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NOTHING BUT THE TRUTH?
LYING IN ARBITRATION

David E. Robbins[1]

1. Overview

It is dispiriting to learn that someone lied to you, especially if that someone is your client. It is not so bad when the dissembler is an adversary witness, but it is really bad if its your own. In the hundreds of securities arbitrations in which I have been involved since the early 1980s, mendacity often reared its ugly head, even after the Chair turned to the witness at the outset of testimony, requested the individual to raise his or her hand and then asked the witness:

> Do you solemnly swear or affirm that the testimony you are about to give shall be the truth, the whole truth and nothing but the truth?[2]

This article will answer the following questions while covering a number of subjects, all dealing with some people's penchant for not telling the truth.

- *Why do people in general lie?*
  You may not be surprised by the answers.
- *Why do customer-clients lie?*
  Because they do not want to take responsibility for their actions or inactions and see you as a means to an end.

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1. © David E. Robbins 2021. Mr. Robbins is a founding member of PIABA. He is a partner in the New York City-based Kaufmann Gildin & Robbins LLP and, for over 40 years, he has represented parties in disputes concerning the securities industry, parties in regulatory matters and the negotiation of financial adviser contracts. He is an American Arbitration Association arbitrator, the author, since 1990, of the *Securities Arbitration Procedure*, and since 1995, author of the annual *McKinney's Practice Commentary on Securities Arbitration for the New York Practitioner.* DAVID E. ROBBINS, SECURITIES ARBITRATION PROCEDURE MANUAL (Matthew Bender, 5th Ed. Dec. 2020); DAVID E. ROBBINS, MCKINNEY'S PRACTICE COMMENTARY ON SECURITIES ARBITRATION FOR THE NEW YORK PRACTITIONER. He co-chairs the New York State Bar Association program on securities arbitration and mediation, is on this Journal's Board of Editors and is rated a "Super Lawyer" in securities law. I sincerely thank fellow PIABA members John Sutherland and Luis E. Minana for their substantive editing of this article.

2. FINRA, HEARING PROCEDURE SCRIPT-3 MEMBER PANEL, (May 4, 2020), https://www.finra.org/sites/default/files/hearing-procedure-script-3-member-panel.pdf.

*Article updated April 27, 2021.

- *Why do brokers lie?*
  Because they do not want to take responsibility for their actions by admitting error or deceit.
- *How can you spot a lying witness at the hearing?*
  Keep your eyes and ears wide open. You were given two of each.
- *What are the ethical implications when you learn the liar is your client?*
  The *Codes of Ethics* provide the answers.
- *Can polygraphs help you settle cases?*
  Absolutely, depending on the experience of the polygraph examiner and your client's truthfulness.
- *How can you effectively cross-examine a liar?*
  Any number of ways, but it takes a great deal of preparation and an ability to listen.
- *How do arbitrators determine a witness is a liar?*
  Primarily in answers to their direct questions. Secondarily, through your cross-examination skills.
- *Why is witness credibility critical to each case?*
  Because the witnesses "were there" and no one else was. Additionally, since one party will win the arbitration and the other party will lose it, sometimes losers are perceived to have been liars.

This article expands greatly on those cryptic answers.

2. Context – Experience as Teacher

The Lady in Red and Her Infamous Attorney - I first met a pathological liar on financial matters in the 1970s when the Securities Bureau of the New York Attorney General's Office successfully prosecuted a female Ponzi schemer named Adela Holzer, who was represented by the infamous Roy Cohn.[3] When we questioned her during a Martin Act investigative deposition, she showed no empathy or other human response to the people who trusted her and the lives she ruined. She did not testify at trial. At sentencing, with Mr. Cohn beside her, Ms. Holzer wore a floor-length mink coat since she was so sure she would receive probation. However, she was probably the first person to become a prisoner at Rikers Island wearing such a coat.

In the years that followed, I have met a number of such individuals, most of whom had committed fraud on a massive scale, not limiting their

3. Robert D. McFadden, *Mrs. Holzer Guilty on 7 Fraud Charges,* N.Y. TIMES (Mar. 16, 1979), https://www.nytimes.com/1979/03/16/archives/mrs-holzer-guilty-on-7-fraud-charges-jury-convicts-investorproducer.html.

misconduct to a single customer or to one household (e.g., Ponzi schemes and stock manipulations).

Witness of the Year - Even experienced attorneys do not realize they have been lied to by their clients. At the end of each year, I look back on the cases I have worked on and advised a particular client that she or he was “the best witness” of that year, usually because the person was so great in helping prepare for the hearing, was consistent on direct and was compelling and straight-forward on cross-examination. For two years in a row, I bestowed that accolade on a financial advisor who looked arbitrators or mediators (and me) straight in the face and answered our questions without any hesitation. His memory was encyclopedic and his ability to put the arbitrators “in the room” when events in question occurred was remarkable.

So, you can imagine how I reacted upon learning that he had enabled his boss (another former client of ours) to commit securities fraud on a grand scale for a significant amount of time. After he pled guilty in federal court to a count of securities fraud (his former boss demanded her right to trial, was convicted, and was then sentenced to 20 years in federal prison), I asked him why he had lied to me for so long and in such an unassuming manner. Did he not feel guilty for doing that to me? Yes, he admitted, but I was a means to an end and he saw no other way out of the mess he had gotten himself into. He said he felt pretty bad about lying, but insisted he had no choice. He did have a choice, of course, and served time in a different federal prison because of it (but not to the extent of his former boss). He was such a good liar.

In the world of securities arbitration, I have represented customers, brokers and officers of brokerage firms who, looking me in the face, tell me something (and repeat it) that I later learned was a lie.

I Forgot to Tell You - We had a customer client in the early 1990s - an elderly gentleman - who claimed in a case we took over from another law firm that it was unsuitable for the brokerage firm to “put on margin” such an old person because that exacerbated his risk. In preparation for the arbitration hearing, he insisted to me that he had little understanding of margin trading but knew it was not for him. So, you can imagine my surprise when he was cross-examined by a well-known defense attorney who first had my client repeat his testimony about his scant knowledge of margin trading, only to be followed by the attorney pulling out a transcript of the client’s testimony – just five months before - at a bankruptcy proceeding where he waxed poetic about the intricacies and vulnerabilities of margin trading. He sheepishly told the arbitrators that he did not recall that testimony. He certainly had not told me about it. The arbitrators gleefully and swiftly denied all of his claims.

After 45 years of practice, I think I am pretty good at lie-spotting, but some clients have gotten through my radar screen. When I subsequently confronted

them with the truth, they were either indifferent, apologetic or defensive. Some rationalized their deceit by saying: "If you knew the truth, you would not have represented me as aggressively" or "I needed to win and I saw you as the means to get my story across in a compelling way." Others continue to deny it, even those who ultimately were incarcerated. Some are such convincing liars that you never really know for sure.

When clients have said "I'll take a lie detector test to prove I'm telling the truth," I have often put them to the test. That they were willing to sit for the polygraph told me the results would be good. And they always were. Although polygraph examinations are usually inadmissible in an arbitration hearing unless the opposing party consents, we have used them effectively to settle cases.

Having a good memory for what your clients told you months ago that differs from what they told you recently helps lie-spotting. Other clients are so convincing, you never saw it coming. You wanted to believe in your clients and let your skepticism take a back seat on your drive through the cases. Based on my experience, I believe that a client who lies to you – as their attorney – does not trust you with the truth and will inevitably lose his or her case.

A Broker Who Lied - I remember representing a financial advisor in a FINRA on-the-record deposition (OTR). He was such a nice guy and insisted, under oath, that his income was limited to what was reported on his 1099s and that he "certainly didn't receive any money from" the company under inquiry. When we walked out of the OTR - at the World Financial Center in lower Manhattan - I told my client that, based on my experiences as the Compliance Director at the American Stock Exchange and former Special Deputy Attorney General for New York, we would not be hearing from FINRA again. I was wrong. We were called back a few months later when, low and behold, my client was presented with checks he had deposited from sources not reported on his 1099s. He was compelled to take a permanent bar from the industry.

Speaking of tax returns, when you send your new client the Statement of Claim for approval and then explain the documents that are presumptively discoverable under the Discovery Guide, if there is a hesitation on the client's part when it comes to tax returns, ask if there will be an issue with them. I have had great cases end at that point.

3. Customers and Financial Advisors Who Do Not Tell the Truth and Ethical Implications

You represent a customer investor who, in her Statement of Claim, asserted specific claims of wrongdoing by her broker and her lack of

knowledge of the conduct while it was occuring. Or you represent a broker who insists he was authorized, by his client, to engage in the securities transactions now claimed to have been unauthorized. Should you take their word? Usually but not always.

A great, now retired defense attorney - my friend Matthew Farley - suggested that as the hearing approaches (be it an arbitration or mediation hearing), it is usually a good idea to have a meeting with your client in your office, close the door and say: "Tell me about the skeletons in your closet. Assume the other side knows." "What are you talking about?" says your indignant client. Tell your client that the worst thing for an attorney is to be surprised at the hearing by "alternate facts" that are actual ones.

In the sanctity of your office, in a conversation protected by the attorney-client privilege, your customer tells you that she may very well have been aware of the trading, but the price of the purchased stock kept rising. Or your broker client says that he may have exercised "time and price discretion" well beyond the one day permitted by FINRA rules. What should you do?

A. Ethics

You learn that your client has lied to you. What are your obligations under the *Code of Ethics*?

In his Ethics and Criminal Practice column for *The New York Law Journal* entitled "When Will a Criminal Lawyer Report His Client?"[4] Joel Cohen cited the concurring opinion of Supreme Court Justice John Brennan in *Nix v. Whiteside* in which the Justice wrote:

> A lawyer's certainty that a change in his client's recollection is a harbinger of intended perjury … should be tempered by the realization that, after reflection, the most honest witness may recall [or sincerely believes he recalls] details that he previously overlooked.[5]

And so, asked Mr. Cohen, "When does a lawyer truly 'know' that her client intends to commit perjury?" His article provides guidance for practitioners.

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4. Joel Cohen, *When Will a Criminal Lawyer Report His Client?,* N.Y. L. J. (Feb. 10, 2020), https://www.law.com/newyorklawjournal/2020/02/10/when-will-a-criminal-lawyer-report-his-client/. Joel Cohen is senior counsel at Stroock & Stroock & Lavan.

5. *Id.* (citing *Nix v. Whiteside*, 475 U.S. 157, 190-91 (1986) (Brennan, J., concurring)).

1. The *New York Rules of Professional Conduct* and *ABA Model Rules of Professional Conduct.* NY Rule 3.3(b) state: "[a] lawyer who represents a client before a tribunal and who knows that a person intends to engage or is engaging or has engaged in criminal or fraudulent conduct related to the proceeding shall take remedial measures including, if necessary, disclosure to the tribunal."[6]
2. What does it mean to *know*? It means "actual knowledge of the fact in question. A person's knowledge may be inferred from circumstances."[7] If "material evidence" is presented and the "lawyer comes to know of its falsity, the lawyer shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal."[8]
3. *Civil v. Criminal Cases* – Unlike in a civil case, noted Mr. Cohen, "in a criminal case a lawyer may not refuse to offer the defendant's testimony who insists on it, even if, surprising as it might seem, the lawyer reasonably believes it is false."[9]
4. *What does actual knowledge entail?* Actual knowledge, wrote Mr. Cohen, is, as it should be, "an extremely high threshold standard. True, most criminal lawyers will plead in protest with their clients who, without being motivated by fear, suggest they might commit perjury. Thus, fortunately, it is rare that a criminal lawyer will find the need to actually inform a judge that his client intends to commit perjury. And that's the way it definitely should be."[10]

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6. MODEL RULES OF PRO. CONDUCT r. 3.3(b) (AM. BAR ASS'N 2020); N.Y. RULES OF PRO. CONDUCT r. 3.3(b) (2020).

7. *Id.*; *see* N.Y. RULES OF PRO. CONDUCT r. 1.0(k) (2020).

8. *Id.* r. 3.3(a)(3); *see United States v. Parse*, 789 F. 3d 83 (2d Cir. 2015); *Doe v. Federal Grievance Committee,* 847 F. 2d 57 (2d Cir. 1988).

9. Cohen, *supra* note 4; *see* N.Y. RULES OF PRO. CONDUCT r. 3.3(a)(3), 3.3(c), 3.4; *cf.* MODEL RULES OF PRO. CONDUCT r. 3.3(a)(3), 3.3(c), 3.4; *People v. DePallo*, 754 N.E.2d 751, 753 (N.Y. 2001) ("A lawyer with a perjurious client must contend with competing considerations--duties of zealous advocacy, confidentiality and loyalty to the client on the one hand, and a responsibility to the courts and our truth-seeking system of justice on the other.").

10. Cohen, *supra* note 4.

B. Studies on Lying – Different Motivations Emerge

1. In an article entitled *Liar, Liar: We All Lie, But Why?*[11] the author noted that:
   a. "Psychologists don't all agree on exactly how common lying is, but research suggests that while most people may rarely lie in ways that are intentionally hurtful, pretty much everyone is untruthful, at least in small ways, quite often."[12]
   b. A lie is "a deliberate choice to mislead,"[13] says Paul Ekman, PhD, who was named one of the 100 most influential people by TIME magazine in 2009.[14] Professor Ekman draws a clear line between lying - which involves intent to deceive - and simply making false statements rooted in bad memory, misinterpretation or individual belief without intent to lie on purpose. He sees two main types of lies:
      i. *Concealing*: Someone asks how your day was and you shrug it off and fail to mention you were fired.
      ii. *Falsifying:* Someone asks how your day was and you say you were promoted when you were actually fired.
   c. "Pathological liars can't always tell truth from falsehood and contradict themselves in an interview," University of Pennsylvania psychologist and criminologist Adrian Raine explained as part of a 2005 study in which interviews revealed, among the most blatant liars, glaring inconsistencies in their life stories. "They are manipulative and [in our study] they admit they prey on people. They are very brazen in terms of their manner."[15]

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11. Robert Roy Britt, *Liar, Liar: We All Lie, but Why?*, ELEMENTAL (Feb. 24, 2020), https://elemental.medium.com/liar-liar-we-all-lie-but-why-cd99e2d3e4ab.

12. *Id.*

13. Paul Ekman, *What is a lie?*, PAUL EKMAN GROUP, https://www.paulekman.com /deception/.

14. Jill Bolte Taylor, *The 2009 Time 100: Paul Ekman*, TIME (Apr. 30, 2009), http:// content.time.com/time/specials/packages/article/0,28804,1894410_1893209_189347 5,00.html.

15. Usha Sutliff, *Liars' Brains Wired Differently*, USC NEWS (Sept. 29, 2005).

d. "Prolific liars rely a great deal on being good with words, weaving their lies into truths so it becomes hard for others to distinguish the difference."[16]

2. Why People Lie[17]

According to Dr. Ekman, there are a number of motives for telling lies. "My data collected during interviews with children and from questionnaires completed by adults suggests that telling lies occurs (at least in part) for one of nine reasons:"[18]

a. *Avoiding Punishment*

"Avoiding punishment is the most frequent reason people tell serious lies, regardless of their age. … It is only in such serious lies, in which the liar would be punished if detected, that lies are detectable from demeanor – facial expression, body movements, gaze, voice, or words. The threat imposes an emotional load, generating involuntary changes that can betray the lie."[19]

b. *Concealing Reward or Benefit*

"In serious lies the falsehood is usually told to conceal the reward or benefit the liar obtained by breaking a rule or explicit expectation. The rule breaker decides before breaking a rule that he or she will, if questioned, lie to cover the cheating. Sometimes the reward could have been achieved – a high mark on an exam – without cheating but not as easily, it would have taken more effort (hours of study in this example)."[20]

c. *Self-Protection*

"To protect yourself from being harmed even when you have not broken any rule is still another motive. … Some lies are told to win admiration from others. Boasting about something untrue is an obvious instance. … If discovered it harms the reputation of the boaster, but not much more than that.

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16. *Men Think They're Better Liars*, SCIENCE DAILY, https://www.sciencedaily.com/releases/2019/12/191220105633.htm (Dec. 20, 2019).

17. Paul Ekman, *Why Do People Lie?*, PAUL EKMAN GROUP, https://www.paulekman.com/blog/why-do-people-lie-motives/.

18. *Id.*

19. Paul Ekman, *Why People Lie?*, PAUL EKMAN GROUP, https://www.paulekman.com/blog/why-people-lie/.

20. *Id.*

Claiming falsely to have earned money for previous investors moves into the criminal realm."[21]

d. *The Thrill of it All!*
"Some people lie for the sheer thrill of getting away with it, testing their unsuspected power. … Some people do this all the time enjoying the power they obtain in controlling the information available to the target."[22]

e. *Avoiding Embarrassment*
"Avoiding embarrassment is still another motive for some serious and many trivial lies. Very often people lie to get out of an awkward social situation. They may not know how to do it – 'can't get a baby sitter' offered to avoid another dull evening and food. 'Sorry I am on my way out the door,' an excuse given by people who do not feel brave enough to be truthful even to a totally unknown telephone solicitor."[23]

3. In a 2018 Business Insider article entitled *The Psychological Reasons Why Some People Can't* Stop *Lying*,[24] Lindsay Dodgson wrote, in part:
   a. In "the third edition of the Diagnostic and Statistical Manual of Mental Disorders, pathological lying is a disorder in its own right, as well as a symptom of personality disorders like psychopathy and narcissism. 'I think it comes from a defect in the neurological wiring in terms of what causes us to have compassion and empathy,' psychiatrist Judith Orloff, author of *The Empath's Survival Guide,* told *Business Insider*, 'because narcissists, sociopaths and psychopaths have what's called empathy-deficient disorder, meaning they don't feel empathy in the way we would.'"
   b. "The truth doesn't matter to narcissists. When you don't care about other people, lies don't seem to matter. A lack of empathy essentially means a lack of conscience, which is a hard concept to grasp for a lot of people. … The only way to escape the

21. *Id.*

22. *Id.*

23. *Id.*

24. Lindsay Dodgson, *The psychological reasons why some people can't stop lying*, BUSINESS INSIDER (Jun. 9, 2018), https://www.businessinsider.com/why-people-are-compulsive-liars-2018-6.

clutches of a pathological liar is to be strong enough to say 'no this is not my fault, this is not ringing true to me, so I can't really trust you,' she said. Unfortunately, people tend to doubt themselves, because the lies can escalate subtly."

c. "If somebody lies, don't try and make an excuse about it," Ms. Orloff said. "A lie is a lie. And if you bring it up to the person and they say it's your fault, or no it didn't happen, just know there's something very wrong going on."

4. *The Future of Lying*

In his TED talk, psychologist Jeff Hancock explained the science of lying[25] and listed a number of things you should know about liars, including these two:

a. *'Normal' Liars vs. 'Prolific' Liars*

"Most people are honest. Recent research shows that the majority of lies are told by the same, small group of people known as 'prolific liars.' Here's how you can try spotting a prolific liar:

- They tend to be younger, male and have higher occupational statuses.
- They are likely to lie the most to their partners and children.
- They are more likely than the average person to believe that lying is acceptable in some circumstances.
- They are less likely to lie because of concern for others and more likely to lie for their own self-interest, such as to protect a secret."[26]

b. *Liars Struggle to Answer Why Questions*

"If you suspect someone might be lying to you but aren't sure, an easy way to find out is to ask them Why questions. It is much more difficult for people to lie about why they did something or why something happened than it is for them to lie about basic facts. If someone struggles to explain their intentions, it's a major red flag that they are lying."[27]

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25. Jeff Hancock, *The Future of Lying*, TED, (Sept. 2012) https://www.ted.com/talks/jeff_hancock_the_future_of_lying?language=en; *see also 9 Things You Should Know About Liars,* SCIENCE OF PEOPLE https://www.scienceofpeople.com/9-things-know-liars/ (last visited Jan. 7, 2021).

26. *Id.*

27. *Id.*

5. In 2017, *Psychology Today* published an article entitled, *6 Reasons People Lie When They Don't Need To – Understanding the motivations of pathological liars*[28] by David J. Ley, Ph.D., who wrote that his work with pathological or compulsive liars found, among other things:
   a. *Most People are Honest* – "People, by and large, are honest by default. Most people tell the truth most of the time. Some people lie more than others, but even frequent liars are actually honest most of the time. But it stands out dramatically when their deceptions are so blatant, easily disproven and seemingly unimportant."[29]
   b. *It is Not a Lie to Them* – "Often, repetitive liars feel so much pressure in the moment that their memory becomes simply unreliable. When they say something, it is often because they genuinely *believe*, at that moment, that it is the truth. Their memory has been overwhelmed by stress, current events and their desire to find a way to make this situation work. Sometimes, this can become so severe that the person almost seems to have created a complete alternate world in their head, one that conforms to their moment-by-moment beliefs and needs."[30]
   c. *They Want It to be True* – "[T]he liar might want their lie to be true so badly that their desire and needs again overwhelm their instinct to tell the truth . . . [S]ometimes, liars hope that they can make something come true by saying it over and over and by believing it as hard as they can. In today's environment of 'alternative facts,' it's hard not to see this as somewhat justified."[31]

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28. David J. Ley Ph.D., *6 Reasons People Lie When They Don't Need To*, PSYCHOLOGY TODAY (Jan. 23, 2017), https://www.psychologytoday.com /us/blog/women-who-stray/201701/6-reasons-people-lie-when-they-don-t-need.

29. *Id.*

30. *Id.*

31. *Id.*

4. Polygraphs Can Help Settle Cases

While I have never heard of a polygraph test being admitted into evidence at an arbitration over the objection of a party, they have been used in mediations - where "anything goes." Do they work? The answer depends on the proficiency of the polygraphist and the veracity of the person being subjected to the examination. From my experience, I can attest that they will tell you if your client is telling you the truth. Their willingness to take the test – once you have explained it to them – usually gives you a preview of its outcome. What does a polygraph test and how can it help you with your cases?

> The polygraph is a scientific instrument which records four physiological changes. These four changes are cardio (heartbeat, blood-pressure changes, pulse wave), chest breathing, stomach breathing, and skin resistance (perspiration). These physiological changes are constantly occurring within the person and are affected by the test questions asked the person during the examination. These changes are permanently recorded in ink on a moving chart which can then be analyzed by the polygraphist so as to be able to render an opinion regarding the persons' truthfulness.[32]

There are two types of polygraph examinations:

1. The "concealed information test" (which focuses on the fact that only the person involved in the crime, for example, could know the answers to certain questions) and
2. The "control question test," which is used more frequently.

As conducted under standard procedures adopted by state boards of polygraph examiners, the "control question" polygraph examination consists of three physiological measurements. "The theory underlying the polygraph is that an individual's autonomic nervous system continues to function in a normal fashion when he or she is being truthful . . . [T]he necessity to conceal through outlandish lies or less than full disclosure will result in stress responses or changes which are observed and monitored by the instrument."[33]

The first measurement is the pneumograph, which measures irregularities in breathing and respiratory conditions. Most polygraphists use a double

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32. Richard O. Arther, *The Use of the Polygraph by Attorneys*, SECURITIES ARBITRATION 1993 (PLI, Vol. II) at 393.

33. *People v. Daniels,* 422 N.Y.S.2d 832, 836 (N.Y. Sup. Ct. 1979); *see also United States v. Wilson,* 361 F. Supp. 510, 512 (D. Md. 1973).

pneumograph. This consists of one tube around the abdominal area and a second tube around the upper thoracic area. The second measurement is the galvanometer, which monitors the galvanic skin reflex or electrodermal response (*i.e.,* perspiration). This involves attaching electrodes to the fingertips to measure deviations in the skin's resistance to electricity. The electrical resistance is affected by changes in perspiration. The third measurement is the cardiosphygmograph, which measures cardiac activity (*i.e.,* blood pressure and pulse rate). During the course of an examination, all three physiological responses used to be transmitted by a recording pen onto a constantly moving piece of graph paper.[34] Now, polygraph tests are conducted with state-of-the-art computer hardware and software that enhance their accuracy when interpreted by an experienced polygraph examiner.

The three steps in administering a polygraph are:

1. *The Pre-Test Interview* - This interview consists of a discussion of the background facts and points to be questioned, along with an explanation of the mechanisms and the procedure and a review of the proposed test questions.
2. *The Examination* - The examination is conducted twice and consists of a series of questions designed to gauge normal physiological response with pertinent questions given after the norm is established. The examiner uses three types of questions for the examination: (1) the irrelevant question (where little or no stress is recorded in the response); (2) the control question (where an investigation of past activities renders greater reaction); and, (3) questions directly relevant to the matter at issue.[35]
3. *Post-Test Interview or Presentation* - All conclusions must be stated in terms of one of three opinions: indication of deception, no indication of deception, or inconclusive.

Anyone who argues for the admissibility of such evidence must acknowledge that the reliability of polygraphs remains a subject of intense scholarly debate. Courts that have allowed their admission - while recognizing this reality - were greatly influenced by the level of professionalism of the polygraph examiner and by the relevance of such evidence to the central issues of a case. Such courts also liken this evidence to other forms of opinion evidence and expect triers-of-fact to give them the weight they deserve.

34. *See United States v. Alexander,* 526 F.2d 161, 163 (8th Cir. 1975).

35. *See Zinn v. Bernic Constr., Inc.,* 416 N.Y.S.2d 725, 726 (N.Y. Sup. Ct. 1979).

A. The Effective Use of Polygraph Evidence

Polygraphs are potentially most effective in securities arbitration cases where credibility is the main issue and where neither side has sufficient documents to support its respective positions. Thus, polygraphs can be useful in unauthorized trading cases, misrepresentation and omission cases and order failure cases. In such cases, the one thing that is certain is that someone is not telling the truth; a polygraph test administered by an experienced and qualified examiner can assist the arbitrators in arriving at the truth (but never replacing their ultimate decision on that critical issue).

In *United States v. Piccinonna*,[36] the Eleventh Circuit Court of Appeals concluded that, under the following conditions, polygraph evidence may be admitted to impeach or corroborate the testimony of a witness at trial (but not to stand on its own to prove the case):

1. "[T]he party planning to use the evidence must provide adequate notice to the opposing party that the expert testimony will be offered."[37] [This gives the opposing party an opportunity to argue for its exclusion.]
2. "[P]olygraph expert testimony by a party will be admissible only if the opposing party was given reasonable opportunity to have its own polygraph expert administer a test covering substantially the same questions."[38]
3. "[T]he admissibility of the polygraph administrator's testimony will be governed by the Federal Rules of Evidence for the admissibility of corroboration or impeachment testimony. For example, Rule 608 limits the use of opinion or reputation evidence to establish the credibility of a witness in the following way: 'Evidence of truthful character is admissible only after the character of the witness for truthfulness has been attacked by opinion or reputation evidence or otherwise.'"[39]

To these three requisites, I believe that three more should be added:

4. The polygraph test itself must incorporate those measurements that are the most recognized and most acceptable by those governmental boards licensing polygraphists and by established

36. *United States v. Piccinonna,* 885 F.2d 1529 (11th Cir. 1989).

37. *Id.* at 1536.

38. *Id.*

39. *Id.*

polygraph associations. In other words, the instrument's reliability and accuracy should be capable of demonstration.

5. The administrator of the test must be competent, qualified, and experienced. He or she should be a member of the American Polygraph Association, established in 1966.[40]
6. The probative value of the evidence should outweigh its potential for prejudice and should be vital to a central issue of the case.

Polygraphs often are utilized by criminal defense attorneys to convince prosecutors to reduce or drop charges. In securities arbitration cases, they can be used for settlement purposes. To be able to present the results to a panel, the polygraph report will have to be produced to opposing counsel 20 days before the hearing. You may want to make the results available at an earlier stage if you believe they will prompt serious settlement discussions. However, you should expect a motion in limine, which, more times than not, you will lose (but you will get the message across to the arbitrators - in advance of the hearing - that your client took the polygraph and, obviously, passed it).

If you, as a practitioner, truly believe in your client's veracity and have confidence in the polygraph examiner, it is recommended that you invite opposing counsel to attend the polygraph examination (with your client's consent, of course). At the examination, the polygraphist should explain the procedure to both you and your opponent, and should illicit proposed test questions from both of you. While you run the risk of having your client "fail" the examination right before the eyes of your adversary, if your client passes, the results can increase the chances of settlement or the likelihood that the arbitrators will not only admit the test into evidence but that they will give it greater weight than had it been conducted in the absence of your opponent.

In *United States v. Crumby,*[41] a federal district court applied the principles set down in *United States v. Piccinonna* and in *Daubert* to justify the

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40. *About the APA*, AMERICAN POLYGRAPH ASSOCIATION, https://www.polygraph.org/about-the-apa (last visited Jan. 7, 2021) (According to its Website "The American Polygraph Association (APA) is the leading professional polygraph organization in the world, representing more than 2,800 experienced polygraph examiners in private business, law enforcement and government. Professional APA polygraph examiners administer hundreds of thousands of polygraph exams each year worldwide. The APA establishes standards of ethical practices, techniques, instrumentation and research, as well as provides advanced training and continuing education programs. APA examiners are highly qualified professionals who are motivated to help protect the public by *verifying the truth*, while following the highest standards of moral, ethical, and professional conduct" (emphasis added)).

41. *United States v. Crumby*, 895 F. Supp. 1354 (D. Ariz. 1995).

admissibility of polygraph evidence. The court held, in part, that "polygraph evidence is sufficiently reliable under *Daubert* to be admitted as scientific evidence."[42] In *Crumby,* the court found that the science of polygraphy has been subjected to vigorous scientific testing; that its underlying scientific principles had been subjected to extensive peer review and publication; that the known error rates for the science of polygraphy are low; that the use of polygraph evidence is widespread; and, that the science of polygraphy was not developed for the purposes of the pending litigation.[43] The court then, however, imposed restrictions on the use of polygraph evidence:

1. The defendant must provide sufficient notice to the government.[44]
2. The government will have the right to administer its own polygraph examination.[45]
3. The evidence is admissible *only* to impeach or corroborate the defendant's testimony.[46]
4. The experts may not testify regarding the specific questions asked, the responses or the physiological reactions since "the prejudicial effect of permitting the jury to hear the specific responses to the question of whether the defendant committed the ultimate crime in the case is overwhelmingly prejudicial.[47]

B. Polygraphs in Mediation

The primary issue in most customer arbitrations is the arbitrators' perception of the parties' credibility. While none of us live our lives to testify about them, arbitrators expect a party to be as honest as recollection will allow. And while securities disputes are document-intensive, securities transactions are still, by and large, oral agreements with little documentary substantiation as to who said what to whom.

In 2015, I was representing a California businessman who asserted that his New York broker engaged in months of unauthorized stock and bond purchases. The broker's attorney produced telephone records showing calls

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42. *Id*. at 1361.

43. *Id.* at 1359-61.

44. *Id.* at 1365.

45. *Id.*

46. *Id*.

47. *Id.*

taking place the days of most of the equity trades (but not the bonds) in question. The customer told me that those calls were unrelated to the trades he claimed to have been unauthorized. The parties agreed to mediate the case, but when each side was steadfast in its position and the highly experienced mediator could not figure out whose recollection of events was more accurate (i.e., truthful), I took my client aside and asked whether he was telling me the truth. He assured me that he was, so I made the following proposal, which I invite securities arbitration practitioners to try:

1. The customer would submit to a polygraph examination on questions related to the issues in the Statement of Claim and Answer.
2. The brokerage firm would be permitted to pose the questions for the polygraph examiner to ask.
3. When/if the customer was determined to have passed the examination, the brokerage firm and the brokers could not object at the arbitration hearing to the report's admission into evidence and would have to reimburse my client's half of the polygraphist's $4,000 fee.
4. If the customer was determined to have failed the examination, however, he would withdraw his arbitration claim (which, in this particular case, sought hundreds of thousands of dollars in compensatory damages).

My client readily agreed to my proposal, but the experienced mediator said he had never heard of it in mediation. Fortunately, Respondents' counsel (who represented the brokerage firm and two of its brokers), said that he believed in his client's veracity and recommended the polygraph as an impasse-breaker. I asked my PIABA colleagues in California who they would recommend, and one name appeared frequently, so he was retained. It took some time to educate the polygraphist about securities arbitration in general and the case issues in particular. My client kept asking me: "Since I know the truth, I can't understand why they would agree." I told him that some people convince themselves that a lie is the truth. He took the examination and passed it, to the opposing attorney's shock. I suggested to the attorney that the results could be of assistance in settling the mediation, which it did.

5. Cross-Examining Liars

One of the greatest nineteenth century trial lawyers was Francis L. Wellman, who, in 1903, wrote the landmark book, *The Art of Cross Examination.*[48] Human nature has changed little since its publication. Liars still lie.

An overarching question that arbitrators often ask themselves in deliberations is: *What do you think probably happened?* While your client's testimony and that of the opposing party will be certain and unequivocal with regard to *the truth of what happened*, you need to appreciate that when the arbitrators rule in favor of one side over the other, they are often determining what, in their mind, *probably* happened -who was telling the truth and who was lying. Mr. Wellman spoke to this central issue:

> Theoretically the goal we all strive for in litigation is the *probable* truth . . . All men stamp as probable or improbable that which they themselves would, or would not, have said or done under similar circumstances . . . This search for probabilities, however, is a hazardous occupation for the inexperienced.[49]

What follows are six important questions that Mr. Wellman answered in his book, which can be obtained online free-of-charge (http://www.gutenberg.org/ebooks/40781).

1. *What are the characteristics of a successful cross-examiner?*

> [It] requires the greatest ingenuity; a habit of logical thought; clearness of perception in general; infinite patience and self-control; power to read men's minds intuitively, to judge their characters by their faces, to appreciate their motives; ability to act with force and precision; a masterful knowledge of the subject-matter itself; an extreme caution; and, above all, the instinct to discover the weak point in the witness under examination.[50]

2. *Before you start the cross-examination (while the witness is on direct), what should you be doing?*

> A skillful cross-examiner seldom takes his eye from an important witness while he is being examined by his

48. FRANCIS L. WELLMAN, THE ART OF CROSS-EXAMINATION (Simon & Schuster, First Touchstone ed., 1997) (1903).

49. *Id*. at 182–84.

50. *Id.* at 28.

> adversary. Every expression of his face, especially his mouth, even every movement of his hands, his manner of expressing himself, his whole bearing—all help the examiner to arrive at an accurate estimate of his integrity.[51]

3. *How can a cross-examiner get the most out of a witness?*

> If . . . the counsel's manner is courteous and conciliatory, the witness will soon lose the fear all witnesses have of the cross-examiner, and can almost imperceptibly be induced to enter into a discussion of his testimony in a fair-minded spirit, which, if the cross-examiner is clever, will soon disclose the weak points in the testimony.[52]

4. How should you examine witnesses who answer questions with long paragraphs and few periods?

> Allow the loquacious witness to talk on; he will be sure to involve himself in difficulties from which he can never extricate himself. Some witnesses prove altogether too much; encourage them and lead them by degrees into exaggerations that will conflict with the common sense of the jury.[53]

5. *Does the testimony pass the smell test?*

> If . . . the manner of the witness and the wording of his testimony bear all the marks of fabrication, it is often useful, as your first question, to ask him to repeat his story. Usually he will repeat it in almost identically the same words as before, showing he has learned it by heart. Try taking him to the middle of the story, and from there jump him quickly to the beginning and then to the end of it.
>
> He cannot invent answers as fast as you can invent questions and at the same time remember his previous inventions correctly; he will not keep his answers all consistent with one another. He will soon become confused and, from that time on, will be at your mercy. Let him go as soon as you have made it apparent that he is not mistaken, but is lying.[54]

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51. *Id.* at 29.

52. *Id.* at 30.

53. *Id.* at 42.

54. *Id.* at 67, 68.

6. *How do you attack perjury?*

> A witness, in anger, often forgets himself and speaks the truth. His passion benumbs his power to deceive… Select the weakest points of his testimony and the attendant circumstances for which he would be least likely to prepare. Do not ask your questions in logical order, lest he invent conveniently as he goes along; but 'dodge him about' in his story and pin him down to precise answers on all the accidental circumstances indirectly associated with his main narrative. As he begins to invent his answers, put your questions more rapidly, asking many unimportant ones to one important one, and all in the same voice.[55]

F. Lee Bailey was a controversial but always effective trial attorney. In his book to law students - *To Be a Trial Lawyer*[56] - he wrote that good cross-examination has a long list of ingredients: control, speed, memory, precise articulation, logic, timing, manner, and termination. Applying some of his insights to securities arbitration hearings, we find:

Control - Mr. Bailey believed that "a cross-examiner must control his witness tightly and not let him or her run away with long, self-serving narrative answers; he must also control the direction and pace of the questioning."[57] This is done by having a game plan defining what you hope to get out of each witness. For example, if one of your issues is excessive compensation on trades that were not fully disclosed on the confirmations, you will want to obtain the firm's copy of the monthly account statements, which include that extra column for "commissions" for each trade (something that is not on the customer's copy of the monthly account statements). If the broker believes you will just be questioning him or her on the customer's copy of the monthly account statements, you can instantly take control in your cross-examination by pulling out the copy the broker received, and not the one the customer received.

Speed - Mr. Bailey believed that "[a] witness telling less than the perfect truth needs time to think up and fashion his answers, time that he must not be allowed to have. Effective cross-examination must be conducted at a pace nothing short of relentless, which will give one who is fabricating his answers

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55. *Id.* at 135, 136.

56. F. LEE BAILEY, TO BE A TRIAL LAWYER (John Wiley & Sons Inc, 1985).

57. *Id.* at 136.

insufficient time to do so."[58] It has been my experience that quite a few brokers are not properly prepared to testify by their attorneys and since many have not even read the Answer, you may be able to quickly go through a checklist of inconsistencies and apparent misstatements in the broker's Answer during your cross-examination of the broker. It will make the witness look confused as to the actual trading and other events (e.g., conversations) that took place.

Logic - "Most questions," wrote Mr. Bailey, "even those meant to ridicule, must be put together within a logical framework. They may be, and often are, put out of control, or in a juxtaposition to one another, but the goal should be to play the witness's total testimony off against a logical sense of what he *should* have said if he were recounting reality."[59] If the witness' answer does not make sense to you, it probably will not make sense to the arbitrators. If it is not logical to the arbitrators, they will probably infer the events in question simply did not take place as the witness has testified – that the witness lied.[60]

Timing - "Once he has backed a witness into a corner, he must go for the jugular moments before the witness has girded himself to repeat the attack."[61] Show the financial advisor the mismarked order ticket that says "unsolicited" as the arbitrators look at the elderly, financially unsophisticated customer.

Termination - "A cross-examiner must know when to quit, on a high point and without insisting that all subjects within a witness' possible knowledge be covered exhaustively."[62] When the financial advisor admits that he entered the trade without speaking with the customer "because I felt it was what she would have wanted," advise the arbitrators that you have no further questions.

For an entertaining and enlightening presentation on the art of cross-examination, many practitioners still benefit from the YouTube presentation of "10 Commandments of Cross Examination" by the late Professor of Law Irving Younger.[63]

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58. *Id.* at 136, 137.

59. *Id.* at 137.

60. *See* DAVID E. ROBBINS, SECURITIES ARBITRATION PROCEDURE MANUAL (Matthew Bender, 5th Ed. Dec. 2020) for a detailed examination of cross-examining customers in securities arbitration.

61. *Id.* at 137.

62. *Id*.

63. *Irving Younger's 10 Commandments of Cross Examination at UC Hastings College of the Law*, YOUTUBE, https://www.youtube.com/watch?v=dBP2if0l-a8 (last visited Jan. 13, 2021).

6. Lie Spotting Through Body Language – Actions Speak Louder Than Words

What is Kinesics?

It is the interpretation of body language (e.g., facial expressions and gestures), the study of non-verbal behavior related to movement of part or all of a person's body. The most common ones that probably come to mind are when you are interviewing a potential client and get to the questions your adversary would ask the person, such as:

- Why did you believe the broker? Why did you trust her?
- Why did you decide to keep the investment even though it had been purchased without your authority? Did you agree to accept it because it had risen in value?
- Why didn't you sell it when you realized it was too risky?
- Did you understand that you were getting greater interest from that lower rated bond because the issuer needed to attract investors to this riskier security?

In response to these attorney-client questions, individuals often get defensive, folding their arms or touching their noses. Some blink rapidly. Others will not look you in the eye. Still others try to evade the question, answering what they wish to say instead. Better to know if your new client is not telling the truth as soon as possible.

Applying Kinesics to Our Practice

Kinesics can be used as signs of deception by interviewers who look for clusters of movements to determine the veracity of the statement. The body's movement conveys specific meanings. As many movements are carried out at a subconscious or at least a low-awareness level, kinesic movements carry a significant assistance to attorneys testing the veracity of witnesses, be they clients or adverse witnesses.

What follows are highlights from *Body Language for Dummies*, *Body Language 101* and the updated edition of *The Complete Idiot's Guide to Body Language*. That will be followed by a closer look at Pamela Meyer's fascinating *Lie Spotting: Proven Techniques to Detect Deception*.[64] Excerpts

64. ELIZABETH KUHNKE, BODY LANGUAGE FOR DUMMIES (For Dummies, 2d ed. 2012.); SUSAN CONSTANTINE, THE COMPLETE IDIOT'S GUIDE TO BODY LANGUAGE (Penguin Group (USA), Inc. 2013); DAVID LAMBERT, BODY LANGUAGE 101

from each book are interspersed with my suggested applications to the practice of securities arbitration.

A. Complete Idiot's Guide to Body Language

In the original, 2004 edition of this book, Peter A. Andersen, Ph.D. wrote that once you come to the conclusion that the person you are speaking with is not telling you the truth, you can press the person further to get to the truth (which could mean not taking the case, not calling a person to testify or having the arbitrators come to the same conclusion as you during your nimble cross-examination). The updated, 2013 edition written by Susan Constantine,[65] includes these insights:

1. *Speaking* - Liars spend so much time and energy making up a story that often there are what she calls "leaks" to look for, including: rapid speech, increased voice volume, higher pitch, pauses between the words, hesitation at the beginning of the speaker's turn, repeating words, unfinished words and broken speech.[66]
2. *The Eyes Have It* - The wider the pupils, the greater the emotion. When a person pulls the outer corner of one eye, he or she is trying to deceive you. Pay close attention if the eyes dart off from contact with your own but by themselves, she writes, eye movements do not reveal deception; they reveal thought processes.[67]
3. *Monotone* - When I prepare a witness to testify, especially my clients, I tell them to write out the word "monotone" and then put a line through it. Why? I tell them that when they speak that way, they can't connect with the arbitrators. This often happens when witnesses are testifying about themselves; they don't want to appear like they are bragging, so they don't speak in a conversational tone. In her book, Ms. Constantine notes that "the flat-line, monotone voice may indicate a skillful liar concealing emotions. A skillful liar thinks that if they appear to be in control

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(Skyhorse, Illustrated ed. 2008); PAMELA MEYER, LIE SPOTTING: PROVEN TECHNIQUES TO DETECT DECEPTION (St. Martin's Press, 2010).

65. https://www.penguinrandomhouse.com/authors/2088292/susan-constantine/.

66. Constantine, *supra* note 64, at 212 – 215.

67. *Id*. at 70, 71 and 99.

and avoids showing any emotion, their lies will appear more believable."[68]

4. *Laughing* – "Unlike spontaneous laughter, which is a natural response, fake laughter is manipulative…[It] may be accompanied by a forced smile, where the mouth turns up and stretches horizontally, avoiding crow's feet. It's almost as if smiling is painful."[69]

B. Body Language 101

According to David Lambert, physical signs of deceit include these three:

1. *Fleeting Expressions*—These are genuinely felt expressions that flip across someone's face in less than one-fifth of a second. Such a micro-expression might momentarily replace a smile with a look of sadness or anger. Most of us register micro-expressions only unconsciously. This, writes Mr. Lambert, helps to explain why we have an uneasy feeling that a person dislikes us even while that person attempts to be friendly.[70]
2. *Dependable Facial Muscles*—These are the facial muscles least under a person's control and are therefore the most dependable for showing the observer what the person is feeling. People can try to mask their effects, for instance, by smiling, but dependable muscles - especially those in the forehead - are likely to let true feelings show. When eyebrows rise and come together, this could betray fear or worry. When lips narrow and eyebrows are pulled downward and inward, this could betray anger.[71]
3. *Self-Touching*—The deceitful person who gesticulates less than normal might make small, self-touching movements. Most movements involve putting a hand to the head, especially the mouth, an eye, an ear or the neck, as if the liar were trying not to speak, see or hear an untruth.[72]

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68. *Id*. at 214.

69. *Id*.

70. Lambert, supra note 64, at 175.

71. *Id*. at. 175 – 179.

72. *Id*. at 182.

C. Body Language for Dummies

Elizabeth Kuhnke[73] stresses similar body language as indications of deception, but in greater detail. Here are a number of her insights:

1. *Feet Talk* - If you suspect someone of lying to you or holding back information, look at his feet. A person who is asked to lie shows more signs of fraud below the waist than above. Are his feet twitching, flicking or going around in circles? Individuals tend to lock their ankles when holding back information.[74]
2. Eye to Eye - Some deceivers look you straight in the eye while telling a boldfaced lie. Others look away. What you have to do is look for the intensity of the action and compare that behavior to what you have noticed in the past. Possible signs of deception include:
    a. Eye *Rubbing*—Men rub their eyes vigorously whereas woman use a small, gentle touching action just below the eye. Both men and women may also look away, avoiding your gaze.[75]
    b. *Inability to Look You in the Eye*—The eyes dart back and forth or fail to connect with yours at all. If she has to make up an answer, her eyes go in search of it. If she is telling you the truth, her eyes follow the pattern established when answering the first set of questions.[76]

D. Lie Spotting

Pamela Meyer, the keynote speaker at the 2016 PIABA annual conference in San Diego, is the author of *Lie Spotting: Proven Techniques to Detect Deception*.[77] Five years before, she gave a TED talk on the subject that is worth watching; the website has the video and a transcript.[78]

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73. For further information about Ms. Kuhnke, visit her website at https://elizabeth kuhnke.wordpress.com/about/.

74. Kuhnke, *supra* note 64, at 179.

75. *Id*. at 283.

76. *Id*.

77. Meyer, *supra* note 64.

78. https://www.ted.com/talks/pamela_meyer_how_to_spot_a_liar/transcript?language=en.

After Ms. Meyer's PIABA presentation, I re-read her book, and noted these insights, among others:

1. *Symmetry in Motion* - Watch for asymmetry in a person's gestures and expressions. Smiles, frowns, and shrugs that are one-sided mask what a person is really feeling. Natural truthful gestures typically occur evenly on both sides. Be on the alert for head nodding that moves in the opposite direction from what a person is saying.[79]
2. *Blink* - It is a myth that liars cannot look directly into the eyes of another person whom they are trying to deceive. Actually, the normal level of eye contact in conversation is only 30% to 60%. Good liars are often skilled at staring into their questioners' eyes. Blink rates are a far more useful indicator of truthfulness than eye contact. Blinking can, of course, be either voluntary or involuntary, but people telling a lie will often involuntarily blink more than they do when they are telling the truth.[80]
3. *Statement Structure* - There are several types of statements liars often use to evade questions or deflect suspicion.
    a. *Parrot Statements* - If you ask a question and someone repeats it back to you, she may be stalling to buy time to think about how she wants to reply. Repeating the question in its entirety suggests that she does not want to answer.[81]
    b. *Guilt-Trip Statements* - A guilt-trip statement is an evasive tactic that tries to put you, the interrogator, on the defensive.[82]
    c. *Bolstering Statements* - Liars want to sound convincing and earnest, so they will often add emphatic phrases to their speech to reinforce their credibility: "*To tell* you the truth …" People use qualifying statements to protect themselves from accusations of false promises or hyperbole or to avoid being held accountable for what they say.[83]

79. Meyer, *supra* note 64, at 60, 67 – 68.

80. *Id.* at 66 – 67.

81. *Id*. at 91 – 92.

82. *Id.* at 92.

83. *Id* at 94 – 97.

7. Credibility and Conclusion

In *Making Your Case—The Art of Persuading Judges*,[84] the late Supreme Court Justice Antonin Scalia and law professor Bryan A. Garner focused on probably the most important quality an advocate can have, whether the attorney is before a court or arbitration panel: truthfulness.

> Your objective in every argument, therefore, is to show yourself worthy of trust and affection. Trust is lost by dissembling or conveying false information - not just intentionally but even carelessly; by mischaracterizing precedent to suit your case; by making arguments that could appeal only to the stupid or uninformed; by ignoring rather than confronting whatever weighs against your case. Trust is won by fairly presenting the facts of the case and honestly characterizing the issues; by owning up to those points that cut against you and addressing them forthrightly; and by showing respect for the intelligence of your audience.[85]

Witness credibility is the fulcrum to success in all adversarial proceedings and is usually the main issue at an arbitration hearing. Since arbitrators, unlike jurors, can question a witness, they are very sensitive to the truthfulness of that individual. If an arbitrator feels that a witness is not believable on one point, it is likely that the entire testimony will be discredited. It is therefore necessary that witnesses be thoroughly prepared so they are as relaxed as possible and can present their testimony in a precise, narrative fashion.

It is important for witnesses to understand how their testimony fits within the entire case. Creating this understanding is the practitioner's goal. For example, customers alleging unsuitability, misrepresentations or omissions must be forewarned about distinguishing between their knowledge of an investment when the transaction occurred and the knowledge they subsequently acquired from their attorney. It is often difficult for customers to articulate this distinction when testifying and, as a result, they do not tell the truth.

"We talk of the credibility of witnesses," said Louis Nizer in *My Life in Court*, [86] "but what we really mean is that the witness has told a story which

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84. ANTONIN SCALIA & BRYAN A. GARNER, SCALIA AND GARNER'S MAKING YOUR CASE: THE ART OF PERSUADING JUDGES (Thomson West, Special Ed. 2009).

85. *Id.* at xxiii – xxiv.

86. LOUIS NIZER, MY LIFE IN COURT (Marino Fine Books, 2012).

meets the tests of plausibility and is therefore credible." Mr. Nizer called it his "rule of probability" and explained his take on human nature as follows:

> Through cumulative experience we can anticipate with reasonable certainty how people react to certain stimuli. By applying this "knowledge" to any set of facts, we can judge whether the conduct described is probable. If implausible, it must be rejected as untrue no matter what assurance the client or witness gives of his recollection. Either he is innocently inaccurate, or he is deliberately lying, or there are surrounding circumstances. The rule of probability rarely misleads.[87]

Be careful before filing a Statement of Claim by stressing to your client that he or she must testify truthfully. Not only can you lose the arbitration - and be ordered to reimburse your adversary's attorney's fees - but if the witness is within the ambit of FINRA Enforcement, that individual could face a permanent bar from the securities industry.[88]

It was Mark Twain who said, "If you tell the truth you don't have to remember anything."[89]

The practitioner's ability to discern deception comes from years of experience with clients and witnesses under stress, the kind of individuals whom we quite often encounter in our practice. The sooner you are able to figure out that a witness is not telling the truth, the more creative and effective you can be in convincing the arbitrators of that inconvenient truth.

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87. *Id.* at 9-10.

88. *FINRA Broker William Garbarino Disbarred for Perjury in an Arbitration Proceeding*, SECURITIES ARBITRATION ALERT (Sept. 29, 2017), http://www.sacarbitration.com/blog/finra-broker-william-garbarino-disbarred-for-perjury-in-an-arbitration-proceeding/.

89. TWAINQUOTES, http://www.twainquotes.com/Truth.html (last visited Jan. 13, 2021).

GETTING THE GOOD STUFF THROUGH LIST 1 OF THE DISCOVERY GUIDE

Michael S. Edmiston[1]

List 1 of the FINRA Discovery Guide makes numerous documents in the possession, custody, and/or control of a broker-dealer presumptively discoverable.[2] A full production of the List 1 documents would likely achieve the goal of fast and efficient dispute resolution.[3] The ideal of efficiency in arbitration, however, rarely fares well in reality. It is nowhere to be found in actual compliance or practice with FINRA's discovery mandates. Despite FINRA's pronouncement that Discovery Guide Items are *presumptively* discoverable, broker-dealers and their counsel view the list as suggestive rather than mandatory. This is because there is no incentive in the FINRA Code of Arbitration Procedure ("FINRA Code") for Respondents to produce the "Good Stuff" until Claimant's counsel applies sufficient pressure to do so.

List 1's "Good Stuff" consists of the documents and information that focus the case on the broker, firm and product. They are the documents that put Respondents' actions and inactions at issue and make their counsel play defense rather than attack the customer-Claimant.

The Good Stuff rarely appears in Respondents' first production. Instead, the initial production usually consists of documents that the Claimant already received or should have received in the course of the account relationship such as account statements, trade confirmations, correspondence and e-mails between the firm and/or broker and Claimant, and the occasional prospectus or offering documents. Generally missing from the initial production are all the internal documents, internal communications and regulatory documents related to the securities, products, broker, and firm. From a defense philosophy, the initial production accomplishes the its goal: make the case about the Claimant.

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1. Laura S. Dunning and Moshe Y. Singer contributed greatly to this article and are both given a hearty "Thank You" for helping us all get the Good Stuff. Another "Thank You" goes to PIABA founding member, Stuart C. Goldberg, for his *PIABA'S 2001 Practice Guide to NASD Discovery and Pre-Hearing Proceedings*. This massive guide dissected the then-operative NASD Discovery Guide and related rules and remains an excellent source of information about key documents; objections; privileges; and why and how to argue for production of the Good Stuff.

2. FINRA, Regulatory Notice 11-17 (2013) [hereinafter Discovery Guide].

3. FINRA states arbitration is "faster, cheaper and less complex than litigation." https://www.finra.org/arbitration-mediation/overview (last visited Dec. 28, 2020).

Obtaining production of missing documents is a critical, if numbingly repetitive, exercise in a customer case. Such documents are often withheld behind walls of obfuscating responses, objections, claims of privilege, and tricky unilateral limitations of promises to produce selections of responsive documents. Getting the Good Stuff requires knowing what documents exist or should exist, and then whittling through the obfuscations and objections, and the generous sounding, but functionally useless, promises to produce the Claimant-related selections of responsive documents.

The Discovery Guide and FINRA Code of Arbitration Procedure ("Code") provide the tools to get those documents. This article will discuss several Items from List 1 of the FINRA Discovery Guide and the categories of documents which often exist but firms do not want to produce; addressing the objections and claims of privilege; the use of affirmations of search; and meet and confer tactics.

I. THE DISCOVERY GUIDE'S GOOD STUFF RESPONDENTS DON'T WANT YOU TO HAVE

List 1, Item 5(a) – Due Diligence, Research, and Testing Data

Item 5(a) requires production of "All materials the firm and/or associated persons prepared or used and/or provided to the customer parties relating to the transactions or products at issue, including research reports, sales materials, performance or risk data, prospectuses, other offering documents, and copies of news articles or outside research, including documents intended or identified as being 'for internal use only.'"

The Respondents' standard tactic is to agree to produce the responsive documents limited to those that were *provided to the Claimant*. The key phrase Respondents seek to avoid is "[a]ll materials the firm and/or associated persons prepared or used…" There is no limitation in this Item to just documents provided to the Claimant. Item 5(a) opens the door to due diligence documents, third-party due diligence, internal and external research sources, and performance testing. Generally, these are documents not given to a customer. In product cases, Item 5 holds the key to what the firm knew about the product, its risks, and its problems.

List 1, Item 7(a) – Supervisory Notes and Memoranda About the Broker

Item 7(a) requires production of the documents showing what the firm's supervisors knew about both the customer and the broker.

Specifically, it requires production of all notes or memoranda evidencing supervisory, compliance, or managerial review of:

1) the customer parties' accounts or transactions therein or
2) of the associated persons assigned to the customer parties' accounts for the period at issue.

The Respondents' typical tactic is to promise production of only the documents indicating supervisory review of the customer's account.

While sometimes the Claimant-specific documents are helpful, what is being excluded is the information the firm had about the overall supervision of the broker. This would include supervisory documents such as heightened supervision documents, written warnings, accumulated risk scores for multiple exception reports, internal e-mails about the broker's activities and practices, and outside business activities which Respondents do not want revealed. For a failure to supervise case, Item 7(a) is a treasure trove of documents showing what the firm knew about, and whether it properly supervised, the broker.

List 1, Item 9 – Communications with the Compliance Department

Item 9 requires production of internal communications between the broker and his/her compliance department about the customer (claims, accounts, and/or transactions) and/or the securities/products at issue. Respondents often unilaterally limit the scope of this request to e-mail communications to/from the broker about the Claimant and Claimant's account(s).

Item 9 discovery can be a gift in product cases because it opens the door to every communication between the broker and the personnel in the "compliance department" about the securities or products at issue. Additionally, where there are claims involving more complex investments which often receive additional regulatory attention, this discovery can be quite fruitful. Where the case involves investments such as non-traded REITs, private placements or structured products, this can be very valuable, particularly when such communications highlight changes to supervisory and compliance manuals to meet regulatory requirements or mandates.

List 1, Item 13(b) – Broker-Specific Exception Reports

Item 13(b) cuts to the heart of what the firm knew about its broker's day-to-day sales activities—the *really* Good Stuff. The documents required to be produced are "…all exception reports, supervisory activity reviews, concentration reports, active account runs, and similar documents produced to review for activity in customer accounts handled by associated persons and related to the allegations in the Statement of Claim that were generated not

earlier than one year before or not later than one year after the transactions at issue."

13(b) is often met with outright objections (e.g., relevancy, burden, and privacy) and Respondents frequently unilaterally try to limit the scope of documents to just those documents related to Claimant and Claimant's account(s). Such a proposed limitation is a rehash of what is already presumptively discoverable under Item 13(a).

Along with revealing a broker's patterns and practices which alert the firm supervisors and compliance officers, the documents often contain the names of such supervisors and compliance personnel, the frequency which a given supervisor sees and/or responds to an exception report, notes and comments about the response, and sometimes "scores" which are weighted by the type of conduct, the frequency with which it occurs, and set time period used to measure the frequency (e.g., six months or one year). The information contained in the 13(b) documents is the reason to pursue discovery early as it may be necessary to propound additional discovery requests based on the information gleaned from that production. 13(b) is also the most likely Item that Respondents will force to a motion to compel because the materials are often so very rich.

List 1, Item 14 – Branch Audit Reports

Item 14 requires production of "[t]hose portions of internal audit reports for the branch in which the customer parties maintained accounts that: (a) concern associated persons or the accounts or transactions at issue…" Respondents often will seek to limit the scope of Item 14 to just those audit reports which mention Claimant or Claimant's accounts. Rarely do such reports mention a particular Claimant of account. What is important is whether the broker was the focus of an internal audit.

Like 13(b), Item 14 can be a jackpot of internal information about the broker's practices coupled with written conclusions by the auditor. Unlike 13(b), the audits may only look at a select few of the broker's accounts in an annual inspection.

Item 14 is particularly valuable in cases against independent broker-dealers with their numerous remote one- and two-person offices. The scheduled annual visit from a compliance officer is often an exercise in how well the auditor checks the boxes on a lengthy checklist and how well the broker, usually having seen a copy of the checklist, has prepared the office to give the "right" answers. Results of an unscheduled audit or follow-up audit are often more revealing about the broker's practices and procedures in independent firms.

Behind the audits are almost always internal e-mails from the auditor to the firm's management about the audit results as well as e-mails exchanged between the broker, supervisor and/or auditor addressing discrepancies found as a result of the audit. These can go a long way in proving improper supervision claims.

List 1, Item 15 – Disciplinary Actions Against Broker

Item 15 requires production of "[r]ecords of disciplinary actions taken against associated persons by any regulator… or employer for all sales practice violations or conduct similar to the conduct alleged in the Statement of Claim."

The Respondents will likely offer to produce those disciplinary actions in which the Claimant or Claimant's accounts were involved. This unilateral limitation makes Item 15 almost useless except for the rare situation where FINRA has already brought an enforcement action based on what occurred to the Claimant.

There is a second level of gamesmanship engaged in by Respondents for this Item because the phrase "conduct *similar* to the conduct alleged" is not more precisely defined in the Discovery Guide.

Item 15 documents can be particularly valuable when their date of creation is earlier than the alleged wrongful conduct in the Statement of Claim. A suspension, heightened supervision, or even cautionary memorandum gives evidence of the firm's supervisors possessing first-hand awareness of the broker's issues. Coupled with Item 13(b) exception reports and Item 14 audit reports, the firm's supervision system and its reasonableness, or lack thereof, in implementation or execution becomes much easier to establish.

Item 15 requires some thoughtful consideration to avoid being trapped by a narrow definition of "conduct similar" and an earmark on the response to save for a meet and confer discussion. Conduct similar does not mean that it has to involve the same product or transaction. Rather, a more broad definition can be argued on behalf of the Claimant. For example, a pattern of unsuitable trading, even if it is in different products, could clearly fall within the definition of "similar conduct."

List 1, Item 16 – Regulatory Investigations, Charges, or Findings and Responses Thereto

Item 16 is a valuable source of documents due to the information flow between the regulator and regulated entity or person. While the fact that an investigation ensued is itself good for a Claimant's case, the responses and documents that the firm and/or broker made to the regulators can yield very

helpful material. The FINRA (or other regulatory agency) investigation generally seeks production of documents such as the trade blotters and exception reports. These are same documents Respondents do not want to produce in the arbitration, but are routinely produced to regulators. Additionally, there are often written responses to questions asked by the regulators which also be helpful to the case.

Although Respondents also generally argue that such production is overly burdensome, because these documents have already been collected and previously produced, there is little burden beyond redaction of non-party information for Respondents to make the same production in the arbitration. As a result, Respondents' effort to keep the documents out of the arbitration falls to the standby of limiting the production to Claimant and Claimant's account, and then usually claiming some sort of "regulatory privilege."

Importantly, there is no "regulatory privilege" prohibiting production of the responsive documents, and the only privilege that does exist belongs to the regulator itself for its investigative files. FINRA particularly does not promise and will not agree to keep the documents submitted to it in a confidential form.[4]

Like Item 15, this Item puts a nexus on the documents, where all that needs to be produced are the documents for "…the associated persons' alleged improper behavior similar to that alleged in the Statement of Claim."

Another obfuscating tactic used by Respondents' counsel is the objection that they will only produce the types of "investigations" and "charges" as defined in the Form U-4 Explanation of Terms. The Form U-4 Explanation of Terms[5] defines an "Investigation" as:

> (a) grand jury investigations; (b) U.S. Securities and Exchange Commission investigations after the "Wells" notice has been given; (c) FINRA. investigations after the "Wells" notice has been given or after a person associated with a member, as defined by The FINRA By-Laws, has been advised by the staff that it intends to recommend formal disciplinary action; (d) NYSE Regulation investigations after the "Wells" notice has been given or after a person over whom NYSE Regulation has jurisdiction, as defined in the applicable rules, has been advised by NYSE Regulation that it intends to recommend formal disciplinary action; (e) formal investigations by other SROs; or (f) actions or procedures designated as investigations by jurisdictions. The term investigation does not include subpoenas, preliminary or

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4. Order at 3, Bussing v. COR Clearing, LLC, et al., No. 8:12CV238 (D. Neb. Oct. 16, 2015), https://www.govinfo.gov/content/pkg/USCOURTS-ned-8_12-cv-00238/pdf/USCOURTS-ned-8_12-cv-00238-18.pdf (last visited Dec. 28, 2020).

5. https://www.finra.org/sites/default/files/AppSupportDoc/p468051.pdf (last visited Dec. 28, 2020).

> routine regulatory inquiries or requests for information, deficiency letters, "blue sheet" requests or other trading questionnaires, or examinations.

The most problematic part of the use of the Form U-4 definition of "investigations" is the final sentence, "The term investigation does not include subpoenas, preliminary or routine regulatory inquiries or requests for information, deficiency letters, 'blue sheet' requests or other trading questionnaires, or examinations." Most FINRA investigations start with a regulatory inquiry, 8210 letter requesting documents, or more recently, a FINRA "Gateway Request"[6] for documents. If left unaddressed, the definition removes everything but the most severe and rare regulatory investigations from the scope of discoverable documents.

The FINRA Discovery Guide does not define the terms "investigations" or "charges." Thus, there is no support for Respondents' narrow U-4 definition. Rather, a plain meaning of these terms should be read into the definition, covering the panoply of documents which is provision was meant to capture.

List 1, Item 17 – Examination Reports

Item 17 considers regulatory examination reports that focused on the associated persons or the customer parties' claims, accounts or transactions, or the product or types of products at issue or that discussed alleged improper behavior in the branch against other individuals similar to the conduct alleged in the Statement of Claim to be discoverable. Once again, the usual response from Respondents is to agree to produce those examination reports *which mention* Claimant and/or Claimant's account.

It is the rare case in which a Claimant or a Claimant's account is mentioned in an examination report. However, with FINRA, the SEC, and state regulators all conducting various routine exams and "for cause" exams, the probability of an examination report existing is great.

The examination reports often identify not only the problematic conduct but also may reveal in-the-moment or post-examination responses from the firm about the conduct and efforts to mitigate or remedy it.

List 1, Item 19 – Broker's Compensation for Client's Accounts

Item 19 is designed to answer how much the broker made from the Claimant's transactions. Sometimes the answer is simple, a single commission

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6. https://www.finra.org/filing-reporting/finra-gateway (last visited Dec. 28, 2020).

for a single product. Other times, hundreds or thousands of trades are at issue, creating a challenging situation to total up the commissions. There are often year end or quarterly commission reports which tally up the commissions per client.

It is important to look at each account at issue and determine whether it is a commission-based or fee-based account. Not only is the compensation different, but the duties owed by the broker or investment adviser representative are different as are the defenses.

Item 19 is also an opportunity to test whether Respondents will try to avoid producing documents in reasonably usable format (e.g., an excel spreadsheet).

List 1, Item 20 – Broker's Overall Compensation (Trade Blotter)

Item 20(a) documents, more *really* Good Stuff, can tremendously help a customer-Claimant's case. It provides for the production of the broker's complete commission run and contains much of the data required to be reported in the broker's trade blotter. It shows what the broker was soliciting, the dates, quantities, compensation, and a minimal detail of account numbers to sort the data but not reveal non-party private data.[7]

Item 20(a) almost always meets with a litany of objections and an attempt to limit the production to the commissions related to Claimant's accounts (duplicative of List 1, Item 19's scope).

The underlying reason for the objections is often that Respondents do not want the broker's patterns and practices revealed. Once introduced, the data in Item 20 can shift the case from the narrow, cornered, customer-specific analysis to an inquiry focused on the basis of the broker's recommendation and pattern of recommendations.

If the Item 20(a) material is voluminous, and it almost always is, a second and equally important goal is getting the data produced in reasonably usable format, an Excel spreadsheet. If the data is produced in pdf format, it will likely be two or three pages wide and likely hundreds of pages long. A pdf production denies two benefits of the document: 1) performing mathematical calculations; and 2) sorting the data.

The ability to use Excel's formula functions allows for efficient and accurate computation of the amount of commissions earned by the broker.

The ability to sort the data by multiple levels, for example, by security name and then by date of transaction, can reveal when a broker grew hot or cold on a security, as well as the commissions earned. A sort by net commissions can reveal higher paying products and even a pattern of certain accounts generating larger commissions. Sorting by product and whether the

7. *See* MICHAEL S. EDMISTON, *Investors, Cornered*, 22 PIABA B.J. 337 (2015).

trades were solicited or unsolicited often contradicts the defense of "the client wanted it" when a large portion of the same broker's clients "wanted" the same obscure product. Sorting by product and commission often defangs the "market-went-down" defense when the broker's commissions reveal the true basis for the recommendations. Finally, if the commissions charged to Claimant make up a large portion of the broker's total commissions, this fact can be extremely helpful.

Like 13(b), Item 20(a) is so data-rich that Respondents may be unwilling to produce it under any circumstances without an order from the Panel.

List 1, Item 21 – Compensation Plan

Item 21 requires production of "record[s] of all agreements pertaining to the relationship between the associated persons and the firm, summarizing the associated persons' compensation arrangement or plan with the firm."

Often the Respondents will offer to produce the "grid" or compensation schedule for the broker showing the split between the firm and broker on commissions.

Obtaining the complete employment and/or independent contractor agreement can be very useful for the case. The Agreement often identifies requirements to carry errors and omissions insurance and whether the broker must indemnify the firm for losses as a result of customer complaints and arbitration claims, and even production goals or references thereto.

Another important compensation item are bonuses paid in the form of forgivable loans. Most commonly seen in recruiting scenarios, the bonuses put immediate pressure on the broker to start producing in order to avoid having to repay the loan. Marrying up the dates of the forgivable loans and trade blotter (Item 20) often may show increased production soon after the loans were funded.

II. READING THE DISCOVERY GUIDE IN REVERSE ORDER MAKES THE GOOD STUFF EVEN BETTER

Looking at the Discovery Guide's "good stuff" in reverse order creates the "follow the money" trail. Obtaining this Good Stuff through artful negotiation and, if necessary, motion practice, can uncover a chain of documents explaining how and why Claimant was damaged and how the broker and firm allowed it to happen from a monetary perspective. Item 21 shows the motivation the broker had to sell the particular investment or strategy. Item 20 shows how much the broker earned and the nature of the broker's business. Items 14, 15, 16, and 17 show the risks and conduct the broker and firm

engaged in to make the commissions. Item 13(b) shows what the firm knew about the broker's conduct while producing the commissions. Item 9 reveals what the firm told the broker about the risks and conduct related to this production. Item 7 reveals how the firm allowed the broker to operate while producing. Item 5 reveals what the firm knew about the securities and products the broker was selling in order to produce.

III. MEET AND CONFER TACTICS – GET THE GOOD STUFF WITHOUT A MOTION

FINRA Code of Arbitration Procedure Rule 12503(a)(1) requires counsel to meet and confer prior to filing a motion. Based on the initial production of documents and litany of objections, unilateral limitations, and agreements to produce only slices of the Discovery Guide, a meet and confer effort is necessary in virtually every case.

Embrace the meet and confer requirement. Invest the time at the start of the meet and confer process, and the remaining steps will be easier. A thorough and well-written meet and confer letter sent prior to the actual meeting will serve as the guide to the meet and confer conference, an outline to memorialize the agreements and disagreements, a checklist to track production of documents from Respondents, a summary of the arguments for a Motion to Compel, and will become Exhibit A to any Motion to Compel. As an added bonus, the detailed meet and confer letter plus the follow-up memorialization and subsequent correspondence will ensure compliance with Rule 12505, which instructs that "…parties must cooperate to the fullest extent practicable in the exchange of documents and information to expedite the arbitration."

A. BURN THROUGH THE GENERAL OBJECTIONS AND ITEM SPECIFIC OBJECTIONS

FINRA Code of Arbitration Procedure Rule 12508(a) sets the standards for making objections to the Discovery Guide List Items and other discovery requests. "If a party objects to producing any document described in Document Production Lists 1 or 2 or any document or information requested under Rule 12507, *it must specifically identify which document or requested information it is objecting to and why."* Rule 12508(a) goes on to state the consequence of not being specific in the objection: "Parties must produce all applicable listed documents or other requested documents or information not specified in the objection…"

Respondents' general objections, which serve as a preamble to their Item specific objections, never meet the Rule 12507 standard since they are not specific to any List Item and do not identify which document or information is being objected to and why. Similarly, Respondents rarely identify or describe the documents they are objecting to producing for each specific List Item. Rule 12508(a) provides the remedy for sweeping and lazy objections: mandatory production. Strategically, Respondents usually wait until the last day of the deadline to file their responses (or last day of an extended deadline). Rule 12508(b) provides that any objection not made within the required time is waived absent a Panel finds substantial justification for the failure to make the objection. Thus, when Respondents serve their responses on the last day possible, they cut off their ability to amend their objections, absent a showing of good faith.

In the meet and confer letter, along with identifying Rule 12508 setting forth the standard for objections, ask Respondents' counsel to describe each document withheld for each General Objection. Rule 12505 requires a good faith compliance with discovery, there is nothing wrong with asking Respondents to comply with their good faith obligation.

B. AGREEMENTS TO PRODUCE SELECTIONS OF NON-PRIVILEGED DOCUMENTS

Respondents usually agree to produce only the "non-privileged" responsive documents and generally further limit that and only those related to Claimant. A claim of privilege, like an objection, is governed by Rule 12508(a). If the privilege is not identified and the withheld document not described, the remedy is production of the document.

Additionally, any asserted privilege must be a legally recognized one. Respondents' claims of privilege are usually the non-existent self-critical analysis privilege,[8] a Graham-Leach-Bliley Act privacy privilege,[9] or a

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8. *E.g.*, *Uniformed Fire Officers Ass'n v. City of New York*, 955 N.Y.S.2d 5 (App Div. 1st Dept. 2012) ("[T]his privilege has never been recognized under New York law…"); *Lamitie v. Emerson Elec. Co.*, 535 N.Y.S.2d 650, 653-54 (App. Div. 3rd Dept. 1988).

9. 15 U.S.C § 6801 (YEAR). Gramm-Leach-Bliley Act, 15 U.S.C. § 6801 et seq. focuses on protecting client data from sale or other unrelated commercial use by a financial institution. Subsection (e)(5) of section 6802 specifically allows disclosure of private customer information to "self-regulatory organizations" such as FINRA, and subsection (e)(8) of section 6802 specifically permits disclosure of private customer information in response to subpoenas and other judicial process.

regulatory investigative privilege.[10] Often pointing out the non-existence of these "non-privileges" is sufficient to move the meet-and-confer discussion forward and resolve the issue before filing a motion to compel.

Asking for Respondent to identify the documents governed by claims of privilege is asking Respondent's counsel to create an Item-specific privilege log. Respondent's counsel has the ability to ask for the same from Claimant's counsel. Within the issue of the privilege log, there lurks a mutually assured destruction issue, attorney-client privileged documents. While a run can be made at Respondents not providing a privilege log of such documents, the reverse can be done to Claimant. Strategically, it may be worth clarifying or excluding claims of attorney-client privilege to avoid the laborious creation and exchange of privilege logs.

C. AFFIRMATIONS OF SEARCH

In 2013, when FINRA revised the Discovery Guide, it changed the rules for affirmations of search. Under the old Discovery Guide, the standard for obtaining an affirmation of search required no documents be produced. The new rule provides:

> If a party does not produce a document specified in a List item on the applicable Document Production List, upon the request of the party seeking the document that was not produced, the customer or the appropriate person in the brokerage firm who has knowledge, must: 1) affirm in writing that the party conducted a good faith search for the requested document; 2) describe the extent of the search including, but not limited to, stating the sources searched; and 3) state that, based on the search, the party does not have the requested document in the party's possession, custody, or control.[11]

Respondents' lazy discovery responses may, once again, be a gift. They may reveal the existence of documents they are not producing. For example, Item 13(b)'s objections and claims of privilege create a fair assumption that there are responsive documents that have not been produced. If there are no responsive documents, why was it necessary to object? If Respondents will not drop the nonsensical objections and claims of privilege, ask for the affirmation of search. There is no requirement in the affirmation that it be

10. PHILIP M. AIDIKOFF ET AL., *Discovery of Regulatory Documents: Debunking the Myth of an "Sec Privilege" in Securities Arbitration*, 18 PIABA B.J. 187 (2011); *Kirkland v. Superior Court (Guess? Inc.)*, 115 Cal. Rptr. 2d 279 (Ct. App. 2002) (holding that investigatory documents and responses thereto are business records and are neither privileged nor confidential).

11. Discovery Guide, *supra* note 2, at 5.

limited to non-privileged documents. At a minimum it will reveal the existence of the withheld documents and provide a description of the documents being withheld. If there truly are no responsive documents, someone in the Respondent's firm will lock the firm into a signed statement affirming that no documents were found and they do not have the documents.

Some Respondents try to have their counsel or an employee in the General Counsel's office execute the affirmation of search rather than the person who "has knowledge" or actually conducted the search. Read that affirmation carefully and seek the signature(s) of the firm-level staff or officers who actually conducted the search.

D. THE E-MAIL AND ELECTRONIC RECORDS SEARCH

There is often a treasure trove of information in e-mail exchanges, many of which have never been sent to the Claimant. Respondents' initial e-mail production is usually limited to the e-mails exchanged between the broker and Claimant. Those e-mails, while responsive to parts of various List Items, are an incomplete universe of the documents. Firms may use electronic communication software beyond just e-mail, and there are certainly other employees of the firm ("repositories") who have sent or received e-mails related to the Claimant, the accounts, product, or broker. Identifying the electronic communications systems from the outside is virtually impossible. Identifying the repositories can be a challenge, the obvious ones are the broker, the broker's supervisor, the broker's assistant(s), and the "compliance department." Less obvious repositories may be due diligence committee members, human resources, Anti-Money Laundering personnel, research personnel, and other firm-specific departments identified in the manuals. Creating a chart of each repository, job title, and relation to the case (e.g., name appears in a previously produced document) helps to explain to Respondents why a search of that given person's e-mail (or other communications system) account is reasonable for the purposes of discovery.

Often, Respondents will ask Claimants to identify the particular search terms to use in an email search. Identifying the search terms can be difficult. Start with the easy terms, Claimants' names and account numbers. From there, expand to product names, CUSIPS, customer numbers, family members' names, FINRA investigation file numbers, and terms found in the prior discovery production(s). This may also be a chance to review the firm and broker's Brokercheck and CRD reports to look for outside business activities, other customers' complaints and claims, and settlement contributions. It may also be an opportunity to search the filings with the SEC and state securities regulators for more terms.

The problem with search terms often becomes one of scope. Asking for all e-mails from all repositories which mention "AAPL" will be so broad that it will objectionable, add a significant redaction burden to the firm, and even if produced, the documents would be overwhelming in their irrelevancy. Go back to Rule 12505 and make a good faith and thoughtful request for search terms, and use Boolean connectors to limit the probability of false positives.

Also be clear on what is to be searched, the subject lines, e-mail text, and attachments. Some firms will try to keep the Good Stuff in attachments to e-mails.[12]

Well prepared search terms and reasonable identification of repositories communicate Claimant's counsel's knowledge of the case, shows respect and reasonableness for the discovery process, force Respondents' counsel to consider the issue from Claimant's standpoint, gets Respondents' decision-makers involved in deciding whether to retain an outside vendor to conduct discovery, and often gets an insurance carrier involved in looking at the costs of the defense.

E. THE INDIVIDUAL LIST ITEMS

For each List Item in dispute, identify the List Item, and ask a few questions (or make a few requests):

A. Please identify all documents responsive to this List Item which are being withheld by a claim of privilege, and the specific privilege claimed for each document withheld.
B. Please identify all documents responsive to this List Item which are being withheld by an objection asserted in response to this List Item and the specific objection claimed for each document being withheld.
C. Please confirm Respondents have completed their search for documents responsive to this List Item.
D. Please confirm all documents other than those being withheld by a claim of privilege or objection have been produced.
E. Please provide the affirmation of search for this List Item.

Depending on the List Item two additional instructions may be helpful:

F. Claimant consents to the redaction of all PCI of non-parties contained in the documents responsive to this List Item. Claimants request that only the last four digits of any account number,

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12. On November 17, 2016, FINRA sanctioned Oppenheimer & Co., Inc. for failing to produce discoverable spreadsheets contained in e-mail attachments in response to discovery requests propounded in seven arbitration claims. FINRA Acceptance, Waiver & Consent, Case No. 2015046355401 (Nov. 17, 2016).

contract number, or policy number associated with any brokerage account, investment or insurance product be left intact.

G. For all spreadsheets produced responsive to this List Item, please produce the spreadsheet in Excel format with full functionality enabled.

The alphabetized checklist of requests will efficiently narrow the issue, and make it very easy to track any agreements to produce documents or provide additional information.

F. A GAME OF TELEPHONIC CAT-AND-MOUSE

A well-written meet and confer letter may knock loose a supplemental production, mainly of documents that were not ready to be produced at the time of the initial production. Often, the Good Stuff still will not be produced.

The meet and confer letter will usually result in a written response explaining why Respondents are objecting (without actually identifying any documents) and a perhaps a polite suggestion to have a call to meet and confer. Translated and summarized, the response letter often reads: "Please go commit a physiologically improbable act, but maybe call me first before risking injury."

The meet and confer call is where all the work put into a detailed meet and confer letter sent prior to the call will result in getting some or all of the Good Stuff produced. The call requires good note taking to memorialize the agreements

1. General Objections and Claims of Privilege

For the General Objections, ask outright whether documents are being withheld pursuant to any General Objection. If the answer is "no," it is usually qualified with a statement that the Item-specific objections control. Make a note for the memorialization.

For the claims of privilege, ask whether documents are being withheld on a claim of privilege other than attorney-client. The answer is oftentimes, "no." If "yes," ask for counsel to identify the List Item, describe the document, and the specific privilege claimed. Other than attorney-client, the claims of privilege will normally evaporate. Make a note for the memorialization. If a claim of privilege is still asserted chase it down to a specific privilege and document description.

2. Affirmations of Search

For affirmations of search, ask for them. Most Respondents' counsel will argue that there is no way their client can search behind every bookcase, under file cabinets, and in the coffee filter drawer for responsive documents. If Respondents' counsel claims "some" documents have been produced wrongly arguing under the old Discovery Guide standard there is no need for an affirmation, ask what documents are being withheld. The response will reveal more documents, confirm all documents have been produced, or most likely send Respondents' counsel back to the client to ask about more documents. Some Respondents' counsel will take the position "Respondents will not provide affirmations." If that occurs, the ability to identify one or two missing documents will often give sufficient support to the meet and confer for Respondents' counsel to reconsider the extreme position.

Insistence and "compromising" that the affirmation only requires a good faith search effort, not a thorough gutting of the building, is often enough to bring Respondents' counsel to agreement. Regardless of what occurs, make a note.

Depending on the response, level of trust with Respondents' counsel, and the case, it may not be necessary to pursue affirmations of search for each List Item. If that is the case, dropping the request for affirmations can reward good behavior of promising to produce and actually producing the full scope of documents. In addition, the use of the threat of asking for affirmations of search may become a negotiation tool to obtain other discovery.

3. The Individual Requests

Getting the documents from the individual List Items will take the majority of time.

The Cat and Mouse game involves using the five to seven questions/requests for each part of the meet and confer letter.

The initial step is to learn whether responsive documents exist. A blunt but polite question based on the specific List Item such as, "are there internal discipline documents for the broker" (Item 15) is not out of line. The usual response from Respondents' counsel is "I don't know." While it may be tempting or sometimes necessary to test the veracity of such an answer, the goal is to get the documents. Fighting over what Respondent's counsel may or should know does little to get the documents produced. The follow up is to ask Respondents counsel to confirm with the client(s) whether there are any responsive documents at all, and then offer to have a discussion if such documents exist. This approach side-steps finger-pointing, puts the onus of Respondent's counsel to go ask its client to search for documents, makes the

client's in-house counsel and business people think about the case, and inescapably educates Respondent's counsel on the issue of whether the desired documents exist.

For the Items which have a "conduct similar" qualifier, ask if documents are being withheld subject to the interpretation of "conduct similar."

Once the documents are confirmed to exist, the discussion often becomes easier as Respondents' counsel generally wants to avoid a motion on the Item. Quite often with the existence of the document known and no reasonable basis for an objection, it will be produced. If Respondents still want to fight the issue, enough groundwork has been made to show the document exists, and if necessary, its relation to "conduct similar" to succeed on a motion to compel.

Of course, if the Respondent's response is no such documents exist, consider asking for the affirmation of search.

When Respondents' counsel refuses to waive the Item specific objections, will not identify the documents being withheld, and says words to the effect, "you will need to get an order from the panel for Respondents to produce those documents," there is one last step. Ask Respondents' counsel "to confirm whether there are actually responsive documents being withheld in order to avoid unnecessary motion practice." It is a reasonable request made in an effort of efficiency. The Request puts Respondents in the position of having to admit whether documents exist or look like they are obstructing discovery and hiding some Good Stuff. No matter the response, make a note for the Meet and Confer memorandum.

4. Set Deadlines to Get the Good Stuff

Usually the discussion of List Items involves representations from Respondents' counsel that it is necessary to check with the client whether there are more documents. Set a deadline for Respondents' counsel to confirm the existence of documents. There will be documents. Set a second deadline for production of those documents. Set a deadline for Respondents to provide the affirmations of search.

5. Is There Anything You Need from Claimant?

Towards the end of the call, it may be worth asking Respondents' counsel if there are documents they are still awaiting from Claimant. Whatever the response, memorialize it. It gives a jump on any disputed issue, helps to meet that Rule 12505 "good faith" standard, and often avoids what just happened to Respondents' counsel from occurring to Claimant's counsel. If there is

something Respondent wants in discovery, a little horse-trading might be just the solution for both sides to resolve a contested Item or two.

6. The Meet and Confer Memorialization

After an hour or two on the phone, there is always a long list of notes, agreements, agreements to disagree and more. Take the laboring oar and offer (or just inform) Respondents' counsel that Claimant will memorialize the meet and confer effort. Be as detailed as possible for each topic and List Item. This is a working document and is not the place for zealous advocacy. Neutral reporting will keep the issues on track, make follow-up easy, and not invite pointless counter-fire from Respondents. The memorialization of the meet and confer will become Exhibit B to the Motion to Compel if necessary.[13]

Once completed, send a copy of the memorandum to Respondents' counsel and ask for counsel's review and correction of any errors. Sometimes nothing comes back, other times it is a chance to clarify a good faith error, or learn Respondents are still not finished qualifying their discovery responses and another meet and confer is necessary.

7. Outside Research on the Respondent Firm's Vendors – Free Discovery!

Sometimes Respondents' counsel does not know or claims not to know much about Respondents' procedures, file architecture, document storage and electronic file architecture. It can be beneficial to ask about the Respondent firm's vendors. Along with being a potential third-party to seek discovery from, vendors usually provide a wealth of resources about their services on their website. Everything from compliance and supervision reports, to e-mail archives, to training materials, to procedures to responding to regulatory and litigation document requests may potentially be found on a vendor's website and/or promotional brochures.[14] Knowing the titles of reports and related documents makes supporting a request for affirmations of search much easier. Giving Respondent's counsel an excerpt of the manual for its client's e-mail

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13. RICHARD A. LEWINS & BIRGITTA SIEGEL, *Discovery in Securities Arbitration: Toss Out a Tennis Ball; Get Back a Chewed-Up Slipper*, 16 PIABA B.J. 289, 297 (2009).

14. *E.g.*, Smarsh makes training materials available on-line for its electronic data record storage system. https://central.smarsh.com/s/article/How-Do-I-Search-Content-by-Keywords (last visited Dec. 28, 2020).

archival system may make the e-mail search much less burdensome than initially claimed. If the vendors are FINRA Member Firms, obtaining an Order to Produce the same documents listed in List 1 of the Discovery Guide is always a potential solution to getting around noisome objections.

8. SEC Record Creation and Retention Rules

Sometimes meet and confer responses from Respondents are that documents were not created or were destroyed in a file purge. There are two sources of information to test the veracity of such statements. The first is the firm's procedures and compliance manuals. A section on document retention policies is a good place to begin. The second are SEC Rules 17a-3[15] and 17a-4.[16] Rule 17a-3 addresses the documents a brokerage firm must create and maintain. Rule 17a-4 gives the time periods for retaining the documents. Rule 17a-4 assists in the production process by requiring many of the documents, including trade blotters to be maintained *in an easily accessible place*.[17] The "easily accessible place" requirement can significantly change the burden argument, and associated effort to cost-shift discovery to Claimant.

IV. CONCLUSION

Getting the Good Stuff requires planning, early scheduling for discovery work, patience, attention to detail, follow-up, more patience, and solid memorialization. Generally, Respondents want to avoid a motion to compel except for the really Good Stuff (Item 13(b) and Item 20)). By persistent, gentle advocacy, many of the issues can be resolved, the Good Stuff produced, and most importantly through the judicious use of affirmations of search, undesirable surprises at the time of hearing can be avoided.

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15. 17 C.F.R. § 240.17a-3 (2020).

16. *Id.* § 240.17a-4.

17. *Id.* § 240.17a-4(a). "Every member, broker or dealer subject to § 240.17a-3 must preserve for a period of not less than 6 years, the first two years in an easily accessible place, all records required to be made pursuant to § 240.17a-3(a)(1) through (3), (5), and (21) and (22), and analogous records created pursuant to § 240.17a-3(d).".

Notes & Observations

REGULATION BEST INTEREST: A BEHAVIORAL ANALYSIS

Tiffany Heravi[*]

Abstract

Our current securities regulatory regime is based on the presumption of efficient markets and rational investors, an unsurprising starting point as neoclassical economics has long proffered the standard utility function as a predictor of an individual's decision-making. Behavioral economics, an ideology that continues to rally support in both economics and legal circles, challenges this presumption. Through the lens of behavioral economics, this Article examines the economic analysis the Securities Exchange Commission conducted when promulgating the hotly contested Regulation Best Interest (Reg BI). Reg BI created a "best interest" standard broker-dealers and associated persons must abide by when providing investment advice to retail clients. The rule aims to protect retail investors, yet its economic analysis inadequately analyzes the cognitive biases these investors are prone to and ignores relevant market forces. A complete analysis would have revealed the shortcoming of utilizing the efficient markets model and yielded the result that a uniform fiduciary standard would better protect investors.

Introduction

Utilizing a varied set of social sciences, behavioral economists argue that investor irrationality is more pervasive than efficient market theorists care to acknowledge. This cautionary tale of human error has been echoed down the halls of administrative agencies in different sects of the legal industry. In 2010 the Office of Information and Regulatory Affairs (OIRA) heeded the tale and Cass Sunstein, former head of OIRA, released a memo explicitly encouraging

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agencies to consider behavioral factors in designing rules.[1] The Securities and Exchange Commission (SEC) has been slow in adopting this advice.[2]

In 2012, the D.C. Circuit issued a scathing opinion in *Business Roundtable v. SEC*, disparaging the SEC for its failure to "adequately assess the economic effects of a new rule."[3] In the ruling, Judge Douglas Ginsburg explained that the SEC has the statutory obligation to consider the effect of a new rule on efficiency, competition, and capital formation,[4] and noted that the agency's failure to adequately adhere to those obligations would make a rule arbitrary and capricious under the Administrative Procedures Act (APA).[5] The court also voiced frustration with the SEC's traditional practices in conducting cost benefit analysis, which had been given a deferential standard of review since its initial development in the early 1970s. Following the decision, the SEC released formal guidance on economic analysis to be utilized in rule making.[6] However, in this guidance behavioral factors are not explicitly encouraged or even mentioned. Years later the SEC has not modernized, and their 2012 guidance remains the only instruction on the matter.

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1. Memorandum from Cass R. Sunstein, Adm'r, Office of Info & Regulatory Affairs, to the Heads of Executive Departments and Agencies 1 (June 18, 2010), available at http://www.whitehouse.gov/sites/default/files/omb/assets/inforeg/disclosure_principles.pdf.

2. As an independent regulatory agency, the SEC is not obligated to follow the guidelines for regulatory economic analysis by executive agencies set out in Executive Order 12866 ("Regulatory Planning and Review") and Executive Order 13563 ("Improving Regulation and Regulatory Review").

3. *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (vacating rule 14a-1–which allowed any shareholder who held at least three percent of public company's stock for at least three years to nominate individuals for election to the board of directors and required the shareholder nominees be included in the corporation's proxy statement–for being arbitrary and capricious due to its inadequate economic analysis).

4. *Id.* (citing 15 U.S.C. §§ 78c(f), 78w(a)(2), 80a-2(c)).

5. Pub. L. No. 79-404, 60 Stat. 237 (1946) (codified as amended in scattered sections of 5 U.S.C.).

6. Memorandum from the Division of Risk, Strategy, and Financial Innovation and the Office of the General Counsel of the SEC to the Staff of the Rulewriting Divisions and Offices of the SEC (Mar. 16, 2012), *available at* https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf. [hereinafter Economic Guidance].

On June 5, 2019, the SEC's prowess in economic analysis was once again called into question with its adoption of Regulation Best Interest (Reg BI). This rule establishes a standard of conduct that broker-dealers must adhere to when giving investment advice to retail customers. Many have argued that the SEC's economic analysis of the rule was not adequately conducted. For that reason, among others, claimants called for the Second Circuit to find the rule arbitrary and capricious and invalidate it. The rule was upheld, but with minimal attention paid to its economic efficacy.

This Article examines the SEC's economic analysis of Reg BI through the lens of behavioral economics. The SEC has yet to fully embrace the consequences behavioral biases have on the decision-making ability of retail investors. Reg BI's impact on the broker-dealer advisory space provides the unique opportunity to showcase the effect of those biases. Part I provides a background of the SEC's practices in conducting a rule's economic analysis. Part II discusses Reg BI, paying special attention to the economic analysis conducted in the Final Rule.[7] Next, Part III sets out an overview of the predominant economic theories shaping securities regulation and analyzes how investor biases manifest themselves during market participation. Part IV sets out the shortcomings of the SEC's use of efficient market hypothesis (EMH) with a discussion on the holes in Reg BI's economic analysis. Part IV further evaluates how regulators should utilize behavioral economics to address these shortcomings. Part V explains why a uniform fiduciary standard is the most realistic policy option.

I. THE SEC'S ECONOMIC GUIDANCE

The SEC is a United States administrative agency subject to the APA.[8] The APA sets out requirements for the rulemaking process.[9] SEC rulemaking typically begins with a rule proposal, which is published in the Federal Registrar for public notice and comment. The public's input is taken into consideration when drafting the final rule. Under Section 706(2)(A) of the APA an agency rulemaking must be invalidated if it is found to be arbitrary and capricious. For SEC rules to meet this standard of review, the economic

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7. *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, 84 Fed. Reg. 33318 (July 12, 2019) (the "Final Rule").

8. Pub. L. No. 79-404, 60 Stat. 237 (1946) (codified as amended in scattered sections of 5 U.S.C.).

9. 5 U.S.C. § 553.

impact of a rule must be adequately evaluated–courts have invalidated rules for an agency's failure to engage in a complete economic analysis. The SEC's economic guidance cites the basic elements of a good analysis as (1) a statement of need for the rule; (2) definition of a baseline against which to measure the rule's likely economic consequences; (3) identification of alternative regulatory approaches; and (4) a cost benefit analysis of the proposed rule and the alternatives, taking into consideration both quantitative and qualitative benefits and costs.[10]

In the background of SEC rulemaking–and by extension SEC economic analysis–is the legal tenant of the "reasonable investor." This protagonist of securities law has been typified as a rational, but nonprofessional, participant in the marketplace, but her identity has never been quite clear.[11] "The 'reasonable investor' is at best a shadowy figure, described only generically in judicial opinions and–in doctrine if not in practice–someone for the fact-finder to identify case-by-case."[12] She is generally understood as an agent of neoclassical economics known as *homo economicus*.[13] The term denotes humans as economic agents who are stringently rational and focused on wealth maximization. This "myth story" sees its origins in the enactment of the

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10. Economic Guidance, *supra* note 6, at 1-2.

11. *See* Tom C.W. Lin, *Reasonable Investor(s)*, 95 B.U. L. Rev. 462, 466-67 ("In the many decades since the birth of the modem financial regulatory framework, regulators, scholars, and courts have not universally agreed upon the identity and defining characteristics of the reasonable investor."); *see also*, Joan MacLeod Heminway, *Female Investors and Securities Fraud: Is the Reasonable Investor a Woman?*, 15 Wm. & Mary J. Women & L. 291, 293-94 (2009) (exploring "certain descriptive and normative characteristics of the reasonable investor associated with the sex of that investor").

12. Amanda M. Rose, *The "Reasonable Investor" of Federal Securities Law: Insights from Tort Law's "Reasonable Person" & Suggested Reforms*, 43 J. Corp. L. 77, 79 (2017).

13. *See* Carlos Rodriquez-Sickert, *Homo Economicus, in* Handbook of Economics and Ethics 223, 223 (Jan Peil & Irene van Staveren eds. 2009); *see also* Margaret V. Sachs, *Materiality and Social Change: The Case for Replacing "the Reasonable Investor" with "the Least Sophisticated Investor" in Inefficient Markets*, 81 Tul. L. Rev. 473, 490 (2006) ("Protecting individual investors is largely unnecessary since the 'homo economicus' is well-informed or at least knowledgeable enough to know when he needs an adviser.").

Securities Act of 1933 and subsequent creation of the SEC.[14] Courts have adopted this phraseology, and the Supreme Court has warned courts not to treat investors like "nitwits" and ascribe to them "child-like simplicity."[15]

II. THE CURRENT STANDING OF REGULATION BEST INTEREST

A. Procedural Posture

On June 5, 2019, the SEC adopted the hotly contested Reg BI.[16] Reg BI establishes a standard of conduct for broker-dealers and associated persons when they make a recommendation to a retail customer of any securities transaction or investing strategy involving securities (including account recommendations).[17] At the time the recommendation is made, the broker must act in the best interest of the customer. This creates an obligation on the broker not to place her own interest–financial or otherwise–ahead of the interests of the retail customer.[18] The term "best interest" is not specifically defined; instead, the general standard is deemed satisfied when a broker fulfills a set of four obligations: Disclosure, Care, Conflict of Interest, and Compliance.[19] Disclosure, a favorite regulatory tactic of the SEC, seems to be the most

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14. Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 Nw. L. Rev. 135, 173 (2002) (The SEC "does not really want to know [the truth about investor behavior], for fear that the myth-story might have to give way to a vision of retail investors somewhat more in keeping with the predictions of the behavioralists."); Lin, *supra* note 11, at 466 n.13.

15. Barbara Black, *Behavioral Economics and Investor Protection: Reasonable Investors, Efficient Markets*, 44 Loy. U. Chi. L. J. 1493, 1494 (2013) (quoting *Basic Inc. v Levinson*, 485 U.S. 224, 234 (1988), and *Flamm v. Eberstadt*, 814 F.2d 1169, 1175 (7th Cir. 1987)). *See, e.g.*, *In re Oracle Corp. Derivative Litig.*, 867 A.2d 904, 941 (Del. Ch. 2004) (explaining a reasonable investor would be aware of the slowing of American economy, understand that it could dampen Oracle's performance, and "would know that a weakening economy could have the effect of causing procurement officers to defer discretionary spending, including spending on the kind of expensive products that Oracle sells").

16. 17 C.F.R. § 240.15l-1(a)(1) (2019).

17. *Id*.

18. *Id*.

19. *Id*.

prominent of these obligations.[20] All material conflicts are to be disclosed to the retail investor (this disclosure is often buried in a voluminous tome of legalese), and behind the scenes brokers are expected to take measures to identify and mitigate those conflicts. This is a transaction-based approach, as compliance with the standard turns on the facts and circumstances of the particular recommendation and the particular retail customer.

Critics were quick to argue that Reg BI was too weak, and many contended the SEC should have implemented a fiduciary standard for brokers akin to that of investment advisors.[21] A little over three months after the rule package was passed, seven states and the District of Columbia filed a federal lawsuit against the SEC–later consolidated with a similar proceeding filed by investment advisor interest group XY Planning Network and one of its members, Ford Financial Solutions.[22] The suit, filed in both the Southern District of New York

20. Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. Cin. L. Rev. 1023 (2000) ("Mandatory disclosure is a–if not the–defining characteristic of U.S. securities regulation. Congress intended the securities laws to 'substitute a philosophy of full disclosure for the philosophy of caveat emptor…'" (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963)); Stephen J. Choi & Adam C. Prichard, *Behavioral Economics and the SEC*, 56 Stan. L. Rev. 1, 26 (2003) (opining the SEC's taste for disclosure stems from context bias whereby deciding between two options, in this context doing nothing and regulating substantive conduct, the compromise possibility–i.e. disclosure as a midway between the options–has an undue effect on the decision).

21. Brief of Current and Former Members of Congress as Amici Curiae in Support of Petitioners, XY Planning Network v. United States Securities and Exchange Commission, No. 19-2886 (2d Cir. 2020) (Former Sen. Christopher J. Dodd (D-Conn.) and former Rep. Barney Frank (D-Mass.), along with 10 current and former congressmen, filed an amicus brief in the case challenging Reg BI. They argue that Dodd Frank fails to harmonize the standard of conduct between broker-dealers and registered investment advisors. Section 913 of Dodd-Frank requires Congress to establish a standard of conduct for brokers that is "no less stringent than the standard applicable to investment advisers.").

22. Complaint, State of New York v. SEC, No. 1:19-cv-8365-VM (S.D.N.Y. Sept. 9, 2019). The seven states involved were California, Connecticut, Delaware, Maine, New Mexico, New York (whose attorney general lead the litigation), and Massachusetts. A day later the XY Planning Network, an organization of fee only investment advisers, and Ford Financial Solutions filed similar proceedings against the SEC. Those cases were consolidated in the Second U.S. Circuit Court of Appeals. XY Planning Network, LLC v. SEC, No. 1:19-cv-08415-VM (S.D.N.Y. Sept. 10, 2019); Consolidation Order, State of New York v. SEC, No. 1:19-cv-

(SDNY) and the Second Circuit, alleges that Reg BI fails to meet the basic investor protections that were laid out in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and points to a flawed cost-benefit analysis.[23] The case was dismissed by SDNY due to the court's self-declared lack of subject matter jurisdiction and deferred to the Second Circuit where the appeal was ultimately denied.[24]

A three-judge panel of the Second Circuit unanimously held (1) the individual investment adviser petitioner had standing to bring its petition to review, (2) section 913(f) of Dodd-Frank authorizes Reg BI, and (3) Reg BI is not arbitrary and capricious.[25] On the issue of standing, State Petitioners cited evidence claiming "[t]he loss of retail investment returns due to conflicted financial advice causes harm to states by lowering their tax revenues."[26] The court held State Petitioners' economic reasoning was far too speculative to

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08365-VM (S.D.N.Y. Sept. 12, 2019), ECF No. 13. Additionally, a few weeks after Reg BI's adoption, the House approved an amendment to an annual appropriations bill prohibiting the SEC from using funds to implement and enforce Reg BI. The amendment was made to the Financial Services and General Government Appropriations Act of 2020, H.R. 3351. *See* https://amendments-rules.house.gov /amendments/SECMAJA6--REVISED%20 AMENDMENT624190937483748.pdf. Since Reg BI's passage, several states have taken steps to adopt uniform fiduciary standard for brokers and investment advisers at the local level.

23. Press Release, New York State Office of the Attorney General, AG James Leads Coalition Suing SEC for Putting Brokers Ahead of Investors (Sep. 10, 2019), https://ag.ny.gov/press-release/2019/ag-james-leads-coalition-suing-sec-putting-brokers-ahead-investors ("[W]ith this rule, the SEC is choosing Wall Street over Main Street," said Attorney General James. "Instead of adopting the investor protections of Dodd-Frank, this watered-down rule puts brokers first. The SEC is now promulgating a rule that fails to address the confusion felt by consumers and fails to remedy the conflicting advice that motivated Congress to act in the first place.").

24. Decision and Order, *State of New York v. SEC*, No. 1:19-cv-08365-VM (S.D.N.Y. Sept. 27, 2019), ECF No. 27 (dismissing the action "on the Court's own motion for lack of subject-matter jurisdiction and in favor of litigation pursuant to the petitions for review filed in the United States Court of Appeals for the Second Circuit").

25. XY Planning Network, LLC v. SEC, Nos. 19-2886 (2d Cir. 2020).

26. *Id*. at 12.

grant Article III standing.[27] Ford, on the other hand, had "standing to bring its petition based on the impairment of its current ability to attract customers by touting the fiduciary duties it owes its clients. In other words, by enabling broker-dealers to advertise their new best-interest obligation, Regulation Best Interest will put Ford and other investment advisers at a competitive disadvantage compared to the status quo."[28]

The court's discussion focused on the language of Dodd-Frank sections 913 (f) and (g) and an arbitrary and capricious review. The court agreed with the SEC's argument that the word "may" in Dodd-Frank is a permissive term Congress utilized to give the commission flexibility in promulgating Reg BI. An interesting interpretation given the SEC has typically taken the position the term "may" lacks the specificity required for investment advisor disclosure language.[29] The court further postulated the Dodd-Frank language indicated Congress gave the SEC the power to make no rule at all. Deference was given to the SEC's analysis of investor confusion around the standard of care owed to them by investment professionals and the SEC's conclusions on the broker-dealer business model.

B. Economic Analysis

Reg BI's economic analysis identifies the main economic problem as the misunderstanding brokers and their customers might have regarding one another's assessments of appropriate risk tolerance.[30] The analysis suggests Reg BI solves this problem by creating a mandatory standard of behavior for

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27. *Id*. at 13. In order to establish Article III standing, petitioners "must have (1) suffered an injury in fact, (2) that is fairly traceable to the challenged conduct of the defendant, and (3) that is likely to be redressed by a favorable judicial decision." *Spokeo, Inc. v. Robins*, 136 S. Ct. 1540, 1547 (2016).

28. XY Planning Network, *supra* note 25, at 13 (dissenting on the issue of standing, Judge Sullivan argued the petitions should have been dismissed in their entirety because he believes all parties lack standing. "The XYPN Petitioners offer a grab bag of standing theories, most of which are easily brushed aside for failing to establish one or more of the three requirements articulated in *Spokeo*.").

29. James G. Lundy et al, *The Second Circuit Upholds Reg BI*, The Nat'l L. Rev. (July 1, 2020), https://www.natlawreview.com/article/second-circuit-upholds-reg-bi.

30. Letter to Brent J. Fields, Sec'y, Securities and Exchange Commission from Former Chief Economist Charles Cox et al. (Feb. 6, 2019) at pg. 3 [hereinafter Economist's Letter].

brokers to adhere to when advising clients, which would improve communication.[31] A portion of the analysis' regulatory baseline is comprised of a discussion of federal and state securities laws. The discussion of the economic baseline further includes an examination of how recommendations given by financial professionals to retail clients could be affected by the client's trust and financial literacy, as well as the effectiveness and limitation of disclosures.[32] The analysis acknowledges alternative regulatory approaches to the rule such as (1) a fiduciary standard for broker-dealers,[33] (2) requiring disclosures to be issued in a prescribed format (such as a form for a financial professional to fill out),[34] and (3) passing only the disclosure prong of Reg BI's four obligations.[35] The costs and benefits of all four obligations of the rule were considered in turn. As is typical of cost-benefit analysis, the models used by the SEC presume rational economic actors. These rational agents only undertake an action when the expected benefit is greater than the expected cost. The analysis noted that given the sources of uncertainty and complexity inherent of the industry and the relationship between brokers and clients, meaningful quantification of many of the costs and benefits was unable to be calculated.

One criticism of Reg BI is the claimed faulty economic analysis underlying the rule. During proposal of the rule, SEC Commissioner Robert Jackson asserted that the economic impact of effecting Reg BI needed to be better addressed.[36] Over the course of the comment period, Jackson voiced on several occasions his belief that the economic analysis was too weak and would face legal challenges, to the point that he ultimately voted against the

31. *Id.*

32. Final Rule, *supra* note 7, at 33431-34.

33. *Id.* at 33462-67.

34. *Id.* at 33467-68.

35. *Id.* at 33468.

36. Commissioner Jackson voted to put the proposed rule out for comment, but stated he made "very clear" he could not support the plan as a final rule unless improvements were made. Investment Adviser Association, SEC Commissioner Jackson's Full Keynote, YOUTUBE (Mar. 28, 2019), https://www.youtube.com /watch?v=1PqK U06IBZc.

Final Rule.[37] Jackson stated that if the analysis "is not up to snuff, you're basically giving the market a call option" to strike down the rule.[38]

Jackson was not the only one to think the SEC's economic analysis left something to be desired. In a sharply worded comment letter, eleven former SEC senior economists faulted the analysis as incomplete and inconsistent with the SEC's own issued guidelines on economic analysis in rulemaking.[39] They found it "worrisome that the proposal's economic analysis does not fully consider some potentially important dimensions of the retail client adviser relationship."[40] Three issues cited in the comment letter were (1) incomplete identification of the specific need for this proposed action, (2) inadequate discussion of the existing financial literature related to financial advising, and (3) heavy reliance on disclosure without evidence that these disclosures would meaningfully inform retail customers.[41] Based on the feedback, the SEC made improvements to the economic analysis but the final results still left something to be desired; notably, it lacked a deeper discussion on the behavioral elements that are particularly crucial to a rule with such a direct effect on retail investors. The SEC chose instead to support their policy decision on the grounds of market efficiency.

III. DEVELOPMENT OF FINANCIAL ECONOMICS THEORETICAL LANDSCAPE

The framework of neoclassical economics can be found in the utility function, under which economic actors seek to maximize the satisfaction they receive from the consumption of goods and services.[42] Accordingly, these actors have the ability to rank their preferences. Such a view fundamentally relies on the assumption that these actors are rational and able to act

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37. Statement on Final Rules Governing Investment Advice (June 5, 2019), https://www.sec.gov/news/public-statement/statement-jackson-060519-iabd.

38. Investment Advisers Association, *supra* note 36.

39. Economist's Letter, *supra* note 30, at 3.

40. *Id* at 2.

41. *Id* at 3-4.

42. Vandenbergh et al., *Regulation in the Behavioral Era*, 95 Minn. L. Rev. 715, 750 (2011); Choi, *supra* note 20, at 3; David A. Jr. Skeel, *Behaviorism in Finance and Securities Law*, 21 Sup. Ct. Econ. Rev. 77, 80-81 (2013).

independently based on full and relevant information.[43] EMH, the theory that asset prices reflect all available information, is built upon the same assumptions.[44] This view still dominates modern economic theory, but is not without controversy.[45] Scholars across the fields of economics, finance, and psychology have questioned the rational actor model EMH rests upon.[46]

A prominent critique of EMH has been noise theory, which states that investors are influenced by "noise" into making irrational decisions when evaluating asset values.[47] This noise comes in the form of emotion, hype, speculation, and inaccurate data. Listening to noise places an actor in the category labeled the "irrational investor". [48] EMH acknowledges these irrational investors do exist, but on a scale small enough that "smart money"– i.e. Wall Street investors–provides a corrective force to counter those biases.[49] Behavioral economics, on the other hand, argues that those biases are

43. Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. Pa. L. Rev. 851, 858 (1992) ("The conventional economic model postulates that rational decision-makers search for the option having the largest subjective expected utility, determined by reference to probabilities derived from the available information set.").

44. Eugene Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. Fin. 383 (1970).

45. Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics*, 17 J. Econ. Persp. 59-82 (2003).

46. Brief of Financial Economists as Amicus Curiae in Support of Respondents at 3, Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 258 (2014) ("[E]conomists do not generally disagree about whether market prices respond to new material information. In particular, there is little doubt that the stock price will increase reasonably promptly after favorable news about a company is released and decline after unfavorable news.").

47. The term noise theory was coined by economist Fischer Black. "By renaming irrational trading 'noise trading' Black avoided the I-word, thereby sanitizing irrationality and rendering it palatable to many analysts who in other settings would not be receptive to such a specification." Stephen Leroy, *Efficient Capital Markets and Martingales*, 27 Econ. Lit. 1583, 1612 (1989).

48. *See* David Hirshleifer & Tyler Shumway, *Good Day Sunshine: Stock Returns and the Weather*, 58 J. Fin. 1009 (2003) (showcasing exogenous factors like the weather impact investment decision-making, even among professionals. Sunshine was found to be highly significantly correlated with daily stock returns).

49. Choi, *supra* note 20, at 3.

systematically pervasive and applicable to professionals, therefore rebutting the rational actor model.

At face value the idea that human beings, with all their emotional baggage, are stringently rational is laughable. Indeed, the wealth of behavioral data indicates investors are influenced by a broad set of motivations. Drawing from the work of several fields–such as psychology, sociology, anthropology and economics–a wide range of data has been yielded. Due to this breadth of information, behavioral economics has been described as a set of mini theories.[50] Lack of a unifying ideology has prompted regulators to use the simpler rational choice model as a default for their policy advocacy. Unfortunately, it appears the SEC's fear of complexity keeps it subscribed to a limited interpretation of investor self-interest.[51] As such, the policy mechanisms employed have focused on disclosure–without much research by the SEC to determine if these disclosures are even effective.[52]

A. The Manifestation of Investor Biases

Rather than looking at how investors *should* behave, behavioral economics seeks to uncover how they *do* behave. Looking back in time it becomes apparent that people's behavioral biases, today characterized as irrational, in fact stem from a rational place. "*Homo sapiens* emerged on the Savannah Plain

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50. *See* Bainbridge, *supra* note 20, at 1035 ("To date, behavioral economics has not (and may not ever) develop a single theory that explains or predicts the full range of human behavior, as rational choice theory claims to do. Instead, it offers a pragmatic collection of 'situation-specific mini-theories useful in the analysis of discrete legal problems.'").

51. Vandenbergh et al., *supra* note 42, at 729-30 ("In the absence of an accessible account that reflects the complex influences on behavior, regulators all too often appear to rely solely on the price mechanism or to fall back on common intuitions.").

52. The SEC began an initiative for more effective disclosure back in 2013 after the Jumpstart Our Business Startups (JOBS) Act mandated a report. In 2019 the SEC voted in favor of proposed changes to the definition of "accelerated filer" and "large accelerated filer", (Release No. 34-85814) proposed changes to rules for disclosure required of publicly registered companies following acquisitions and dispositions of business (Release No. 33-10635), and adopted amendments intended to simplify some of the disclosure requirements outlined in Regulation S-K (Release No. 33-10618). In that vein, the SEC has recently been more receptive to information regarding how investors understand disclosures and several studies on the matter were noted in Reg BI's economic analysis.

some 200,000 years ago, yet according to evolutionary psychology, people today still seek those traits that made survival possible then: an instinct to fight furiously when threatened, for instance, and a drive to trade information and share secrets. Human beings are, in other words, hardwired."[53] The primal, also known as the old, brain decision pathways evolved for survival in the wild. Under such context, the validity of the behavioral biases people harbor, and subsequently exhibit during investment decision making, is apparent. There are certain biases that investors commonly exhibit, including loss aversion, over confidence, confirmation bias, and herd mentality.

Loss aversion refers to the asymmetry in value that investors showcase–investors are more sensitive to the disutility of loss than the utility of gain.[54] This bias can be typified as emotional. An investor would feel more discontent (approximately 2.5 times as much) about the loss of $100 than pleased about the gain of $100.[55] Consequently, investors are more willing to undertake risk to avoid a loss than to receive the equivalent gain. Examples of loss aversion include investors selling a stock when the price has gone up slightly just to realize a gain of any amount, when analysis indicates that holding that stock longer would realize a greater profit; investing in bonds over stocks when someone has the capacity to take on more risk; and pulling money out of the market during a downturn to avoid the pain of loss. Back on the Savannah Plain one had to consider the rustling in the bushes could be a tiger, under this primal context overreacting to loss in response to a low probability event makes sense.[56] However, it makes less sense in a quantitatively understood probability function like an investment.

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53. Nigel Nicholson, *How Hardwired Is Human Behavior?*, 76 Harv. Bus. Rev. 134-47 (1998).

54. Donald C. Langevoort, *Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review*, 51 Vand. L. Rev. 1499, 1503 (1998); Kahneman, *infra* note 61, at 199-203.

55. Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision under Risk*, 47 Econometrica 263-91 (1979).

56. As a species, we appear to be biologically programmed to see patterns and conspiracies, and this tendency increases when we sense that we're in danger. "We are hard-wired to overreact to coincidences," says Persi Diaconis. "It goes back to primitive man. You look in the bush, it looks like stripes, you'd better get out of there before you determine the odds that you're looking at a tiger. The cost of being flattened by the tiger is high. Right now, people are noticing any kind of odd behavior and being nervous about it." Lisa Belkin, *The Odds of That*, N.Y. Times, Aug. 11, 2002, § 6, at 32.

Overconfidence leads investors to put too much weight into the quality of their information and the ability to use their information to yield a good investment result.[57] This leads investors to trade in a higher frequency and volume, underreact to new information in the market, and creates an increased probability of making bad investment choices–i.e. buying the wrong stock. Akin to overconfidence is confirmation bias. Everyone wants to be right and it is natural to seek or overemphasize information that confirms an existing conclusion. When processing information, people rate confirming information as more convincing and distort new information to fit their preferred alternative.[58] For instance, an investor who buys a mutual fund concentrated in the technology sector is likely to overemphasize information indicating the sector is doing well and discount information to the contrary.

Investors also seek to imitate each other, creating a herding effect. This herd mentality denotes the social aspect of being a participant in the market.[59] Chasing market trends and making investment decisions based on advice from friends and family (or any other social influence) are examples of herding. Research has found that individuals are willing to conform their attitudes and beliefs to those around them, even to their own detriment.[60] Status quo, a bias that contributes to herding, has a substantial effect on an individual's decision-making.[61] In one experiment, influence of the status quo caused retirement

57. Dimitrios Kourtidis, Zeljko Sevic, Prodromos Chatzoglou, *Investors' Trading Activity: A Behavioral Perspective and Empirical Results*, 40 J. Econ. Sociol. 548, 549 (2011). *See also* Steven Pressman, *On Financial Frauds and Their Causes: Investor Overconfidence*, 57 Am. J. Econ. Sociol. 405-21 (discussing how investor biases–particularly overconfidence–lead to financial fraud).

58. Lyn M Van Swol, *Perceived Importance of Information: The Effects of Mentioning Information, Share Information Bias, Ownership Bias, Reiteration, and Confirmation Bias*, 10 J. Group Processes & Intergroup Relations 241, 244 (2007).

59. *See* Kourtidis, *supra* note 57, at 549; Bainbridge*, supra* note 20, at 1037-41. *See also* Jennifer Arlen & Stephan Tontrup, *Strategic Bias Shifting: Herding as a Behaviorally Rational Response to Regret Aversion*, 7 J. Legal Analysis 517 (2015) (explaining how decision-making allows people to mute anticipated regret, creating a debiasing effect. This study finds individuals can employ herding as a behaviorally rational response to improve expected outcomes and reduce regret).

60. Vandenbergh et al., *supra* note 42, at 733.

61. *See generally* William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. Risk & Uncertainty 7 (1988); *see also*, Daniel Kahneman et al., *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 J. Econ. Persp. 193, 197-99 (1991).

plan holders to maintain their original plan although transferring to a different plan (a plan often chosen by new members) would provide better performance with less risk.[62] In another experiment, when asked a simple judgement question, roughly one-third of participants conformed their responses to match the others in the room, even when others gave obviously incorrect answers.[63]

Additionally, incomplete or inaccurate information can mislead individuals to act in opposition to their own self-interest.[64] For example, according to the Environmental Protection Agency (EPA) it is cost effective for an individual not to idle her vehicle for more than thirty seconds. However, the average individual is under the belief that it is cost effective to idle her vehicle for four minutes. This inaccurate information means individuals are losing out on gas savings and causing unnecessary wear to their vehicles.[65]

The presentation of information can guide the choice of a decision-maker. The framing effect is a bias where the way the positive and negatives of a choice are presented affect the attractiveness of that option.[66] Therefore, utilizing the knowledge of loss aversion, an investment marketed as an opportunity to avoid losses is more likely to induce investment than the typically used framing of an opportunity for gain.[67] The way a broker presents an option influences the decision their client makes, whether they realize or not. Consider, for example, the plight of a cancer patient choosing among three treatment options: surgery, radiation, and watchful waiting.[68] Her ultimate choice ends up correlating with the specialty of the doctor she sees. Since watchful waiting is not a specialization, it is unlikely to be picked. Framing can cause investors to misjudge the information presented to them. Suppose an investor is presented with two scenarios. In the first, she will gain $1,000 over the course of the year but lose $200 of profit due to year end market

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62. Samuelson, *supra* note 61, at 26-31.

63. Vandenbergh et al., *supra* note 42, at 733. *See* the Asch Effect. McLeod, S. A. Solomon Asch - Conformity Experiment (Dec. 28, 2018), https://www.simplypsychology.org/asch-conformity.html.

64. Vandenbergh et al., *supra* note 42, at 743.

65. *Id*.

66. *See generally* Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions*, 59 J. Bus. S251 (1986).

67. Vandenbergh et al., *supra* note 42, at 749.

68. *See* Richard H. Thaler et al., *Choice Architecture*, *in* The Behavioral Foundations of Public Policy, 428, 434 (Eldar Shafir ed., 2012) (citing to Zeliadt et. al., *Why Do Men Choose One Treatment over Another?*, 106 Cancer 1865–74 (2006)).

volatility. In the second, she will gain $1,000 over the course of the year and retain $800 at the end of the year. The outcome of both scenarios is the same, a profit of $800, but the second option is framed to present a gain instead of a loss and therefore will be preferred.

Cognitive biases exist regarding the understanding of disclosures as well. The "halo effect" is one such bias, and it occurs when an initial impression colors overall perception.[69] For example, consumers may choose a product just because they love the brand name. Investors may choose a broker because they like the name of the brokerage firm, and a positive first impression of the broker may influence them to believe what the broker says. Additionally, the halo effect could make investors more susceptible to fraud from financial professionals who come across as credible and trustworthy.[70] Another relevant bias is moral hazard, which occurs when actors are not incentivized to guard against risk because they believe they are protected from consequences–like with insurance.[71] Regarding disclosures, investors could believe that the very existence of a disclosure acts as a protection, and therefore are more willing to increase their risk exposure without necessarily understanding the contents of the disclosure itself.

B. Bias and Risk Tolerance

The financial practitioner must take biases into consideration to effectively counsel their clients. Understanding how these biases interplay with the wants

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69. *See generally* Richard E. Nisbett & Timothy DeCamp Wilson, *The Halo Effect: Evidence for Unconscious Alteration of Judgments*, 35 J. Pers. Soc. Psychol. 250-56 (1977). *See* David Hirshleifer, *Investor Psychology and Asset Pricing*, 56 J. Finance 1533, 1542 (2001) (noting in an efficient market, the attractive growth aspects of a stock are not an indication of the stock's future risk adjusted returns. If investors extend their positive impression of a stock's earning prospects to its return prospects, growth stocks will be overpriced).

70. Pressman, *supra* note 57, at 416-17 (many Ponzi schemes have been headed by charming and seemingly trustworthy personalities).

71. David Rowell & Luke Connelly, *History of the Term "Moral Hazard"*, 79 J. Risk. Insur. 1051-75 (2012). There is some psychological evidence that suggests disclosures may not only fail to solve problems created by conflicts of interest but could even increase the bias in advice. The party issuing the disclosure feels morally licensed by the very act, thus encouraging opportunistic behavior. *See* Daylian Cain et. al., *The Dirt on Coming Clean: Perverse Effects on Disclosing Conflicts of Interest*, 34 J. Legal Stud. 1 (2005).

and needs of a client will more appropriately determine the investor profile. "One of the most important concepts advisers should keep in mind is that the least risk-tolerant investors and the most risk-tolerant investors are driven by *emotional* biases, whereas the two types in between these two extremes are mainly effected by *cognitive* biases."[72] Low risk investors are made uneasy by times of stress and change, and losing money makes them emotional. Highly aggressive investors are often individuals who have been successful in their control of their own business incomes and are overconfident they can do the same thing in investing. Moderate investors are willing to take on medium risk and tend to follow the lead of others, falling susceptible to cognitive biases like hindsight bias. Growth investors have a medium to high risk tolerance and their behavioral bias orientation is cognitive. These investors often make decisions by trusting their gut, making them more predisposed to confirmation bias to validate their beliefs.

When considering a client's risk tolerance, an advisor must grapple with the tension between an investor's willingness to take on risk versus ability to take on risk. In making such considerations there are a lot of unknowns–a realm of risk often associated with irrational investor behavior. Known risks are those that can be reasonably modeled and understood. They can be thought of as normal risks and exists one or two standard deviations away from the normal.[73] Unknown risks are more difficult to measure and conceptually exist three or more standard deviations away from the norm.[74] For example, the 2008 financial crisis can be thought of as an unknown risk. Advisors must elicit an understanding of their client's likely reaction to both known and unknown risk to create a comprehensive risk profile. Understanding which investors are prone to certain biases and diagnosing those issues will allow an advisor to deliver results closer to a client's expectations.

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72. Michael M. Pompian, *Risk Profiling through a Behavioral Finance Lens*, 2 The CFA Institute Research Foundation Briefs 1, 7 (2016).

73. *Id* at 5-6.

74. *Id* at 6.

IV. CRITIQUING THE SEC'S ECONOMIC ANALYSIS OF THE RELATIONSHIP BETWEEN BROKER-DEALERS AND RETAIL INVESTORS

A. Shortcomings of Utilizing an EMH Based Economic Analysis

As noted by several previous examples, investors do not make investment decisions in a vacuum. They are influenced by their own emotional and cognitive biases, as well as the biases of those around them. These biases impact both retail and professional investors. Importantly, these biases impact the relationship financial professionals have with their retail clients. Understanding the identity of investors and how that identity is affected by the presence of a broker is of the utmost importance to creating sound regulation that benefits Main Street investors.

There appears to be a gap between the SEC's understanding of a rational investor and the behavioral understanding. This contention begs the question, who really is the rational investor? The legal system has a preoccupation with the employment of reason, and that notion is most popularly denoted in the reasonable person standard. That standard appears to have been somewhat adopted in the creation of the character known as the "reasonable investor". The reasonable person is a hypothetical, one that plays out in the context of tort and criminal law where social norms and common-sense guide human action. But building out this character in the context of securities regulation produces a comedic outcome. This character has become an individual who makes decisions solely based on calculable logic. She does not fall prey to the snake whispers of brokers; she can understand the convoluted legal language of disclosures with ease; she never pays for a security more than the efficient market price; and she can parse out all emotion and bias from her mind.

A regulatory scheme has been created that balances precariously on an ideal that is not in accordance with reality. The SEC and courts may say investors are reasonable, but empirical evidence suggests otherwise. Studies indicate many retail investors in fact lack both an understanding of their behavioral biases and financial literacy.[75] It does not seem fair for those investors to bear the obligation of conducting due diligence, especially when they do not understand what risks to be aware of. Disclosure documents are lengthy and densely written, it does not make sense for investors to spend their

75. U.S. SEC & Exch. Comm'n, Study Regarding Financial Literacy Among Investors, at vii-viii (2012), *available at* https://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf.

time pouring through them to receive information when they have already employed a broker.[76]

The Final Rule acknowledges trust as an important factor in an investor's consideration to accept a broker's recommendation. Trust is of such significance that an investor "might be inclined to simply accept all of the associated person's recommendations without evaluating for themselves whether the recommendations are efficient."[77] A disclosure will not negate the investor's perception of this relationship. All the measures imposed by Reg BI, when understood by the investor, are meant to increase an investor's confidence in the safety of utilizing a broker. But in reality, Reg BI merely informs investors of pitfalls only discernible after much due diligence.

The proponents of Reg BI argue adamantly about the preservation of choice–the choice to decide between hiring a broker-dealer or investment advisor.[78] This argument is behind Reg BI's maintenance of a regulatory distinction between the roles. But do investors understand the difference between these roles? The choice argument is premised upon utility theory and its suggestion that an individual can rank her preferences.[79] However, someone cannot rank her options when she does not know what those options are. A choice is irrelevant if it is not informed. The data shows that retail investors are confused about the different standards of a broker and investment

76. Black, *supra* note 15, at 1494.

77. Final Rule*, supra* note 7, at 33402.

78. Jay Clayton, Chairman, Securities and Exchange Commission, Regulation Best Interest and the Investment Adviser Fiduciary Duty: Two Strong Standards that Protect and Provide Choice for Main Street Investors (July 8, 2019) (transcript available at https://www.sec.gov/news/speech/clayton-regulation-best-interest-investment-adviser-fiduciary-duty).

79. This author finds the choice argument to be a strong indicator of deceptive self-interest. Similar arguments were made about tobacco use (despite being addictive) and public consumption, seat belts, drinking and driving, climate change, and so forth.

advisor.[80] This is unsurprising, given the blurred lines between the two roles.[81] Brokerage firms have already been marketing themselves as advisers, and they will utilize the best interest language with customers to further an impression of safety (the impression of a fiduciary).[82] "Retail investors should not have to parse through legal distinctions to determine" the type of advice thy are entitled to receive.[83] Reg BI's enhanced measures will serve to exacerbate

80. Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 mandated the SEC conduct a study evaluating regulation of broker-dealers and investment advisers. In the study, the Staff recommended a uniform fiduciary standard for investment advisors and broker-dealers when providing investment advice to retail investors. *See* Staff of the U.S. Securities and Exchange Commission, Study on Investment Advisers and Broker-Dealers As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Jan. 2011) ("Section 913 Study") at 8-12, *available at* www.sec.gov/news/studies/2011/913studyfinal.pdf.

81. Angela A. Hung et al., *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*, RAND Institute for Civil Justice (2008) (Research study commissioned by the SEC found blurred distinctions between broker-dealer and investment advisors, which is not surprising given broker-dealers have been styling themselves as financial advisers); Complaint at 7-9, State of New York v. SEC, No. 1:19-cv-8365-VM (S.D.N.Y. Sept. 9, 2019) (mentioning how over time brokers have increasingly been functioning as financial advisers without being regulated accordingly. Dual registration also increases the potential of investors to be confused by the roles of each financial professional).

82. *See* Executive Vice President & General Counsel, Financial Services Institute ("FSI") (Aug. 7, 2018); Letter from Jon Stein, Founder and CEO, Benjamin T. Alden, General Counsel, and Seth Rosenbloom, Associate General Counsel, Betterment (Aug. 7, 2018); Letter from Christopher Gilkerson, Senior Vice President and General Counsel, and Tara Tune, Director and Corporate Counsel, Charles Schwab & Co., Inc. (Aug. 6, 2018); Letter from Kurt N. Schacht, Managing Director, et al., CFA Institute (Aug. 7, 2018) ("Investor confusion about the roles and duties of different financial services providers who use 'adviser/advisor' in their titles has become problematic from both an investor protection and trust standpoint. Use of the proposed CRS, alone, will not allay the substantial investor confusion in the marketplace about the differences between broker-dealers and investment advisers.").

83. Press Release, Securities Exchange Commission, SEC Releases Staff Study Recommending a Uniform Fiduciary Standard of Conduct for Broker-Dealers and Investment Advisors (Jan. 22, 2011), https://www.sec.gov/news/press/2011/2011-20.htm.

investors confusion about the standard of care owed to them by a broker, especially as the new standard evolves over time.

B. Considering a Uniform Fiduciary Standard

Many believe Reg BI was the wrong move and that brokers should have been held to a fiduciary standard. The SEC addresses this alternative, but the selectivity in their data does not paint the full picture. The Final Rule uses the vacated Department of Labor (DOL) fiduciary rule to draw conclusions on the negative effects a fiduciary standard would have, and conveniently ignores the current data on state fiduciary laws which suggest otherwise.[84] The DOL rule was still being phased in when the Fifth Circuit Court of Appeals effectively killed it.[85] At that point broker-dealers were preparing for compliance with the rule, and some firms adjusted their practices in response. Industry studies found these adjustments included eliminating or reducing access to brokerage services, shifting commission-based accounts to fee-based accounts, and moving clients with low balances to robo-advisors.[86] The pool of data used to make these observations comprises a small set of firms, and a short time frame; however, the SEC focuses on the study of this limited data.

The SEC need not resort to conjecture, as there is pertinent evidence at their disposal which was conveniently ignored.[87] Several states have implemented fiduciary standards for brokers and a study of that data found that those brokers provide a better a set of menu options to clients that ultimately saved them money.[88] This showcases the effects of choice architecture.[89] An environment can be created which nudges people to make better decisions. Choice architects can employ behavioral tools such as framing to structure

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84. The DOL created a fiduciary standard for retirement advisors. The rule was subsequently vacated in toto by the United States Court of Appeals for the Fifth Circuit. *Chamber of Commerce v. U.S. Dep't of Labor*, 885 F.3d 360 (5th Cir. 2018).

85. *Id*.

86. Final Rule, *supra* note 7, at 33421-22.

87. *See* Vivek Bhattacharya et al., Fiduciary Duty and the Market for Financial Advice (Nat'l Bureau of Econ. Research, Working Paper No. 25861).

88. *Id*.

89. *See* Richard H. Thaler et al., *Choice Architecture*, *in* The Behavioral Foundations of Public Policy, 428 (Eldar Shafir ed., 2012).

complex choices, pushing individuals to make decisions that are best for their welfare.

The Final Rule made the argument several times that imposing a fiduciary duty would not be optimal for retail customers with a buy-and-hold strategy. The SEC argues that a fiduciary standard would cause the compliance costs associated with commissioned advice to rise and ultimately not be worth the brokerage's bottom line, thereby shifting customers to fee-based brokerage accounts. As a result, clients would be overpaying for advice typically associated with a buy-and-hold investment strategy. Many clients would also be pushed into robo-advisory accounts. But perhaps online brokerage accounts without fees are the best option for this type of client, and today there are many to choose from.

What self-directed accounts lack is personalized advice, and even buy-and-hold investors may want that advice a few times a year. But markets are responsive to demand, and if more clients of discounted brokers have this desire, the choices should adapt to supply that desire. One possibility is for advisors to charge an hourly rate for personalized investment advice or charge a fee for a one-time appointment to discuss strategy. Brokers could also be incentivized to release better research to educate investors.

Interestingly, the theories of EMH and behavioral economics find a practical intersection in the decision of a retail investor to hire a financial professional. EMH assumes markets as a whole are rational; it does not prescribe rationality to each individual actor. It would logically follow that hiring a financial professional, i.e. smart money, to combat the irrationality of a retail investor would serve to make the markets overall more efficient. Consequently, the EMH argument the SEC puts forth to justify Reg BI can be viewed as lending itself in support of a fiduciary standard.

"Although financial professionals may be hired to help overcome "investment mistakes" made my investors, a number of studies show that financial professionals themselves may be subject to the same behavioral biases as unadvised retail investors, such as return chasing and overconfidence."[90] The SEC makes this acknowledgement in their economic analysis while evaluating the limitations of receiving professional financial advice. However, they do not evaluate whether these biases would limit the effect of a broker fiduciary standard. Evidence suggests advisers invest in their own portfolios in a manner consistent with the advice they give to their

90. Final Rule, *supra* note 7, at 33427.

clients.[91] Many customers would believe an adviser practicing what she preaches is a positive. The concern from a behavioral standpoint comes from the possible exacerbation of biases rather than the correction of them. An advisor that overly trades and favors expensive actively managed funds will causally affect her clients to behave similarly. Thus, even fiduciaries can be misguided in their attempt to do good by their clients. One could argue this is enough to render a fiduciary standard moot. But if a financial professional cannot be trusted to make sound financial decisions, then where is the retail investor to turn? Such a proposal certainly flies in the face of "smart money."

Notwithstanding these behavioral concerns, financial professionals still hold a sizable advantage over retail investors in the form of information. There are two ways informational asymmetry benefits the financial professional in her relationship with a retail investor. First, the professional receives information regarding the markets that may not be available to the retail investor. Second, the professional could take advantage of the asymmetrical nature of the relationship itself to the detriment of her client. A well-designed system of choice architecture can help an investor improve their decision-making ability, but it is easy to see how such knowledge can be used by a broker with negative intent.

C. Why and How Irrationality Should be Addressed Through Regulation

Regulators might stick their heads in the sand regarding investor behavior, but players in the industry are employing complex analytics to leverage irrationality to their advantage.[92] There are funds that boast their core investment strategy as being focused on finding arbitrage opportunities based on investor's irrational behavior. One financial advisory fund explains its approach as such: "Well documented, recurring behavioral errors drive irrational actions in financial markets–behaviors that are often contrary to investors' best interests. Structural challenges also limit market efficiency. Together, these factors create mispricing on a global scale. This is where we

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91. *See* Juhani T. Linnainmaa, et al., *The Misguided Beliefs of Financial Advisors*, Kelley Sch. of Bus., Research Paper No. 18-9 (May 2018), available at https://ssrn.com/abstract=3101426.

92. *See* Nick Hoffman, et al., *An Analytics Approach to Debiasing Asset-Management Decisions*, McKinsey & Company (Dec. 2017), https://www.mckinsey.com/industries/financial-services/our-insights/an-analytics-approach-to-debiasing-assetmanagement-decisions.

find our advantage."[93] Reg BI's economic analysis acknowledges investor bias, but that admission is as far as the SEC goes.[94] If investor irrationality is being preyed upon, that warrants at least a discussion.

Those concerned with the implementation of behavioral economics in rulemaking argue the field of study is inherently paternalistic.[95] Whereas, "federal securities regulation in the United States has always taken a distinctly non-paternalistic approach to the securities markets. The federal securities laws utilize disclosure, rather than heavy-handed substantive rules, to regulate securities transactions."[96] Because the range of behavioral findings are somewhat broad, skeptics worry the SEC could find some kind of empirical evidence to justify any rule it desires to enact. However, thus far the SEC has not effectively utilized the plethora of empirical evidence behavioral economics offers–as seen in the economic analysis of Reg BI. If behavioral findings are such an effective bargaining chip for the SEC, it likely would have employed such findings by now. As previously discussed, the securities regulatory structure has been propped up on neoclassical economics. There is a fear that adopting behavioralists' findings will cause that structure to

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93. Acadian Asset Management, https://www.acadian-asset.com/about-acadian/our-approach (last visited May 1, 2020).

94. Final Rule, *supra* note 7 at 33425; *id.* at n.1047.

95. *See* Cass R. Sunstein, *The Storrs Lectures: Behavioral Economics and Paternalism*, 122 Yale L.J. 1826 (2013); ("Rejecting the laissez-faire normative outlook that underlies much law and economics scholarship, the behavioral economics school generally subscribes to an 'anti-antipaternalism.'") (citing Cass R. Sunstein, *Behavioral Analysis of Law*, 64 U. Chi. L. Rev. 1175, 1178 (1997) (Explaining the understanding of human behavior does not necessarily lead to a paternalistic view, but rather what he calls an anti-antipaternalism. There is validity to behavioral finding and such "objections to paternalism should be empirical and pragmatic, having to do with the possibility of education and likely failures of government response, rather than a priori in nature.")). Behavioral economist Richard Thaler and legal scholar Cass Sunstein coined the phrase "libertarian paternalism"–a philosophy that choice architecture can be used to nudge people to make better decisions (as judged by themselves) without forcing certain outcomes on anyone. *See* Cass Sunstein & Richard Thaler, *Libertarian Paternalism*, 93 Am. Econ. Rev. 175 (2003).

96. Susanna Kim Ripken, *Paternalism and Securities Regulation*, 21 Stan. J.L. Bus. & Fin. 1, 2 (2015).

crumble, particularly by creating damage to materiality and fraud on the market claims where the ideology of the reasonable investor is significant.[97]

The lack of adaptability could also be a result of the biases particular to regulators. The SEC staff is knowledgeable about markets. This knowledge could make them too far removed from understanding the mindset of a Main Street investor with little to no financial literacy. Group think bias also inhibits the SEC's creativity in developing new rules to protect investors. Comment letters are important in aiding to bridge this gap, but generally letters are not focused on economic implications. To give retail investors a voice in creating the rules that affect them, the SEC must work to listen. Research into who investors are and what they know is crucial. The value of EMH in designing securities regulation has been overemphasized. The focus of EMH's model is the determination of price, not the understanding of economic actors. As discussed earlier, EMH does not contest that there are irrational investors. It only proposes the effect of those anomalies on the market are limited by the arbitrage of well-funded, sophisticated investors. EMH proponents follow that logic to conclude markets are efficient. However, that conclusion still does not result in retail investors behaving efficiently. In an "efficient" market the irrational retail investor still requires the protection of the SEC, and behavioral economics provides insight into who those people are.

V. CREATING REALISTIC POLICY

The truth is hidden from retail investors, and a fiduciary duty is crucial to shedding a guiding light. A broker acting as a fiduciary would have no choice but to notify her clients that active management is a fallacy. Backed by a myriad of evidence, this is a reality brokers know all too well.[98] Generally, passive investing in an index fund is the way to go for the unsophisticated retail investor. This is information brokers would rather not tell their clients because to do so would showcase their lack of efficacy. "Wall Street wants everyone

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97. Black, *supra* note 15, at 1493-94 ("The elements of a private federal securities fraud claim under Rule 10b-5 include a misstatement of a material fact and the investor's reliance on that misstatement. Because materiality is defined as information that a reasonable investor would consider important in making investment decisions, the reasonable investor standard serves to distinguish between material and immaterial statements and hence to determine defendants' disclosure obligations.").

98. The Series 7 exam, a requirement to becoming a broker, tests applicants on Modern Portfolio Theory.

to believe everything they do is so complicated."[99] Additionally, the ill-informed investor being made privy to this knowledge would likely shallow the pockets of brokers. "The fiduciary tag tends to reduce the urge for advisors or brokers to trade or churn accounts, and sell expensive annuities or high commissioned alternative investments."[100] With the use of a more suitable passive index-style management strategy, revenues are capped at a management fee. The broker loses the commissions, fees, and trails they would otherwise enjoy from selling alternative investments or variable annuities. For example, a mutual fund may pay a broker a trailer fee in the range of .25% to 1% per year, while products like non-traded Real Estate Investment Trusts (REITs) boast a 15% commission rate. [101]

Brokers are a colorful cast of characters. They often market themselves under the title of 'financial advisor' and flaunt their advanced knowledge of the markets. But, without a fiduciary standard there is no guarantee such knowledge will be imparted for the *benefit* of the investor. Countless brokers are con artists. Sam, for example, met with clients at their homes to give investment advice. [102] Sam would sit with 75-year-old Peyton at Peyton's own kitchen table and misrepresent the products he was recommending. Sam induced Peyton to invest in products diametrically opposed to his stated and written investment profile. Products whose prospectuses clearly indicated they were not suitable for an investor like Peyton. Products that, conveniently, offered high commissions. As a result of Sam's negligent recommendations, Peyton lost most of his investment and the hope of helping his granddaughter pay off her student loans.

Sam hops from one employer to another, some with recognizable Wall Street names, even though he continues to rack up customer complaints. He continues to tout himself as an expert in complex alternative products on social media to further the charade. In a court of a law a judge once referred to Sam as cagy, consistently obstructive, and willing to lie–yet he continues to manage client's money. Given his poor character it can easily be argued that even with

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99. Sara Hanley, Joe Wojciechowski, & Bradley Stark, *Investors Cornered: Regulation Best Interest – It's Not a Fiduciary Duty, but the Industry Hopes Investors Think It Is*, 27 PIABA B.J. 237, 240-241 (2020).

100. *Id* at 238.

101. *Investor Bulletin: Non-Traded REITs*, U.S. Securities Exchange Commission Investor Alerts and Bulletin (Aug. 31,2015), https://www.sec.gov/oiea/investor-alerts-bulletins/ib_nontradedreits.html#:~:text=Non%2Dtraded%20REITs%20are%20illiquid,its%20assets%20to%20achieve%20liquidity.

102. The behavior of the broker Sam is based on an actual case.

a fiduciary standard in place such a broker would breach that duty. While that may be true, at least the client has a stronger claim for restitution.

Sam knows that conning the little guy is the way to go. Generally, if an investor loses less than $100,000, private attorneys are not interested in representing them. "[I]t is not economically feasible for those customers with low-dollar value claims to retain counsel because legal fees would dwarf any possible recovery. Similarly, investors with larger claims but with few remaining disposable assets (precisely because of the monetary losses stemming from the alleged misconduct) may be unable to afford to retain private counsel or pay for upfront costs such as filing fees, forum fees, and expert witness fees."[103] So financial advisors like Sam continue to take on elderly clients who live off social security. Clients who, after a lifetime of saving, still have a low net worth.[104] These clients can seldom afford an attorney, and even with an attorney by their side around 55% of investors who go to FINRA arbitration still walk away with nothing.[105] These are all realities

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103. Jill Gross, *The Improbable Birth and Conceivable Death of the Securities Arbitration Clinic*, 15 Cardozo J. Conflict Resol. 597, 599-600 (2014).

104. Looking at the clientele of securities arbitration clinics provides further color on who some of these vulnerable investors are. "Law school and investor advocacy clinics fill a crucial gap for retail investors by providing high quality legal advice and representation to investors with small claims, that otherwise, would have no access to representation……Generally, law school investor advocacy clinics provide legal representation to investors with claims up to $100,000. Clinic clients are working-class Americans, such as or including hairdressers, homemakers, mechanics, skilled tradesmen, paralegals, and schoolteachers. Often, clinic clients are between 60 and 90 years old, retired or on the verge of retiring, living on social security and have little or no prior investment experience. However, clinic clients also include young investors receiving disability benefits, young people whose parents have passed and left them a small sum of money, immigrants with limited English language skills, and disabled persons with, or living off of, disabled persons' trusts. Clients hail from diverse racial, ethnic, religious and cultural backgrounds. Most clients have few assets beyond a small IRA, personal account, or those assets that were invested in the questionable investments." U.S. Securities Exchange Commission, Recommendation of the Investor Advisory Committee Subcommittee of the Whole: Financial Support for Law School Clinics that Support Investors, 4-5 (March 2018).

105. *See* https://www.finra.org/arbitration-mediation/dispute-resolution-statistics/2019#howcasesclose.

FINRA is aware of, and the regulator has publicly supported a broad fiduciary standard for years.[106]

Broker malfeasance does not only plague sympathetic victims like the elderly; doctors, professors, and scientists can also be misled. Even these highly educated individuals are retail investors and, just like 75-year old Peyton, they require protection when provided with personalized investment advice. Financial literacy is not synonymous with education level. After all, a primer on the financial markets is not a requirement to earn a PhD in Neuroscience. In fact, these individuals are often biased in their measurement of their own financial savvy because of how highly educated they are.

It can be difficult to comprehend that the financial markets, so shrouded in mystery, could hold any sort of transparency for an investor. But the very integrity of the system depends on it. Conning senior citizens out of their retirement savings and children out of college funds is not the way to operate. Far from theoretical conjecture, the implementation of a fiduciary standard creates a realized positive impact. It is disappointing that such a resolution has been subjected to political squabble, when looking out for the American people is a bipartisan endeavor.[107]

VI. CONCLUSION

In the final rule of Reg BI, the SEC does argue persuasively what has been widely evident: retail investors need better protection. The debate that ensued

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106. "FINRA has publicly advocated for a fiduciary duty for years and agrees with the Department that all financial intermediaries, including broker-dealers, should be subject to a fiduciary "best interest" standard." Marcia E. Asquith, FINRA Senior Vice President and Corporate Secretary, Comment Letter, Re: Proposed Conflict of Interest rule and Related Proposals, July 17, 2015, at 2. Yet despite their clear position, three years later when Reg BI was proposed they chose to stay quiet and simply follow the SEC's lead. *See* FINRA letter to Senators Warren, Brown and Booker, https://images.thinkadvisor.com/contrib/content/uploads/documents/415/304534 /FINRA-Response-Ltr-08.03.18.docx.pdf.

107. For years there was loud support for the implementation of a uniform fiduciary standard. Mary Jo White in her capacity as former SEC Chair made known her plans to push such a standard, public statements made by FINRA showcased their support (*supra* footnote 106), and a study implemented by the SEC staff determined such a standard would best serve investors (*supra* footnote 80). Then entered the Trump Administration and the roll back of investor protections. Trump issued orders to delay implementing the fiduciary rule already passed under Obama and soon

focuses on the extent and form of that protection. The private sector has already been attempting to utilize behavioral data to their advantage, and other administrative agencies have considered behavioral elements when writing regulation to protect their own constituents. No longer folklore, behavioral economics has been proven credible. Several noble laureates were awarded for their contributions to the field and influential leaders in economics, such as former Federal Reserve Chair Janet Yellen, have affirmed its importance.[108]

Ultimately, this Article concludes that the use of choice theory as the principal defense for Reg BI is weak, and disclosures are not enough to protect investors from broker misconduct. Unfortunately, the Second Circuit was not properly presented with these economic realities. However even if they had, their predicament was apparent–uphold a faulty rule or uphold the status quo. As Reg BI stands, investor confusion will only be exacerbated and innovation for the broker-dealer business model has been chilled. The SEC should pay attention to these effects and propose amending the rule in favor of a uniform fiduciary standard that will appropriately protect investors.

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thereafter the SEC proposed Regulation Best Interest – a rule serving the best interest of Wall Street elites over retail investors.

108. Daniel Kahneman, Richard Thaler, and Robert Schiller each won Noble Prizes in Economics for their contributions to behavioral economics. "[Janet Yellen] has devoted much of her career to showing why markets fail so often and therefore government intervention is needed, says Nobel Prize-winning economist Joseph Stiglitz, her former teacher at Yale and a longtime friend. Far more than previous Fed chiefs, Yellen also embraces the young field of behavioral economics, which posits that people often don't act rationally the way economic models say they should. Yellen knows that the Fed's traditional powers are limited now because the economy may be caught in a "liquidity trap," with interest rates already so low that additional injections of cash by the central bank will do little or nothing to stimulate the economy. But she is constantly on the hunt for novel interventionist solutions; "out of the box" is one of her favorite phrases. "She knows that labor markets don't work perfectly; capital markets don't work perfectly," Stiglitz says. He adds that Yellen understands that monetary policy is itself the best proof of this thesis—because it wouldn't be needed at all if markets always worked correctly." Michael Hersch, *How Janet Yellen Can Save the Economy*, The Atlantic, Dec. 16, 2013, *available at* https://www.theatlantic.com/business/archive/2013/12/how-janet-yellen-can-save-the-economy/282401/.

Notes & Observations

MINORITIES AND WOMEN IN THE SECURITIES INDUSTRY: THE DISPROPORTIONATE IMPACT OF SECURITIES FRAUD EXPLOITATION

Jenice L. Malecki[1]

People of color and women have been greatly impacted in the securities arena whether it is as victims of fraud or through their underrepresentation in the field as a career prospect. During an age of Black Lives Matter Protests and women speaking out against gender discrimination, the securities sector has a great task on its hands in creating prevention programs for fraud in these communities as well as revitalizing inclusive practices in the employment process. It is important to address the privilege of securities industry employees or investors who may be immune to or ignorant of the issues that plague the world in which they exist. Creating a community that encourages employment of women and minorities in official board roles as well ensuring an informative environment through which vulnerable populations can protect themselves from fraud is critical.

The securities industry is not known for its diversity. It is not every day we have a "Lauren Simmons" come to the forefront of our attention, challenging the status quo of the predominantly white and male securities industry. Lauren Simmons became the youngest trader at the New York Stock Exchange at just 22 years old. She was the second black female trader of her

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1. This piece has been created with the assistance of Tina Thermadam. Tina completed her Bachelor of Arts degree in Political Science with a minor in Orthodox Christian Studies at Fordham University- Lincoln Center, graduating in 2020. She is currently attending Albany Law School. Over the course of her academic career, Tina interned for Hillary Rodham Clinton, Senator Chuck Schumer as well as local Senator David Carlucci.

Malecki Law is dedicated to protecting the justice and equality of vulnerable individuals that are negatively impacted by fraud. The firm will continue to strive for favorable results for individuals that are disproportionately impacted by schemes and fraudulent financial practices. Ensuring a vocal, progressive, and inclusive workspace is a crucial priority for us as a team. For over two decades, Malecki Law has upheld a fair and equal workplace as well as committed itself to ensuring favorable outcomes for ALL of our clients. We stand by and support inclusive measures, fraud prevention programs or informative workshops that are compatible with the values of our firm for the purpose of protecting both employees and fraud victims of all backgrounds.

time. It wasn't until 1952 that the first African American securities firm was founded with an NASD license. It took almost another decade, until 1960, for the first African American securities firm to be opened by Phil Jenkins and Harry Wright. It took until the early 2000s for Stanley O'Neal to be named the first African American CEO of a major brokerage firm. Even with that major breakthrough, the United States Equal Employment Opportunity Commission ("EEOC") noted in 2006 that African Americans made up only 7% of the banking subsector as well as only 4.4% of the securities subsector. It's quite evident that the journey towards inclusivity within the securities sector has been slow and challenging for various populations.

Similarly, while in 2018 women of all races constituted nearly half (46.9%) of the finance and securities labor force according to the U.S. Bureau of Statistics, they only hold 19.4% of the senior-level positions. Geraldine Weiss was a quintessential example of a woman trying to push past the restrictive hierarchy within the securities industry. In 1962, no investment firm wanted to hire her in a position above secretary, although her qualifications were much greater. Immediately, once companies saw her female name, they relegated her to a lower position that hindered her career growth. Eventually, she went by G. Weiss so her identity remained ambiguous, which allowed her financial strategies to speak for themselves, achieving above-average returns. That is just the tip of the iceberg. Muriel Siebert, Abigail Johnson, Abby Joseph Cohen, Lubna Olayan, and so many more women's stories show what struggles they had to overcome to rise to the forefront of their field merely because of their gender. It is quite fascinating to imagine the strength, power, and potential of the securities industry if it looked primarily at merit and less in regard to race and gender.

An audit regarding the Representation of Minorities and Women in the SEC's Workforce run by the Office of Inspector General (2013-2014), reveals an alarming trend in which women and minorities received fewer cash awards or bonuses and were exposed to lower performance management and recognition scores. The results of that audit suggested that various diversity initiatives within the SEC have not taken the appropriate steps or research to truly understand the barriers that exclude minorities and women that currently operate in the SEC's workplace. The EEOC did not complete a thorough analysis of the inner workings that impose restrictions on equal opportunity for women and minorities at the SEC. The Office of the Inspector General found that women were underrepresented at higher levels at the SEC. In addition, the rate of complaints filed against the SEC in regard to equal opportunity was statistically greater by African American individuals or women. The positive aspect of this audit was a memorandum attached to the bottom indicating all the aspects within the SEC that require change as well as

the management response. The management was committed to data and tables of the following year as required by the Management Directive and compliance with Section 342 of the Dodd-Frank Act in order to correct hurdles to equal opportunities.

In regard to the Hispanic community, they are also significantly underrepresented in leadership roles within the securities and financial services industry. According to the 2003-2004 Corporate Governance Study, Hispanic persons only served on boards within 166 of Fortune 1000 Companies. Furthermore, according to the study, 15% of the United States Population is Hispanic but only 4.7% of that population work in the securities industry. The EEOC in 2006 explained that Hispanic officials constitute at most 5.1% of the central banking subsector while only making up 2.9% of the securities subsector. The chair of the board of directors of the New American Alliance, Ana Maria Fernandez Har, provided an array of guidelines that would enhance Hispanic participation which include actively expanding the diversity within corporate boards, launching inclusive teams, broadening hiring protocol and having current leaders emphasize the value of corporate diversity.

There are some regulations that exist within the securities industry that disproportionately impact people of color, specifically African Americans and Hispanic members. The Securities Exchange Act of 1934 requires that the SEC suspend privileges, dismiss, revoke registrations, or order severe consequences for individuals that have been sentenced for misdemeanors or felonies. This is determined through fingerprints that are submitted by potential and current employees regularly. This practice can arguably be in violation of Title VII which protects employers from employment practices that unfairly impact a particular population. For example, fingerprinting specifically impacts African Americans and Hispanic persons as they are more likely to have a criminal record due to the nature of our criminal justice enforcement practices. Incarceration negatively impacts African and Hispanic communities about 6.5 and 2.5 times greater respectively than white individuals There are proposals for narrowing the range of the fingerprinting rule to encompass criminal records in regard to the business necessity.

The 2006 EEOC report quite explicitly states that out of the thousands of jobs that exist within the various sectors of the financial services industry, participation of women and minorities lingers at 47.3%, with only 0.1% in top-level roles, namely officers as well as managers. The securities industry consistently has the lowest percentage of inclusion when compared to the other subsectors (banking, insurance, funds, central banking) regardless of the roles or races being discussed. This quite evidently puts into perspective how complex the path may be within the securities industry for a person of color or

for a woman, and it may be even more problematic for those that identify as LGBTQA+.

In addition to the employment perspective, it seems that similarly, from an investor standpoint, people of color are more likely victims of securities fraud than white individuals. According to the Federal Trade Commission, African American and Hispanic populations under-report fraud, despite the statistics revealing that securities fraud is more likely to impact these communities. These populations and demographics are often impacted by fraud targeting their income and debt. Vulnerable populations are often the target of misleading work from home offers, affinity fraud, pyramid schemes, debt relief, mortgage relief, and other schemes that profit off of an individual's financial insecurities. In addition, a lack of sound financial backing could mean that those populations are unable to fund a legal case. In a report to Congress by the Federal Trade Commission from 2016, it indicated that about 10.8% of the United States population had been defrauded, which equates to over 25 million people. The purpose of this report was to design various strategies that would reduce fraud in African American and Hispanic communities and ensure preventative methods. These methods must motivate financial regulatory institutions to closely understand the hurdles that make these vulnerable populations more susceptible to fraud, as well as begin reversing that unfortunate reality.

In conclusion, while I could call for FINRA to recruit more minorities and women qualified for arbitration panels, and for corporate boards to increase the number of minorities and women, this article is for the PIABA Bar Journal. I will make my plea more focused to this group, which is equally important. When I joined PIABA, I looked up to the few women leaders there were in the organization. As I aged in PIABA, I believe that some younger women looked up to me. Each generation of women make it easier for the next generation of women, and that is a burden women in the organization should accept and attempt to foster. The same would be true of minorities in PIABA, but there are not many minority members. With the Puerto Rico Closed End Bond cases, we saw many Puerto Rican members join, but we could do better. Overall, PIABA's minority numbers are small. We could say that it is FINRA's problem or corporate board problems, but it is also our problem. We need to recruit more minority and women members. We all need to foster them, men and women of the organization alike. We need to seek them out in our practices and have them grow to important partnership and leadership roles. Unless we do that, we are just another part of the overall societal problems plaguing our nation today, so the problem is one for everyone in our industry – including ourselves.

RECENT ARBITRATION AWARDS

Melanie Cherdack, Esq. and Sara Hanley, Esq.

With this issue's featured arbitration awards we have entered a new era. All of the highlighted arbitrations have one thing in common—the hearings were all held virtually, mostly via videoconference. In these "virtual" awards, FINRA panels have awarded compensatory damages, pre- and post- award interest, punitive damages, attorneys' fees and expungements. Two of the awards contain findings of a duty owed to a customer (although one is in a dissent). These awards once again demonstrate that these forms of relief can be won with proper case presentation and a receptive panel. This issue's survey features a case in which a FINRA panel concluded that seven out of seven occurrences on a Broker's CRD could be expunged even though these were separate unrelated claims on disparate factual and legal issues, proving once again that a Customer's non-participation or failure to object in an expungement hearing tilts the scales in favor of the broker being granted an expungement. The notable awards summarized below also include an award in which a broker was found liable to both the Claimants and his brokerage firm and a case which discusses the exclusion of an expert witness, as well as testimony permitted by an expert witness who was not timely disclosed in accordance with FINRA Rules.

Joshua Travis Anue Trust, Tenaya Laurel Anue Trust (Claimants) vs. E*Trade Securities, LLC (Respondents)

Case No. 19-01505
San Francisco, California
Hearing Dates: July 28, 2020 – July 30, 2020 (via videoconference)
Award Date: August 17, 2020
Counsel:

Counsel for Claimants: Samuel B. Edwards, Esq. and David W. Miller, Esq., Shepherd, Smith, Edwards & Kantas, LLP Houston, Texas.
Counsel for Respondent: John E. Bersin, Esq. and Meredith F. Hoffman, Esq., New York, New York.

Arbitration Panel:

Peter H. Daly, Presiding Chairperson
Philip Aaron Tymon, Public Arbitrator
Robert James Wilkie, Public Arbitrator

Investments at Issue:

The causes of action relate to the escheatment of each Claimant's shares of Cadence Design Systems, Inc., which were in their accounts with Respondent, and subsequent losses incurred by Claimants as the result of negligence by Respondent.

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Breach of contract and warranties;
(2) Promissory estoppel;
(3) Conversion;
(4) State fraud statutes;
(5) Violation of the California Consumer Legal Remedies Act; and
(6) Claims under common law.

Relief Requested:

(1) All sums lost in the accounts;
(2) All lost opportunities as a result of acts and/or omissions;
(3) Rescission of any or all transactions as sought;
(4) Statutory damages as provided by applicable law;
(5) Punitive damages in an amount that the Panel shall deem appropriate;
(6) Pre-award and pre-judgment interest on all sums invested from the date deposited until the date of the award and/or judgment and until such sums are paid, all at the highest rate allowed by the law;
(7) All costs of these proceedings and for recovery of damages incurred, including legal fees, including while on appeal, if any, and for collections;
(8) Any and all relief available to Claimants, in law or equity or otherwise, which may be granted by the Panel.

Relief Requested Post Hearing:

At the close of the hearing, Claimants presented several different time related scenarios for damages as follows:

(1) Compensatory (liquidation) damages:
  a. Through September 2018 in the amount of $139,318.30;
  b. Through May 30, 2019 in the amount of $236,066.30;
  c. Through July 9, 2020 in the amount of $425,539.62;
(2) Interest in the amount of 9% per annum;
(3) Attorneys' fees as 33% of the compensatory damages awarded; and
(4) Litigation expenses in the amount of $3,335.97.

Award:

(1) Respondent is liable for and shall pay to Claimants the sum of $139,318.30 in compensatory damages.

(2) Respondent is liable for and shall pay to Claimants interest on the above-stated sum at the rate of 9% per annum from September 2018 until the award is paid in full.
(3) Respondent is liable for and shall pay to Claimants the sum of $3,415.97 in costs.
(4) Respondent is liable for and shall pay to Claimants the sum of $300.00 as reimbursement of non-refundable filing fee.
(5) Respondent is liable for and shall pay to Claimants the sum of $45,975.04 in attorneys' fees pursuant to *Synegy Gas Co. v. Sasso*, 853 F.2d 59 (2d Cir.), cert. denied, 488 U.S. 994 (1988); and *Royal Alliance Assocs. V. Piniewski,* 2016 U.S Dist. LEXIS 196443, *12, 2016 WL l1581005.
(6) Any and all claims for relief not specifically addressed herein, including any requests for rescission and punitive damages, are denied.

Analysis:

This award is noteworthy because in May 2020 Claimants filed a request for an order compelling a virtual arbitration hearing. Respondents filed an opposition to the request for a virtual hearing and Claimants filed a Reply. The Panel held a pre-hearing conference to hear oral arguments on the request for a virtual hearing. The Panel granted Claimants' request for a virtual hearing. Claimants were successful in obtaining substantial relief, including interest, costs, and attorneys' fees. Claimants' counsel was one of the pioneers helping to pave the way to evidentiary hearings via videoconferencing with this case.

Maria Kate Dunn Redwine (Claimant) v. Morgan Stanley & Co. LLC (Respondents)

Case No. 19-02913
Columbia, South Carolina (via videoconference)
Hearing Dates: November 23, 2020- November 25, 2020; November 27, 2020
Award Date: December 11, 2020
Counsel:

Counsel for Claimants: Carl D. Liggio, Sr., Esq. and William B. Fleming Esq., Gage Spencer & Fleming, New York, New York.
Counsel for Respondents: Adam M. Kauff, Esq. and Jonathan Perrelle, Esq., Kauff Laton Miller LLP, New York, New York.

Arbitration Panel
Langfred W. White, Public Arbitrator, Presiding Chairperson
Karl A. Vogeler, III, Public Arbitrator
John Winslow Griesser, Public Arbitrator

Investments at Issue:
The causes of action relate to the alleged misappropriation of assets in Claimant's trust account with Respondent, including a private placement investment (the "VIP" investment).

Claimants' Claims:
Causes of Action in Statement of Claim:
(1) Failure to Supervise,
(2) Fraud,
(3) Breach of Fiduciary Duty,
(4) Conversion,
(5) Negligence,
(6) Respondeat Superior.

Relief Requested:
(1) Compensatory damages in the amount of $977,509.64 for misappropriation,
(2) Market adjusted damages in the amount of no less than $2,000,000.00,
(3) Punitive damages in the amount no less than five times the compensatory damages awarded or to be determined by the Panel,
(4) Respondent be ordered to purchase the VIP investment from Claimant at cost, less amounts received by Claimant from VIP, plus interest thereon,
(5) Interest,
(6) Attorneys' fees,
(7) Costs.

Relief Requested Post Hearing:
Compensatory damages between $7,353,550.79 and $8,103,073.86 plus interest, costs, attorneys' fees, and punitive damages.

Award:
(1) Respondent was found to be liable for and shall pay to Claimant the sum of $74,950.00 in compensatory damages, plus pre-award interest through November 27, 2020 of $92,344.26, for a total of $167,294.26,
(2) Respondent was found to be liable for and shall pay to Claimant interest on the sum of $74,950.00 at the rate of $17.97 per day from November 28, 2020 until this Award is paid in full.
(3) Any and all claims for relief not specifically addressed herein, including any requests for punitive damages and attorneys' fees, are denied and

(4) The parties asked for an explained decision which stated:

> During the time the trust for Claimant's benefit was held at Respondent, Respondent owed a duty to its customer. The Panel concurs that Respondent failed to adequately supervise its associated person and failed to enforce its own rules, thereby allowing misappropriation from its customer to occur. Therefore, the Panel finds Respondent liable for misappropriations which occurred during the time the trust was Respondent's customer.

Analysis:

This award is noteworthy because it grants both pre- and post- award interest to Claimant, but even more so, because of the findings in the explained decision. In the decision, the Panel states that Morgan Stanley owed a duty to its customer and that therefore it was liable for misappropriations from its customer. It further found that it failed to supervise the broker and enforce its own rules allowing the misappropriation. Although this duty is not articulated more fully, the sole duty alleged by Claimant in its claims is the fiduciary duty.

Amanda B. Straight Revocable Trust (Claimant) v. UBS Financial Services Inc. (Respondents)

Case No. 19-02180

New York, New York (via videoconference)

Hearing Dates: August 11, 2020-August 12, 2020, August 31-September 4, 2020, September 11, 2020

Award Date: October 16, 2020

Counsel:

Counsel for Claimant: Seth E. Lipner, Esq., Deutsch & Lipner, Garden City, New York.

Counsel for Respondents: Joseph Serino, Jr., Esq., Latham & Watkins LLP, New York, New York.

Arbitration Panel:

John F. Duane, Public Arbitrator, Presiding Chairperson

Gerald H. Grayson, Public Arbitrator

Patricia Kathleen Costello, Public Arbitrator

Investments at Issue:

The causes of action relate to unspecified securities. The dissent mentions options.

Claimant's Claims:

Causes of Action in Statement of Claim:

(1) Unsuitability,
(2) Violations of FINRA Rules 2111, 2360(b)(19), 2210, 2020, and 2010,
(3) Misrepresentation and fraud,
(4) Breach of fiduciary duty,
(5) Negligence,
(6) Negligent supervision,
(7) Breach of contract, and
(8) Omissions of material fact.

Relief Requested:

(1) Compensatory damages in excess of $1,000,000 but no more than $1,500,000,
(2) Interest at the legal rate,
(3) Punitive damages,
(4) Expert witness fees,
(5) A disciplinary referral to FINRA for Respondent and the advisor,
(6) Disgorgement of fees, and
(7) Costs.

Award:

1. Claimant's claims are denied in their entirety.
2. The majority of the Panel recommended the expungement of all references to Occurrence Number 2044830 from registration records maintained by the CRD for Unnamed Party Wendy Holmes (CRD Number 2944190) with the understanding that, pursuant to Notice to Members 04-16, Unnamed Party Wendy Holmes must obtain confirmation from a court of competent jurisdiction before the CRD will execute the expungement directive. Unless specifically waived in writing by FINRA, parties seeking judicial confirmation of an arbitration award containing expungement relief must name FINRA as an additional party and serve FINRA with all appropriate documents.

Pursuant to Rule 12805 of the Code of Arbitration Procedure ("Code"), the majority of the Panel has made the following Rule 2080 affirmative finding of fact: The claim, allegation, or information is false. The majority of the Panel has made the above Rule 2080 finding based on the following reasons: The evidence presented at the hearing demonstrated that the options trading strategy at issue was suitable for the Claimant, and that Claimant understood the risk involved and was capable of assuming that risk. During the time the trust for Claimant's benefit was held at Respondent, Respondent owed a duty to its customer. The Panel concurs

that Respondent failed to adequately supervise its associated person and failed to enforce its own rules, thereby allowing misappropriation from its customer to occur. Therefore, the Panel finds Respondent liable for misappropriations which occurred during the time the trust was Respondent's customer.

3. The majority of the Panel recommends the expungement of all references to Occurrence Number 2044832 from registration records maintained by the CRD for Unnamed Party Eric Andrew Wittenberg (CRD Number 1552330) with the understanding that, pursuant to Notice to Members 04-16, Unnamed Party Eric Andrew Wittenberg must obtain confirmation from a court of competent jurisdiction before the CRD will execute the expungement directive. Unless specifically waived in writing by FINRA, parties seeking judicial confirmation of an arbitration award containing expungement relief must name FINRA as an additional party and serve FINRA with all appropriate documents. Pursuant to Rule 12805 of the Code of Arbitration Procedure ("Code"), the majority of the Panel has made the following Rule 2080 affirmative finding of fact: The claim, allegation, or information is false. The majority of the Panel has made the above Rule 2080 finding based on the following reasons: The evidence presented at the hearing demonstrated that the options trading strategy at issue was suitable for the Claimant, and that Claimant understood the risk involved and was capable of assuming that risk.

4. Any and all claims for relief not specifically addressed herein, including any requests for punitive damages, are denied.

Analysis:

This award is noteworthy because of the complete disagreement of the facts and law between the majority panel and Arbitrator Grayson who penned a reasoned dissent. In this split decision, the majority denied Claimant's claims, and even expunged the broker's records with the required finding under FINRA Rule 2080 that the claim, allegation or information was false and explicitly stating that the options strategy was suitable for the Claimant and that Claimant understood the risks. Notwithstanding this, Arbitrator Grayson's dissent found that:

> Based upon all of the testimony and all of the documentary evidence presented by both parties to this matter, I have reached the following conclusions: The UBS Holmes-Wittenberg Group failed to meet their obligations under FINRA Rule 2111 as to suitability in regard to the options investments that they recommended to the Amanda B. Straight Revocable Trust; the UBS Holmes-Wittenberg Group failed to meet their obligations under FINRA Rule 2360 as to suitability in regard to the options

investments that they recommended to the Amanda B. Straight Revocable Trust; and, as Investment Advisors, the Holmes-Wittenberg Group failed to meet their responsibilities as fiduciaries.

This rare explained split decision highlights why many cases ultimately settle before a final hearing. Here, the divergent opinions demonstrate how arbitrators can all hear the same evidence and still come out on opposite sides.

James L. Springer (Claimant) v. UBS Financial Services, Inc. (Respondent)

Case No. 20-01606
Boca Raton, Florida (via telephone conference)
Hearing Dates: December 10, 2020
Award Date: January 8, 2021
Counsel:

Counsel for Claimant: Nisha S. Wright, Esq., Stein & Stein, P.A., Palm Beach, Florida.

Counsel for Respondent: Omar Perez, Esq., UBS Business Solutions US LLC, Nashville, Tennessee.

Arbitration Panel

Edward R. Niederriter, Public Arbitrator, Presiding Chairperson
Justin Wallace Askins, Public Arbitrator
Sheryl Sagel, Non-Public Arbitrator

Investments at Issue:

Claimant asserted a claim seeking expungement of customer dispute information regarding seven occurrences from registration records maintained by the Central Registration Depository ("CRD") Two of these occurrences were related in that one was a complaint letter that became a FINRA arbitration.

Claimant's Claims:

Causes of Action in Statement of Claim:

(1) Expungement of Occurrence Numbers 1917472, 1771228, 1635259, 1451955, 1398515, and 1463559from registration records maintained by the CRD for Claimant James L. Springer.

Relief Requested:

(1) Expungement of Occurrence Numbers 1917472, 1771228, 1635259, 1451955, 1398515, and 1463559 from registration
records maintained by the CRD for Claimant James L. Springer.

Relief Requested At Hearing: Claimant additionally asked for expungement of Occurrence Number 1725330 at the hearing.

Award:

(1) The Panel recommended the expungement of all references to Occurrence Numbers 1917472, 1771228, 1635259, 1451955, 1398515, 1463559, and 1725330 from registration records maintained by the CRD for Claimant James L. Springer (CRD Number 2535792) with the understanding that, pursuant to Notice to Members 04-16, Claimant James L. Springer must obtain confirmation from a court of competent jurisdiction before the CRD will execute the expungement directive.

Unless specifically waived in writing by FINRA, parties seeking judicial confirmation of an arbitration award containing expungement relief must name FINRA as an additional party and serve FINRA with all appropriate documents.

Pursuant to Rule 13805 of the Code of Arbitration Procedure (“Code”), the Panel has made the following Rule 2080 affirmative findings of fact:

The claim, allegation, or information is factually impossible or clearly erroneous;

The registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds; and

The claim, allegation, or information is false. The Panel has made the above Rule 2080 findings based on the following reasons:

As to Occurrence Number 1917472: The Customers alleged excessive fees were charged on multiple accounts. The Panel finds these claims were false because the Customers signed and agreed to such fees as part of the investor application and the fees were further disclosed in monthly and yearly statements, as well as 1099s. The Customers’ letter complaint was filed 2 and 1/2 years after Claimant was terminated by Respondent and was the result of Respondent attempting to change the fee structure for such accounts. The Customers never complained to Claimant and testimony by one of the Customers at the hearing indicated he did not oppose expungement but his appearance was merely "to supply information" for the Panel.

As to Occurrence Number 1771228: The Customer alleged certain real estate partnerships were unsuitable investments for his Individual Retirement Account and he sought recoupment of tax consequences related to such investments. The Panel found such allegation false; that the investments were made in 2004 and 2005 but the written complaint

was not filed until 2015, nearly a year after Claimant had been terminated by Respondent. All appropriate documentation (including qualified purchaser documentation) was executed by the Customer which disclosed the potential tax consequences. The Customer remained a client of Claimant during his entire tenure with Respondent and the investment was profitable.

As to Occurrence Number 1635259: This was a written complaint which alleged that a portion of the Customer's investment in asset management funds were in gold and such was a speculative unsuitable investment. The Panel found such claim false inasmuch as this type of investment was suitable based on the Customer's recorded risk tolerance and that he was a highly sophisticated and a qualified investor. The Customer remained a client of Claimant after his claim was denied. The Customer informed counsel at the time of notice of this hearing that he would not appear, nor did he oppose expungement.

As to Occurrence Numbers 1451955 and 1725330: Occurrence Number 1451955 was a written complaint filed against Respondent and Occurrence Number 1725330 was a FINRA Arbitration (Case Number 14-02636) filed against Respondent by the same Customer. The written complaint alleged that one of the Customer's investments was speculative and unsuitable. The arbitration claim had similar allegations related to unsuitability of an investment. The written complaint was denied by Respondent with no further action taken, while the arbitration claim was settled for a fraction of the relief requested. The Panel decided that both Occurrences were false; that the Customer was a highly sophisticated and active investor; that his varied investments were in line with his recorded risk profile and were suitable. The Panel also reviewed the settlement agreement and confirmed that Claimant was not a party to the action and did not contribute any money or sign the settlement agreement. Counsel reported that when the Customer received notice of the expungement action, he stated he would not participate nor oppose expungement.

As to Occurrence Number 1398515: This was a written complaint against Respondent that related to the industrywide breakdown in the market for auction rate securities ("ARS"). The Customer was a highly sophisticated investor that utilized ARS in lieu of a cash account. The Panel found that Claimant was not involved in the alleged sales practice violation and that the Customer's investments were in line with his recorded risk profile. Moreover, Respondent, as part of a global settlement with regulatory bodies, repurchased the ARS securities from the Customer at par value. Claimant did not participate

in any of the settlement discussions nor did he contribute to the settlement.

As to Occurrence Number 1463559: This was a FINRA Arbitration (Case Number 10-02352) against Respondent wherein the Customer alleged an unsuitable recommendation of Lehman Structured Products and failure to follow an Order to sell the products. The Panel found that this allegation was clearly erroneous and false. The evidence indicated that this investment by the Customer was unsolicited; that the Customer reviewed the prospectus and offering material in advance of his decision to purchase, and that the investment was suitable and in line with the Customer's risk profile. Also, the Panel found that Claimant did not participate in settlement negotiations nor did he contribute to the settlement.

Analysis:

This award is noteworthy because seven separate occurrences regarding six disparate customers and involving completely different products and facts were collectively expunged after a one day hearing at which only one Claimant appeared. That Claimant's appearance was simply to state that he did not object to the expungement of occurrence 191742 which related to excessive commissions charged. While four of the seven occurrences did ostensibly involve product issues (excessive fees, Auction Rate Securities and Lehman Structured Products) all seven of the occurrences were expunged by the Panel in one sweeping award. The remaining occurrences which were not product related contained allegations of 1) the unsuitable purchase of a real estate partnership in an IRA account; 2) an unsuitable recommendation in a speculative gold security; and 3) unsuitable unspecified speculative investments. This expansive expungement order shows just how easy it is to file a FINRA claim and "sanitize" a broker's record which had been littered with customer complaints.

Valeria Blanchard (Claimant) v. First Financial Equity Corporation. (Respondent)

Case No. 20-01189
Reno, Nevada (via telephone conference)
Hearing Dates: November 16, 2020 (Motion to Dismiss)
Award Date: January 5, 2021
Counsel:

Counsel for Claimants: Lauren Koch, Nevada City, California

Counsel for Respondent: Jason L. Cassidy, Esq., Ryley Carlock & Applewhite, Phoenix, Arizona.

Arbitration Panel

David I. Levine, Public Arbitrator, Presiding Chairperson

Arocles Aguilar, Public Arbitrator

Mary H. Evans, Non-Public Arbitrator

Investments at Issue: Various unspecified securities in a Trust Account.

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Elder Abuse,
(2) Fraud,
(3) Misrepresentation,
(4) Failure to Supervise,
(5) Breach of Fiduciary Duty,
(6) Errors/charges, and
(7) Omissions of fact.

Relief Requested:

(1) Compensatory damages of $120,000.00,
(2) Punitive damages of $100,000.00.

Award:

(1) Claimant's claims were dismissed pursuant to Rules12200, 12201, and 12504
(2) Claimant is liable for and shall pay to Respondent the sum of $5,000.00 in attorneys' fees pursuant to Arizona Revised Statutes §12-349, and
(3) Any and all claims for relief not specifically addressed herein, including any requests for punitive damages, are denied.

Analysis:

This case is notable for the pre-hearing dismissal and attorney's fees assessed against the son of the Claimant who having no authority to do so brought this claim (and who acted as his own attorney). He was sanctioned $5,000 for not investigating the facts underlying the claims he sought to bring. The son had no authority from his mother or her trust to bring the claims. Neither the Claimant nor her son had an account at the Respondent firm (the accounts were in the name of a family trust), and the complained of agreements for advisory services were all between the family trust and an outside investment advisory who was not the Respondent. The Claimant had no authority from the trustees of the family trust to bring the arbitration. Most importantly, the trustees of the family trust had previously settled these same claims in writing. Based upon this set of overwhelming facts, the panel dismissed all claims and a sanctioned the son, assessing $5,000 for attorney's fees against him under Arizona law

and finding as follows:
Respondent sought an award of reasonable attorney's fees as part of the relief requested in its answer and in its motion. Pursuant to A.R.S. § 12-3021(B), "an arbitrator may award reasonable attorney fees and other reasonable expenses of arbitration only if that award is authorized by law in a civil action involving the same claim...." The Panel believes that an award of reasonable attorney's fees would be justified under A.R.S. § 12-341.01 because this action arose out of a contract applying Arizona law. An award is also justified against Mr. Koch under A.R.S. § 12-349. He brought this claim on behalf of his mother without substantial justification and the proceedings were unreasonably delayed by his actions. Pursuant to A.R.S. § 12-350, the reasons why an award is justified under A.R.S § 12-349 include the following: (a) A minimum amount of effort prior to the assertion of these claims would have demonstrated that neither Ms. Blanchard nor Mr. Koch were entitled to bring these claims to this arbitration. (b) No effort was made after the commencement of the action to reduce the number of claims being asserted or to dismiss the invalid claims. (c) The operative facts which would have determined the invalidity of the claim were readily available to Mr. Koch. (d) These facts were never reasonably in conflict in this matter. (e) Claimant has prevailed on no claims in controversy. (f) In mitigation, the Panel presumes that Mr. Koch and Ms. Blanchard have fewer financial resources than Respondent. Although the Respondent submitted evidence that it incurred much higher (but still reasonable) attorney fees, the Panel concludes that an award of $5,000 against Mr. Koch only is appropriate to mitigate the burden of the expense of litigation. A.R.S. § 12-349. See A.R.S. § 12-341.01(B).

The Van Dierendonk Family Trust, Edmond W. Van Dierendonk and Susanna M. Van Dierendonk (Claimants) v. ProEquities, Inc., Narinder Kaur Singh, Transamerica Financial Advisors, Inc. (Respondents) and ProEquities, Inc. (Cross-Claimant) v. Narinder Kaur Singh (Cross-Respondent)
Case No. 19-02711
Phoenix, Arizona
Hearing Dates: July 20, 2020 and July 21, 2020 (via videoconference)
Award Date: August 14, 2020
Counsel:
Counsel for Claimants: Jeffrey A. Feldman, Esq., Law Offices of Jeffrey A. Feldman, San Francisco, California.

Counsel for Respondent: Stephen C. Jackson, Esq., Maynard, Cooper & Gales, P.C., Birmingham, Alabama

Arbitration Panel:

John H. Fearnow, Presiding Chairperson
Michael Kelley, Public Arbitrator
Floyd Gerry Hoffman, Public Arbitrator

Investments at Issue:

The causes of action relate to an investment contract in Express Asset and Wealth Management that resulted from cash generated from the sale of Claimants' home in California.

Claimants' Claims:

(1) Violation of the Arizona and California Securities Act;
(2) Breach of Fiduciary Duty
(3) Negligent Supervision
(4) Misrepresentation
(5) Fraud
(6) Constructive Fraud
(7) Breach of Contract
(8) Violation of the Arizona Consumer Fraud Act
(9) Conversion
(10) Elder abuse under the California Welfare and Institutions Code.

Cross-Claim:

ProEquities denied the allegations made in the Statement of Claim, asserted various affirmative defenses and asserted a Cross-Claim against Singh for breach of contract, contractual indemnity and common law indemnity and contribution.

Relief Requested:

Claimants requested an award against Respondents in an amount between $1,000,000 and $2,000,000 as follows:

(1) Rescission of the investment contracts sold to Claimant together with 10% interest from the dates of the investments;
(2) In the alternative, with respect to the investment contracts, lost principal in the amount of $412,500 and well managed account damages relating to that sum;
(3) Reasonable attorneys' fees pursuant to the Arizona Securities Act, Arizona Consumer Fraud Act, and the California Welfare and Institutions Code relating to elder abuse;
(4) Treble damages pursuant to California Civil Code Section 3345;
(5) All reasonable costs incurred during this arbitration;
(6) Punitive and exemplary damages according to proof at the arbitration hearing; and

(7) Such other relief as the Panel deems just and proper.

In the Cross-Claim, ProEquities requested:

(1) Rejection of Claimants' Statement of Claim in its entirety;

(2) Judgment against Singh;

(3) An award of all damages available under the law, including but not limited to its attorneys' fees in this case.

Relief Requested at Hearing:

Claimants requested a finding of fraud and/or breach of fiduciary duty.

Award:

(1) Singh is liable for and shall pay to Claimants the sum of $207,620.70 in compensatory damages.

(2) Singh is liable for and shall pay to Claimants interest in the amount of $103,125.00, at the rate of 5% on the sum of compensatory damages and costs, accruing from January 1, 2019 through July 6, 2020, pursuant to the Investment Contract.

(3) Singh is liable for and shall pay to Claimants the sum of $100,000.00 in punitive damages pursuant to *Thompson v. Better-Bilt Aluminum Products Co*., 171 Ariz. 550, 832 P2d 203. The Panel found that Singh's conduct in this matter constituted fraud and/or breach of a fiduciary duty to Claimants, which is the basis for the punitive damages award.

(4) Singh is liable for and shall pay to Claimants the sum of $83,048.00 in attorneys' fees pursuant to the ARS Section 12-341.01.

(5) Singh is liable for and shall pay to Claimants the sum of $484.71 in costs.

(6) Singh is liable for and shall pay to ProEquities the sum of $67,500.00 in compensatory damages.

(7) Singh is liable for and shall pay to ProEquities the sum of $45,350.80 in attorneys' fees pursuant to the contract agreement between Respondent and ProEquities, and *Goetel vs. WSI-Cunningham*, 194 Arizona 236, 980 P2d 489.

Analysis:

This award is noteworthy because the parties filed a stipulation to have the evidentiary hearing held via videoconferencing and the Panel granted the parties' request. Also noteworthy, is that the Claimants filed a notice of partial settlement advising that all claims against Transamerica and ProEquities were dismissed with prejudice. The Claimants and Cross-Claimants proceeded to hearing with their causes of action against Respondent Narinder Singh. Respondent Singh was found liable to both Claimants and ProEquities. The substantial award for Claimants included interest, costs, punitive damages, and attorneys' fees. Furthermore, the

Panel found that Singh's conduct constituted fraud and/or breach of fiduciary duty to Claimants which was the basis for the punitive damages award. Singh was also found liable to ProEquities for compensatory damages and attorneys' fees.

Kyle T. Busch and Samantha L. Bush v. Commonwealth Financial Network, Charles Franklin Parks and C.F. Parks & Co., Inc.
Case No. 17-02244
Charlotte, North Carolina
Hearing Dates: February 4-6, 2020 in person and October 12-16, 2020 (via videoconference)
Award Date: November 17, 2020
Counsel:
Counsel for Claimants: Michael S. Taaffe, Esq., Shumaker, Loop & Kendrick, LLP, Sarasota, Florida.
Counsel for Respondent: Charles Franklin Parks, and C.F. Parks & Co., Inc. and Peter B. King, Esq., Wiand Guerra King, P.A., Tampa, Florida.
Arbitration Panel:
Richard E. Miley, Presiding Chairperson
Patricia Ann Tracey, Public Arbitrator
James Howell Harrison, Jr., Public Arbitrator
Investments at Issue: Various securities.
Claimants' Claims:
(1) Violation of North Carolina Securities Act;
(2) Breach of contract;
(3) Breach of fiduciary duty;
(4) Violation of FINRA Rule 2010;
(5) Violation of FINRA Rule 2111;
(6) Common law fraud;
(7) Constructive fraud;
(8) Negligence/negligent misrepresentation or omission; and
(9) Negligent supervision.
Relief Requested:
(1) Unspecified compensatory damages;
(2) Punitive damages;
(3) Interest;
(4) Attorneys' fees and costs pursuant to North Carolina Securities Act; and
(5) Such other relief as the Panel deems just and equitable.
Relief Requested Post Hearing:

(1) Claimants requested damages in the amount of $1,700,000.00 together with attorneys' fees and costs.

Award:

(1) Respondents Commonwealth, Parks, and C.F. Parks are jointly and severally liable for and shall pay to Claimants the sum of $110,000 in compensatory damages for the breach of contract count and violation of FINRA Rule 2111 (suitability).

(2) Respondent Commonwealth is liable for and shall pay to Claimants the sum of $25,000.00 in compensatory damages for negligent supervision.

(3) Respondent Commonwealth, Parks and C.F. Parks are jointly and severally liable for and shall pay to Claimants interest of $110,000 at the rate of 8% per annum from the date of the award until payment in full on the award for breach of contract and suitability.

(4) Respondent Commonwealth is liable for and shall pay to Claimants interest of $25,000 at the rate of 8% per annum from the date of the award until payment in full on the award of negligent supervision.

(5) Claimants' remaining claims are denied in their entirety.

(6) Respondent Park's request for expungement of his CRD record is denied.

(7) Any and all claims for relief not specifically addressed herein, including any requests for punitive damages and attorneys' fees were denied.

Analysis:

This award is noteworthy because after Claimants' case-in-chief, Respondents made a Motion to Dismiss asserting that Claimants had failed to prove all essential elements of the claims asserted in the Statement of Claim, particularly as to suitability (violation of FINRA Rule 2111), and Claimants opposed the motion. After due deliberation, the Panel denied Respondents' Motion to Dismiss. Additionally, Claimants asserted error and unfairness regarding the Panel's sustaining Respondents' objections and not allowing their witness to testify as an expert witness on the suitability of certain investments. However, during the course of the witness's testimony, Counsel for Claimant stated several times that the witness was offered as an expert witness on other matters and not as to suitability. The Panel found that the witness also testified in essence that she did not have expertise on suitability issues. Furthermore, Respondents objected to Claimants' offer of a second expert witness on the grounds that the witness was not included as a witness on Claimants' 20-day disclosure list. The Panel allowed the witness to testify subject to Respondents' objections and the Panel reserved its ruling on the acceptance of the

expert's testimony. During deliberation, the Panel overruled Respondents' objections and then allowed and considered the expert witness's testimony. Ultimately, Claimants' efforts prevailed and Claimants received an award of compensatory damages and interest.

CASES AND MATERIALS

Jason Burge

The Fourth Circuit reaffirms that the standard for review of an arbitration award is highly deferential and upholds an arbitration award that premised liability on breach of contract based on a firm's violations of FINRA rules.[1]

Interactive Brokers LLC v. Saroop, 969 F.3d 438 (4th Cir. 2020):

Investors with accounts at Interactive Brokers LLC ("IB") managed by an independent advisor suffered significant losses during a period of market volatility on August 24, 2015, when their portfolio margin account suffered a margin blowout, leaving them indebted to IB. *Interactive Brokers LLC v. Saroop*, 969 F.3d 438, 440-41 (4th Cir. 2020). The investors initiated a FINRA arbitration asserting nine causes of action. *Id.* at 441. Although they alleged that IB violated FINRA rules governing portfolio margin and duties, the investors did not assert an independent cause of action for violation of FINRA rules. *Id.* IB asserted a counterclaim seeking payment of the debt and attorney's fees. *Id.* Neither party requested a reasoned decision from the arbitration panel. *Id.* Following a hearing, the panel ruled in the investors' favor, awarding over a million dollars in damages and attorney's fees, and dismissed the counterclaim. *Id.* The panel's damage award was based on the value of the Investors' accounts on August 19, 2015. *Id.* In dismissing the counterclaim, the panel stated that the counterclaim's dismissal was "based on [IB's] violation of FINRA Rule 4210 as further explained in regulatory notice 08-09 [because] the securities placed in the portfolio margin account were not eligible for that account based on these rules and regulations." *Id*.

IB moved to vacate the arbitration award. *Id.* The district court, after considerable criticism of the arbitration process and the "baffling" damages award, remanded the claim to the arbitrators for additional "brief explanation." *Id.* at 441-42. On remand, the panel issued a modified award, repeating the liability finding and appending an additional explanation for its application of FINRA Rule 4210 to IB's counterclaim:

> [The Broker's] position that the Panel should not enforce a FINRA rule amounts to saying that FINRA should provide an opportunity for investors to commit financial suicide by investing in securities that are

1. Thank you to W. Scott Greco for his contributions to this case note.

> ineligible for inclusion in a portfolio margin account. To ignore a FINRA rule by the Panel would defeat the purpose of FINRA.

Id. at 442. The panel also noted that it awarded damages based on the account value on August 19, 2015 because it "lacked evidence about the performance of the accounts prior to that date." *Id.* at 446 (Niemeyer, J. dissenting).

IB then moved to vacate the modified award. *Id.* at 442. The district court, after describing the arbitration as a "jackleg operation," vacated the award in favor of the investors, and remanded IB's counterclaim to a new panel of arbitrators. *Id.* The district court reasoned that the modified award was "a manifest disregard of the law because the law is clear that there is no private right of action to enforce FINRA rules." *Id.* The investors appealed.

The Fourth Circuit reversed the district court, finding that it erred in vacating the modified award. *Id.* at 445. The Fourth Circuit began with the standard of review, noting that a "party seeking vacate an arbitration award bears a 'heavy burden,'" and that a searching review of arbitration awards on appeal would "'render informal arbitration merely a prelude to a more cumbersome and time-consuming judicial review process' and bring arbitration theory to grief." *Id.* at 443 (citations omitted). Because IB had consented to arbitration, it had consented to "extremely limited appellate review" and assumed "the risk that the arbitrator may interpret the law in a way with which they disagree." *Id.*

The Fourth Circuit noted that the panel had not stated which cause of action provided the basis of its award to the investors, so IB "must show that it would be manifest disregard of the law to enforce all causes of action asserted by the Investors." *Id.* at 444. In particular, the Fourth Circuit noted that the parties' contracts stated that "all transactions are subject to rules and policies of relevant markets and clearinghouses, and applicable laws and regulations." *Id.* Accordingly, it was not manifest disregard of the law for the panel to "premise liability on breach of contract" because "parties may incorporate the FINRA rules into a contract." *Id.* The Fourth Circuit held that "[i]mposing liability based on a contractual obligation to comply with the FINRA rules is, at the very least, an arguable interpretation of the parties' contracts" and "not in manifest disregard of the law."

On damages, the Fourth Circuit noted that contractual damages "are awarded to place the injured party in the same position as he would have been in had the contract been fully performed," and that the award at least "arguably" placed the investors in the position they would have been had the contracts been properly performed after August 19. *Id.* 444-45. Although this was not "the only reading of the law, or perhaps even the best," the Fourth Circuit cautioned that "a district court may not overturn an arbitration award just because it believed, however strongly, that the arbitrators misinterpreted

the applicable law." *Id.* at 445. The Fourth Circuit concluded that a judge's job in reviewing an arbitration award is "not to determine the merits of the dispute between the parties but rather to determine only whether the arbitrator did his job — not whether he did it well, correctly, or reasonably, but simply whether he did it." *Id.*

Judge Niemeyer dissented, arguing that the Court should have remanded because the arbitrators' award of damages was "based solely and arbitrarily on the value of the investors' accounts on a given date," and that determination was "divorced entirely from the pertinent facts and any legal theory." *Id.* at 446. Judge Niemeyer accepted the majority's breach of contract theory, but noted that IB had an obligation to perform its contractual obligations for the duration of the parties' relationship and the trades at issue had occurred prior to August 19. *Id.* at 449. He argued that the panel's ruling failed to return the investors to the position they would have been in but for the breach because it "did not consider the profits and losses in the portfolio margin accounts between the accounts' creation and August 19." *Id.* He would have affirmed the district court's order vacating the modified arbitration award "on somewhat different grounds" and he would have remanded "both the investors' claims and [IB]'s counterclaim to a new arbitration panel for reconsideration." *Id.* at 450.

Delaware Supreme Court rules that Delaware corporations can adopt federal forum provisions in their certificates of incorporation, designating federal courts as the exclusive forum for Securities Act claims
Salzberg v. Sciabacucchi, 227 A.3d 102, 114 (Del. 2020)

The Securities Act of 1933 requires corporations offering securities for sale to the public to provide "full and fair disclosure of relevant information," and creates a private right of action for investors to enforce this disclosure requirement. 15 U.S.C. § 77e; 15 U.S.C. § 77k. Pursuant to the Securities Act, such actions can be brought in state or federal court and, if brought in state court, cannot be removed. 15 U.S.C. § 77v(a). In 2018, the United States Supreme Court held in *Cyan, Inc. v. Beaver Cty. Employees Ret. Fund* that state courts continued to have concurrent jurisdiction over these actions even after the passage of Securities Litigation Uniform Standards Act ("SLUSA"), and that class actions under the Securities Act could not be removed to federal court pursuant to SLUSA's class action removal provisions. 138 S. Ct. 1061. Following *Cyan*, there was a 55% increase in Securities Act filings in state courts, with a corresponding decrease in Securities Act filings in federal courts. *Salzberg*, 227 A.2d at 114.

In anticipation of the Supreme Court's ruling in *Cyan*, corporations such as Blue Apron Holdings, Inc. and Roku, Inc. began adopting federal-forum provisions (FFPs) into their charters, to seek to avoid state court class actions arising from their initial public offerings. *Id.* at 109. A standard FFP provides:

> Unless the Company consents in writing to the selection of an alternative forum, the federal district courts of the United States of America shall be the exclusive forum for the resolution of any complaint asserting a cause of action arising under the Securities Act of 1933. Any person or entity purchasing or otherwise acquiring any interest in any security of [the Company] shall be deemed to have notice of and consented to [this provision].

Salzberg, 227 A.3d at 109.

The Plaintiff, Sciabacucchi, purchased shares in three IPOs, including Blue Apron and Roku, and challenged the enforceability of their FFPs. The Delaware Chancery Court ruled in favor of the Plaintiff, holding that the "constitutive documents of a Delaware corporation cannot bind a plaintiff to a particular forum when the claim does not involve rights or relationships that were established by or under Delaware's corporate law." *Id.*

The Delaware Supreme Court reversed. The Court analyzed the text of Section 102 of the Delaware General Corporation Law, which permitted corporations to include in their certificates of incorporation "any provision for the management of the business and for the conduct of the affairs of the corporation" and "any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of the stockholders, ... if such provisions are not contrary to the laws of this State." *Id.* at 113. The Court found that FFPs were valid under either of these provisions, because they "can provide a corporation with certain efficiencies in managing the procedural aspects of securities litigation" and avoid "the costs and inefficiencies of multiple cases being litigated simultaneously in both state and federal courts." *Id.* at 115. Further, the Court held that FFPs were not violative of Delaware public policy, the scope of which is "broadly enabling" of corporate charter provisions because "corporate charters are contracts among a corporation's stockholders [and] are given great respect under our law." *Id.* at 116.

The Court also held that FFPs were not violative of the provisions of Delaware law requiring corporations to allow "internal corporate claims" to be brought in Delaware State court (*Id.* at 116-20) and that charter provisions are not limited to "internal affairs" matters. *Id.* at 121-29. Finally, the Court recognized that there remained an issue whether FFPs would be enforced by courts in other states when plaintiffs asserted claims in those state courts under the Securities Act. *Id.* at 133-34. *See also* 15 U.S.C. 77v ("Any such suit or

action may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took place, if the defendant participated therein, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found."). The Court recognized that this presented a thorny issue of comity, but strongly urged other state courts to enforce the FFPs of Delaware corporations. *Salzberg*, 227 A.3d at 133-37.

The effect of *Salzberg* will likely be a wholesale adoption of FFPs by Delaware corporations in advance of public share offerings. The advantages to a corporate defendant of litigating Securities Act claims in federal court—from the ability to consolidate cases filed in different states to the various procedural limitations on class actions in the PSLRA—are simply too attractive for most corporate defendants to allow class actions to proceed in state court. The effect will likely be to nip the post-*Cyan* expansion of state court Securities Act class actions in the bud. For the practitioner, it also means that before filing a Securities Act claim against a Delaware corporation, it will be necessary to review the corporations' charter to determine whether there is a FFP. It remains to be seen whether state courts outside Delaware will follow the Delaware Supreme Court's guidance and enforce FFPs to require Securities Act claims brought against Delaware corporations in other states to be asserted in federal court.

The Supreme Court clarified what equitable relief the SEC can obtain in a civil action under its § 78u(d)5) powers.

Pursuant to § 78u(d) of the Securities Exchange Act, the SEC can bring a civil action for violations of the securities laws to obtain civil penalties and "any equitable relief that may be appropriate or necessary for the benefit of investors." 15 U.S.C. § 78u(d)(5). Historically, lower courts had held that "restitution" and "disgorgement" were among the equitable remedies that the SEC could obtain. *See SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1307-08 (2d Cir. 1971); *SEC v. Blatt*, 583 F.2d 1325, 1335 (5th Cir. 1978); *SEC v. Washington Cty. Util. Dist.*, 676 F.2d 218, 227 (6th Cir. 1982). In 2017, however, the Supreme Court held that disgorgement constituted a "penalty" for the purposes of a separate statute, 28 U.S.C. § 2462, which establishes a 5-year statute of limitations for a civil action for the enforcement of a penalty. *See Kokesh v. SEC*, 137 S.Ct. 1635 (2017). Traditionally, equity never "lends its aid to enforce a forfeiture or penalty, or anything in the nature of either." *Marshall v. Vicksburg*, 82 U.S. 146, 149 (1873). Accordingly, the question

arose whether the SEC could obtain restitution or disgorgement pursuant to its powers to seek equitable relief.

Petitioners Charles Liu and Lisa Wang defrauded investors of nearly $27 million through the EB-5 Immigrant Investor Program, based on a scheme to allegedly build a cancer-treatment center. *Liu v. SEC*, 140 S.Ct. 1936, 1941 (2020). The SEC brought a civil enforcement action, alleging that Liu and Wang misappropriated millions of dollars. *Id.* at 1942. The district court found for the SEC, awarded the highest civil penalty allowable, and held the petitioners jointly and severally liable for disgorgement equal to the full amount petitioners had raised minus the small amount that remained in the corporate account. *Id.* The petitioners objected that this award exceeded even their net profits because it failed to reduce the award by their reasonable business expenses. *Id.* The district court rejected their argument, and the Ninth Circuit affirmed. *Id.*

The Supreme Court began by determining that restitution was an available remedy in traditional equity jurisprudence. The Court articulated two general principles. First, "equity practice long authorized courts to strip wrongdoers of their ill-gotten gains," regardless of the precise label attached to the remedy. *Id.* Based on the "foundational principle [that] it would be inequitable that a wrongdoer should make a profit out of his own wrong," equity courts had awarded this relief under the headings of disgorgement, profits-recovery, accounting, and restitution. *Id.* at 1943 (internal citations omitted). Second, to avoid making restitution into a "punitive sanction, courts restricted the remedy to an individual wrongdoer's net profits to be awarded for victims." *Id.* at 1942. Often, restitution was characterized as a "constructive trust on wrongful gains for wrongful victims," requiring that the funds be returned to the victim. *Id.* at 1944. Restitution was generally awarded against individuals or partners who engaged in concerted activity based on their individual profits, not on a joint-and-several liability basis. *Id.* at 1945. And courts "limited awards to the net profits from wrongdoing, that is, the gain made upon any business or investment, when both the receipts and payments are taken into account." *Id.*

Based on those principles, the Supreme Court cast doubt on some aspects of the disgorgement remedies that the SEC had historically obtained. The Court noted that courts have awarded disgorgements in three ways that deviate from historical equity practice: (1) by depositing disgorged funds "in Treasury funds instead of disbursing them to victims;" (2) by "imposing joint-and-several disgorgement liability;" and (3) by "declining to deduct even legitimate expenses from the receipts of fraud." *Id.* at 1946. The Court found that these deviations were "in considerable tension with equity practices." *Id.* Nonetheless, the Court held that within the limits outlined in common-law cases, restitution could be a remedy within the SEC's equitable powers. *Id.*

The Court concluded by outlining principles that should guide the application of the SEC's equitable restitution or disgorgement remedy in the future. First, the Court held that "the equitable nature of the profits remedy generally requires the SEC to return a defendant's gains to wronged investors for their benefit." *Id.* at 1948. A benefit to "the public at large by virtue of depriving a wrongdoer of ill-gotten gains" is insufficient to satisfy the requirements of § 78u(d)(5) that the equitable relief be "appropriate or necessary for the benefit of investors." *Id.* The Court left open the possibility that depositing disgorged funds into the Treasury could be appropriate where "it is infeasible to distribute the collected funds to investors," but where investors can be identified, disgorged funds should be returned. *Id.* at 1948-49.

Second, the Court held that joint-and-several liability risks transforming an "equitable profits-focused remedy into a penalty." *Id.* at 1949. Instead, courts should hold defendants "liable to account for such profits only as have accrued to themselves … and not for those which have accrued to another, and in which they have no participation." *Id.* The Court recognized "some flexibility to impose collective liability" "for partners engaged in concerted wrongdoing," but indicated that individual liability should be the norm. *Id.*

Finally, the Court held that restitution must be on a net profit basis. "Courts must deduct legitimate business expenses before ordering disgorgement." *Id.* at 1950. The Court recognized an exception where the "entire profit of a business or undertaking results from the wrongdoing," such that the expenses are "merely wrongful gains under another name." *Id.* Where the expenses were paid to an arms-length third party, however, they must be deducted from the disgorgement award. *Id.* While the Supreme Court remanded the case for consideration of these principles in the first instance by the lower court, the Court did note that certain expenses of Liu and Wang's scheme, including leases and cancer-treatment equipment, had "value independent of fueling a fraudulent scheme" and should likely be deducted from the disgorgement award. *Id.*

Justice Thomas filed a solo dissent. He would have held that disgorgement is not a traditional equitable remedy, and thus was not available to the SEC under § 78u(d)(5). *Id.*

Notes & Observations

WHERE WE STAND

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

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

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

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

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1. To review all PIABA Comment letters, visit www.PIABA.org. For more information, contact David Meyer at dmeyer@meyerwilson.com, or Michael Edmiston at msedmiston@stocklaw.com, or Robin S. Ringo at rsringo@piaba.org for assistance.

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The following Comment Letter regarding *SR-FINRA-2020-030 (FINRA proposed rule change to modify the current process relating to the expungement of customer dispute information)* was submitted to the Securities and Exchange Commission by David Meyer on January 29, 2021. (prepared with the assistance of Christine Lazaro).

J. Matthew DeLesDernier
Assistant Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
via Electronic Submission

Re: File Number SR-FINRA 2020-030

Dear Assistant Secretary DeLesDernier:

The Public Investors Advocate Bar Association ("PIABA") submits this rebuttal comment related to a series of changes to FINRA's expungement process proposed by SR-FINRA 2020-030 dated October 1, 2020. We refer to the changes to FINRA's proposal set forth in a December 18, 2020 letter from FINRA to the SEC (the "Revised Proposal"). We thank the Commission for the opportunity to submit our rebuttal comment.

PIABA continues to support much of FINRA'S proposed incremental changes to the expungement process. PIABA also supports broader fundamental changes in order to solve more of the systemic problems in expungement proceedings.

Until the expungement process is moved from FINRA DR's arbitration forum to a better-suited and streamlined regulatory process, PIABA supports the recommendation of The PIABA Foundation that an Advocate be created and embedded into the expungement process to represent and protect the CRD. Such an Advocate would protect the state records of the CRD, the interests of state and federal regulators who use the CRD to make regulatory and enforcement decisions, the customers and investors who are told to use BrokerCheck (which is based on filtered CRD information) to select financial professionals, and the future employers of brokers who are obligated to use the CRD to perform due diligence on prospective hires. All of these stakeholders rely on the CRD for critical information and have a vested interest in the protection of the integrity of the CRD database. As FINRA acknowledges, these stakeholders' interests often go unrepresented in the current

expungement arbitration process. The proposed Advocate would be able to satisfy FINRA's goal of eliminating one-sided presentations by brokers seeking expungement and protect the interests of the frequently unrepresented stakeholders. Further, the proposed Advocate would also preserve the traditional roles of the parties and their counsel as advocates and arbitrators as neutrals in these proceedings.

Thank you again for requesting comment on the Revised Proposal. For the reasons set forth above, PIABA supports The PIABA Foundation's request for a hearing pursuant to Rule 19b-4. We believe the Commission would benefit from oral arguments being presented on this issue.

Sincerely,

David P. Meyer
PIABA President

The following Comment Letter regarding *Request for Comment on SR-FINRA-2020-045 Proposed Rule Change to Amend FINRA Rule 8312* was submitted to the Securities and Exchange Commission by David Meyer on January 20, 2021. (prepared with the assistance of Courtney Werning).

Ms. Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
rule-comments@sec.gov

RE: Request for Comment on SR-FINRA-2020-045 Proposed Rule Change to Amend FINRA Rule 8312 (FINRA BrokerCheck Disclosure)

Dear Ms. Countryman:

I write on behalf of the Public Investors Advocate Bar Association[1] ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by the Financial Industry Regulatory Authority ("FINRA") relating to investor protection.

PIABA strongly opposes SR-FINRA-2020-045, which seeks to amend Rule 8312 to: 1) make information about formerly registered individuals subject to a final regulatory action available through BrokerCheck on a permanent basis only for those individuals who have been registered on or after August 16, 1999; and 2) exclude information from BrokerCheck about deceased individuals.

PIABA supports any rule that makes BrokerCheck more effective and accurate and has frequently commented on prior proposals for changes to BrokerCheck. FINRA advertises that the BrokerCheck reports are "complete" and provide meaningful and substantive information to investors wanting to learn more about specific brokerage firms and registered representatives. The investing public should be able to rely on BrokerCheck to vet their financial professionals, but can only do so if such information is accurate and meaningful. FINRA's proposal to amend Rule 8312 is a leap backwards in

1. Formerly known as the Public Investors Arbitration Bar Association.

investor protection, because it proposes to remove vital information that investors have the right to know.

FINRA should proceed carefully to ensure the protection of the public's interest in relevant information. FINRA's embrace of widespread pre-dispute arbitration agreements currently acts to conceal public access to information about many disputes because records from FINRA proceedings are not available to the public as they are in public court proceedings. As such, FINRA must only promulgate rules and policies that facilitate the removal of information from BrokerCheck in the most extraordinary circumstances, because any removal diminishes the ability of reputation to police business misconduct.

1. FINRA's Proposal to Remove the Permanent Inclusion of Regulatory Actions

Under the current Rule 8312, information is made available through BrokerCheck on a permanent basis for those formerly registered individuals who are the subject of a final regulatory action, which is categorized by FINRA as a "Permanent Disclosure Event." In 2009, FINRA amended Rule 8312 to make information concerning final regulatory actions against brokers permanently available in BrokerCheck, regardless of when they were employed in the securities industry. FINRA Reg. Notice 09-66, p. 1. The stated goal was to help investors make informed decisions when considering who to choose to handle their hard-earned funds. FINRA noted the importance of allowing public access to information about formerly registered persons who, although no longer in the securities industry in a registered capacity, may still work in other investment-related industries or attain other positions of trust and about whom investors may wish to learn relevant disciplinary information. Id. at 2.

The current proposal abandons FINRA's prior position of investor protection. FINRA was correct in 2009. There are many career paths that a former associated person could take that would place him or her in a position of trust with access to client funds. PIABA's members frequently get calls from investors harmed by ex-brokers who are defrauding the public but have not been registered since the 1980s and 1990s. There is no reason to remove these disclosures from the public record; doing so is antithetical to FINRA's mission of protecting investors.

FINRA cites data limitations as a motivation for changing Rule 8312, in that minimal information about the final regulatory action is available for publication in the BrokerCheck reports. While that may be accurate, it is not

sufficient reason to remove the regulatory action in its entirety from BrokerCheck. Even where details of the action are limited, the fact that a final regulatory action against an individual took place at all is highly important information to the public. If the investor knows about the regulatory action, there is an opportunity to ask the financial professional questions about it, do his or her own research, and make an informed decision about entrusted funds to that person.

The other rationale FINRA gives for the proposal is that FINRA staff must manually create BrokerCheck reports for these individuals due to the fact that their information is not available in the Web CRD system. With all due respect, that is what FINRA was supposed to be doing since the implementation of the "Permanent Disclosure Events" in November of 2009. Now, twelve (12) years later, FINRA is claiming that it is too onerous of a process? The paper-based legacy of the CRD system should have been resolved a long time ago, and any inconvenience for FINRA to bring the BrokerCheck system up to its advertised standards is far outweighed by the needs of the investing public for that information. The better question to be asked here, is how many records remain to be updated?

2. FINRA's Proposal to Remove All Information for Deceased Brokers

FINRA states that including information about deceased individuals in BrokerCheck offers little investor protection value. PIABA strenuously disagrees.

It is not unusual for aggrieved investors to seek out a lawyer and file an arbitration claim relating to a deceased broker's misconduct. Sometimes investors file claims against the deceased broker's supervising brokerage firm shortly after his or her death; and sometimes it is several years after the events that gave rise to their losses. Indeed, the FINRA Code of Arbitration Procedure affords investors the opportunity to submit claims that are up to six (6) years after the event or occurrence giving rise to the claim. (FINRA Customer Code of Arbitration Procedure, Rule 12206(a)). Claims relating to negligent supervision and vicarious liability do not disappear simply because the brokerage firm's agent is deceased.

FINRA cites two defective rationales for the proposal. First, FINRA argues that maintaining information about a deceased broker may result in unnecessary distress for the individual's family. The assumption here is that the broker's history reflects bad acts – otherwise, having the information available for public view would not be distressing. It makes no sense for

FINRA to be jumping through hoops to protect the reputation of these bad brokers, to the detriment of the investors which it is supposed to protect.

Without that information publicly available, attorneys representing aggrieved investors will search the BrokerCheck system, not locate the deceased broker, and conclude (incorrectly) that the person was never registered with a FINRA-member firm. Take, for example, now deceased former broker Karl H. Romero (CRD # 403473). Mr. Romero died in 2016. Before his passing, he accumulated nine customer complaints and/or arbitration claims related to sales practices regarding various alternative investments, starting in 2009. After his death, five (5) additional customers filed complaints or otherwise complained about Mr. Romero's sales practices regarding various alternative investments. According to Brokercheck, the most recent complaint about Mr. Romero was filed in December 2019, and was settled by Mr. Romero's employer in February 2020. Had FINRA's proposed changes been implemented, those customers may not have brought and resolved their legitimate claims because they and their counsel were deprived of valuable information related to Mr. Romero's past history. Further, those claimants could have been denied valuable discovery about the prior disputes and any related FINRA investigations.

Second, FINRA claims that maintaining information about a deceased individual in BrokerCheck could possibly make it easier for someone to steal the deceased person's identity in an attempt to defraud investors. That is simply not a credible argument. BrokerCheck does not identify whether an individual is deceased, so it makes it no more likely that a scammer would learn that the individual was deceased from BrokerCheck than other sources. If a scammer has that information, it necessarily would have been from a different source. Moreover, there is no personal confidential information shared about an individual, deceased or otherwise, on BrokerCheck, such as home addresses, dates of birth, social security numbers, account numbers, or taxpayer identification numbers. It is a hollow argument that keeping information on deceased brokers publicly available will make it any more likely that they are the subject of identity theft and certainly does not outweigh the concrete value of substantive information to harmed investors.

There is rarely a good reason to whitewash Brokercheck and deny valuable information to prospective investors and victims of bad brokers. The death of a broker is no reason to conceal his or her misdeeds. It appears the only benefit to deleting such valuable information would be to the firm or firms which employed the broker.

Further, PIABA wonders whether the removal of the bad acts of deceased brokers would cause FINRA to undercount the metrics related to determining

whether a member firm should be placed on FINRA'S proposed restricted firm list.[2]

As an association of attorneys who represent aggrieved investors in FINRA arbitration proceedings and in court, PIABA believes that all of the information that is disclosed for current FINRA member firms and associated persons should remain in the public domain indefinitely. We urge FINRA to withdraw SR-FINRA-2020-045 immediately.

Sincerely,
David P. Meyer,
PIABA President

2. SR-FINRA-2020-041.

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The following Comment Letter regarding *SR-FINRA-2020-041 – Proposed Rule Change To Adopt FINRA Rule 4111 (Restricted Firm Obligations) and FINRA Rule 9561 (Procedures for Regulating Activities Under Rule 4111* was submitted to the Securities and Exchange Commission by David Meyer on December 28, 2020. (prepared with the assistance of Christine Lazaro, Amber Heinze, and Robert Girard).

Ms. Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
rule-comments@sec.gov

Re: SR-FINRA-2020-041 - Proposed Rule Change To Adopt FINRA Rule 4111 (Restricted Firm Obligations) and FINRA Rule 9561 (Procedures for Regulating Activities Under Rule 4111

Dear Ms. Countryman:

I write on behalf of the Public Investors Advocate Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by the Financial Industry Regulatory Authority ("FINRA") relating to both investor protection and disclosure. As such, PIABA frequently comments upon proposed rule changes and retrospective rule reviews in order to protect the rights and fair treatment of the investing public.

In general, PIABA supports SR-FINRA-2020-041, which proposes to adopt FINRA Rules 4111, 9561 and Capital Acquisition Broker Rule 412 and amend FINRA Rule 9559 and Funding Portal Rule 900(a) regarding the treatment and obligations of "Restricted Firms" ("Rule Proposal"). In particular, Rule 4111 would categorize member firms that have significantly higher levels of risk-related disclosures than similarly sized peers as "Restricted Firms" and impose certain obligations on those firms. Such obligations may include requiring a member firm to maintain a specific deposit amount, with cash or qualified securities in a segregated account at a bank or clearing firm, from which the member firm could make withdrawals only with

FINRA's approval ("Restricted Deposit Account"). The obligations also may include conditions or restrictions on the operations and activities of the member firm and its associated persons that relate to, and are designed to address the concerns indicated by, the preliminary identification criteria used by FINRA to determine if a member firm qualifies as a Restricted Firm.

PIABA is a firm supporter of FINRA's efforts to enhance its programs to address the risks posed to investors by individual brokers and member firms that have a history of misconduct. The proposed changes in SR-FINRA-2020-041 are a step toward that end, however, the proposed measures do not do nearly enough to discourage bad actors from engaging in misconduct nor purge the securities industry of member firms and brokers with a history of misconduct that, by FINRA's own admission,[1] may be predictive of future misconduct. Further, while the proposed Rule allows FINRA to consider outstanding unpaid arbitration awards and settlements as criteria when designating a firm as a Restricted Firm, the Rule fails to establish a remedy, such as, by way of example, requiring these outstanding debts to be paid by the firm prior to depositing funds into a Restricted Deposit Account to cover future obligations, which could preclude the need to consider such criteria in the first place. Finally, PIABA also must reiterate its grave concerns that expungement of customer disputes from firms' and brokers' industry records – which remains rampant and predominantly unchecked – will adversely affect FINRA's ability to determine whether a firm should be deemed Restricted, yet the Rule Proposal offers no remedy for the skewed data that FINRA will rely upon in its deliberations.

The Rule Proposal Seeks to "Incentivize" Compliant Behavior Rather than Enforce Compliance

As FINRA noted, the member firms affected by the Rule Proposal often fail to meet their supervisory obligations and persistently employ brokers who engage in misconduct. FINRA asserted that the Rule Proposal was intended to "incentivize" these firms to engage in more rigorous supervision of their problematic brokers:

The proposed rule is intended to place additional restrictions on identified firms and increase scrutiny by these firms on their brokers. As a result, FINRA anticipates that the proposed rule will reduce the risk and associated costs of

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1. FINRA's 2015 study published by the Office of the Chief Economist found that past disclosure events, including regulatory actions, customer arbitrations and litigations of brokers, have significant power to predict future investor harm.

possible future customer harm and lead to improvements in the compliance culture, relative to the economic baseline of the current regulatory framework. The proposed rule is intended to create incentives for firms and brokers **to limit or end practices** that result in customer harm and provide increasing restrictions on those that choose not to alter their activities. (Emphasis added.)[2]

It is laudable, and indeed imperative, to encourage firms and brokers with a history of misconduct to improve their compliance culture and supervisory efforts, and PIABA supports the additional conditions and restrictions that FINRA may impose on Restricted Firms. PIABA is supportive of FINRA including a non-exhaustive list of examples of such conditions and restrictions within the Supplementary Material to the proposed Rule. However, investors are still left vulnerable to such firms and brokers. FINRA has determined that these firms represent a heightened risk to the investing public, yet by keeping this information private, FINRA is preventing investors from making informed decisions about those with whom they are investing. FINRA should reconsider its decision to keep a firm's designation as a Restricted Firm private, especially if a firm is so designated for a period of time exceeding one year.

The Rule Should Clarify How Awards and Settlements May Be Paid From the Restricted Deposit Account

As FINRA is aware, the problem of uncollectable arbitration awards from member firms and registered representatives is a significant one and an issue that PIABA has worked diligently to address. As we have stated repeatedly, if FINRA arbitration is to promote confidence in the markets and be perceived as a fair alternative to jury trials, investors who are forced through the process and receive an award must be able to collect that award. In the same vein, there must be a mechanism that ensures firms will abide by the settlement agreements they enter into in resolution of customer disputes.[3]

It appears that, in direct response to PIABA's comments on Regulatory Notice 19-17, FINRA has taken the position that the Rule Proposal is not

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2. Proposed Rule Change To Adopt FINRA Rule 4111 (Restricted Firm Obligations) and FINRA Rule 9561 (Procedures for Regulating Activities Under Rule 4111), 85 Fed. Reg. 78540, 78563 (Dec. 4, 2020) ("Rule Proposal").

3. We note that FINRA has included unpaid settlements related to arbitrations within the definition of "unpaid arbitration awards." *See* Rule Proposal, p. 78542, fn. 11.

intended to remedy investors' inability to collect on awards or settlements. FINRA repeated throughout the Rule Proposal:

FINRA believes that a financial requirement is the measure most likely to motivate Restricted Firms to change behavior. As such, the Restricted Deposit Requirement is an essential feature of the proposal to protect investors, *with the possible secondary benefit* of helping to address the issue of unpaid arbitration awards.[4]

As noted in PIABA's comment to Regulatory Notice 19-17, the language in the proposed Rule limiting the amount FINRA can require a high-risk firm to set aside to a sum that will "not significantly undermine the continued financial stability and operational capability of the member as an ongoing enterprise over the next 12 months"[5] means that the more thinly capitalized firms may not be required to deposit funds sufficient to cover outstanding awards and settlements, let alone "Covered Pending Arbitration Claims." Since unpaid and anticipated awards are used as criteria to determine Restricted status and the maximum deposit required by a Restricted Firm, it is axiomatic that the maximum deposit should at the very least cover those criteria.

PIABA has reviewed the list of firms with unpaid awards between 2013 and 2017, available on FINRA's website, and calculated the unpaid award amount for each firm.[6] Half of the firms listed appear to have 2 or more unpaid awards. More than 85% of the firms have unpaid awards of $100,000 or more. Forty percent of the firms have unpaid awards in excess of $1 million. Requiring those firms to deposit small sums in a Restricted Deposit Account will simply not have a material impact on the issue of unpaid awards or settlements.

Additionally, we see nothing in the rule proposal that explains why, exactly, the rule would incentivize member firms to pay awards. The Rule Proposal does not mandate that outstanding awards or settlements be paid at all, merely considered as factors when (1) determining the maximum amount to be deposited by a Restricted firm, and (2) determining whether to allow a firm to withdraw funds for another purpose.[7] In fact, it seems that, even if a

4. Rule Proposal, p. 78540 (emphasis added).

5. Regulatory Notice 19-17, p. 12; Rule Proposal, p. 78545.

6. PIABA assumed any awards issued following a firm's termination of membership or within a year prior to the firm's termination were unpaid.

7. *See* Rule Proposal, p. 78542.

current member firm[8] funds a Restricted Deposit Account, there is no assurance that FINRA would approve such funds to be used to satisfy unpaid awards or settlements and instead demand that the firm find the money elsewhere. *See, e.g.,* Rule Proposal, p. 78565 ("The presumptions of denial that would apply when a Restricted Firm … applies for a withdrawal from a Restricted Deposit would still apply when the firm seeks to use the funds to satisfy unpaid arbitration awards; unless the presumption of denial can be overcome, those firms would generally need to satisfy unpaid arbitration awards using funds other than those in a Restricted Deposit Account.") Thus, even after a firm has funded its Restricted Deposit Account, there is no guarantee that the funds will be used to pay outstanding arbitration awards or settlements.

The proposed rule should address how aggrieved investors can access those restricted deposits to satisfy the arbitration awards that the Restricted Firms refuse to pay themselves. While the Rule Proposal addresses the rebuttable presumption that a former member firm may withdraw funds to pay an outstanding award or settlement, the proposed Rule should address how an investor may access these funds if the former firm refuses to apply for a withdrawal, or if no one from the former firm is available to make such a request on behalf of the investor.

Further, the fact that FINRA will not make public that a firm is Restricted may mean that an investor with an unpaid award or settlement is not aware that the Restricted Deposit Account even exists. To the extent the funds in the account are available to satisfy unpaid arbitration awards and settlements, that can only be accomplished if investors are aware that there are funds available from which such awards and settlements may be satisfied. For this reason, as well as those stated above, FINRA should make investors aware when a firm is designated as a Restricted Firm.

Expungement of Customer Dispute Disclosures Will Skew the Data FINRA Relies Upon to Determine Whether a Firm Should be Restricted

Proposed FINRA Rule 4111 also calls into question the ongoing problem related to the pervasive nature of expungement of customer disputes. First and foremost, to the extent the threshold analysis to determine "restricted" status reviews a member firm's disclosure history, FINRA can only review the

8. It is only if the firm is no longer a member that there is a rebuttable presumption that the withdrawal will be used to pay outstanding awards or settlements.

disclosures that exist in the record; if customer complaints are expunged, FINRA will be unable to consider the full breadth of relevant disclosures and likely overlook certain firms and brokers who are recidivists and should be designated "Restricted," yet have expunged their records. According to a report devoted to the issue of expungement in the securities industry, "successful and, to a greater extent, unsuccessful expungement attempts, are a significant predictor of future misconduct."[9] "Roughly one-third of advisers with misconduct are repeat offenders. Prior offenders are five times as likely to engage in new misconduct as the average financial adviser."[10] Despite this predictive quality, customer dispute disclosures are expunged regularly. As PIABA has pointed out, expungements of customer disputes are granted all too frequently, and in violation of FINRA's attempts to ensure expungement is an extraordinary remedy, rather than the norm as it exists today.

PIABA first reported on the issue on September 24, 2007 and found that expungement was granted in 98.4% of the cases. PIABA's 2013 report entitled "Expungement Study of the Public Investors Arbitration Bar Association,"[11] found that, for awards issued from May 18, 2009, through December 31, 2011, expungement was granted 96.9% of the time it was requested in cases resolved by settlement or stipulated awards. PIABA then updated its analysis in 2015 in a report titled simply "Update to the 2013 Expungement Study of the Public Investors Arbitration Bar Association."[12] The update found that, for cases filed from January 1, 2012, through December 31, 2014, expungement was granted in 87.8% of the cases. In 2019, PIABA published a study that noted, "From 2015-2018, there has been an explosive increase in the filing of what are

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9. Honigsberg, C. and Jacob, M., "Deleting Misconduct: The Expungement of BrokerCheck Records" (Nov. 14, 2018), p. 2 ("Honigsberg Report"), p. 1.

10. Egan, M., Matvos, G. and Seru, A., "The Market for Financial Adviser Misconduct" (Sept. 1, 2017), Journal of Political Economy, Forthcoming, p. 1 ("EganReport"); https://ssrn.com/abstract=2739170 or http://dx.doi.org/10.2139/ssrn.2739170. *See also* Honigsberg Report, p. 15 ("just over 16% of brokers with an unsuccessful expungement received another allegation of misconduct after the expungement – for comparison, only 4% of non-expungement brokers receive an allegation of misconduct").

11. Available at https://piaba.org/system/files/2018-01/REPORT%20-%20Expungement%20Study%20of%20the%20Public%20Investors%20Arbitration%20Bar%20Association.pdf.

12. Available at: https://piaba.org/sites/default/files/newsroom/2015-10/Update%20on%20the%202013%20Expungement%20Study%20of%20PIABA%20%28October%2020%2C%202015%29.pdf.

known as “Expungement-Only” cases, which rose 924% from 2015 to 2018…. ¶ The 2,194 customer complaints contained in 1,078 arbitration proceedings that brokers requested be expunged increased by 1016% from 2015 to 2018. One individual broker successfully requested that twenty-four (24) complaints be expunged in a single proceeding.”[13] In short, despite FINRA’s attempts to curb the problem of rampant expungements, the problem remains unabated with only very small progress having been made on this issue over the last decade.

This creates serious concerns regarding the efficacy of FINRA’s ability to discern whether a firm should be Restricted, because member firms and its brokers can sanitize their records.

The proposed rule therefore will have the likely and unintended consequence of further incentivizing member firms and registered representatives to pursue expungement of customer complaints. Although FINRA acknowledged PIABA’s concerns regarding expungements, it asserted that “FINRA believes, however, that the data reported on the Uniform Registration Forms is reliable enough on which to base proposed Rule 4111.”[14] FINRA further asserted:

FINRA recognizes that the number of expungement requests may increase as a result of this proposal. However, the existing regulatory framework and FINRA rules are designed to ensure that expungements are granted only after a neutral adjudicator (arbitrator or judge) concludes that expungement is appropriate.

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Accordingly, FINRA does not believe that the proposal would directly result in inappropriate expungements being granted or appropriate expungements being not granted, or that it would undermine the quality of the underlying CRD information used for the proposed metrics.[15]

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13. Doss, J., Braganca, L. “2019 Study on FINRA Expungements: A Seriously Flawed Process that Should be Stopped Immediately to Protect the Integrity of the Public Record.”.

14. Rule Proposal, p. 78561.

15. Rule Proposal, p. 78561.

Although PIABA disagrees with FINRA's conclusions, PIABA recognizes that FINRA has made strides to reform the expungement process and supports FINRA's continuing efforts to address this serious issue.[16]

Other Considerations

1. PIABA reiterates its concerns that the Rule does not account for an analysis related to failed products. Limiting the analysis as the proposed rule does ignores the all-too-common problem presented by product failures. High-risk firms will often focus a large percentage of their business on selling particular products, commonly non-publicly traded investments. A failure of such a product will bring a rash of claims. And, in the event the member firm bears culpability for the sale of the products (such as UBS with Puerto Rico municipal bonds or Securities America with Medical Capital), the resulting liabilities can destroy the firm and leave investors without recourse. Securities America threatened to do exactly that when it testified, in court, that the failure to approve a minimal class action settlement would result in its bankruptcy over the following weekend.[17] Any threshold analysis must therefore consider the nature of the products sold by the member firms, and the extent to which it sells said products. If FINRA is truly trying to protect against risky behavior, the member firms' actual ongoing sales behavior must be factored into the analysis.

2. The Rule Proposal is intended to address "certain firms that have a concentration of associated persons with a history of misconduct, and some of these firms consistently hire such individuals and fail to reasonably supervise their activities."[18] However, the Rule Proposal allows firms a one-time staff reduction option to stave off Restricted status. It is unclear how this is designed to "deter and remedy misconduct by member firms and the individuals they hire." Rather than incentivize member firms to diligently monitor and supervise its brokers, it incentivizes them to discharge the "low

16. *See, e.g.,* Rule Proposal, p. 78561, fn. 130 re: proposed amendments to the FINRA *Code of Arbitration Procedure*.

17. *See* Susanne Craig, "*Judge Backs Arbitration in Case Against Securities America*," Dealbook, March 18, 2011, available at: https://dealbook.nytimes.com /2011/03/18/judge-backs-arbitration-in-securities-america-case/.

18. Rule Proposal, p. 78541.

hanging fruit" and continue business as usual. It is unclear how this services FINRA's mission to protect investors or market integrity.

3. The term "Covered Pending Arbitration Claim" is defined in proposed Rule 4111(i)(2) as:

> [A]n investment-related, consumer-initiated claim filed against the member or its associated persons in any arbitration forum that is unresolved; and whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the member's excess net capital. The claim amount includes claimed compensatory loss amounts only, not requests for pain and suffering, punitive damages or attorney's fees, and shall be the maximum amount for which the member or associated person, as applicable, is potentially liable regardless of whether the claim was brought against additional persons or the associated person reasonably expects to be indemnified, share liability or otherwise lawfully avoid being held responsible for all or part of such maximum amount. This term conforms, in relevant part, to the definition of Covered Pending Arbitration Claim in Rule 1011(c). *See* Securities Exchange Act Release No. 88482 (March 26, 2020), 85 FR 18299 (April 1, 2020) (Order Approving File No. SR—FINRA-2019-030).[19]

The fact that a claim is only covered if it exceeds a firm's excess net capital improperly excludes claims that are less than a firm's excess net capital yet may still remain unpaid by the firm. Further, because the designation as Restricted occurs based on a snapshot of the firm as of a particular date, and the restricted deposit requirement is likewise determined based on fixed point in time, a firm may be able to manipulate whether an arbitration claim is covered simply by adjusting its excess net capital while FINRA is determining the restricted deposit requirement. Allowing the firm such control would undermine the purpose of the rule proposal.

4. The Rule Proposal fails to address the issue of fluctuating valuation of "qualified securities" deposited into the Restricted Deposit Account in lieu of cash. Asserting that the "qualified securities" have an aggregate value that is not less than the member's Restricted Deposit Requirement ("except in certain identified situations") presupposes the value of the securities at the time they are deposited; there is no guarantee that the securities will retain that value up

19. Rule Proposal, pp. 78541-2, fn. 10.

to the time they are redeemed to pay an outstanding debt by the firm, and there is no mechanism in the Rule Proposal to ensure the Restricted Deposit Account maintains its valuation between FINRA reviews. Therefore, the Rule Proposal should address the frequency of the Restricted Deposit Account valuation and establish rules requiring account replenishment as necessary.

Conclusion

Once again, PIABA acknowledges and appreciates the considerable time and effort FINRA put into the Rule Proposal and in addressing the questions and comments made to its precursor, Regulatory Notice 19-17. While PIABA supports FINRA's continuing efforts to build and strengthen the tools available to protect investors against unscrupulous member firms and securities professionals, much more must be done to ensure high-risk bad actors are held accountable for prior misconduct, such as ensuring the payment of outstanding arbitration awards and settlements, taking account of product failures, and successfully culling bad actors from the securities industry before they can take advantage of unsuspecting investors. There remains a concern that the Proposed Rule could have the unintended consequence of making the expungement problem worse. Moreover, while the clear purpose of the proposed rule is to better regulate high-risk firms and brokers, we strongly urge FINRA to consider the additional changes set forth herein.

We thank you for the opportunity to comment on the Rule Proposal and urge FINRA to consider the issues set forth above before any final version is adopted.

Sincerely,
David P. Meyer
PIABA President

The following Comment Letter regarding *Regulatory Notice 20-34, Request for Comment on Retrospective Rule Review (Rule 2165 – Senior Investors)* was submitted to Financial Industry Regulatory Authority by David Meyer on December 4, 2020. (prepared with the assistance of Darlene Pasieczny).

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

RE: Regulatory Notice 20-34
Request for Comment on Retrospective Rule Review (Rule 2165 – Senior Investors)

Dear Ms. Piorko Mitchell:

I write on behalf of the Public Investors Advocate Bar Association[1] ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by the Financial Industry Regulatory Authority ("FINRA") relating to investor protection.

PIABA members frequently represent senior investors, and we are particularly concerned with enhancing protections for this vulnerable population. PIABA previously commented on FINRA Regulatory Notices 15-37 and 19-27, which included a variety of senior protection proposals. Regulatory Notice 20-34 ("RN 20-34") seeks comment on proposed revisions to one of those protections, FINRA Rule 2165, which creates a "uniform national standard" for FINRA-registered members and associated persons regarding certain tools to help prevent financial exploitation of specified adults, including a "safe harbor" provision allowing firms to place a temporary hold on a disbursement of funds or securities when there is suspected misconduct. Based on FINRA's retrospective review, FINRA proposes

1. Formerly known as the Public Investors Arbitration Bar Association.

extending the time of the permissible hold period under Rule 2165 and to allow temporary holds on securities transactions (not just disbursements).

PIABA Supports Enhanced Protections – With Caution

PIABA deeply appreciates FINRA's recognition that our elder population is particularly vulnerable to financial abuse. Abuse by a family member or friend is, tragically, common throughout the United States. The "safe harbor" protections of Rule 2165 give brokers important tools to help their clients and prevent potential abuse by third-party bad actors. The results of FINRA's member survey described in RN 20-34 give important insights for improving these tools.

However, PIABA is also concerned with investor autonomy and protecting senior investors *from member firms* potentially misusing the expanded hold periods and extension of holds to securities transactions.

State Law Alignment Considerations

RN 20-34 references the Model Act to Protect Vulnerable Adults from Financial Exploitation, first promulgated by the North American Securities Administrators Association ("NASAA") in September 2015. To date, 28 states have enacted legislation or regulations based on this Model Act.[2] Several additional states enacted statutes prior to the Model Act that include at least some of its elements.[3] The majority of these states follow the Model Act's definition of "vulnerable adult" as including anyone age 65 or older, as well as other provisions: the 25-business day total time frame for permissive delays of disbursements, mandatory record keeping and state access to such records, mandatory reporting of suspected abuse to specified state agencies, and permissive notification to certain previously identified individuals (provided that they are not the suspected abuser).[4]

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2. http://serveourseniors.org/about/policy-makers/nasaa-model-act/update.

3. *See e.g*., Washington State, RCW 74.34.215 (Financial Exploitation of Vulnerable Adults) (allowing permissive temporary holds on disbursal of funds).

4. For a detailed comparison, *see* Darlene Pasieczny, *States Adopting NASAA's Model Act to Protect Vulnerable Adults from Financial Exploitation (Mandatory and Permissive Conduct by Financial Advisors)*, PIABA Bar Journal, vol. 26, no. 2 (October 2019). Since the article's submission for publication, several additional states adopted versions of the Model Act or adopted revised pending versions:

According to RN 20-34, 16 of the 31 states with laws that allow investment advisers or broker-dealers to place some form of hold on suspicious requests extend to securities *transactions within an account,* as well as distributions of funds or securities out of an account. This is different than the Model Act, which is limited to disbursements only. Furthermore, an extension of the hold time to 30 business days would go beyond the Model Act's total 25-business day hold period for permissive delays.

In its comment to RN 19-27, PIABA cautioned FINRA against substantive changes to Rule 2165 that might conflict with enacted state law.[5] However, it appears that states recently adopting some version of the Model Act and now about half of the states with such laws *prefer the extension to securities transactions* as well as distributions. The firm feedback noted in RN 20-34 suggests firms may benefit from increased permissible hold periods with appropriate safeguards.

Mandatory Reporting Requirement May Dissuade Misuse of Rule 2165

PIABA is cautious regarding the proposed extension to securities transactions, as there could be significant monetary losses due to the failure to execute a legitimate purchase or sell instruction. PIABA is also concerned about potential misuse of the extended 30-business day hold period, for the same reason of market pricing changes, as well as potential delays in transferring an account to another brokerage firm. Bad faith conduct by the member firm to delay for purpose of financial benefit – for example, generating another month of commissions or fees – is not only frustrating but may be costly to an investor. A potential safeguard against such conduct is to add the requirement in the FINRA Rule 2165 that the member firm *must report* the suspected abuse to the appropriate state Adult Protective Services and state securities regulator. Most states adopting the Model Act *already have mandatory* reporting requirements to promptly notify state Adult Protective Services and the commissioner of securities (e.g., the state securities regulator)

Arizona, California, Florida, New Hampshire, New Jersey, Rhode Island, and West Virginia.

5. State law protections following the Model Act apply to "qualified individuals" defined as any "agent, investment adviser representative or person who serves in a supervisory, compliance, or legal capacity for a broker-dealer or investment adviser." Thus, these state laws generally apply to a broader category of individuals, but overlap with FINRA Rule 2165 for FINRA-registered members and associated persons.

upon reasonable belief that financial exploitation of an eligible adult may have occurred, may have been attempted, or is being attempted.

Therefore, PIABA recommends that FINRA add to Rule 2165 the general requirements that the member firm: (1) update its written supervisory manuals to include training and review transactions suspected of elder abuse; (2) include in its retained records documentation of the firm's reasonable efforts to quickly investigate the matter; and (3) file a report with the appropriate Adult Protective Services agency and state regulator *as soon as reasonably practical but no later than seven business days from the initial hold period.*

By including more express documentation and a mandatory reporting requirement in the FINRA rules, no additional burden is put on the firms already making such reports in compliance with state law, and firms may be dissuaded from misuse of extending permissive hold periods.

Additional Protections Should Be Considered

PIABA urges FINRA to continue to consider the following improvements to FINRA rules and practices:

- Amending the Sanctions Guidelines to add as a principal consideration for enhanced sanctions whether a victimized customer is a "specific adult," i.e., a person 65 or older or a person 18 or older who the member firm reasonably believes has a mental or physical impairment that renders the individual unable to protect his or her own interest.
- Mandating heightened supervision for the marketing and sale of particular products or investment strategies to seniors that may have inherently higher risks, such as annuities, structured notes, private placements, and other illiquid, complex or "alternative" products.
- Emphasizing in Notice to Members and the Arbitrator's Guide that an expedited case (designated expedited based on age or illness) scheduled for an evidentiary hearing beyond six months from the Initial Prehearing Conference *should be the exception and only granted for good cause shown or stipulation of the parties*.
- Regularly reviewing and improving the legibility and ease of navigation of the FINRA website for senior investors to find the Securities Helpline for Seniors, the Investor Complaint Center, and generally, information about Arbitration and Mediation.

Conclusion

PIABA encourages FINRA to continue to work in tandem with NASAA and state regulators, who are positioned to understand the needs of their particular aging populations. PIABA also applauds FINRA for its continued review of its rules and guidance to improve investor protections. We thank you for the opportunity to comment on the proposed rule and urge FINRA to consider the issues set forth above.

Sincerely,
David P. Meyer
PIABA President

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The following Comment Letter regarding *SR-FINRA-2020-038 - Proposed Rule Change to Amend FINRA Rules 5122 (Private Placements of Securities Issued by Members) and 5123 (Private Placements of Securities)* was submitted to the Securities and Exchange Commission by David Meyer on November 27, 2020. (prepared with the assistance of David Neuman).

via email to rule-comments@sec.gov
Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: SR-FINRA-2020-038 - Proposed Rule Change to Amend FINRA Rules 5122 (Private Placements of Securities Issued by Members) and 5123 (Private Placements of Securities)

Dear Ms. Countryman:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by the Financial Industry Regulatory Authority ("FINRA") relating to both investor protection and disclosure. As such, PIABA frequently comments upon proposed rule changes and retrospective rule reviews in order to protect the rights and fair treatment of the investing public.

In SR-FINRA-2020-038, FINRA proposes to change Rules 5122 and 5123 regarding private placements ("Rule Proposal"). In particular, the changes would require members to file retail communications concerning private placement offerings with FINRA. PIABA supports the Rule Proposal.

SR-FINRA-2020-038 indicates that there is a significant problem with retail communications related to private placements. As noted in Page 12 of the Rule Proposal, a 2018 spot check of retail communications revealed that 76% of these communications had "significant violations" of FINRA Rule 2210, which governs communications with the public. This included: 45% of these communications using prohibited projections or unreasonable forecasts; 44.6% exhibited a failure to balance the benefits with the risks; 39.9% failed

to adequately disclose general risks of the investment; and 21.8% had readily apparent false or misleading claims. Footnote 12 noted that 13% of retail communications contained such serious Rule violations that FINRA mandated that the firm not use that particular communication.

These numbers are troubling, considering that private placements are, by their nature, private and information about them is limited. Investors seeking information about publicly-traded investments have many sources to gather information about the particular investment or company. If the investing public wants to get information about a private investment, the only sources of information about the investment come from: the issuer (usually in lengthy, boilerplate private placement memoranda with legalese that is only understood by a small percentage of the population); the Form D filing with the SEC (which usually contains little information about the offering or the underlying company); or the advisor/brokerage firm selling the products to the investor. Since most investors are relying on the information provided by their advisor or brokerage firm, FINRA needs this rule to ensure that accurate and meaningful information is being provided to investors. The Rule Proposal would enable FINRA to ensure that all of the materials provided to investors are accurate , transparent, and consistent with regulatory standards. Further, the Rule Proposal would extend FINRA's ability to understand the scope and severity of existing issues in a more accurate and efficient manner, which would further enhance FINRA's surveillance and enforcement activities and discover significant violations before the sale of the security. This Rule gives FINRA the ability to prevent investor harm before it occurs.

FINRA must keep an eye of private placement sales abuses, because the numbers of persons who can invest in private placements has increased substantially over the last several decades. The SEC first established standards for "accredited" investors in 1982. This accredited investor standard included having a $1 million net worth or an income of $200,000 per year for individuals (or $300,000 per year for joint filers). By these standards, in 1982, only 1.8% of American households qualified as "accredited", while in 2013, this number had risen to 9.9%. See Commissioner Luis Aguilar's Statement on "Revisiting the 'Accredited Investor' Definition to Better Protect Investors at fn 3 (Dec. 17, 2014) (available at https://www.sec.gov/news/statement/spch 121714laa.html#_edn3). In a December 2019 statement, Commissioner Allison Herren Lee estimated that this accredited investor pool will grow to 22.7% of American households in the next decade. See Commissioner Allison Herren Lee's "Statement on the Proposed Expansion of the Accredited Investor Definition" (Dec. 18, 2019) (available at https://www.sec.gov/news/ public-statement/statement-lee-2019-12-18-accredited-investor#_ftnref6).

The growing pool of "accredited" investors stems from a variety sources, but including inflationary pressures, and does not translate to an increase in sophistication or experience with investing. With more "accredited" investors in the pool there are more investors susceptible to abusive sales practices. The Rule Proposal will increase the pressure on members and issuers to provide consistent and accurate information, thereby enhancing investors' ability to adequately ascertain the risks of these investments.

These numbers will only worsen if FINRA does not enact the proposed changes to Rules 5122 and 5123. FINRA must be mindful of these challenges and devote adequate resources to policing these abuses. While the Rule Proposal would increase FINRA's oversight of private placement offerings, there would be little to no economic impact to firms and issuers, because they are already required to file private placement offerings with FINRA. The predominant impact would be to the benefit of the investing public.

In summary, PIABA supports the proposed changes to Rule 5122 and 5123 and hopes that FINRA can do more to curb abuses of sales of private placements.

Sincerely,
David P. Meyer
PIABA President

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The following Comment Letter regarding *SEC File Number S7-13-20 - Proposed Exemptive Order Granting Conditional Exemption from the Broker Registration Requirements of Section 15(a) of the Securities Exchange Act of 1934 for Certain Activities of Finders* was submitted to the Securities and Exchange Commission by David Meyer on November 12, 2020. (prepared with the assistance of Jorge Riera, Courtney Werning, and Robert Girard).

Via Email: rule-comments@sec.gov
Ms. Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: SEC File Number S7-13-20 - Proposed Exemptive Order Granting Conditional Exemption from the Broker Registration Requirements of Section 15(a) of the Securities Exchange Act of 1934 for Certain Activities of Finders

Dear Ms. Countryman:

I write on behalf of the Public Investors Advocate Bar Association ("PIABA"), an international, not-for profit bar association that consists of attorneys who represent investors in disputes with the securities industry. Since its formation in 1990, PIABA's mission has been to promote the interests of the public investor by, among other things, seeking to protect such investors from falling prey to investment fraud, 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 U.S. Securities and Exchange Commission ("SEC") that govern the practices of brokers and broker-dealers.

PIABA strongly opposes SEC File Number S7-13-20 ("Proposed Exemptive Order"), which seeks to dramatically expand the ability of unregistered – and hence unsupervised – individuals, so-called "Finders," to engage in certain brokerage activities on behalf of private issuers, and to be compensated through transaction-based payments, without being subject to the regulations designed to protect investors from unscrupulous sales activities. For the reasons detailed below, PIABA believes that a Finder must be subject to all of the requirements that would apply to a broker-dealer when acting in that same capacity.

The Proposed Exemptive Order frustrates the SEC's mission to protect investors, contradicts significant SEC precedent regarding broker-dealer registration, and is contrary to the SEC's warnings that allowing Finders to receive transaction-based compensation would incentivize abusive sales practices that registration/licensure is intended to regulate and prevent. Moreover, even assuming that the terms of the Proposed Exemptive Order may "clarify" the regulatory status of Finders and/or benefit small and minority-owned businesses' ability to raise capital, acting through an exemptive order is not the proper means to achieve those ends. This proposal should be withdrawn.

I. The Devastating Impact to Investor Protection

The Proposed Exemptive Order seeks to establish two "tiers" of Finders and, among other deleterious provisions, permits the following:

- All Finders may receive transaction-based compensation, incentivizing aggressive sales tactics at the expense of investors;
- Tier I Finders are not required to provide investors with written disclosures, thereby undermining the SEC's stated goal of transparency for investors;
- Tier I Finders may only participate in one (1) capital raising transaction in a 12-month period, which will encourage them to engage in aggressive sales tactics at the expense of investors;
- While there are some limitations for Tier II Finders, they essentially can do what a broker does to solicit accredited investors for non-registered, private company investments, thus wholly undermining the purpose of regulation and licensure of brokers; and,
- There are no limits on the amounts that can be raised from investors, the size of the offerings, or the types of issuers that can take advantage of the relief. Instead, issuers of any size would be permitted to employ Finders to raise unlimited amounts of capital without regulatory oversight.

Under the terms of the Proposed Exemptive Order, a Tier II Finder would be permitted to engage in a wide range of activities that the SEC has long held constitute brokerage activities that should be regulated and subject to appropriate oversight. For example, the Proposed Exemptive Order would permit unregistered Finders to contact potential investors, distribute sales material, discuss the sales material with investors, participate in meetings with the issuer and investors, and receive transaction-based compensation. All of these activities would be permitted without any regulatory oversight, even

though brokers engaging in the same activities are subject to oversight, conduct rules, and discipline should the broker engage in misconduct while undertaking these same activities. Finders can and will engage in misconduct that the industry's regulatory rules are designed to prevent, namely soliciting unaccredited investors, misrepresentations and omissions, and other broker bad acts, knowing their activities are less likely to be noticed by regulators.

The SEC is well aware that private markets, as compared to public markets, are less liquid, impose higher transaction costs, are susceptible to valuation errors, often provide opaque or *de minimus* financial information, and are highly prone to fraud.[1] Finders in particular are often associated with fraudulent activity.[2] Regulators historically have waged war on unregistered Finders because their actions undermine the investor protection measures in every security law.

Regulators have a substantial concern over the "finders" who flout the securities laws. We estimate that the various states bring well over 100 enforcement cases against unregistered finders on an annual basis (and probably a great deal more because statistics are not available from NASAA or the states to identify the full extent of state action). The NASD brings a large number of cases against individuals who are engaged in selling away

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1. *See* NASAA, Comment Letter on Proposed Rule to amend the "Accredited Investor" definition (Mar. 16, 2020) ("private offerings are often characterized by opaque disclosures, related party transactions, illiquidity, minimal financial information and, unfortunately, fraud."). *See also* NASAA, Legislative Agenda for the 116th Congress (Mar. 5, 2019) ("NASAA Report") at n. 10 ("There is a well-documented relationship between private offerings sold by brokers and an elevated risk of fraud, and a disproportionate percentage of persons acting as brokers in the private offering marketplace are brokers with red flags in their record.") (citing Jean Eaglesham and Coulter Jones, A Private Market Deal Gone Bad: Sketchy Brokers, Bilked Seniors and a Cosmetologist, The Wall Street J. (May 7, 2018)); PIABA, Comment Letter on Concept Release: Harmonization of Securities Offering Exemptions (Sept. 24, 2019) (listing SEC enforcement actions in connection with private securities offerings).

2. *See* Advisory Committee on Small and Emerging Business, Notable by Their Absence: Finders and Other Financial Intermediaries in Small Business Capital Formation, (Jun. 3, 2015) (stating that, in many cases, "persons acting as finders represent 'the dark side' of the securities business: purveyors of fraudulent shell corporations; front-end fee con artists; purported Regulation S specialists who send stock off-shore and wait to dump it back into the U.S. through unscrupulous brokerage firms or representatives who are receiving under-the-table payments for promoting stocks and micro-cap manipulators.").

from their brokerage firms for acting as unregistered financial intermediaries, often barring them from the business or imposing long suspensions. This is the second most frequently cited grounds for sanctioning registered representatives and has been for the past several years.[3]

Since both Tiers receive transaction-based compensation, Finders have an incentive to aggressively pursue investors by any means necessary, and financial professionals often push these products to unsophisticated investors. PIABA's members frequently see private securities presented as alternative income investments appealing to elderly investors often living on a fixed income. The products are pitched as offering income higher than what is available in conventional fixed-income securities, and/or also providing diversification to the investor's portfolio because their value is not correlated to the stock market or other conventional asset classes. Many clients solicited to invest in these types of products end up losing their entire investment.

The only investor protection the SEC has proposed is in the form of disclosure, and only for Tier II Finders. The SEC will require the Tier II Finders to provide a potential investor the following disclosure:

- the name of the Tier II Finder;
- the name of the issuer;
- the description of the relationship between the Tier II Finder and the issuer;
- a statement that the Tier II Finder will be compensated for their solicitation activities by the issuer and a description of the terms of the compensation arrangement;
- any material conflicts of interest resulting from the relationship between the Tier II Finder and the issuer; and
- a statement that the Tier II Finder is acting as an agent of the issuer, is not a an associated person of a broker-dealer, and is not undertaking to act in the best interests of the investor.

Surprisingly, these disclosures may be made orally by the Finder, although the investor must also receive a written disclosure no later than the time of the investment. This in no way adequately replaces the standards of conduct that a registered broker-dealer would be subject to when soliciting a prospective investor. First, it will be virtually impossible for the SEC to police the oral disclosures to ensure that they are adequate. Second, the written disclosures will come too late, and will likely be consumed by the myriad other disclosures an investor receives at the time of an investment. Third, the SEC has ample evidence that disclosure is not effective investor protection.

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3. American Bar Association, Report and Recommendation of the Task Force on private Placement Broker-Dealers at 13 (June 20, 2005).

With respect to private placements, PIABA members often see broker-dealers placing blank subscription agreements or subscription agreements rife with incorrect information before investors and convincing them to sign them. The investors do not read the documents; they do not examine the statements they are certifying in the documents; they rely on the statements made by their trusted advisor and sign where they are told to sign. The brokers then rely on those documents to disclaim liability. The only party protected by the disclosures are the brokers.

Moreover, the SEC relies on the fact that Finders will be limited in working with proposed investors who are accredited investors or who the Finders reasonably believe are accredited investors. This also offers little comfort in terms of investor protection. Last month, the SEC declined to update the accredited investor definition to account for inflation that has occurred since the income and net worth standards were first adopted in 1982.[4] At that time, only about 1.5 million households, 1.8%, qualified as accredited investors.[5] Today, 16 million, or 13% of households qualify as accredited investors.[6] Investors who, merely by the effects of inflation, qualify as accredited often do not have a "sufficient level of financial sophistication to participate in investment opportunities that do not have the additional protections provided by registration."

The standards of conduct governing broker-dealers recognize that simply meeting income and net worth standards does not make an investor "sophisticated" or make a private placement an appropriate investment for an accredited investor. Broker-dealers must still adhere to either the FINRA suitability rule or Regulation Best Interest to ensure that such an investment is appropriate for such an investor. Under the Proposal, all accredited investors will lose those protections when a Finder presents the offering.

The SEC's proposal to eliminate the important investor protections the established broker-dealer framework provides in an area of the securities markets that is already prone to fraud is misguided. Our members have seen firsthand what unregistered Finders can do to investors, and we received thousands of calls from investors who were scammed by these people during the recent $1.2 billion Ponzi scheme known as the Woodbridge Group of

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4. *See* SEC, Accredited Investor Definition, 85 Fed. Reg. 64,234 (Oct. 9, 2020).

5. *See* SEC, Report on the Review of the Definition of "Accredited Investor" (Dec. 18, 2015).

6. *See* SEC, Concept Release on Harmonization of Securities Offering Exemptions, 84 Fed. Reg. 30,460 (June 26, 2019).

Companies ("Woodbridge"). Robert Shapiro was able to unleash his Woodbridge investment fraud scam in every corner of the country by using an enormous team of unregistered Finders.

Unregistered Finders widely marketed Woodbridge as safe and secure and a conservative retirement and income plan, and thousands of unsophisticated retirees unknowingly bought into the sales pitch from these individuals. The SEC cracked down on the Woodbridge unregistered Finders by filing multiple fraud lawsuits, stating that "[t]he broker-dealer and securities registration provisions are vital protections for retail investors... the defendants, while not registered as broker-dealers, pocketed millions of dollars in unlawful commissions from their widespread sales of unregistered Woodbridge securities." SEC Press Release 2018-157, *SEC Charges Unregistered Brokers Who Sold Woodbridge Securities to Main Street Investors* (August 20, 2018). It is unclear how the SEC can recognize the abuse investors suffer at the hands of unregistered Finders, and the importance of registration provisions in protecting investors, yet support the Proposed Exemptive Order, which will almost certainly result in further abuses akin to the Woodbridge debacle.

II. The Intended Beneficiaries – Small and Minority-Owned Business – May Also Be Adversely Impacted by Allowing Unregulated Finders to Engage in Broker Activities

Investors are not the only ones put at risk by allowing unregistered Finders to engage in broker activities. Private issuers who deal with unscrupulous Finders may never see any of the monies purportedly raised by their offering. Even when the businesses do receive funding, dealing with unscrupulous Finders can present significant problems for the issuer. "They can taint an offering by creating the basis for rescission rights, raise enforcement concerns, make fraudulent representations and engage in general solicitation which disqualifies the offering for exemption from registration."[7]

While these issues are clearly significant, the Proposed Exemptive Order fails to acknowledge that fraudulent activity by Finders is a widespread problem it should seek to address. That is an abrogation of the SEC's central investor protection mission and its capital formation mandate. Because, unless the Commission also deals with the fraud problem, simply clarifying the regulatory status of Finders is unlikely to promote healthy capital formation.

7. *Id.*

III. Finders Get All of the Benefits, None of the Restrictions

The Proposed Exemptive Order proposes to allow Finders to engage in conduct that the SEC has long held constitutes brokerage activity that should be regulating in order to protect investors from unscrupulous bad actors. The only supposed limitation is that a Finder may not provide advice as to the valuation or advisability of the investment. Commissioner Lee provides a clear picture of what this looks like in practice:

Imagine a discussion in which a finder, who stands to gain proportionately for every dollar invested, finds an investor, teams up with an issuer to present offering materials and analysis, and sings the praises of a proposed investment. All she needs to do to avoid registration is refrain from concluding the presentation with the words "you should invest." The issuer itself can handle that last step, if it is even needed.[8]

Commissioner Lee is correct: the supposed restriction is only a restriction in form, not substance. There is no practical difference between allowing a Finder to state, "Boy, do I have a wonderful investment for you," but not allowing them to say, "you should invest." In both instances, the sale of a security has been solicited. In fact, the securities industry concluded long ago that the scope of the proposed activities for Finders would in fact be a "recommendation" that should trigger the requirements of FINRA and SEC rules governing recommendations, including Regulation Best Interest. Now, three months after the compliance date for Regulation Best Interest, the SEC proposes rolling back those protections, as well as other crucial protections, in favor of allowing security sales with no obligation to comply with industry rules.

IV. The SEC Has Consistently Viewed Transaction-Based Compensation as the Hallmark of Broker-Dealer Activity

A person's receipt of transaction-based compensation is a hallmark of broker-dealer activity.[9] Accordingly, any person receiving transaction-based

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8. Commissioner Allison Herren Lee Public Statement, *Regulating in the Dark: What We Don't Know About Finders Can Hurt Us* (October 7, 2020).

9. *See* Securities Exchange Act Release No. 61884 (April 9, 2010) ("the receipt of transaction-based compensation often indicates that such a person is engaged in the business of effecting transactions in securities." (internal citation omitted)). *See also* Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, to Thomas D. Giachetti, Stark & Stark, regarding 1st Global, Inc. (May 7, 2001)

compensation in connection with another person's purchase or sale of securities typically must register as a broker-dealer or be an associated person of a registered broker-dealer.

The SEC has consistently argued that "if the securities activities are engaged in for commissions or other compensation with sufficient recurrence to justify the inference that the activities are part of the person's business, [a person] will be deemed to be engaged in the business."[10] In addition to the regularity of business, the SEC have identified indications of broker activity that include "holding oneself out as a broker-dealer, recruiting or soliciting potential investors, handling client funds and securities, negotiating with issuers, and receiving transaction-based compensation." *See Anthony Fields*, AP File No. 3-14684, 2015 WL 728005, *18 (Feb. 20, 2015) (Commission Opinion). The receipt of "transaction-based compensation is one of the hallmarks of being a broker-dealer." *Gualario & Co.,* AP File No. 3-14340*,* 2012 WL 627198, *14 (Feb. 14, 2012) (Initial Decision).

The underlying concern that has led the SEC to consider transaction-based compensation as a hallmark for broker-dealer activity is that it represents a potential incentive for abusive sales practices. Having a financial stake in the potential transaction warrants registration with all of its investor protections, including the requirements of Regulation Best Interest.

V. Expelled Individuals Can Resurface as Finders

Securities regulators work hard to weed out the bad actors in the industry and routinely expel individuals who have committed serious infractions and are not of good business repute. There is nothing impeding a former registered representative or investment adviser who has been barred from registration from simply becoming an exempt Finder. The Proposed Exemptive Order fails to address this serious issue. Should individuals previously barred from acting as a broker start soliciting clients into the private market, there is nothing securities regulators will be able to do about it under the Proposed Exemptive Order.

(reiterating the staff's position that "the receipt of securities commissions or other transaction related [*sic*] compensation is a key factor in determining whether a person or an entity is acting as a broker-dealer. Absent an exemption, an entity that receives commissions or other transaction-related compensation in connection with securities-based activities that fall within the definition of 'broker' or 'dealer' ... generally is required to register as a broker-dealer." (internal citations omitted)).

10. *InTouch Global, LLC*, SEC No-Action Letter (Nov. 14, 1995).

VI. The Rulemaking Process Should Be Used In Lieu of the Proposed Exemptive Order

The Proposed Exemptive Order seeks to circumvent the formal rulemaking procedure. By circumventing the rulemaking process, the SEC is not required to perform any economic analysis of the impact of the exemption nor consider its impact on capital formation. Further, the SEC is not required to support its proposed policy with any actual evidence tying the proposal to the SEC's stated goal.

The SEC speculated that the proposal would benefit minority and women-owned businesses, but there is nothing in the proposal supporting that supposition and nothing in the Proposed Exemptive Order that would be specifically tailored to that purpose. More importantly, because of the SEC's lack of oversight of the private market, it would not have any way of evaluating the Proposed Exemptive Order's use or abuse.

The SEC proposes to adopt this radical policy change through an exemptive order, despite the fact that an alternative is available – working with FINRA and state securities regulators to adopt a regulatory regime tailored for these private market intermediaries. That is the approach that the Treasury Department recommended in its 2017 report, when it suggested adoption of "a 'broker-dealer lite' rule that applies an appropriately scaled regulatory scheme on finders." Similarly, that is the approach advocated by an American Bar Association Task Force in a 2005 report that was subsequently endorsed by the SEC's Advisory Committee on Smaller Public Companies, among others.

A modified broker-dealer regulatory framework that addressed the specific nature of entities that act solely as Finders would be more appropriate that wholly exempting such entities from registration. Subjecting such entities to standards of conduct, such as the FINRA suitability rules, communications rules, and supervisory rules, among other, as well as Regulation Best Interest for activity that involves solicitation is appropriate and will ensure that investor protection is a priority alongside capital formation. Such a framework will also ensure that there is a Regulator that has the resources to regularly examine the entities engaged in this conduct to ensure that they are following the conditions set forth, and are not engaged in conduct which we have seen in the past – conduct aimed at exploiting the disparities of information in the private placement space at the expense of investors and retirees.

The Proposed Exemptive Order is not an appropriate vehicle to address the myriad issues related to unregulated Finders.

VII. Conclusion

The Proposed Exemptive Order will severely undermine investor protection and does nothing to protect small businesses from unscrupulous Finders. PIABA stresses and reminds the SEC of its primary objective of protecting investors. For all of the reasons set forth in this letter, the Proposed Exemptive Order should be withdrawn.

Respectfully submitted,
David P. Meyer
PIABA President

The following Comment Letter regarding *File No. SR-FINRA-2020-030 (FINRA proposed rule change to modify the current process relating to the expungement of customer dispute information)* was submitted to the Securities and Exchange Commission by David Meyer on October 23, 2020. (prepared with the assistance of Daren Luma and Albert Copeland).

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

Re: File No. SR-FINRA-2020-030 (FINRA proposed rule change to modify the current process relating to the expungement of customer dispute information)

Dear Mr. Fields:

I write on behalf of the Public Investors Advocate Bar Association ("PIABA"), an international, not-for profit, voluntary bar association that consists of attorneys who represent investors in disputes with the securities industry. Since its formation in 1990, PIABA's mission has been to promote the interests of the public investor by, among 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 govern the practices of brokers and broker-dealer firms.

We welcome the opportunity to comment on the proposed changes that would modify the current process relating to the expungement of customer dispute information from an associated person's Central Registration Depository ("CRD"). As you know, PIABA has studied and commented on issues surrounding expungement extensively. Past PIABA studies have found that where there had been a stipulated award or settlement, expungements were granted in 87.8% of cases. Recently, and consistent with PIABA's findings, FINRA found that expungement was granted in 88% of settled cases. In short, expungement is not the "extraordinary remedy" that it is supposed to be, but something that is granted 9 out of 10 times when it is sought and something associated persons have come to take for granted.

With that background, PIABA supports FINRA's efforts to examine the issue and attempt to find solutions to the issues PIABA has previously identified. SR-2020-030 is largely a step in the right direction, but it is clear that FINRA has not gone far enough and appears to have succumbed to industry pressure on a few key points in the past three years since sought comment on FINRA Regulatory Notice 17-42.

First, in a step backwards from Notice 17-42, FINRA has determined to allow arbitrators to recommend expungement via a majority of arbitrators considering the issue, as opposed to a unanimous decision. As described below, if expungement is to truly be extraordinary, there should be no doubt in anyone's mind that the claim being expunged was factually impossible or clearly erroneous. A requirement of a simple majority sends a contradictory message to both arbitrators and parties. Second, PIABA disagrees with FINRA's determination not to propose that the panel must find "no investor protection or regulatory value." Third, the time limits for expungement requests should only be one year as proposed in Notice 17-42.

In short, FINRA knows it could do more to ensure that customer dispute information is not improperly expunged from an associated persons' public records. SR-FINRA-2020-030 is a step backwards from FINRA's proposals in Notice 17-42.

A. Expungement Decisions Should Be Decided by Unanimous Agreement

In Notice 17-42[1], FINRA proposed rules to expand the criteria a panel must follow before it may decide an expungement request. One of those rule proposals was that to recommend expungement, a three-person panel of arbitrators would require unanimous agreement.[2] The purpose of the expansion of the criteria was to clarify the process and guide the arbitrator's decision-making.[3]

After considering comments, FINRA determined to allow arbitrators to recommend expungement through a mere majority – not unanimous -

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1. Regulatory Notice 17-42, Financial Industry Regulatory Authority (December 7, 2017), available at https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-42.pdf.

2. *Id.*at 9.

3. *Id.*

decision.[4] While PIABA believes that expungement determinations should be made outside of the arbitration process, we respectfully disagree with FINRA's determination on this issue.

As evidenced by FINRA's own longstanding position[5] on this matter, expungement is an extraordinary remedy. Requiring unanimous decisions properly reflects the heightened burden and importance for such proceedings. Indeed, FINRA has promulgated rules and policies in the past that facilitate customer complaints from the CRD in extraordinary circumstances, and it must continue to do so.

However, opting for majority rule over unanimous decision for expungement determinations is simply incommensurate with the extraordinary nature of this particular remedy. Moreover, not requiring unanimous agreement for expungement determinations undercuts the intent behind the proposed rule change, which is to (1) help preserve in CRD information that is valuable to investors and regulators (2) while allowing associated persons reasonable mechanisms to remove information that is inaccurate.[6] As explained below, a majority decision for expungement determinations will ultimately only harm the one group FINRA is charged to protect: public investors.

1. Unanimous Decisions Ensure Expungement Remedies Remain Extraordinary

FINRA makes clear that expungement should not be a common event. Whether discussed in its guidance, arbitration materials, or regulatory notices, the significance of the expungement process cannot be overstated. A permanent deletion of customer complaint information from the CRD system

4. *See* Securities and Exchange Commission Release No. 34-9000, File No. SR-FINRA-2020-030, *Notice of Filing of a Proposed Rule Change to Amend the Codes of Arbitration Procedure Relating to Requests to Expunge Customer Dispute Information, Including Creating a Special Arbitration Roster to Decide Certain Expungement Requests,* (September 25, 2020).

5. *See, e.g. id.* at 3.

6. *See, e.g.* Securities and Exchange Commission Release No. 34-9000, File No. SR-FINRA-2020-030, *Notice of Filing of a Proposed Rule Change to Amend the Codes of Arbitration Procedure Relating to Requests to Expunge Customer Dispute Information, Including Creating a Special Arbitration Roster to Decide Certain Expungement Requests,* (September 25, 2020), at 141.

is indeed extraordinary relief, so it only makes sense that such a weighty determination is arrived through unanimous agreement by a panel.

Other rule proposals by FINRA support the gravity of the remedy. For example, the proposed change for FINRA Rule 12805(c) and 1380(c), which will remove the word "brief" before "written explanation," indicates to the panel that it must provide enough detail in the award to explain its rationale for recommending expungement.[7] This deletion strengthens the existing consensus that a short explanation is insufficient for such a meaningful determination.

It remains PIABA's position that if one of the arbitrators on a three-person panel believes that the customer dispute information has some meaningful investor protection or regulatory value, the information should remain on the associated person's record. Allowing unanimous consent by an arbitration panel will help ensure that expungement remains an extraordinary remedy.

2. *Divided Panel Determinations are Clearly Valuable to Public Investors and Associated Persons Still Have Access to Reasonable Mechanisms to Remove Inaccurate CRD Information*

One purpose of the proposed rule change is to help preserve in CRD information that is valuable to investors and regulators while allowing associated persons a reasonable mechanism to remove information that is inaccurate. However, by allowing arbitrators to recommend expungement through only a majority decision, FINRA is essentially declaring some arbitrators' dissenting opinions as valueless to investors. Public investors deserve full disclosure to protect themselves from harm, and having the ability to view divided panel decisions is an important tool aid in that goal of investor protection.

One such harm to investors is falling prey to bad actors who otherwise might have been avoided. Absent allowing unanimous panel agreements, investors will not have an accurate or comprehensive view of brokers' complaint history on CRD, which undermines the integrity of the entire process.

Moreover, requiring unanimous decisions by arbitration panels does not impact an associated persons' ability to remove inaccurate information because the procedural mechanisms available to an associated person are the exact same if unanimous panel agreement was required. Rule 2080 standards will still provide grounds to expunge alleged inaccurate information.

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7. *Id.* at 195-196.

3. Unanimous Panel Decisions are Consistent in Other Provisions of the Customer and Industry Code

In its rule proposal, FINRA acknowledges that the majority rule determination was consistent with what is required for other decisions in customer and industry arbitrations.[8] Specifically, FINRA cited Rules 12904(a) and 13904(a), which provide that all awards shall be in writing and signed by a majority of the arbitrators.[9] But the fact that the awards must be signed by a majority of arbitrators should not a primary, guiding consideration.

One reason is because rule consistency can be likewise found for unanimous agreement in other portions of the Customer and Industry Codes. For example, consider Motions to Dismiss[10] and Time Limitations dismissals,[11] which require unanimous agreement by the arbitration panel. Like awards, dismissals are an important part of the arbitration process yet the rule proposal does not explain the rationale for why matching the majority rule standards for awards is preferable.

In sum, PIABA respectfully disagrees with FINRA's determination that expungements are permitted by a mere majority decision.

B. Excluding the "No Investor Protection or Regulatory Value" Standard from the Proposal Harms Public Investors and Threatens the Integrity of the CRD

PIABA disagrees with FINRA's determination not to propose that the panel must find "no investor protection or regulatory value" to recommend expungement. By excluding this additional finding, arbitrators will continue to misinterpret and misapply Rule 2080 standards, which risks the accuracy and value of the CRD information for public investors and regulators.

As already set forth in PIABA's February 2018 Comment Letter to FINRA Regulatory Notice 17-42, Rule 2080 findings (*e.g.* factual impossibility or clearly erroneous, falsity) are high standards, which makes sense considering that expungement is an extraordinary remedy. Unfortunately, the confusion

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8. *See, e.g., id.* at 121.

9. *Id.*

10. FINRA, Rule 12504(a)(7); FINRA, Rule 13504(a)(7).

11. Rule 12206(b)(5); Rule 13206(b)(5).

already present among arbitration panels, such as whether a claim is factually impossible or false where customers did not meet their burden to establish liability, or where an affirmative defense was present to limit liability, will only continue with FINRA's determination to not propose this language. The result will be the permanent unavailability of highly valuable, relevant information to the investing public.

Maintaining the integrity of the information in the CRD system cannot be overstated. That is why PIABA continues to believe that clarifying this standard in the rules, combined with training, remains the best approach to obtain successful results in the expungement process.

C. The Time Limits for Expungement Requests Should Revert Back to the One Year Limit Previously Proposed by FINRA

In Notice 17-42, FINRA proposed one-year time limits for the filing of expungement requests for both arbitration cases that had closed without an award and for customer complaints that had not progressed to arbitration.[12] PIABA supported these limitations, stating, "PIABA believes that *"at a maximum,* a one-year time frame is acceptable" for these type of situations.[13] PIABA asserted that "a more stringent timeline will also lead to a higher quality of evidence for the Panel to consider, both in terms of testimony and documentary evidence, both which become less reliable and available with the passage of time."[14] PIABA further noted that a customer was "far more likely to participate in an expungement hearing when in takes place in close proximity to the underlying arbitration hearing."[15]

Unfortunately, rather than affirming the prior proposed one-year time limitation for the filing of expungement requests, FINRA's current proposal succumbs to industry pressure and goes backward by proposing to expand these limitations significantly. PIABA strongly disagrees with this revision to the prior proposal and urges the Commission to reinstate the one-year time limitations previously proposed.

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12. *See* FINRA Regulatory Notice 17-42, *Expungement of Customer Dispute Information* (December 2017).

13. *See* PIABA Comment Letter to Marcia Asquith, FINRA Regulatory Notice 17-42, *Expungement of Customer Dispute Information* (February 2, 2018), p.6 (emphasis in original).

14. *Id.* at p. 5.

15. *Id.*

First, FINRA proposes to double the time limitation to two years for the filing of expungement requests after an arbitration is closed without going to award. FINRA asserts that a two-year time period "would help ensure that the expungement hearing is held close in time to the customer arbitration or civil litigation, when information regarding the customer arbitration is available and in a timeframe that would increase the likelihood for the customer to participate."[16] FINRA further states that such a time limitation "would allow the associated person time to determine whether to seek expungement."[17]

PIABA believes that extending the time limitation an additional year will unnecessarily degrade the quality of evidence for a panel to consider in making an expungement determination and decrease the likelihood that the customer will participate in the hearing for no additional benefit. Given that FINRA arbitrations are often filed several years after the underlying events that are the subject of the arbitration and can take two years or more to administer, giving associated persons a further two-year time period to *file* a new arbitration claim for expungement could mean that the expungement hearing itself will not occur until over a decade or more has passed from the underlying events. Further, since under the proposed rules firms and associated persons will be required to seek expungement in a customer's arbitration case or waive the ability to make such a request (should the case go to an award), there is no rationale or benefit for giving associated persons two additional years "to determine whether to seek expungement" since they would have already made that determination in the underlying customer arbitration. As such, the previously proposed one-year timeframe for expungement requests that were the subject of arbitrations that do not go to award should be reinstated by the Commission, as it provides ample time for registered representatives to decide if they wish to file a new arbitration claim for expungement, while ensuring that the timeframe for the expungement request is much closer to the original closed arbitration, thereby increasing the chances both that the customer will participate and the quality of the evidence for the new arbitration panel to consider.

While FINRA's proposal to double the time limitation for arbitrations that do not go to award is ill-advised and unnecessary, its new proposal for the time limitations to make expungement requests for customer complaints that are not filed in arbitration is far worse. FINRA's proposed rule change increases the time limitation ***six-fold*** – from one-year to six-years – from its prior proposal

16. *See* SEC Release No. 34-90000; File No. SR-FINRA-2020-030 (October 1. 2020), 62171.

17. *Id.*

made in RN 17-42. Such an increase in the time limitation to file these expungement requests will significantly degrade the evidence for arbitrators to consider and lower the chances that a customer will participate in the arbitration hearing. As such, this will increase the chances that associated persons will be able to present a one-sided, distorted presentation of the facts of circumstances given rise to the customer complaint that the rule proposal is purportedly designed to prevent.

The rationales given by FINRA and the financial industry commentators for this six-fold expansion to the time limitation for these expungement requests are insufficient to justify the harm to investor protection that would occur due to the strong likelihood of more numerous one-sided, distorted expungement hearings with such an expansion.

Firms do not need *six years* to "complete investigations of customer complaints and close them in the CRD system." Indeed, any firm that had not completed its investigation of a customer complaint within six years would likely be sanctioned by FINRA for failure to maintain an adequate supervisory system. Six years is nowhere close to a "reasonable time limit to encourage customer participation and help ensure the availability of evidence," especially since customer complaints are almost never made with the assistance of counsel and do not have any of the additional fact-finding process, procedures and devices available to them that FINRA arbitrations do. As such, registered representatives making such expungement requests many years after the underlying customer complaint would be able to cherry pick whatever "evidence" they chose to present to the arbitration panel, distorting the process further.

The risk of duplicative requests for expungement should a customer complaint that was not an arbitration matter become one after the registered representative files an expungement claim is a small price to pay for the regulatory benefit – through better and more available evidence and increased customer participation – that will result from maintaining a one-year time limitation for these expungement requests, rather than increasing the time limits. Moreover, there are other alternatives that FINRA could consider that would lessen any perceived detriment to possible second expungement requests that would not decrease the regulatory benefit of a one-year time limitation, such as waiving the filing fee for the additional expungement request.

Accordingly, PIABA urges the Commission to reinstate the one-year time limitation that FINRA previously proposed for these expungement requests.

D. Expungement is a Regulatory Determination That Has No Place in FINRA's Dispute Resolution Forum

The CRD system was developed jointly by FINRA and the state securities regulators (NASAA), to maintain regulatory and licensing records for the brokerage industry. Through the use of uniform rules and corresponding rules, NASAA, FINRA and the SEC designed a framework that sets forth when and how regulatory information, including customer complaints, must be reported to regulators. Thus, any decision to expunge information from the CRD system is necessarily a ***regulatory determination*** since it is superseding the considered and deliberate decisions made by securities regulators as to what information should be reported and maintained in the CRD system.

In contrast, FINRA's arbitration forum, is a private dispute resolution forum that is completely separate and distinct from FINRA's regulatory duties. FINRA arbitrators are charged with resolving disputes between investors and members of the securities industry. Asking FINRA arbitrators to also make the important regulatory determination as to whether or not information should be expunged from the CRD system is nonsensical as it usurps an important regulatory function from securities regulators whose statutory duties include protecting the investing public and maintaining the CRD system.

The fact that FINRA arbitration panels conduct arbitration hearings, review evidence, and take witness testimony concerning a customer dispute, does not qualify them to make regulatory determinations any more than it does to make broker disciplinary determinations. Just as FINRA arbitration panels are only permitted to make disciplinary referrals concerning broker conduct to FINRA's Department of Enforcement, but are prohibited from undertaking any disciplinary action or determinations, so should arbitrators be prohibited from making regulatory determinations as to the expungement of customer dispute information. Such important regulatory decisions should be made by the securities regulators who have been specifically tasked with making such determinations and who have overall responsibility for the CRD system.

While PIABA appreciates many of the reforms FINRA proposes to the expungement process as steps in the right direction, it believes that the long-term solution to correcting the expungement process must begin with removing expungement determinations from the FINRA arbitration forum altogether and instead have these determinations made by the securities regulators directly or through a regulatory tribunal established and agreed to by FINRA, NASAA and the SEC.

Respectfully submitted,
David P. Meyer, PIABA President

Notes & Observations