIABA has long been concerned about this issue as well, as we see firsthand the impact on investors when they are unable to recover for broker and brokerage firm misconduct.

Take for example the Sheas. The couple has been together for over 40 years. Mr. Shea started out with a dairy route in southern Illinois. After saving for about a decade, the couple purchased a dairy farm, which they operated for the next twenty years. Although they have given up the dairy part of the farm, they continue to grow crops. As you can imagine, the life of a farmer is not an easy one. The Sheas saved their money over time, and eventually accumulated about $1.5 million. As they approached retirement, they considered what to do with their life savings. Their broker, with the firm Windsor Street Capital, aggressively pursued the Sheas, eventually convincing them to invest with him. Within one year, the Sheas lost a significant portion of their savings. The broker traded their account for his own benefit, something commonly called churning. His trading resulted in annualized turnovers of between 10 and 38, far in excess of what would be considered reasonable (which is typically something between 0 on the low side and 6 on the extreme high side). Earlier this year, the Sheas were awarded over $1.3 million in compensatory damages, and $3 million in punitive damages after the arbitration hearing. Although the Sheas lost so much of their life savings, and the arbitration panel agreed that the firm engaged in misconduct, the Sheas have not recovered from the firm. And it is unlikely they will as the firm has shut down.

The Sheas' situation is not unique. Another investor recently received an award against Legend Securities, Inc., a firm which had been expelled by FINRA in April 2017. This investor opened an account with his broker after hearing what is a fairly common pitch – invest a little now, and if the broker is able to show good returns, invest more. And that is exactly what the investor did, convinced that the early successful trade demonstrated that the broker was trustworthy. Unfortunately, the broker was anything but trustworthy. Over a relatively short period of time, the broker lost all of this investor's money; with the exception of the little he had been able to withdraw to cover medical bills. The investor sued Legend, which did not appear at the arbitration hearing. The case proceeded under FINRA's default rules, which require that the customer prove their claim to the arbitrator. After considering the submissions, the arbitrator awarded the full amount the investor lost at Legend Securities: $33,000, as well as interest of over $15,000. The award has gone unpaid, and will likely never be paid since the firm has ceased operations. Unfortunately, that leaves this investor with no hope of recovery, and left to wonder how he will pay his medical bills going forward.

PIABA has published two papers on this topic. The first was an extensive paper drafted in 2016, which walked through the history of the problem, and evaluated possible solutions to the problem. PIABA updated the paper earlier this year. There, PIABA talked about Mr. Wilkerson's case. Mr. Wilkerson is a former NFL player. He trusted his savings to a broker, who used the funds to pay his own personal expenses, the expenses of a company he controlled, and to pay so called dividends and proceeds to other investors for false securities transactions he claimed to have made on their behalf. Mr. Wilkerson was awarded losses of $600,000 and other statutory damages by an arbitration panel. However, the firm had been shut down by the time the award was issued, and Mr. Wilkerson didn't get paid what he had been awarded. Like so many other investors, he was left with a hollow victory.

There are a number of possible ways to address this issue. Insurance is one possibility, but its biggest shortcoming is that it will not help those who have been harmed by the most egregious conduct. It cannot provide assistance to those who were defrauded by their broker.

The best solution is a national investor recovery pool. There are a number of ways such a pool may be funded and administered. In our opinion, it would be best that a pool be administered by FINRA, the entity already responsible for tracking whether arbitration awards are paid.

As the industry regulator, FINRA is also in the best position to fund the pool. There are a number of viable funding options. FINRA may fund a pool with money collected from fines. Between 2014 and 2016, FINRA has assessed fines far in excess of unpaid awards. For example, in 2016, FINRA assessed $173.8 million in fines, while $14 million in awards went unpaid. Using fine money also ensures that those firms and brokers who have engaged in misconduct are the ones compensating harmed investors.

Alternatively, FINRA may fund a pool through a member surcharge. Based on the number of registered representatives, assessments of $23 to $120 per broker would have fully compensated investors with unpaid awards each year between 2012 and 2016. But, it is not necessary to charge firms the same for each broker. FINRA can assess a surcharge based on the overall risk of the firms' businesses. FINRA has said it is using a risk-based framework to conduct member examinations. It can utilize the same framework to fund a pool. Those members engaged in high risk conduct, conduct most likely to result in investor harm, would pay a larger fee.

PIABA has also offered guidance on the administration of a pool to ensure that frivolous claims are not paid. First, we proposed that FINRA rules require that an investor meet her burden of proof, even if the broker or firm do not appear at the arbitration hearing. Second, PIABA suggests that awards be confirmed by a court of competent jurisdiction before being eligible to be paid. Next, PIABA suggests that the pool be funded based on a five year average of unpaid awards. If, in a given year, there are not enough funds in the pool to pay all awards, compensatory damages should be paid before punitive damages, and investors may be paid on a pro-rata basis. Additionally, investors would subrogate their interest in the award to FINRA to the extent they have been paid by the pool. This would give FINRA the ability to pursue the broker or firm for any sums paid out.

We understand that there are concerns that payment of awards by anyone other than those found responsible could create moral hazards. However, certain of our suggestions for administering the pool should address such concerns. For example, the broker and the firm will not be let off the hook for misconduct. The pool would retain the ability to pursue the parties involved to obtain payment. Additionally, FINRA will continue to condition membership on full payment of awards.

The following PIABA Comment Letter regarding *File Nos. S7-08-18; S7-09-18 and S7-07-18; Comments on RAND Corporation's Testing of Form CRS Relationship Summary* was submitted to the Securities and Exchange Commission by Christine Lazaro on December 7, 2018 (prepared with the assistance of Melinda Steuer and Teresa Verges).

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

RE: File Nos. S7-08-18; S7-09-18 and S7-07-18; *Comments on RAND Corporation's Testing of Form CRS Relationship Summary*

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 arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules which govern the conduct of those who provide advice to investors.

PIABA submitted a comment letter in response to the Notice of Proposed Rulemaking regarding Regulation Best Interest ("Rule"), issued by the Securities and Exchange Commission on May 9, 2018. Although PIABA strongly supports the Commission's efforts to heighten the standard of conduct required of brokers when they make investment recommendations to their customers, we expressed concerns about the efficacy of the proposed Client Relationship Summary ("CRS") form, and its role in discharging a broker's disclosure obligation under the proposed Rule.[1] I write in relation to the recently released RAND Corporation report on investor testing of the CRS.[2]

The RAND report confirms the validity of PIABA's concerns about whether the CRS form can or will provide effective disclosure to retail investors, whether such a form will be lost in the voluminous written materials which retail investors typically receive when making a securities transaction, and whether investors will be able to reasonably understand and synthesize the information on the form. PIABA continues to believe that retail investors will rely on what their trusted advisors tell them and will expect their advisor/broker to explain the form to them. In short, PIABA continues to believe that the CRS form is far less likely to be a valuable resource for the investor than to be used by the brokerage firms to protect themselves. Indeed, it appears that several respondents to the survey expressed that exact opinion.[3]

The RAND report provides compelling evidence in support of the concerns PIABA raised in its comment letter about efficacy and limits of disclosure. The report confirms previous surveys and studies that show investors (even those with some investment experience) do not have a meaningful understanding of the differences between brokerage and advisory accounts, or the differences between the standards governing investment advice. Importantly, the report also illustrates that written disclosure is largely ineffective in helping retail investors understand these differences. In fact, the responses to specific questions about the disclosures reveal that a significant number of participants did not understand important sections of the form, and still had a general misunderstanding of the different standards governing investment accounts and financial professionals. The RAND report also reflects that many of the participants were unable to synthesize and apply the information.[4]

For example, almost one-quarter of respondents described the "Types of Relationships and Services" and "Our Obligations to You" sections as

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1. The proposed Rule provides that a broker's required disclosure relating to the scope and circumstances of its relationship with the customer would be made through the CRS form, provided to customers at the opening of a new account. 17 CFR Part 240, 249, 275 and 279, Release No. 34-83063 (April 18, 2018).

2. Angela A. Hung, et al., Investor Testing of Form CRS Relationship Summary, Prepared for United States Securities and Exchange Commission, RAND Corporation ("Report"), November 2018, https://www.sec.gov/comments/s7-07-18/s70718-4628415-176399.pdf.

3. *See* Report, at 42.

4. *Id.* at 47-48.

"difficult" or "very difficult" to understand.[5] The responses were even higher for the "Fees and Costs" and "Conflicts of Interest" sections, with approximately 35 percent of respondents describing these sections as "difficult" or "very difficult" to understand.[6] Disturbingly, RAND's interviews with live participants revealed a far greater level of misunderstanding than self-reported in the written surveys. Interview participants found a number of the financial terms confusing, and many did not understand the term "fiduciary."[7] Although some participants appeared to understand discrete sections of the CRS forms when reviewing it, questioning at the end of the interviews revealed that they did not synthesize the information sufficiently to apply it.[8] For example, one individual was able to differentiate the fees related to advisory and brokerage accounts, but incorrectly believed an advisor had a greater incentive to encourage frequent trading.[9] Still other participants in the interviews misunderstood the differences between account types and financial professionals from the very beginning and throughout the interview process.[10] For example, one individual was unable to answer what kind of investor would be better off with a brokerage account versus an advisory account.

PIABA has serious concerns as to whether any form seeking to disclose the type of information covered in the CRS form can provide effective disclosure to investors, particularly those with limited prior investment experience. In our experience, investors are often overwhelmed with the volume of paperwork when opening an account, thereby diminishing the effectiveness of any written disclosure. Instead of carefully reading through the paperwork, investors typically rely on what their brokers tell them and sign or initial where indicated. This is borne out by the RAND report, which reflects that more than half of all respondents had never reviewed an investment advisor's Form ADV or a brokerage firm's account opening agreement, and another 20% of respondents did not know if they had ever done so.[11] Investors trust their financial professionals because they believe (often

5. *Id.* at 11-13.

6. *Id.* at 11; 14-16.

7. *Id.* at 41.

8. *Id.* at 45.

9. *Id.*

10. *Id.* at 45-46.

11. *Id.* at 32.

incorrectly) that the financial professional will place the investor's financial interest before his or her own.

In conclusion, the RAND report reinforces PIABA's concern that the CRS form will not sufficiently protect investors, and that it will only serve to protect the financial industry. The RAND report confirms PIABA's view that a broker's obligation of disclosure cannot be sufficiently discharged with documents because many investors do not realize that their brokers are not already verbally providing them with the necessary information, or have difficulty understanding the documents. The RAND report also supports our view that a "one size fits all" document is not sufficient to satisfy the disclosure obligation. As the RAND report reflects, the level of understanding varied widely among the participants. That is even more likely to occur when such a form is presented across the entire retail marketplace, as opposed to a limited group of people who agreed to participate in the SEC's survey.

Accordingly, PIABA continues to believe that the standard for disclosure should go further than handing an investor an additional boilerplate document. Rather, the broker should be required to make reasonable efforts to talk to the investor about the relationship, the fees, and the recommendations, in a manner that is understandable to the investor. Additionally, brokers should be held to high standards of conduct, which match the expectations that have been created as a result of the firms' own marketing.

PIABA thanks the SEC for the opportunity to comment further on this important issue.

Very truly yours,
Christine Lazaro
PIABA President

The following PIABA Comment Letter regarding *File No. SR-FINRA-2018-37, Post-Employment Conflict of Interest Restrictions* was submitted to the Securities and Exchange Commission by Christine Lazaro on November 28, 2018 (prepared with the assistance of Aaron Israels, Hugh Berkson and Jason Kane).

Via email to rule-comments@sec.gov
Mr. Brent J. Fields, Secretary
Securities and Exchange Commission
100 F. Street, N.E.
Washington, DC 20549-1090

Re:File No. SR-FINRA-2018-37
Post-Employment Conflict of Interest Restrictions

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 is 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 impact investor protection.

Proposed FINRA Rule 9910 (Post-Employment Conflict of Interest Restrictions; Nonpublic Information) seeks to implement post-employment restrictions on FINRA staff in an effort to avoid conflicts of interest in subsequent proceedings that arise from their previous employment with FINRA. These restrictions include *inter alia* restricting former officers from appearing before FINRA within one year of their departure from FINRA and restricting a former employee's appearance before FINRA when the former employee supervised or was substantially involved with a FINRA member or registered person during the time that they were a FINRA employee. The proposed rule places date restrictions on a former employee's post-employment restrictions, depending on their level of involvement with the individual or entity involved in the hearing, but also, restricts a former FINRA employee's ability to disseminate nonpublic information obtained in the course of his or her employment with FINRA. The rule proposal purports to model itself after other, similar, regulations concerning governmental ethics.

FINRA's rule proposal is a welcome step forward in encouraging investor confidence in the self-regulatory system. Absent the rule, and as things stand now, former employees are permitted to participate in FINRA proceedings without restriction immediately following the end of their FINRA employment. Accordingly, numerous conflicts of interest arise, eroding the public's trust and confidence in the system. Likewise, when former FINRA employees are permitted to "switch sides" and immediately take up advocacy before FINRA on behalf of broker-dealers regarding matters they previously worked on while at FINRA, it would give a strong appearance of impropriety, which calls into question the fairness of any hearing in which the former employee participates.

As a result, PIABA supports the proposed rule change because it reduces potential conflicts of interest, as well as the appearance of impropriety, and is consistent with PIABA's goal of encouraging FINRA's efforts to remove systemic conflicts of interest. PIABA believes that the elimination of unnecessary conflicts of interest within the self-regulatory framework is important to maintaining integrity within the system.

For these reasons, PIABA supports the Rule as proposed and thanks the Secretary for the opportunity to comment on this issue.

Respectfully submitted,
Christine Lazaro
PIABA President

The following Testimony regarding the Pre-Proposed Amendment N.J.A.C 13:47A-6.3, Fiduciary Duty, was submitted to the New Jersey Bureau of Securities by Christine Lazaro on November 19, 2018 (prepared with the assistance of Jean-Pierre Bado, Celiza Braganca, Brent Burns, Brady Sparks, Matthew Thibaut and Teresa Verges).

Statement of Christine Lazaro
On behalf of the Public Investors Arbitration Bar Association (PIABA)
Before the New Jersey Bureau of Securities

November 19, 2018

Thank you for the opportunity to speak here today. My name is Christine Lazaro and I am the president of the Public Investors Arbitration Bar Association. PIABA is a national bar association whose mission is to promote the interests of the public investor in securities arbitration; to make securities arbitration as just and fair as systematically possible; and to create a level playing field for the public investor in securities arbitration. PIABA has almost 400 member attorneys who practice across the country and have represented thousands of investors who have been harmed by inappropriate investment advice.

PIABA has long advocated for a true fiduciary standard for brokers, one which acknowledges the position of trust and confidence such individuals occupy when dealing with their clients. A true fiduciary standard would consist of:

• a duty of care which should include on-going monitoring and advice, when appropriate; and

• a duty of loyalty.

As you know, brokers are currently held to a suitability standard. A suitability standard only requires that a broker make recommendations “appropriate” for an investor based on that investor’s profile. However, brokers will often have a wide range of products to choose from. Some products may seem similar but pay the broker varying levels of commission. Under the current standard, the broker may select the product from that collection which provides the greatest benefit to the broker. The broker is not required to disclose to the investor that there are lower cost products available, or that the broker's recommendation is driven by incentives for the broker which create conflicts of interest. While FINRA has long viewed the suitability rule as requiring that a broker's advice be in the investor's best interest,[1] the rule does not explicitly include such a requirement, and brokers continue to be influenced by conflicts of interest that incentivize the broker to act in his own best interests.

Unlike brokers, investment advisers are held to a "fiduciary standard." This fiduciary standard consists of two parts: a Duty of Loyalty and a Duty of Care.[2] The Duty of Loyalty requires investment advisers to act in their clients' best interests and to disclose all conflicts of interest.[3] The Duty of Care requires investment advisers to provide suitable investment advice after investigating a client's financial situation and investment objectives.[4]

There are circumstances when a broker will also be held to a fiduciary duty. For example, where a broker exercises discretion or special circumstances are present, the broker will be held to a common law fiduciary standard.[5]

While in most circumstances, a broker is not held to a fiduciary standard, brokerage firms continue to advertise that they will provide investors with services that most would consider fiduciary in nature. Firms encourage investors to trust them, saying they will provide advice and guidance, implying they are there for the long term. However, the firms do not make clear that they are actually providing episodic advice tainted by conflicts.[6] For example, on its website, Charles Schwab tells investors, "Let us help plan your financial

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1. *See* FINRA Rule 2111 (Suitability) FAQ, A7.1, available at http://www.finra.org/industry/faq-finra-rule-2111-suitability-faq.

2. *See* Study on Investment Advisers and Broker-Dealers, SEC 22 (2011), *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

3. *Id.*

4. *Id.* at 27–28.

5. *See* Leib v. Merrill, Lynch, Pierce, Fenner & Smith, 461 F.Supp. 951, 953 (E.D.Mich.1978).

6. Peiffer, Joseph C. and Christine Lazaro, Major Investor Losses Due to Conflicted Advice: Brokerage Industry Advertising Creates the Illusion of a Fiduciary Duty, Misleading Ads Fuel Confusion, Underscore Need for Fiduciary Standard (March 25, 2015), available at https://piaba.org/sites/default/files/newsroom/2015-03/PIABA%20Conflicted%20Advice%20Report.pdf.

future."[7] Wells Fargo advertises that "Our Financial Advisors are committed to providing you with top-notch service and attention that you expect and deserve."[8] Merrill Lynch says, "Your advisor will help guide you, making adjustments as your needs change."[9] These are not the words of mere salesmen. The firms are holding themselves out as trusted life-long partners, partners their clients can rely upon.

Although brokers hold themselves out as trusted advisors, they only remain subject to a suitability standard, not a fiduciary standard. Under the suitability standard, brokers are often incentivized to recommend certain products. For example, if a broker sells a non-traded REIT (real estate investment trust), he may earn substantially more money than if he sold an index ETF (Exchange Traded Fund). While both investments may generate income for a client, the non-traded REIT will have more risk and be potentially illiquid. The client likely will not understand that to generate the income, she has given up the ability to access her principal, and may be subject to a substantial amount of investment risk. The client has not asked these questions because she trusted the advice she received from her broker, believing that her broker would only put her in something if he believed that investment was best for her.

PIABA members have represented many investors who have been harmed by conflicted advice. For example, one New Jersey couple from Middlesex County, in their late forties, opened an account with a broker. They thought they were doing something responsible to help prepare them for retirement. The broker placed their funds in a combination of private placements, REITs, and other high risk alternative investments. The broker told the couple the investments were safe, and met their goals of preservation of capital and growth. The couple didn't know that, while the investments may have offered some potential for growth, they were highly risky. No doubt, the broker and his firm were not motivated by the interests of their clients, but rather by the substantial fees earned from these investments. Had the broker recommended truly appropriate investments, he would have earned much less. Unfortunately,

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7. Charles Schwab, Investing Based on Your Goals, available at https://www.schwab.com/public/schwab/investing/invest.html (last visited Nov. 11, 2018).

8. Wells Fargo Advisors, Why Choose Wells Fargo Advisors, available at https://info.wellsfargoadvisors.com/form.aspx?type=wellsfargoadvisorspacket&cid=WFA140043903&in tcid=WFA140043903 (last visited Nov. 11, 2018).

9. Merrill Lynch, Working with Us, available at https://www.ml.com/working-with-merrill-lynch- financial-advisor.html (last visited Nov. 11, 2018).

the only person who benefited from this trading was the broker. Meanwhile, the couple lost a significant amount of their retirement savings.

Another New Jersey couple from Ocean Township opened several brokerage accounts. The couple has been married for over 50 years, and, after retiring, decided it was important to entrust their retirement savings, amassed after a lifetime of hard work, to a broker whom they could trust to take care of them. Unfortunately, once the broker had control of the couple's accounts, he purchased promissory notes and other private placements. The couple believed their broker had chosen investments which were safe, and would provide them with a steady stream of income. And, while the investments did generate some income, the broker never conveyed how much risk they had assumed. The broker benefited from the purchases, because he made substantial money every time he invested them into one of the private placements. However, in the end, the couple lost a substantial amount of their savings.

Unfortunately, these cases are all too common. Brokers recommend complex investments, claiming they are appropriate for the investors' growth or income investment objectives. While the investments may generate some potential for growth or income, they are often risky and illiquid. The brokers end up compromising their clients' needs by focusing on one aspect of their investor profiles. The brokers themselves are driven by incentives, directing their clients to investments that will pay the broker the most. This behavior can be prevented by adopting a true fiduciary standard, one that requires a broker to put the needs of his client ahead of his own.

We ask that the Bureau adopt a standard that recognizes the relationship of trust and confidence that exists between an investor and her broker. Such a duty should consist of a Duty of Care and a Duty of Loyalty.

The Duty of Care should replicate the duty that had been adopted by the Department of Labor as part of its Best Interest Contract Exemption. Brokers should be required to "act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, based on the investment objectives, risk tolerance, financial circumstances, and needs of the ... investor, without regard to the financial or other interests" of the broker.[10]

Such a duty will continue to incorporate the requirement to provide suitable investment advice; however the advice should be the best possible advice given the circumstances. Investment costs must be a factor in

10. See Best Interest Contract Exemption, Department of Labor, 81 FR 44773, 44784 (July 11, 2016), available at https://www.federalregister.gov/documents/2016/07/11/2016-16355/best-interest-contract- exemption-correction.

determining what investment is best for a client, as should investment objectives, risk, and liquidity.

Moreover, we recognize that there are different business models, and that variances in the models may benefit some clients. Clients should have the option to pay commissions or asset based fees. However, how the client has paid the broker should not determine what that broker's duties are. Studies have shown that investors are confused about the level of monitoring they will receive from their brokers.[11] In is unfair that brokers can hold themselves out as "advisers," but not have to meet the expectations such a title creates. Unless a client is directing the trading in the account herself, a broker's duties should be continuous.

Additionally, brokers may be dually registered, acting as both a broker and an investment adviser, many times with respect to the same client. Investors do not understand that their broker may have one duty with respect to their brokerage account, and a separate and different duty with respect to their advisory account. Clients do not differentiate the accounts based on the duties owed; they differentiate the accounts based on the fees paid. They believe they are paying the broker in different ways for the same services, not bargaining for different services. Brokers who are dually registered should have an on-going duty of care.

Brokers should also be held to a Duty of Loyalty. Such a duty should require the mitigation or elimination of conflicts of interest. Incentives which encourage brokers to engage in conduct that they would not otherwise engage in should be prohibited. Brokers should not be paid differential compensation that is dependent on the product recommended. Commissions should be leveled so that the incentive to recommend one product over another is eliminated. Regardless of whether the broker recommends a REIT, a mutual fund, or an annuity, the broker should be paid the same fee. This will ensure that a broker is considering the needs of his client, rather than his own wallet. Additionally, sales contests should be prohibited. There is a significant amount of misconduct flowing from sales contests because brokers are paid to sell particular products. Such behavior encourages a broker to put his own interests

11. See Final Report on Testing of Proposed Customer Relationship Summary Disclosures, AARP, Consumer Federation of America, and Financial Planning Coalition 12 (Sept. 10, 2018), available at https://consumerfed.org/wp-content/uploads/2018/09/testing-of-proposed-customer-relationship- summary-disclosures-report.pdf; Investor Testing of Form CRS Relationship Summary, SEC 46 (Nov. 2018), available at https://www.sec.gov/about/offices/investorad/investor-testing-form-crs-relationship-summary.pdf.

ahead of his client's. It should be clear from any rulemaking that such conduct is unacceptable.

Investors turn over their life savings to brokers. Of course, they trust their brokers, believing that their brokers are acting in their best interests, not understanding that the brokers may be faced with incentives that challenge their ability to do what's best for their clients. Brokers should be held to a higher standard, one that ensures they will put their clients' interests first. Brokers should be held to a true fiduciary standard.

Thank you for the opportunity to speak to you today. The gap in standards between investment advisers and brokers is harmful to investors. We applaud the Bureau for looking into this issue and look forward to working further with the Bureau as it considers the adoption of a fiduciary duty for brokers.

The following PIABA Comment Letter regarding *Regulatory Notice 18-22* was submitted to the Financial Industry Regulatory Authority by Andrew Stoltmann on September 28, 2018 (prepared with the assistance of William Young, Hugh Berkson and Aaron Israels).

pubcom@finra.org
Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K. Street, NW
Washington, D.C. 20006-1506

Re: Regulatory Notice 18-22 (Comment on FINRA Rule Amendments Relating to Discovery of Insurance Information in Arbitration)

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 ("FINRA") relating to both investor protection and disclosure. As such, PIABA frequently comments upon proposed rule changes in order to protect the rights and fair treatment of the investing public.

PIABA submits this comment because it believes amending the Discovery Guide to require disclosure of third-party insurance coverage information in customer cases would benefit the investing public. PIABA further believes that this information would reduce the number of unpaid arbitration awards, which is a matter of great concern to the organization and a major problem within the financial industry.

Background

FINRA seeks comment on proposed rule amendments to the Discovery Guide List 1 (hereinafter "List 1") that would require firms and associated persons, upon request, to produce documents concerning third-party insurance coverage in customer arbitration proceedings. The proposed amendments would strictly limit the circumstances under which insurance coverage information could be presented to the arbitrators. Additionally, the proposed amendments would not require production of documents relating to self-insurance; firms with sufficient capital to pay arbitration awards would not be required to produce insurance information automatically in every arbitration case.

Comments

PIABA supports the proposed amendment to the Discovery Guide to require routine disclosure of liability insurance coverage by registered broker/dealers who are thinly capitalized or not self-insured. Many members of our organization have represented clients with the unfortunate experience of receiving an award against a brokerage firm or broker only to later discover the party with the award rendered against it either had no insurance coverage or the policy did not cover the wrongdoing in that particular case. Learning of the existence of insurance or, if there is insurance, the limits of coverage and/or liability cold save those already wronged investors of the additional damage of proceeding with an inevitably fruitless case.

While a few comments to date indicate that some members of the industry are reluctant to provide this information, PIABA believes this proposal is in the best interest of all parties, including brokerage firms and brokers. For example, when liability coverage exists, it is in the best interest of the brokerage firm to timely disclose the existence of the claim to its carrier. When member firms do not timely report potential claims, coverage can be denied if a claim is made outside of a claim period on a "claims made" insurance policy. The result is that the member firm ends up not obtaining any benefit for the insurance it purchased. Our members have also seen this happen often where a registered representative has insurance coverage through his/her firm, but is not aware of how the policy works and therefore is unaware of how to properly invoke the insurance policy. If a claimant knows of the existence of a policy for which no claim has been submitted by a brokerage firm, the claimant can take action to alert the carrier of the claim.

When claims go unreported to carriers, the proceeding can quickly turn into a lose-lose scenario. In such a situation, a customer spends a large amount of time and effort, only to get an award against a brokerage firm that cannot pay, and then often has to close its doors, where viable coverage may have been able to protect both the firm and the investor. Similarly, a customer may have a claim against a brokerage firm that has already gone out of business, but the claims could be prematurely dropped by the customer if they are not informed about a potential method of recovery from an insurance policy.

Once notice of the claim is reported to the carrier, the insurance company will either affirmatively cover the claim, decline to cover it, or cover it with a reservation of rights in favor of the carrier. Knowledge of a carrier's response to a claim will provide better insight to all parties on the true value of a claim, which can help claimants make better and more informed decisions regarding settlement of their claims, particularly if the policy is a "wasting policy" where a firm's attorneys' fees and costs are paid from the portion of the policy apportioned to the claim.

The production of insurance information will also prevent registered firms that have coverage from threatening a bankruptcy or a Form BDW to settle arbitrations for much less than their value, in order to avoid reporting the claim to its carrier. If insurance information is disclosed to the claimant, then appropriate actions can be taken to protect the rights of a potential claimant and avoid a potential settlement based upon false information. As FINRA has not mandated that its members maintain adequate capital reserves to pay for customer claims has not required its membership to maintain liability coverage, PIABA believes this is the least FINRA can do in furtherance of its stated goal of promoting investor protection.

The idea that the disclosure of insurance coverage would entice filings is an admission by the Industry that its members in fact do "plead poverty" as a tactic to avoid claims. The amendment would help put an end to such disingenuous tactics. FINRA claims should be decided on the facts and merits rather than a FINRA member's tactical choice to withhold liability coverage information because the firm or associated person wants to avoid potential premium increases or high retentions associated with the policy.

The implementation of the proposed amendment would resolve inconsistencies with Federal law and a majority of states, which already require the disclosure of insurance coverage information at the onset of cases. The fact that the Federal Rules of Civil Procedure require initial disclosures to contain coverage information is demonstrative of how relevant this information is in all civil proceedings.

While a policy declaration page would be the preferable document required under the Discovery Guide, PIABA believes, at a minimum, FINRA's Discovery Guide amendment should include disclosure of the name(s) of each insurer who could potentially provide coverage for a given claim, the name of the insured(s), the limits of the coverage, a copy of the policy and a copy of any reservation of rights letter to the insured. In addition, while PIABA appreciates that this information may not be relevant against some of the larger member firms, FINRA should be mindful of drawing clear lines as to what firms do, and what firms do not, have to disclose such information. FINRA's failure to do so could result in burdensome proceedings to resolve who has to produce insurance, thereby undermining the benefit of requiring this information under the Discovery Guide.

Conclusion

In summary, PIABA strongly supports the proposed amendment as it would benefit the investing public, as well as the brokerage industry itself, for all the reasons set forth above. PIABA further believes that this information could reduce the number of unpaid arbitration awards, a problem which currently plagues the financial industry. We appreciate the opportunity to comment on a proposal that would be of benefit to all parties participating in the FIRNA arbitration process.

Very truly yours,
Andrew Stoltmann