PIABA BAR JOURNAL

VOLUME 28, NO. 2 • 2021

a publication of

Public Investors Advocate Bar Association

PIABA BAR JOURNAL

VOLUME 28 | 2021 | NO. 2

EDITORIAL BOARD

Generally published three times per year by PIABA, 1225 W. Main St., Ste. 126, Norman, Oklahoma 73069. Subscriptions, copies of this issue and/or all back issues may be ordered only through PIABA. Inquiries concerning the cost of annual subscriptions, current and/or back issues should be directed to PIABA.

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

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

PIABA BAR JOURNAL

VOLUME 28 | 2021 | NO. 2

In this Issue

PIABA BAR JOURNAL

VOLUME 28 | 2021 | NO. 2

TRADING IN THE TIME OF COVID: A ROBINHOOD BROMANCE

*Melanie Cherdack**

Introduction

In ancient times, circa 1960, an investor would dial his stockbroker on a rotary phone, place an order to purchase shares in IBM stock, the broker would call his trader on the floor of the NYSE, the trader would make a bid to the specialist for the shares, the buy order would be matched with an order to sell, the trade would be recorded with a pencil and a scrap of paper, the order would be filled, the stock certificate would be sent through the mail, and the investor would hold the shares for decades. Not so anymore. Every aspect of investing has changed. The types of securities sold, the proliferation of exchanges, and the disparate trading systems have altered the ways in which the business of securities trading is conducted.[1] And, the era of algorithms and electronic high speed trading,[2] coupled with individual investors' ease of access to the markets through apps and trading platforms, has drastically changed the nature of trading securities. With that, the profile of the individual investor has also morphed. Suffice it to say, "Its not your father's stock market anymore."

An App Is Born

The shift to discount brokerage firms and internet trading through platforms like E*Trade and Charles Schwab opened the markets to include a

---

 Ms. Cherdack is of counsel to the law firm of Genovese Joblove & Battista, P.A. Her practice primarily consists of representing individual and institutional investors in securities arbitration claims. She formerly served as assistant general counsel to PaineWebber Inc. (now known as UBS Financial). For more information, go to: www.investorfraudlaw.com.

1. By year end 2018, trading in the U.S. equity markets was spread among a number of highly automated trading centers: 13 registered exchanges, more than 40 alternative trading systems and over 200 over-the-counter market-makers. Press Release, *SEC Adopts Rules That Increase Information Brokers Must Provide to Investors on Order Handling*, SEC, (Nov. 2, 2018), https://www.sec.gov/news/press-release/2018-253.

2. Bob Pisani, *Man Vs. Machine: How Stock Trading Got So Complex*, CNBC, (Sept. 13, 2010, 6:03 P.M.), https://www.cnbc.com/id/38978686.

new breed of individual investor seeking to make investments on their own without the use of a traditional broker. Historically, although some products were commission free, these "DIY" online trading firms generally charged commissions on every stock trade.[3] The creators of Robinhood Financial LLC ("Robinhood"), Vlad Tenev and Baiju Bhatt, two young engineers who met while studying at Stanford, saw an untapped opportunity in the niche of younger investors who did not have large sums of money to invest. The duo, who were creating software for hedge funds and other firms enabling high frequency trading, noticed that online brokerage firms had a stronghold on investors in their 40s and 50s but were failing to capture younger, less profitable investors who had smaller sums to invest.[4] They were struck by the economics, where institutions were paying fractions of a penny for trading and transactions, but where the everyday retail investor would cough up $10 in fees for executing a single trade on other platforms. In creating their platform, Tenev and Bhatt estimated that there were approximately 1.5 million individual active traders trading securities more than 10x per month—and that this could add up to thousands of dollars each year to the then existing online brokerage firms.[5]

After two years of development and raising $16 million in funding, Robinhood had 500,000 potential users on a waitlist before its "official" launch on the iOS Apple Store on December 11, 2014.[6] Most users were under the age of 30.[7] The mission, and the name of the company, derive from the founders'

---

3. *See* Casey Bond, *Brokerage Companies That Let You Trade For Free*, HUFFINGTON POST, (May 6, 2019, 9:40 P.M.), https://www.huffpost.com/entry/trade-free-commission-investing_l_5cd07733e4b0e4d757369f28.

4. Halah Touryalai, *Forget 10 dollar trades, Meet Robinhood: The New Brokerage Targets Millennials With Little Cash*, FORBES, (Feb. 26, 2014, 10:03 A.M), https://www.forbes.com/sites/halahtouryalai/2014/02/26/forget-10-trades-meet-robinhood-new-brokerage-targets-millennials-with-little-cash/?sh=d460d577f483.

5. *Id.*

6. Josh Constine, *Robinhood Launches Zero-Fee Stock Trading App*, TECHCRUNCH, (Dec. 11, 2014, 9:01 A.M.), https://techcrunch.com/2014/12/11/robinhood-free-stock-trading/.

7. Janet Morrissey, *With No Frills and No Commissions, Robinhood App Takes on Big Brokerages*, N.Y. TIMES, (Feb. 18, 2017), https://www.nytimes.com/2017/02/18/business/robinhood-stock-trading-app.html.

stated goal to create "products that would provide *everyone* with access to the financial markets, not just the wealthy."[8]

The app took off immediately. In 2015, the first full year of its existence, Robinhood executed $2 billion in trades.[9] On April 26, 2017, Robinhood announced that it had reached 2 million users and executed over $50 billion in trades.[10] In December 2017, Robinhood added options trading to its commission-less platform.[11] In December 2019, Robinhood announced the ability to buy "fractional shares" in stocks and Exchange Traded Funds ("ETFs") on its trading app stating that this feature "will open up investing to even more people, and we'll continue to find ways to democratize the financial system so everyone can participate."[12]

Robinhood's user base has ballooned since the pandemic began, with app downloads soaring. According to the *Wall Street Journal*, Robinhood, which had about 13 million accounts in May 2020, had amassed 20 million users by the year's end.[13] On January 30, 2021, it reached a record of one million downloads in a day.[14]

Charles Schwab, Meet Candy Crush

When a Robinhood investor opens the app, they are welcomed with a burst of candy colored and eye-catching offerings: showers of confetti to celebrate

---

8. *Our Story,* ROBINHOOD, https://robinhood.com/us/en/support/articles/our-story/ (last visited Apr. 21, 2021).

9. Morrissey, *supra* note 7.

10. *Two Million Thanks,* ROBINHOOD, https://blog.robinhood.com/news/2017/4/26/two-million-thanks (last visited Apr. 21, 2021).

11. *Introducing Options Trading,* ROBINHOOD, https://blog.robinhood.com/news/2017/12/12/introducing-options-trading (last visited Apr. 21, 2021).

12. *Id.*

13. Peter Rudegeair, Kirsten Grind & Maureen Farrell, *Robinhood's Reckoning: Facing Life After GameStop*, WALL ST. J., (February 5, 2021), https://www.wsj.com/articles/robinhoods-reckoning-can-it-survive-the-gamestop-bubble-11612547759?mod=searchresults_pos16&page=1.

14. Eliza Haverstock, Alex Conrad & Antoine Gara, FORBES, *Robinhood Upping Emergency Funding to $3 Billion as Download Hits Record 1 Billion Per Day,* (Feb. 1, 2021, 11:44 A.M.), https://www.forbes.com/sites/elizahaverstock/2021/02/01/exclusive-robinhood-secures-another-1-billion-in-funds-and-is-in-talks-for-more-as-downloads-hit-record-1-million-per-day/?sh=824fac030055.

transactions, the hot pink price of bitcoin and a list of popular stocks to trade.[15] As one reporter noted, "Charles Schwab meet Candy Crush."[16] It is designed this way to encourage people to engage in trading since Robinhood is paid more if its customers trade more. Robinhood's success appears to have been built on a Silicon Valley playbook of behavioral nudges and push notifications, which has drawn inexperienced investors into the riskiest trading.[17]And, data shows, the more that customers engage in such behavior, the better it is for the company.[18]

People in the industry note that Robinhood's home page features a prominent ticker for bitcoin along with quotes for stocks with big daily swings in price, while exchange-traded funds — a low-cost way of diversifying a stock portfolio — are not as accessible, leading people to get into individual stocks and cryptocurrency.[19] Even more enticing is Robinhood's business model — "Commission-Free Investing." And, as its home page touts, if you sign up now, you can "get your first stock for free."[20]

---

15. David Ingram, *Designed to Distract: Stock App Robinhood Nudges Users to Take Risks*, NBC NEWS, (Sept. 12, 2019, 2:59 P.M.), https://www.nbcnews.com/ tech/tech-news/confetti-push-notifications-stock-app-robinhood-nudges-investors-toward-risk-n1053071. Robinhood has recently abandoned the confetti, replacing it with new imagery congratulating the user on investing milestones. Maggie Fitzgerald, *Robinhood Gets Rid of Confetti Feature Amid Scrutiny Over Gamification of Investing*, CNBC, (Mar. 31, 2020, 9:05 a.m.), https://www.cnbc.com /2021/03/31/robinhood-gets-rid-of-confetti-feature-amid-scrutiny-over-gamification.html.

16. *Id.*

17. Nathaniel Popper, *Robinhood Has Lured Young Traders, Sometimes with Devastating Results,* N.Y. TIMES, (Feb. 2, 2021), https://www.nytimes.com /2020/07/08/technology/robinhood-risky-trading.html.

18. *Id.*

19. Ingram, *supra* note 15.

20. *Investing for Everyone,* ROBINHOOD, https://robinhood.com/us/en/ (last visited Apr. 21, 2021).

Money for Nothing: How is Trading "Free"?

So, you might ask, if Robinhood doesn't charge commissions, how does it make money? Its income comes from three primary sources: the interest earned on customer balances, payment for order flow, and margin lending.[21] Payment for order flow was the original business model.[22] It is essentially a back end payment paid to Robinhood by a third party that executes the trade. Payment for order flow is when a market maker (a firm that buys and sells securities on a regular and continuous basis at a publicly quoted price) agrees to pay another brokerage firm for routing an order to it.[23] Because Robinhood executes millions of trades, its profits from payment for order are quite substantial. According to its public filings, Robinhood made $271 million from this type of payment in the first half of 2020.[24] The trading by the third party market makers, such as Citadel Securities, is referred to as "off market," meaning that small investors' orders are executed privately instead of routing them to public markets including the New York Stock Exchange and the Nasdaq Stock Market.[25]

---

21. Morrissey, *supra* note 7.

22. One of the early services Robinhood rolled out to create a revenue stream is called "Robinhood Gold." Launched in September 2016, Robinhood Gold offered after hours trading, margin loans and instant bank deposits for a monthly fee. *Robinhood Gold,* ROBINHOOD, (Sept. 29, 2016), https://blog.robinhood.com /news/2016/9/28/robinhood-gold. Of the $1.4 billion Robinhood in margin which it loaned out as of June 30, 2020, the company had just over $47 million in "doubtful accounts." This amount, although a small percentage, has been called remarkably high by industry standards. Stephen Gandel, *Robinhood offers loans to buy stock – they were 14 times more likely to default,* CBS NEWS, (Feb. 5, 2021, 6:09 P.M.), https://www.cbsnews.com/news/robinhood-stock-loans-were-14-times-more-likely-to-default-than-rivals/.

23. *Executing an Order,* SEC, https://www.sec.gov/fast-answers/answerspayordf htm.html.

24. ROBINHOOD, RHS SEC Rule 606a and 607 Disclosure Report Q2 2020, https://cdn.robinhood.com/assets/robinhood/legal/RHS%20SEC%20Rule%20606a%20and%20607%20Disclosure%20Report%20Q2%202020.pdf?source=content_type%3Areact%7Cfirst_level_url%3Anews%7Csection%3Amain_content%7Cbutton%3Abody_link.

25. Alexander Osipovich, *GameStop Mania Highlights Shift to Dark Trading*, WALL ST. J., (Feb. 12, 2021, 5:33 A.M.), https://www.wsj.com/articles/gamestop-mania-highlights-shift-to-dark-trading-11613125980.

This payment for order flow to Robinhood gets jacked up when trading is short term and frequent, such as trading in options. "Commission free" options trading, which was rolled out in December 2017,[26] is a huge profit center for Robinhood. The popularity of Robinhood's options platform soared during the pandemic when millions of investors opened accounts using the app to pass time and earn cash.[27] According to data compiled by Bloomberg Intelligence from regulatory filings, at the end of 2020, Robinhood's monthly volume of options contracts traded jumped 197% from the start of the year, eclipsing the 54% collective increase on Schwab and TD Ameritrade's platforms, as well as a 46% uptick at E*Trade.[28]

Options Trading, Democratized

For a fraction of what it costs to buy a 100 shares of a stock, a small investor can purchase a call option on that stock. Below is Robinhood's explanation of buying a call option in Uber:

> On July 15, 2019, Uber's stock was trading at $44. If you were bullish on Uber and thought the stock was going to rise, you could have bought a call with an exercise price of $48 that expired Jan 17, 2020. That option cost $3.40, and since it gives you the right to buy 100 shares of Uber for $48 any time before January 17, 2020, it cost $340 (plus fees and commissions). That premium is your cost, and you hope that Uber's price rises above $48. If it does, you could make a gain. If the price increases to $55 (for example), you could exercise the option, buying 100 shares for $48 each even though they're worth $55. If the stock stays below $48 through the expiration, that option won't have any value for you and you'll lose the $340.29

This explanation outlines how an investor can buy call options on Uber stock for 100 a contract, or a mere $340, where that investor may not have the

26. *Introducing Options Trading,* ROBINHOOD, https://blog.robinhood.com /news/2017/12/12/introducing-options-trading (last visited Apr. 21, 2021).

27. Annie Massa and Sara Ponczek, *Robinhood's Lucrative Options-Trading Platform Attracts Mounting Scrutiny*, BLOOMBERG, (Feb. 4, 2021, 7:00 A.M.), https://www.bloomberg.com/news/articles/2021-02-04/robinhood-tallies-an-options-bonanza-while-newcomers-wreak-havoc.

28. *Id.*

29. *What is an Option?,* ROBINHOOD, https://learn.robinhood.com/articles/ 4q86vJm1iPRWhoPVzvD63r/what-is-an-option/ (last visited Apr. 21, 2021).

means to buy 100 actual shares of Uber stock for $4400. To the young investor with not a lot of cash, this could appear quite enticing as it seems to make investing both easy and affordable. Unlike stock, though, this option contract has an expiration date and if it does not reach the target price of $48 by that date, it will become worthless. In essence, it is a simple bet of 100% of the option premium paid. It is also the most basic type of options trading. While Robinhood does disclose on this page that "Options often expire with no value, so you should understand their risks before investing. Also, be aware some complex options might expose you to losses beyond what you paid or earned in your original transaction."[30] It then provides this puzzling analogy:

> Takeaway
>
> An option is like an umbrella...
>
> It could be valuable for you, or it could end up having no value at all. The beauty with an option, and with an umbrella, is that you don't have to use it. You bought it, now it's your option whether to exercise it or not. You use the umbrella when it rains. You exercise the option if it's in the money. Options expire though, umbrella's (sic)[31] don't (no analogy is perfect).[32]

Ah yes, the imperfect analogy. The imperfection is that it's missing the end of the sentence which should read "Options expire, though, umbrella's don't, AND YOU COULD LOSE YOUR ENTIRE INVESTMENT." One might say that spoiled mango yogurt which you bought six month ago on a whim, found in the back of your refrigerator, and had to throw out, might be a more apt analogy. But alas, Robinhood's Takeaway's — nothing to worry about here — umbrella message (subtly suggesting the investor is protected) prevailed.

And, more good news, Robinhood empowers its customers "to place your first options trade directly from your app."

---

30. *Id.*

31. This is not the only grammatical error or typo on the website. Remember, these guys are genius engineers, not liberal arts majors.

32. *Id.*

As stated on the app, here's how its done:

Placing an Options Trade

1. Tap the magnifying glass in the top right corner of your home page.
2. Search the stock you'd like to trade options for.
3. Tap the name of the stock you're looking for.
4. Tap **Trade** in the bottom right corner of the stock's Detail page.
5. Tap **Trade Options**.[33]

Voila! Your trade is placed in a matter of seconds. At the bottom of these instructions, Robinhood links to the levels of options trading strategies that it offers to its customers: "You can learn about different options trading strategies in our (sic) by checking out Basic Options Strategies (Level 2) and Advanced Options Strategies (Level 3)."[34] It was reported last year that there were fewer hurdles at Robinhood for investors to get approval for options trading based upon investor's own suitability assessments and their ability to revise their answers.[35]

As of December 2020, applying for access to options on Robinhood's app was reportedly relatively frictionless. After tapping "continue" on successive screens and setting profile parameters such as income and risk tolerance, the app greets entrants to its most advanced level with a green fireworks graphic and congratulatory message: "You're Level 3! You can now trade vertical spreads, calendar spreads, iron condors and more."[36]

As 2020 ended, options trading on Robinhood skyrocketed. Bloomberg reported that Robinhood earned an average of about 64 cents per options contract executed in December 2020, which was more than most major brokerages.[37] This is almost double the earnings of 36 cents per every 100 shares which Robinhood reportedly made on trades in S&P 500 companies that month.[38] The options platform was integral to Robinhood's earnings last

33. *Placing an Options Trade,* ROBINHOOD, https://robinhood.com/us/en/support/articles/placing-an-options-trade/ (last visited Apr. 21, 2021).

34. *Id.*

35. Gunjan Banjeri and Alexander Osipovich, *Free Trades, Jackpot Dreams Lure Small Investors to Options*, WALL ST. J., (June 24, 2020, 5:30 A.M.), https://www.wsj.com/articles/free-trades-jackpot-dreams-lure-small-investors-to-options-11592991000?mod=hp_lead_pos3.

36. Massa and Ponczek, *supra* note 27.

37. *Id.*

38. *Id.*

year; it accounted for $440 million, or roughly two-thirds, of the company's order-flow revenue in 2020.[39]

The *New York Times* has reported that more than at any other retail brokerage firm, Robinhood's users trade the riskiest products and at the fastest pace.[40] The majority of its users are male.[41] Its users are young, with an average age of 31, and half of its customers have never invested before.[42] Robinhood estimates that the average amount in their accounts is less than $5,000, versus an estimated six figures at competing firms.[43]

But, luring young investors with no experience has come at a cost.

Suicide of an Options Customer

Robinhood came under scrutiny after it was reported that a 20 year old took his life as a result of seeing a misleading negative balance of $730,000 in his account after executing a "bull put spread" options trade. A civil lawsuit filed by his parents details the facts underlying their son's suicide.[44] The complaint alleges that one day in June, Kearns made an options trade that he thought carried a maximum loss exposure of $10,000. Later that evening, he received an email from Robinhood notifying him that his account had been restricted. He then checked the app and saw a negative cash balance of $730,165.72. But that staggering figure may have simply reflected the processing of only one side of the options transaction the lawsuit states. Kearns repeatedly contacted Robinhood's customer support team to ask what was

39. *Id.*

40. Popper, *supra* note 17.

41. Veronica Dagher and Caitlin McCabe, *Robinhood Wants More Female Investors. So Does Everyone Else,* WALL ST. J., (Jan. 7, 2021, 5:30 A.M.), https://www.wsj.

com/articles/robinhood-wants-more-female-investors-so-does-everyone-else-11610015400.

42. *Id.*

43. Avi Salzman, *Robinhood's User Base is Still Growing, Analyst Says,* BARRON'S, (Oct. 7, 2020, 3:40 P.M.), https://www.barrons.com/articles/robinhoods-growth-rate-is-still-super-hot-analyst-projects-51602099647.

44. Maggie Fitzgerald*, Robinhood sued by family of 20-year-old trader who killed himself after believing he racked up huge losses,* CNBC, (Feb. 8, 2021, 9:26 P.M.), https://www.cnbc.com/2021/02/08/robinhood-sued-by-family-of-alex-kearns-20-year-old-trader-who-killed-himself-.html.

going on, but was unable to speak with anyone. Instead, he received an email from the company at 3:26 a.m. notifying him that he did not meet the "cash requirements" for an earlier trade, and would need to deposit $178,612.73 within days. In truth, according to the lawsuit, other options that Kearns held in his account would have "more than covered his obligation." But that wasn't clear from the automatically generated emails he received in response to his desperate queries. Several hours later he ended his life, leaving a note to his family stating "How was a 20 year old with no income able to get assigned almost a million dollars worth of leverage?"[45]

After this tragic event, Robinhood announced that it had made improvements to options offerings including the ability to exercise contracts in the app, guidance to help customers through early assignment, updates to how we display buying power, more educational materials on options, and new financial criteria and revised experience requirements for new customers seeking to trade Level 3 options.[46]

The Regulators Expose the True Costs of "Free" Trading

As renegade as Robinhood likes to appear, it is still, however, governed by a complex system of securities laws and regulations. Robinhood faced a major regulatory issue in the form of an agreed to SEC fine of $65 million for its failures to fully disclose its payments for order flow business model on its website, as well as misleading representations about obtaining the "best execution"[47] for their customers on their trades. In December 2020, the SEC announced an agreement with Robinhood for this civil penalty as well as a corrective action plan. In announcing this substantial fine, the SEC stated that

45. *Id.*

46. *An Update on Robinhood's Options Offering,* ROBINHOOD, https://blog.robinhood.com/news/2020/9/7/an-update-on-robinhoods-options-offering (Sept. 7, 2020).

47. The SEC's action against Robinhood reiterated that broker-dealers such as Robinhood owe their customers a duty of "best execution." *See* In the Matter of Robinhood Fin., LLC, Respondent, Release No. 10906 (Dec. 17, 2020), https://www.sec.gov/litigation/admin/2020/33-10906.pdf [hereinafter "SEC 12/17/20 Order"]. Best execution requires that a broker-dealer endeavor to execute customer orders on the most favorable terms reasonably available in the market under the circumstances. This includes taking into account price, order size, trading characteristics of the security, as well as the potential for price improvement and other factors. *Id. at* ¶ 13 (citations omitted).

"Robinhood provided misleading information to customers about the true costs of choosing to trade with the firm," and that "Robinhood failed to seek to obtain the best reasonably available terms when executing customers' orders, causing customers to lose tens of millions of dollars."[48]

The SEC's complaint alleged that in FAQs on its website describing how it made money, and in certain communications with customers addressing the same issue, Robinhood omitted payment for order flow when it described its revenue sources because it believed that payment for order flow might be viewed as controversial by customers. Robinhood also instructed its customer service representatives not to mention payment for order flow in responding to questions about Robinhood's sources of revenue.

The SEC also charged Robinhood with failing to meet its "best execution" obligation to its customers. It alleged that in October 2018, after media outlets raised questions about whether Robinhood's payment for order flow rates negatively affected the execution prices that Robinhood customers received on their orders, Robinhood responded by claiming as part of an FAQ page on its website that its order execution quality matched or beat that of its competitors. However, at that time, Robinhood had begun comparing Robinhood's execution quality to competitors' and was aware it was worse in many respects. By March 2019, Robinhood had conducted a more extensive internal analysis that found Robinhood's execution quality and price improvement metrics were substantially worse than other retail broker-dealers' in many respects, and senior Robinhood personnel were aware of this analysis. Nevertheless, the claim about Robinhood's execution quality matching or beating its competitors was not removed from its website until June 2019.

The SEC found that the failure of Robinhood to comply with its best execution obligation to its customers resulted in Robinhood's customers losing significant money, making trading *more expensive* to its customers even taking into account that traditional discount firms were charging an average of $5 dollars per trade. The SEC's action alleges that "Between October 2016 and June 2019, certain Robinhood orders lost a total of approximately $34.1 million in price improvement compared to the price improvement they would have received had they been placed at competing retail broker-dealers, even after netting the approximately $5 per-order commission costs those broker-dealers were charging at the time."[49] On December 19, 2020, Financial

---

48. Press Release, *SEC Charges Robinhood Financial With Misleading Customers About Revenue Sources and Failing to Satisfy Duty of Best Execution*, SEC, https://www.sec.gov/news/press-release/2020-321 (last visited May 11, 2021).

49. SEC 12/17/20 Order at ¶ 42, *supra* note 47.

Industry Regulatory Authority ("FINRA") also sanctioned Robinhood for violating its rules regarding best execution and its failure to supervise for best execution.[50]

A State Regulator Chimes In….

Suffice it to say that Christmas 2020 was not a merry time for Robinhood. On December 16, the same month as the large regulatory fines against it were announced, the Massachusetts Securities Division filed an administrative complaint against Robinhood alleging violations of state securities laws for, among other things, "aggressive tactics to attract new, often inexperienced investors" and "use of strategies such as gamification to encourage and entice continuous and repetitive use of its trading application."[51] As an example of aggressive marketing, the complaint alleges that one advertisement is a clip of a young adult stating "I'm a broke college student and investments might help my future tremendously."[52] And, Robinhood provides "First Lists" on its home screen displaying "stocks chosen based upon their popularity on Robinhood's platform," which, the regulator alleges, "have the potential to influence the securities that new, unsophisticated customers with no investment experience purchase."[53] This is alleged to encourage risky, unsuitable trading in violation of the Massachusetts suitability rules.[54]

The state regulator alleges that Robinhood uses gamification strategies such as confetti raining down when a trade is completed, promises of "winning" free stock despite the low probability of this, sending constant push notifications, and contests such as "tapping" on a virtual debit card to encourage "constant participation and long term engagement" with the app with the goal of facilitating frequent risky and unsuitable trading.[55] The complaint also alleges that Robinhood failed to implement policies and

50. FINRA, Letter of Consent, Waiver and Consent, No. 2017056224001, https://www.finra.org/sites/default/files/2019-12/robinhood-awc-121919.pdf.

51. *In re Robinhood Financial, LLC,* Docket No. E-2020-0047, Massachusetts Securities Division, https://www.sec.state.ma.us/sct/current/sctrobinhood/MSD-Robinhood-Financial-LLC-Complaint-E-2020-0047.pdf

52. *Id* at ¶ 21.

53. *Id* at ¶ ¶ 34, 36.

54. *Id* at ¶ 39.

55. *Id.* at ¶ ¶ 40-51.

procedures designed to prevent and respond to outages and disruptions on its trading platform.[56]

Robinhood filed a 50 page answer in which it disagrees with the Massachusetts regulator's allegations. In particular, it states that the newly enacted Massachusetts fiduciary duty rule does not apply to it because it is only relevant when a broker-dealer gives a customer a recommendation or provides investment advice and thus it is inapplicable since its customers make their own trading decisions.[57] It also argues that the claim fails because the regulator lacked authority to adopt a state fiduciary rule.[58] Calling out the regulator in true "Ok Boomer" fashion, Robinhood denies that it "gamifies" the experience for investors claiming that this perception of digital confetti "reflects a distinctly antiquated view of communication in the digital age."[59]

Perhaps the regulators were onto something. Events related to risk-taking and game playing in the stock market manifested themselves in a big way in January 2021, with Robinhood as an accomplice.

r/WallStreetBets: Winner Winner Chicken Dinner

The Covid-19 lockdown became a heyday for day-trading apps as people were looking to escape from the isolation and boredom in their everyday lives.[60] With the increase in day traders, digital communities of stock gurus sprouted up on Twitter and Discord, a chat app popular with gamers.[61] Social

56. *Id.* at ¶ ¶ 23-33. Some of these outages have resulted in several class action lawsuits which have been consolidated *Beckman v. Robinhood Financial, LLC et al.* (3:20-cv-01626-JD) (N.D. Cal. 2020).

57. Caitlin McCabe, *Robinhood, Facing Ire on Many Fronts, Defends its App to Regulators*, WALL ST. J., (Jan. 29, 2021 6:43 P.M.), https://www.wsj.com/articles/robinhood-facing-ire-on-many-fronts-defends-its-app-to-regulators-11611963829.

58. Nate Raymond, *Robinhood Rejects Massachusetts Regulator's Charges it Encourages Risky Trading,* REUTERS, (Jan. 29, 2021 6:37 P.M.), https://www.reuters.com/article/us-massachusetts-robinhood/robinhood-rejects-massachusetts-regulators-charges-it-encourages-risky-trading-idUSKBN29Y343.

59. *See* McCabe, *supra* note 57.

60. Michale Wurstorn, Misha Frankl-Duval and Gregory Zuckerman, *Everyone's a Day Trader Now*, WALL ST. J., (July 25, 2020 12:01 A.M.), https://www.wsj.com/articles/everyones-a-day-trader-now-11595649609.

61. *Id.*

media became a space for an entire subculture of irreverent investors. Investors began transforming social-media platforms into a place to swap tips, hype stocks and brag about extraordinary trading gains (and losses). Nowhere is this more prevalent than in the subreddit forum r/WallStreetBets ("r/WSB"). The r/WSB forum is a cacophony of memes and screenshots of gigantic losses (captioned "loss porn") and gains, both of which are equally applauded. The underlying principle for r/WSB users is extreme betting with the highest possible risks; generally, this means short-term options trading.[62] This type of investor is speculating in the securities markets as a form of gambling, and their decisions are entirely unrelated to the fundamentals of the underlying company.[63] The average person would have never heard of r/WSB but for the colossal stunt they attempted to orchestrate on the hedge fund investors.

As r/WSB users began to look at GameStop, a retail video game store, as an undervalued stock, they also noticed how heavily shorted the stock was by institutional investors.[64] Some user suggested that, if they acted all together, they could stick it to the short sellers (*i.e.*, the hedge funds) and make a profit doing so.[65] They encouraged forum users to buy the GameStock stock to drive up the price and to also buy calls options which similarly had the effect of driving the price up. This caused a "Short Squeeze" forcing the short sellers (hedge funds) to go into the market and buy the shares that they shorted to reduce their leverage and cover their potential market exposure. As a result, during the month of January 2021, GameStop's stock price ballooned to a high of $483 from a low of $17.[66]

But what does this have to do with Robinhood? A lot. The /rWSB crowd did much of their frenzied trading on Robinhood, which added more than

62. John Sarlin, *Inside the Reddit army that's crushing Wall Street*, CNN, (Jan. 30, 2021 7:10 A.M.), https://www.cnn.com/2021/01/29/investing/wallstreetbets-reddit-culture/index.html.

63. Jason Zweig, *Playing the Market Has a Whole New Meaning*, WALL ST. J., (June 12, 2020 11:00 A.M.), https://www.wsj.com/articles/playing-the-market-has-a-whole-new-meaning-11591974010.

64. Emily Stewart, *The GameStop stock frenzy, explained,* VOX, (Jan. 28, 2021 12:29 P.M.), https://www.vox.com/the-goods/22249458/gamestop-stock-wallstreetbets-reddit-citron.

65. *Id.*

66. Annie Nova, *More bubbles, less shorting. What the GameStop craziness could mean for the future of investing,* CNBC, (Feb. 10, 2021 9:49 A.M), https://www.cnbc.com/2021/02/06/what-the-gamestop-craziness-could-mean-for-the-stock-markets-future.html.

500,000 users during that time period while their app zoomed to the top of the Apple store.[67] The unprecedented trading came to a halt on January 28, 2021, when Robinhood temporarily blocked purchases of GameStop stock and other volatile stocks which were also being pumped up by the /rWSB traders.[68] Much speculation swirled as to the reasons why this occurred. Robinhood insists that the restrictions were a result of its inability to meet their clearinghouses' requirements of collateral deposits to cover the unanticipated surge in trading volume.[69] The trading restrictions have resulted in a number of class action lawsuits[70] and congressional hearings.[71]

The congressional hearings had a circus like element as the Reddit user who started the frenzy, Roaring Kitty, seemed to poke fun at the establishment.[72] Political pundits referred to the hearings as "a lot of yelling," but believe that no real legislation will come of it.[73] Instead, it may be up to

---

67. Peter Rudegeair and Orla McCaffrey, *Robinhood Raises $1 Billion to Meet Surging Cash Demands*, WALL ST. J., (Jan. 29, 2021 10:25 P.M.), https://www.wsj.com/articles/robinhood-raises-1-billion-to-meet-surging-cash-demands-11611928504?page=1.

68. Ben Winck. *Robinhood blocks purchases of GameStop, AMC, and others after days of Reddit-fueled Rallies*, BUSINESS INSIDER, (Jan. 28, 2021 2:54 P.M.), https://markets.businessinsider.com/news/stocks/robinhood-removes-gamestop-amc-reddit-wallstreetbets-fueled-stock-rally-gme-2021-1-1030015292.

69. *What happened this week,* ROBINHOOD, https://blog.robinhood.com/news/2021/1/29/what-happened-this-week (Sept. 7, 2020).

70. Megan Leonhardt, *Robinhood now faces roughly 90 lawsuits after GameStop trading halt--here's how customers might actually get their day in court*, CNBC, (Feb. 17, 2021, 3:04 P.M.) https://www.cnbc.com/2021/02/17/robinhood-faces-lawsuits-after-gamestop-trading-halt.html.

71. Alex Gangitano and Sylvan Lane, *Robinhood braces for lawmaker outrage at GameStop hearings,* THE HILL (Feb.4, 2021 6:00 A.M.), https://thehill.com/policy/technology/537266-robinhood-braces-for-lawmaker-outrage-at-gamestop-hearings.

72. Jessica Menton and Savannah Behrmann, '*I am not a cat': Chaotic GameStop hearing provides tense exchanges, humor as lawmakers grill key players in saga*, USA TODAY, (Feb. 18, 2021 6:45 P.M.) https://www.usatoday.com/story/money/markets/2021/02/18/robinhood-vladimir-tenev-keith-gill-roaring-kitty-gamestop-hearing/6799946002/.

73. Tory Newmyer, Douglas MacMilliam and Hamaz Shaban, *Congress presses Robinhood CEO on Company's role in GameStop stock frenzy*, WASH. POST: BUSINESS, (Feb. 18, 2021 7:32 P.M.), https://www.washingtonpost.com/

the regulators, such as the SEC, to act. FINRA has announced one of its initiatives for 2021 is to focus on communications with the public risks associated with app-based platforms with interactive or "game-like" features that are intended to influence customers, their related forms of marketing, and the appropriateness of the activity that they are approving clients to undertake through those platforms, (*e.g.*, options). [74] FINRA is also focusing on best execution by "zero commission" firms.[75]

The Ultimate Bro Move, Robinhood and Reddit Showboat at the SuperBowl

In the aftermath of the Short Squeeze, many of the retail /rWSB investors who didn't get out of their positions suffered huge losses.[76] There were posts on /rWSB by people who cashed out of their 401(k) at the start of the pandemic, invested at the wrong time, and lost everything.[77] They may also have incurred significant tax liability, with an inability to pay it.

---

business/2021/02/18/gamestop-robinhood-citadel-roaring-kitty-hearing-live-updates/.

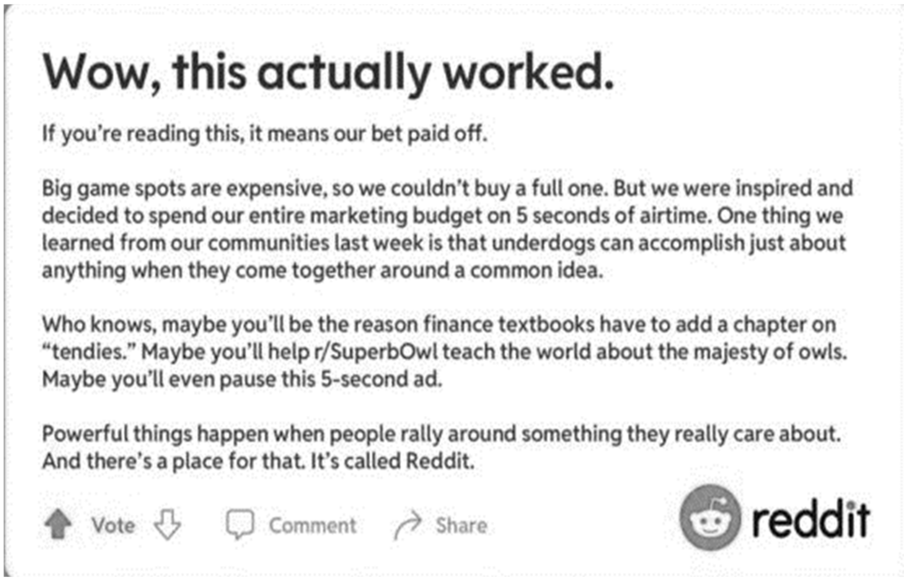
74. FINRA, *2021 Report on FINRA's Examination and Risk Monitoring Program,* https://www.finra.org/rules-guidance/guidance/reports/2021-finras-examination-and-risk-monitoring-program/selected-highlights (last visited May 12, 2021).

75. *Id.*

76. Abram Brown, *Reddit Traders Have Lost Millions Over GameStop. But Many Are Refusing to Quit.*, FORBES, (Feb. 4, 2021 9:05 A.M.), https://www.forbes.com/sites/abrambrown/2021/02/04/reddit-traders-have-lost-millions-over-gamestop-but-many-are-refusing-to-quit/?sh=2a227fed2d8f.

77. Emily Stewart, *Who gets to be reckless on Wall Street*?, VOX, (July 9, 2020 8:00 A.M.), https://www.vox.com/business-and-finance/2020/7/9/21314119/stock-market-day-trading-reddit-dave-portnoy-barstool-robinhood.

In the meantime, Reddit was a proclaiming victory. It plunked down its entire advertising budget for a five second SuperBowl advertisement using this screen shot[78]:



Reddit applauds itself as helping the little guys take on Wall Street in the Short Squeeze. The ad references "tendies" which is /rWSB speak meaning profits-in a sly wink to the bros. Robinhood also ran its own SuperBowl ad with the tag line "We're all Investors," perpetuating its "democratization" of the stock market ideal.[79] All this amounted to some expensive chest beating for helping the little guys' massive participation in the securities markets during Covid.

78. Tiffany Hsu, *Reddit's 5-Second Ad Was an Unlikely Superbowl Winner*, N.Y. TIMES, (Feb. 8, 2021), https://www.nytimes.com/2021/02/08/business/media/reddit-super-bowl-ad.html.

79. Jordan Valinsky, *Robinhood is airing a Super Bowl ad amid its GameStop fiasco*, CNN, (Feb. 5, 2021 9:09 A.M.), https://www.cnn.com/2021/02/03/media/robinhood-super-bowl-commercial/index.html.

Robinhood Keeps its Eyes on Its Public Offering

Worlds collided when Reddit's Internet sharing platform met Robinhood's instant trading app, creating havoc in the financial markets for a few days. The /rWSB investors tried to weaponize the market against the hedge funds — their perceived enemies — and did in fact succeed in increasing the price of GameStock and some other waning brick and mortar stocks that were shorted. But in the end, for every winner in the market, there is a loser. And, many of those losers were /rWSB users who traded through Robinhood. It seems, however, that no matter what, Robinhood and Wall Street capitalists who invested in it may still end up on the winning side. Shortly after the Robinhood trading shutdown, it raised an additional $3.4 billion though convertible debt, allowing it to maintain its $11.7 billion valuation.[80] It also obtained a $600 million line of credit from Goldman Sachs and JP Morgan, making it poised for an anticipated IPO, direct listing or Special Purposed Acquisition Company merger.[81] Hmm, doesn't sound much like "investing for *everyone.*"

The Future Is In The App

Robinhood has made the stock market more accessible to all though its innovative ideas. It's responsible for a reduction in trading fees across the board at the traditional brokerage firms.[82] And, it appears that trading apps are here to stay as they are becoming wildly popular downloads on Apple's app store.[83] While Robinhood's zero-commission bait and its offers of free stock to new users attracts a stampede of new investors , the downside is that many of these folks are inexperienced, reducing their true ability to reap the benefits from their new market access. Most of the Robinhood trades are made based

---

80. Kate Rooney, *Why investors were willing to write Robinhood a $3 billion check during the GameStop chaos*, CNBC, (Feb. 3, 2021 6:36 P.M.), https://www.cnbc.com/2021/02/03/why-investors-were-willing-to-write-robinhood-a-3-billion-check-during-the-gamestop-chaos-.html.

81. *Id.*

82. Varun Jadia, *The Drivers and Obstacles of Financial Democratization*, BUSINESS REVIEW BERKLEY (May 3, 2019), https://businessreview.berkeley.edu/the-drivers-and-obstacles-of-financial-democratization.

83. *See*, Audrey Conklin, *Robinhood rival apps aim to make mobile trading easy for amateur investors*, FOX BUSINESS, (Jan. 29, 2021), https://www.foxbusiness.com/technology/robinhood-alternative-apps.

upon price fluctuations rather than stock fundamentals.84 Research shows that many individual investors would do better using a different trading model and that investors underperform the market by trying to time it or by acting as short term traders, such as those trading options.[85] This leads to an inherent conflict because Robinhood makes more money if its customers frequently trade stocks and options, whether or not their customers make money.[86] As a result, Robinhood customers may end up overtrading, to their own detriment. Without increased financial literacy, the app merely provides a newbie investor access to a type of slot machine, rather than an opportunity to create wealth for the future.[87]

Incoming SEC Chairman Gary Gensler has set his sights on new trading platforms which he characterizes as "using psychological props to get people to trade more."[88] Addressing the House Committee on Financial Services, Mr. Gensler stated that new rules may be needed to address the gamification of stock trading on such brokerage apps. He announced that an SEC report addressing the issues raised by the Game Stop episode will be released this summer.[89]

New technology and app based trading platforms allowing small retail customers instant access to the financial markets is the new frontier. With proper regulation and oversight, including investor education and financial literacy elements, this could possibly be a win for the bros.

---

84. *Id.*

85. David Jackson, *Robinhood and its customers are changing the brokerage industry - here's how,* SEEKING ALPHA, (Sept. 1, 2020 7:31 A.M.), https://seekingalpha.com/news/3610381-robinhood-and-customers-are-changing-brokerage-industry-how.

86. *Id.*

87. Jadia, *supra*, note 82.

88. Matthew Goldstein, *S.E.C. chair Gensler emphasizes transparency in markets*, N.Y. TIMES, (May 6, 2021), https://www.nytimes.com/2021/05/06/business/gary-gensler-priorities-gamestop.html.

89. *Id.*

Notes & Observations

DOWN, BUT NOT OUT: AFTER *LIU*, DISGORGEMENT CHALLENGES FOR THE SEC IN FCPA ENFORCEMENT

David Levintow[1]

Abstract

Over the last several years, the Supreme Court has chipped away at the SEC's primary monetary remedy.[2] *In 2017, the Supreme Court ruled in Kokesh v. SEC that disgorgement in an SEC enforcement action constitutes a "penalty" for purposes of 28 U.S.C. § 2462, and is therefore subject to a five-year statute of limitations. And this term, while the Supreme Court in Liu v. SEC upheld the Commission's general authority to seek disgorgement in U.S. District Court, it did so with several caveats. After Liu, the SEC has to make significant modifications to its disgorgement practice. No longer are gross profits a permissible measure of disgorgement; joint and several disgorgement liability may only be rarely imposed; and funds disgorged from wrongdoers should be returned to the victims of fraud – depositing disgorgement proceeds in the Treasury is no longer a sanctioned practice. While the Liu case will reverberate across the securities enforcement landscape, it will perhaps most disadvantage the SEC in Foreign Corrupt Practices Act ("FCPA") enforcement. Identifying the victims of an apparent FCPA violation, a prerequisite to returning funds to harmed investors, is particularly challenging, both from a theoretical and practical standpoint. In addition, the SEC regularly imposes de facto joint and several liability on public companies for the misconduct of their foreign subsidiaries. The permissibility of that practice has been thrown into uncertainty after Liu. Further, disagreements over the legitimacy of overseas business expenses, particularly as they pertain to third party intermediaries, will further strain the SEC's enforcement*

---

1. J.D. Candidate, The George Washington University Law School, 2021. Special thanks to Dean Jessica Tillipman, Professor Caprice Roberts, and Professor Karen Woody for both guiding and challenging my work.

2. Practitioners should be aware that Congress, in the most recent NDAA, gave the SEC express disgorgement authority for civil actions in district court. While the legislation is surely relevant to this article, the author is of the opinion that this explicit grant does not substantively change anything for the SEC. To read why, *see* David Levintow, *Sorry, but the NDAA did not just redefine disgorgement*, THE FCPA BLOG (Feb. 23, 2021), https://fcpablog.com/2021/02/23/sorry-but-the-ndaa-did-not-just-redefine-disgorgement/.

resources. While the SEC will no doubt continue to energetically investigate alleged FCPA violations and seek disgorgement, the targets of those investigations now have an array of defensive weapons to challenge particular disgorgement calculations. Consequently, increasingly protracted and contentious settlement negotiations may become the new normal in FCPA investigations.

> "[E]quity practice long authorized courts to strip wrongdoers of their ill-gotten gains, with scholars and courts using various labels for the remedy. [But] to avoid transforming an equitable remedy into a punitive sanction, courts restricted the remedy to an individual wrongdoer's net profits to be awarded for victims."[3]

1. INTRODUCTION

Monday, June 22, 2020 was a relatively quiet day at the Supreme Court. The Court released one opinion, and not one of the "blockbusters" that legal commentators, scholars, and the general public were eagerly anticipating.[4] Over the course of this term, the Justices ruled that the Civil Rights Act of 1964 protects gay and transgender workers from workplace discrimination,[5] that a Louisiana law requiring doctors who perform abortions to have admitting privileges at nearby hospitals was unconstitutional,[6] that the Trump administration could not immediately shut down DACA,[7] that employers may

3. Liu v. SEC, 140 S. Ct. 1936, 1942 (2020).

4. Mark Joseph Stern (@mjs_DC), TWITTER (June 22, 2020, 10:01 AM), https://twitter.com/mjs_DC/status/1275066321848262662 ("We have just one SCOTUS opinion today, Liu v. SEC, which is not one of the blockbusters you are all waiting for."); Steven Mazie (@stevenmazie), TWITTER (June 22, 2020, 10:01 AM), https://twitter.com/stevenmazie/status/1275066365838147587 ("Just one opinion at SCOTUS today: Liu v. SEC, one of the few minor cases left to go."); Robert Barnes (@scotusreporter), TWITTER (June 22, 2020, 10:03 AM), https://twitter.com/scotusreporter/status/1275066818202202113 ("Only decision today is Liu v. SEC. Not one of the big ones.").

5. Bostock v. Clayton Cty., 140 S. Ct. 1731 (2020).

6. June Med. Servs. L.L.C. v. Russo, 140 S. Ct. 2103 (2020).

7. Dep't of Homeland Sec. v. Regents of the Univ. of Cal., 140 S. Ct. 1891 (2020).

deny contraceptive coverage to female workers on religious or moral grounds,[8] that employment discrimination laws do not protect teachers at parochial schools,[9] that the president may fire the director of the Consumer Financial Protection Bureau without cause,[10] that states may require members of the Electoral College to vote for the candidates they had pledged to support,[11] and that much of eastern Oklahoma is an Indian reservation.[12]

In the midst of these and other weighty decisions, the Court's pronouncement that the Securities and Exchange Commission ("SEC" or "Commission") could seek a particular type of equitable relief, albeit with certain limits,[13] raised few eyebrows.[14] While the steps of the Supreme Court were not flooded with throngs of protestors or supporters when the ruling was handed down, the implications of *Liu* should not be overlooked. Disgorgement, the equitable remedy upheld (with caveats) by the Court, is the principal sanction imposed by the SEC on alleged wrongdoers. The SEC obtained $3.25 billion in disgorgement in 2019,[15] the second highest total ever

---

8. Little Sisters of the Poor Saints Peter & Paul Home v. Pennsylvania, 207 L.Ed.2d 819 (U.S. 2020).

9. Our Lady of Guadalupe Sch. v. Morrissey-Berru, 140 S. Ct. 2049 (2020).

10. Seila Law LLC v. Consumer Fin. Prot. Bureau, 140 S. Ct. 2183 (2020).

11. Chiafalo v. Washington, 140 S. Ct. 2316 (2020).

12. McGirt v. Oklahoma, 140 S. Ct. 2452 (2020).

13. Liu v. SEC, 140 S. Ct. 1936 (2020).

14. In fact, both the petitioners and the SEC were pleased with the outcome. Gregory Rapawy, Liu's counsel, stated he and his clients were "pleased to see that the Supreme Court overturned the judgment against Mr. Liu and Ms. Wang and clarified that traditional equitable principles limit the S.E.C.'s authority to seek an award of net profits for the benefit of victims." The SEC similarly expressed satisfaction, stating that the decision "allows us to continue to strip wrongdoers of their ill-gotten gains and return money to its rightful owners, following the court's direction to ensure that our efforts embody principles of equity and fairness." *See* Adam Liptak, *Supreme Court Limits S.E.C.'s Power to Recoup Ill-Gotten Gains*, N.Y. TIMES (June 22, 2020) (available at https://www.nytimes.com/2020/06/22/us/supreme-court-sec.html).

15. U.S. Sec. & Exch. Comm'n, *Division of Enforcement 2019 Annual Report* at 21 (hereinafter "*2019 Enforcement Report*").

and, in terms of dollar value, nearly three-quarters of the total monetary sanctions the SEC obtains each year.[16]

Despite, or perhaps because of its increasing use, the Court recognized that several aspects of SEC disgorgement are inconsistent with the remedy's historical underpinnings.[17] Modern day disgorgement, in the Court's view, is not really disgorgement at all. Rather, it looks like a penalty, which lies beyond the SEC's authority to seek, and a court's authority to order, "equitable relief."[18] But the Court in *Liu* found a middle ground. It upheld the SEC's general authority to seek disgorgement but outlined three significant limitations to the practice.[19] *Liu* will change the securities enforcement landscape, and perhaps in no area more so than the Foreign Corrupt Practices Act ("FCPA"). The limitations sketched by the Court bear particular relevance to FCPA enforcement and will therefore likely prove to be particularly limiting. After *Liu*, one might fairly question whether the SEC can remain a key driver of FCPA enforcement, and if so, what practices it will adopt and what arguments it will make to do so.

2. THE INVESTOR'S ADVOCATE

a. A New Deal Creation – Brief History of the SEC

The SEC was created during an economic low point for America. Ferdinand Pecora, then-chief counsel to the Senate Banking and Currency Committee, presided over two years of hearings during which he and his staff exposed countless serious securities violations that collectively led to the stock market crash of 1929.[20] In so doing, Pecora discredited "the laissez-faire economic policies of the pre-New Deal era and expos[ed] the shady securities dealings and lucrative financial arrangements of Wall Street."[21] The stock

16. *See id.*

17. Liu, 140 S. Ct. at 1946.

18. 15 U.S.C. § 78u(d)(5).

19. *See* Liu, 140 S. Ct. at 1947-50.

20. *See generally* Barbara Black, Introduction: *The SEC at 75*, 78 U. Cin. L. Rev. 445 (2009); Ann Schneider, *Ferdinand Pecora Put Capitalism on Trial for its Life*, 69 Nat'l Law. Guild Rev. 138 (2012); Michael Perino, *Ferdinand Pecora: The Hellhound of Wall Street*, 21 Experience 15 (2011).

21. *Id.* at 447.

market is an important and perhaps principal capital formation tool, and after the crash of 1929 many investors no longer felt that they could invest in public companies with any confidence. The Roosevelt administration thus saw creating an independent regulatory agency as a way to both regain the trust of investors and catalyze America's economic recovery.[22]

As a result, Congress in 1933 and 1934 enacted two landmark statutes regulating securities. The 1933 Securities Act sought to "provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes."[23] The Securities Exchange Act of 1934 was enacted shortly thereafter "to provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes."[24] Put somewhat simplistically, the 1933 Act governs the conduct of companies as they prepare to go public, while the 1934 Act governs their conduct once they have done so.[25]

Section 4 of the 1934 Act created the SEC, an independent regulatory agency headed by five commissioners that are appointed by the President with the advice and consent of the Senate.[26] The SEC's varied responsibilities include interpreting and enforcing federal securities laws, promulgating rules to implement legislation, providing oversight of the securities industry, and coordinating securities regulation with other regulatory bodies.[27] In administering the 1933 and 1934 Acts, the SEC applies several core principles, including "requiring sellers of securities to make material disclosures to

22. *See* U.S. Sec. & Exch. Comm'n, What We Do (available at https://www.sec.gov/Article/whatwedo.html) ("The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."); *see also* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) ("A fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.").

23. 15 U.S.C. § 77a et seq.

24. 15 U.S.C. § 78a et seq. *See also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 727-28 (1975).

25. The 1934 Act also governs individuals and entities who sell and trade securities, such as brokers, dealers, and securities exchanges.

26. 15 U.S.C. § 78d(a).

27. U.S. Sec. & Exch. Comm'n, *What We Do* (available at https://www.sec.gov/Article/whatwedo.html).

facilitate informed decision-making; placing heightened responsibilities on key market participants; and using [its] examination and enforcement resources to bolster those requirements and protect investors."[28] By applying these principles, and identifying and sanctioning wrongdoers, the SEC advances its tripartite mission and maintains investor confidence in the stock market.

b. The SEC's Enforcement Authority Has Increased Since Its Creation.

The securities laws provide the SEC with sweeping investigatory and enforcement powers,[29] which have evolved over time. As initially codified, the sole statutory remedy available to the SEC in an enforcement action was an injunction, a judicial order restraining an individual or entity from future violations of securities laws.[30] Recognizing the limitations of this remedy, the SEC began seeking judicial enforcement of remedies beyond injunctive relief in the late 1960's and early 1970's.[31] In *Texas Gulf Sulphur*, the Second Circuit first recognized the SEC's authority to obtain restitution, so that defendants could not retain "the gains of their wrongful conduct."[32]

Over time, a panoply of both monetary and non-monetary remedies have become available to the SEC. The SEC's *non-monetary* remedies, which may be best thought of as establishing meaningful forward-looking protections for investors, include undertakings,[33] conduct-based injunctions,[34] bars,[35] and suspensions.[36] In addition, there are two forms of *monetary* relief available to

28. U.S. Sec. & Exch. Comm'n, *Draft Strategic Plan for Fiscal Years 2018-2022*, at 3 (available at https://www.sec.gov/files/SEC_Strategic_Plan_FY18-FY22_FINAL .pdf).

29. SEC v. Materia, 745 F.2d 197, 200 (2d Cir. 1984).

30. *See* 1 T. Hazen, Law of Securities Regulation §1:37 (7th ed., rev. 2016).

31. *See* SEC v. Tex. Gulf Sulphur Co., 312 F. Supp. 77, 90 (S.D.N.Y. 1970) *aff'd in part and rev'd in part*, 446 F. 2d 1301 (CA2 1971).

32. Tex. Gulf, 446 F.2d at 1308.

33. 15 U.S.C. §78u(d)(5); 15 U.S.C. §§ 78o(b)(4), (6), and 78u-3(a).

34. *Id.*

35. 15 U.S.C. §78u(d)(2).

36. *Id.*

the SEC – penalties and disgorgement. The difference between the two, at least in theory, is that civil penalties are used as both specific and general deterrence,[37] whereas disgorgement is used to deprive wrongdoers of their ill-gotten gains.[38]

Venue matters greatly in securities enforcement. In 1990, Congress enacted the Securities Enforcement Remedies and Penny Stock Reform Act,[39] which permitted the Commission ***in administrative proceedings*** to seek civil penalties as well as disgorgement.[40] The 2002 passage of Sarbanes-Oxley included an amendment to Section 21(d) of the Exchange Act.[41] This amendment authorized the Commission, ***in civil actions brought in district court***, to seek penalties as well as "any equitable relief that may be appropriate or necessary for the benefit of investors."[42]

In both practice and in terms of total dollars obtained, disgorgement is the SEC's principal monetary remedy.[43] In 2019, the SEC ordered $3.25 billion in disgorgement, as compared to $1.1 billion in penalties.[44] From FY2015-

37. If a company engages in impropriety, levying a penalty should deter that company (specific) as well as other companies (general) from committing similar misconduct in the future.

38. Steven Peikin, Co-Director, Division of Enforcement, Speech at PLI White Collar Crime 2018: Prosecutors and Regulators Speak (Oct. 3, 2018) (text of speech available at https://www.sec.gov/news/speech/speech-peikin-100318#_ftnref14).

39. 15 U.S.C. §77t(d).

40. 15 U.S.C § 77h-1 ("In any cease-and-desist proceeding…the Commission may enter an order requiring accounting and disgorgement, including reasonable interest.").

41. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §305(b), 116 Stat. 745 (2002) (codified at 15 U.S.C. § 78u(d)(5) (2012)).

42. 15 U.S.C. § 78u(d)(5) ("In any action or proceeding brought or instituted by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may grant, **any equitable relief that may be appropriate or necessary for the benefit of investors**").

43. *See, e.g.*, SEC v. Yun, 148 F.Supp.2d 1287, 1290 (M.D. Fla. 2001); SEC v. Berlacher, No. 07-3800, 2010 U.S. Dist. LEXIS 95759, at *39-40 (E.D. Pa. Sep. 13, 2010) ("Disgorgement has become the routine remedy for a securities enforcement action. If a person is found in violation and has profited from the ensuing transaction, courts generally order the disgorgement of those profits.").

44. *2019 Enforcement Report* at 16.

FY2019, disgorgement made up 71.4% of total monetary remedies ordered.[45] However, when the SEC obtains disgorgement, the money is only sometimes returned to the harmed investors.[46] More often, the funds are deposited in the Treasury.[47] How the SEC handles disgorged funds is critical to determining whether or not the agency has indeed sought disgorgement, or some other (punitive) remedy.[48]

c. The SEC Shares FCPA Enforcement Authority with the DOJ.

The SEC is responsible for civil enforcement of the FCPA, an anti-bribery statute enacted in 1977.[49] Congress enacted the FCPA to further many of the same principles as the 1933 and 1934 Acts: the law sought to repair the reputation of U.S. businesses, restore public confidence in the financial integrity of U.S. companies, and deter conduct seen as an impediment to the efficient functioning of global markets.[50] Broadly speaking, the FCPA prohibits the making of improper payments to foreign government officials and requires strict recordkeeping and internal controls requirements to both deter violations and facilitate potential enforcement actions.[51] The FCPA's anti-bribery provisions prohibit companies and individuals from corruptly making any offer, payment, or promise to pay of any money, gift, or thing of value to a foreign government official for the purpose of obtaining or retaining business.[52] The FCPA's books and records provisions essentially require

---

45. *Id.*

46. In 2019, $1.2 billion of the $3.2 billion disgorgement total was returned to investors. *See 2019 Enforcement Report* at 17.

47. Kokesh v. SEC, 137 S. Ct. 1635, 1644 (2017).

48. *See* Sections 4 and 5, *infra*.

49. Foreign Corrupt Practices Act, 15 U.S.C. §§ 78dd-1, 78dd-3, 78ff, 78m (2012).

50. *See* H.R. Rep. No. 95-640, at 4-5; S. Rep. No. 95-114, at 3-4.

51. Foreign Corrupt Practices Act of 1977, Pub. L. No. 95–213, 91 Stat. 1494 (1977).

52. 15 U.S.C. § 78dd-1 to -3.

companies to devise a system of internal accounting controls and maintain books and records that fully and accurately reflect their transactions.[53]

The FCPA delineates several different categories of persons over whom the government may exercise jurisdiction.[54] First, the statute applies to any company with a class of securities listed on a national securities exchange in the United States, or any company with a class of securities quoted in the over-the-counter market in the United States and required to file periodic reports with the SEC (an "issuer"), prohibiting them from using interstate commerce in connection with certain types of corrupt payments to foreign officials.[55] Those same prohibitions apply to any "domestic concern,"[56] a broad term that encompasses "any individual who is a citizen, national, or resident of the United States,"[57] wherever that person happens to be in the world. Additionally, the FCPA covers businesses that are organized under state or federal law, or have their principal places of business in the United States.[58] The SEC's jurisdiction covers "issuers," and the agency exclusively enforces the books and records provisions of the FCPA.

FCPA enforcement was almost non-existent until the early 2000's but is now quite active. Since 2015,[59] the DOJ and SEC have completed over 200 enforcement actions and levied over $10 billion in fines against covered entities and individuals.[60] The SEC is responsible for 90 of those actions, thanks in large part to their specialized FCPA Unit, established in the SEC's

---

53. *Id. See also* U.S. Dep't of Justice and U.S. Sec. & Exch. Comm'n, *A Resource Guide to the U.S. Foreign Corrupt Practices Act Second Edition*, 38 (July 2020) (available at https://www.justice.gov/criminal-fraud/file/1292051/download).

54. United States v. Hoskins, 902 F.3d 69, 84-85 (2d Cir. 2018).

55. 15 U.S.C. § 78dd-1(a). ("It shall be unlawful for any issuer which has a class of securities registered pursuant to section 78l of this title or which is required to file reports under section 78o(d) of this title…").

56. 15 U.S.C. § 78dd-2(a).

57. 15 U.S.C. § 78dd-2(h)(1)(A).

58. 15 U.S.C. § 78dd-2(h)(1)(B).

59. And through September 30, 2020.

60. Stanford Law School, Foreign Corrupt Practices Act Clearinghouse: A Collaboration with Sullivan & Cromwell (available at http://fcpa.stanford.edu /statistics-analytics.html?tab=2).

Division of Enforcement in 2010.[61] FCPA enforcement actions brought by the SEC bring in a disproportionate amount of fines levied by the agency. In FY2018 and FY2019, FCPA cases made up only 3% of the actions brought by the agency, but roughly 22% of its penalties and disgorgement totals.[62] The SEC obtains disgorgement from accused wrongdoers in nearly all of its FCPA resolutions.[63] Thus, any curtailment of the SEC's disgorgement power in the FCPA context will have an outsized impact on SEC enforcement as a whole.

3. A BRIEF HISTORY OF DISGORGEMENT

While not the primary subject of this article, a basic understanding of equitable remedies[64] is critical to understanding the Court's reasoning in *Liu*, as well as what the decision will mean for the SEC in future enforcement actions. As noted previously, 15 U.S.C. § 78u(d)(5) authorizes the SEC in district court to seek "any equitable relief that may be appropriate or necessary for the benefit of investors." When a statute references equitable relief, it "authorizes the kinds of relief typically available in equity in the days of the divided bench, before law and equity merged."[65] Two questions are therefore

---

61. *Id. See also* U.S. Sec. & Exch. Comm'n, SEC Enforcement Actions: FCPA Cases (available at https://www.sec.gov/spotlight/fcpa/fcpa-cases.shtml).

62. This figure was calculated by reviewing both the 2019 and 2018 Enforcement Reports, as well as the SEC's FCPA page referenced in note 60, *supra*). The SEC notes that FCPA cases make up 3% of total enforcement actions (*see 2019 Enforcement Report* at 28). In 2019, FCPA actions resulted in $515 million in monetary relief, 11.8% of total monies ordered by the agency. In 2018, FCPA actions resulted in over $1.3 billion in monetary relief, 33% of total monies ordered.

63. Steven Peikin, Co-Director, Division of Enforcement, Speech at PLI White Collar Crime 2018: Prosecutors and Regulators Speak (Oct. 3, 2018) (text of speech available at https://www.sec.gov/news/speech/speech-peikin-100318#_ftnref14).

64. While legal remedies are primarily monetary, equitable remedies are intended to be flexible, and correct a party's injury when a purely legal remedy is inadequate. For example, a court sitting in equity could stop a party from doing something (an injunction), require a party to do something (specific performance), reform the language of a contract to better reflect the parties' intent, or order a party that has been unjustly enriched to compensate the other party. Disgorgement is most akin to this theory of unjust enrichment.

65. US Airways, Inc. v. McCutchen, 569 U.S. 88, 94-95 (2013) (*citing* Mertens v. Hewitt Associates, 508 U.S. 248, 256 (1993) (internal citations omitted).

pertinent. First, is disgorgement a kind of relief typically available in equity? And second, do the SEC's modern disgorgement practices align with the remedy's historical contours?

The first question can be answered in the affirmative. Disgorgement is an "ancient remedy rooted in restitution."[66] Restitution reflects a principal tenet of equity jurisdiction, that a wrongdoer should not be unjustly enriched, but also not punished.[67] Disgorgement of a wrongdoer's profits has a long history in both state and federal courts, in areas such as patent, trademark, and copyright infringement, as well as fraud.[68] And in the regulatory context, some thirty years prior to *Texas Gulf Sulphur*, the Supreme Court recognized the district courts' inherent authority to order any form of equitable relief, including disgorgement of profits, once their equitable jurisdiction was invoked.[69]

The second question is less certain. As mentioned, disgorgement is intended to be neither punitive nor fully compensatory.[70] Put another way, while a disgorgement award may amount to less than a victim's total losses, it should never exceed the amount of a wrongdoer's gains. As the *Restatement (Third) of Restitution and Unjust Enrichment* defines it:

> [T]he unjust enrichment of a conscious wrongdoer, or of a defaulting fiduciary without regard to notice or fault, is ***the net profit attributable***

66. Caprice L. Roberts, *Supreme Disgorgement*, 68 Fla. L. Rev. 1413, 1416 (2016).

67. *See* Sheldon v. Metro-Goldwyn Pictures Corp., 309 U.S. 390, 399 (1940) (Recovery of profits is "in accordance with the principles governing equity jurisdiction, not to inflict punishment but to prevent an unjust enrichment by allowing injured complainants to claim that which, *ex aequo et bono*, is theirs, and nothing beyond this.").

68. *See generally* Brief of Remedies and Restitution Scholars as Amici Curiae in Support of Neither Side, Liu v. SEC, 140 S. Ct. 1936 (2020) (No. 18-1501) (hereinafter "Brief of Remedies and Restitution Scholars").

69. Porter v. Warner Holding Co., 328 U.S. 395, 397-98 (1946) ("[T]he comprehensiveness of this equitable jurisdiction is not to be denied or limited in the absence of a clear and valid legislative command. Unless a statute in so many words, or by a necessary and inescapable inference, restricts the court's jurisdiction in equity, the full scope of that jurisdiction is to be recognized and applied."). In *Porter*, the Court held that § 205(a) of the Emergency Price Control Act of 1942, which authorized the Administrator of the Office of Price Administration to seek an injunction or "an order enforcing compliance" with the Act, provided the District Court with all of its inherent equitable powers, including restitution.

70. Brief of Remedies and Restitution Scholars at 13.

> ***to the underlying wrong. The object of restitution in such cases is to eliminate profit from wrongdoing while avoiding, so far as possible, the imposition of a penalty***. Restitution remedies that pursue this object are often called "disgorgement" or "accounting."[71]

An early example best colorizes these principles. *Sheldon v. Metro-Goldwyn Pictures Corp.*[72] involved a copyright dispute. A precursor to the "true crime" genre so well-known today, the petitioners in *Sheldon* wrote and copyrighted the script of a play based upon the 1857 murder trial of Madeleine Smith in Scotland.[73] They discussed selling the rights to the play to the respondents, who wished to turn the story into a movie.[74] When negotiations over price broke down, the respondents produced the movie anyway, using both the script and information in the public record to do so.[75]

The movie was profitable, and the petitioners sued.[76] But at trial, the District Court recognized that the film's total profits were not the appropriate measure of relief.[77] The "popular actors, the scenery, and the expert producers and directors" all also contributed to the film's profitability.[78] As such, relief had to be apportioned to the "small part of the net profits [that] was attributable to the infringement."[79]

The Supreme Court affirmed the apportionment of the net profits.[80] The respondents had not performed a copyrighted play but taken information (albeit wrongfully) from that play's script to create something of their own.[81] The Court likened the case to that of a party that uses another's patent as one component of an intricate machine that is used to generate profits for the

---

71. *Restatement (Third) of Restitution and Unjust Enrichment* §51(4) (emphasis added).

72. 309 U.S. 390 (1940).

73. *Id.* at 397.

74. *Id.*

75. *Id.*

76. *Id.* at 396.

77. *Id.* at 398.

78. *Id.* at 397-98.

79. *Id.* at 398.

80. *Id.* at 409.

81. *See id.* at 406.

infringer.[82] In those cases, the correct measure of disgorgement is that share of profits attributable to the patented component, not those profits driven by the "additions or valuable improvements made by the infringer."[83] To make an award of profits greater than that attributable to the infringement "would be not to do equity but to inflict an unauthorized penalty."[84]

Sheldon demonstrates two principles of disgorgement, one explicitly and one implicitly. First, the correct measure of disgorgement is the share of a wrongdoer's net profits attributable to their misconduct, whether that is copyright infringement, patent infringement, fraud, or otherwise. And second, disgorged sums should be returned to the victim. Under the Copyright Act, the relevant statute in *Sheldon*, § 25(b) required that an infringer disgorge profits to the "copyright proprietor."[85] Similarly, § 78u(d)(5) permits the SEC to seek equitable relief "for the benefit of investors." Adherence to these principles keeps disgorgement within its traditional limits. Conversely, exceeding them risks transforming disgorgement into an "unauthorized penalty."[86]

4. THE SUPREME COURT IN *KOKESH* CALLED INTO QUESTION WHETHER DISGORGEMENT CONSTITUTES "EQUITABLE RELIEF."

As early as the first time a district court recognized the SEC's authority to seek disgorgement, accused wrongdoers have decried it as a penalty.[87] Characterizing disgorgement as either a penalty or a form of equitable relief has more than semantic implications. There is a catchall five-year statute of limitations that applies federal civil penalties where the enabling statute does

82. *Id.*

83. *Id.* at 402; *see also* Westinghouse Elec. & Mfg. Co. v. Wagner Elec. & Mfg. Co., 225 U.S. 604, 615, 32 S. Ct. 691, 694 (1912) ("[I]f plaintiff's patent only created a part of the profits, he is only entitled to recover that part of the net gains.").

84. *Id.* at 405.

85. *Id.* at 399.

86. *Id.* at 405.

87. Tex. Gulf, 446 F.2d at 1308 ("Appellants, of course, contend that the required restitution is indeed a penalty assessment. This contention overlooks the realities of the situation…Restitution of the profits on these transactions merely deprives the appellants of the gains of their wrongful conduct.").

not provide a specific limitations period.[88] If the five-year limitation period set forth in § 2462 applies to disgorgement, the SEC would be significantly hamstrung in its ability to recoup wrongfully obtained profits. Fraudsters are usually adept at concealing fraud,[89] and the Supreme Court ruled in 2013 that the limitations period of § 2462 runs from the date of the violation, not from the date the violation is discovered.[90] The question of whether disgorgement is a penalty for purposes of § 2462 was before the Court in *Kokesh v. SEC*.[91]

Charles Kokesh had engaged in a fraud running fourteen years before the SEC brought an enforcement action against him in district court.[92] Kokesh, the owner of two firms that provided investment advice to business development companies, misappropriated $34.9 million dollars from his clients from 1995 to 2009 and filed false or misleading SEC reports in an attempt to cover his tracks.[93] Of the nearly $35 million misappropriated, Kokesh had obtained $29.9 million before October 27, 2004 – the date five years prior to the SEC's filing of the complaint.[94] As such, the Supreme Court was faced with the question of whether the five-year statute of limitations in § 2462 applied to disgorgement, and whether Kokesh could keep the lion's share of his ill-gotten gains.[95]

The Supreme Court in *Kokesh* answered that question in the affirmative.[96] In determining whether a particular sanction constitutes a penalty, the Court noted two common characteristics. First, a sanction may represent a penalty if

88. 28 U.S.C. § 2462 ("Except as otherwise provided by Act of Congress, an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, **shall not be entertained unless commenced within five years from the date when the claim first accrued** if, within the same period, the offender or the property is found within the United States in order that proper service may be made thereon.").

89. *2019 Enforcement Report* at 21 ("[M]any securities frauds are complex, well concealed, and are not discovered until investors have been victimized over many years.").

90. Gabelli v. SEC, 568 U.S. 442, 447-49 (2013).

91. Kokesh, 137 S. Ct. at 1635.

92. *Id.* at 1641.

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.* at 1643.

"the wrong sought to be redressed is a wrong to the public, [rather than] a wrong to the individual."[97] And second, a monetary sanction imposed not to compensate a victim, but rather to punish the offender and deter others, represents a penalty.[98]

Disgorgement, as sought by the SEC, embodied both characteristics.[99] A securities enforcement action is brought to remedy a wrong committed against the United States.[100] The SEC can proceed with an enforcement action independent of an individual's private claim, even if the victim does not support the SEC bringing an enforcement action in the first place.[101] And second, courts have frequently emphasized the deterrent purpose of disgorgement.[102] When a wrongdoer is ordered to make a "noncompensatory sanction to the Government as a consequence of a legal violation, the payment operates as a penalty."[103]

---

97. *Id.* at 1642 (2017) (*citing* Huntington v. Attrill, 146 U.S. 657, 668 (1892)) (internal citations omitted).

98. *Id.* This second principle of penalties can be broken into two parts. In that way, Kokesh established a quasi-three-part test for determining whether a sanction is a penalty. A sanction is a penalty if it (1) addresses a wrong against the state, (2) is imposed for deterrent purposes, and (3) is not used to compensate the victim. *See* Urska Velikonja, *Public Enforcement after Kokesh: Evidence from SEC Actions*, 108 Geo. L.J. 389, 392 (2019) (noting that the *Kokesh* Court created a "vague three-part test" for determining a penalty).

99. *Id.* at 1643.

100. *Id.*

101. *Id.*

102. *See* Tex. Gulf, 312 F. Supp. at 92 (depriving defendants of wrongful gains "will protect the investing public by providing an effective deterrent to future violations"); SEC v. Fischbach Corp., 133 F.3d 170, 175 (2d Cir. 1997) ("The primary purpose of disgorgement orders is to deter violations of the securities laws by depriving violators of their ill-gotten gains."); SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1474 (2d Cir. 1996) ("The primary purpose of disgorgement…is to deprive violators of their ill-gotten gains, thereby effectuating the deterrence objectives of those laws."); SEC v. Rind, 991 F.2d 1486, 1490 (9th Cir. 1993) ("The theory behind [disgorgement] is deterrence and not compensation."); SEC v. Blavin, 760 F.2d 706, 713 (6th Cir. 1985) ("[T]he district court possesses the equitable power to grant disgorgement without inquiring whether, or to what extent, identifiable private parties have been damaged by Blavin's fraud.").

103. Kokesh, 137 S. Ct. at 1644; *see also* Porter v. Warner Holding Co., 328 U.S. 395, 402 (1946).

If disgorgement is a penalty, then the SEC would seemingly lack statutory authority to seek it.[104] While the SEC may seek disgorgement in administrative actions,[105] when it brings an action in district court, its remedies are limited to civil penalties and "equitable relief."[106] But, as noted, the question before the Court was not whether the SEC could seek disgorgement when it brings an enforcement proceeding in district court. Rather, the Court was examining whether disgorgement functions as a penalty for purposes of determining the applicable statute of limitations.[107] As the Court explained in Footnote 3:

> *Nothing in this opinion should be interpreted as an opinion on whether courts possess authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context. The sole question presented in this case is whether disgorgement, as applied in SEC enforcement actions, is subject to §2462's limitations period.*[108]

So, while the Court answered one question, it left another, arguably more important one, unanswered. Does the SEC even have the underlying authority to seek disgorgement in the first place? Barrels of digital ink were spilt predicting the implications of *Kokesh*, and rightly so.[109] The years since have

---

104. *See* 15 U.S.C. § 78u(d)(5).

105. 15 U.S.C § 77h-1.

106. 15 U.S.C. § 78u(d)(3), (5).

107. Kokesh, 137 S. Ct. at 1641.

108. Kokesh, 137 S. Ct. at 1642 n.3 (2017).

109. *See, e.g.*, Armando Lopez, *SEC Disgorgement Actions: Equitable Remedy or Penalty*, 38 J. NAT'L ASS'N ADMIN. L. JUDICIARY 353, 381 (2018) ("We can expect SEC violators facing disgorgement actions will take on the Supreme Court's apparent invitation to challenge whether disgorgement is a valid SEC remedy at all."); Roberta S. Karmel, *Will Fifty Years of the SEC's Disgorgement Remedy Be Abolished*, 71 SMU L. REV. 799, 806 (2018) ("The critical and interesting question raised by *Kokesh* is whether disgorgement can be a penalty for purposes of the statute of limitations, but nevertheless be a viable equitable remedy in SEC actions for an injunction."); Patrick L. Butler, *Saving Disgorgement from Itself: SEC Enforcement after Kokesh v. SEC*, 68 DUKE L.J. 333, 365 (2018) (To save disgorgement, the SEC should "limit disgorgement to amounts that restore the pre-wrongdoing status quo, instead of pursuing disgorgement beyond the amount the wrongdoer gained…[and] distribute the funds obtained through disgorgement not to the U.S. Treasury or its own coffers, but rather to defrauded investors as much-needed compensation."); M. Sean Royall, Richard H. Cunningham & Ashley Rogers, *Are Disgorgement's Days Numbered: Kokesh v. SEC May Foreshadow Curtailment*

seen an unmistakable impact on securities enforcement – the SEC estimates that, since the decision, the Commission had "to forgo approximately $1.1 billion dollars in disgorgement in filed cases."[110] *Kokesh*, in highlighting the punitive aspects of SEC disgorgement, laid the theoretical groundwork for its dismantling, and it did not take long for another alleged wrongdoer to challenge the SEC's disgorgement authority in its entirety.

5. THE SUPREME COURT IN *LIU* BOTH RECOGNIZED AND LIMITED THE SEC'S DISGORGEMENT AUTHORITY.

Charles Liu and his wife ("petitioners") defrauded foreign investors out of nearly $27 million dollars.[111] They solicited these investments under the guise of the EB-5 Immigrant Investor Program, which permits noncitizens to apply for permanent residence in the United States by investing in certain approved commercial enterprises.[112] Liu and his wife promised investors that their contributions would go to constructing a new cancer-treatment center.[113] Instead, Liu spent nearly $20 million of the investor funds on "marketing expenses and salaries."[114] He also transferred a significant amount of funds to a personal bank account controlled by his wife.[115] A mere "fraction of the funds" went towards construction of the cancer-treatment center.[116]

The SEC brought an enforcement action against the petitioners in District Court.[117] After finding for the SEC, the District Court ordered a disgorgement award equal to the full amount Liu raised from investors, holding Liu and his

of the FTC's Authority to Obtain Monetary Relief, 32 ANTITRUST 94, 96 (2018) ("[I]t appears very likely that FTC disgorgement will be limited by the five-year limitations period found in Section 2462...The more interesting question is whether Kokesh portends additional limits on the FTC's authority to obtain monetary relief. There are good reasons to believe that it does.").

110. *2019 Enforcement Report* at 21.

111. Liu, 140 S. Ct. at 1941.

112. *Id.*

113. *Id.*

114. *Id.*

115. *Id.* at 1942.

116. *Id.*

117. *Id.*

wife jointly and severally liable.[118] The petitioners appealed this ruling, arguing that the disgorgement award ordered failed to account for their business expenses.[119] The Ninth Circuit affirmed the District Court's ruling, noting that *Kokesh* did not decide whether the SEC had the authority to seek disgorgement in district court.[120] Relying instead on Circuit precedent, the Ninth Circuit concluded that the "proper amount of disgorgement in a scheme such as this one is the entire amount raised less the money paid back to the investors."[121]

The Supreme Court upheld the SEC's authority to seek disgorgement as an equitable remedy but rejected the Ninth Circuit's conclusions on its scope and limitations.[122] The Court first reviewed disgorgement's historical underpinnings, and recognized that a fundamental principle of equity jurisprudence is that an individual should not profit from his wrongdoing.[123] Courts have used various terms to describe this profits-based remedy, including disgorgement, an accounting, and restitution.[124] At the same time, forcing a wrongdoer to pay more than his share of profits transforms an equitable remedy into a punishment.[125] In addition, traditional profits-based remedies often imposed a constructive trust, converting the wrongdoer into a

118. *Id.*

119. *Id.*

120. SEC v. Liu, 754 F. App'x 505, 509 (9th Cir. 2018).

121. *Id.*

122. Liu, 140 S. Ct. at 1940.

123. *Id.* at 1943; *see also* Root v. Ry. Co., 105 U.S. 189, 207 (1881) ("When, however, relief was sought which equity alone could give, as by way of injunction to prevent a continuance of the wrong, in order to avoid multiplicity of suits and to do complete justice, the court assumed jurisdiction to award compensation for the past injury, not, however, by assessing damages, which was the peculiar office of a jury, but requiring an account of profits, on the ground that if any had been made, it was equitable to require the wrong-doer to refund them, as it would be inequitable that he should make a profit out of his own wrong.").

124. *Id.* at 1942-43.

125. *Id.* at 1943; *see also* Tilghman v. Proctor, 125 U.S. 136, 145-46, 8 S. Ct. 894, 899 (1888) ("[I]t is inconsistent with the ordinary principles and practice of courts of chancery, either, on the one hand, to permit the wrongdoer to profit by his own wrong, or, on the other hand, to make no allowance for the cost and expense of conducting his business, or to undertake to punish him by obliging him to pay more than a fair compensation to the person wronged.").

trustee for the victim of the wrongdoing.[126] Finally, disgorgement is typically only ordered against multiple individuals on a joint and several theory of liability if those individuals were "engaged in concerted wrongdoing.[127]

After concluding that disgorgement is a traditional equitable remedy that the SEC may seek pursuant to § 78u(d)(5), the Court in *Liu* described in dicta[128] three aspects of the SEC's modern disgorgement practice that are "in considerable tension with equity principles."[129] First, the SEC returns a relatively small percentage of disgorged funds to harmed investors.[130] This practice is seemingly incompatible with both traditional disgorgement[131] as well as the command of § 78u(d)(5), that equitable relief may be sought and ordered "for the benefit of investors."[132] Contrary to the SEC's assertion that disgorgement's primary purpose is to deprive a wrongdoer of ill-gotten gains, the Court explained that the Commission "must do more than simply benefit the public at large by virtue of depriving a wrongdoer of ill-gotten gains. To hold otherwise would render meaningless the latter part of §78u(d)(5)."[133] A bedrock maxim of statutory interpretation is that courts should give effect to all statutory language.[134]

---

126. *Id.* at 1944; *see also* Burdell v. Denig, 92 U.S. 716, 720 (1875) ("Profits are not the primary or true criterion of damages for infringement in…cases in equity, and [that rule] is based upon the idea that the infringer shall be converted into a trustee, as to those profits, for the owner of the patent which he infringes.").

127. *Id.* at 1945; *see also* Belknap v. Schild, 161 U.S. 10, 25-26 (1896) ("The defendants, in any such suit, are therefore liable to account for such profits only as have accrued to themselves from the use of the invention, and not for those which have accrued to another, and in which they have no participation.").

128. *Id.* at 1947 ("Because the parties focused on the broad question whether any form of disgorgement may be ordered and did not fully brief these narrower questions, we do not decide them here.").

129. *Id.* at 1946.

130. 2019 Enforcement Report at 17. Over the past three years, the SEC has returned roughly 25% of penalties and disgorgement to harmed investors.

131. *See* Burdell, 92 U.S. at 720.

132. 15 U.S.C. § 78(u)(d)(5).

133. Liu, 140 S. Ct. at 1948.

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

Second, the SEC at times seeks to impose joint and several disgorgement liability on a wrongdoer for benefits that accrued to his affiliates.[135] The rule underlying joint and several liability is that each defendant is responsible for the full amount of the plaintiff's damages, regardless of their respective degrees of culpability.[136] That practice runs counter to the general rule of disgorgement that defendants are only responsible for the profits they personally obtain.[137] Unless two persons or entities are engaged in "concerted wrongdoing," imposing joint and several liability risks transforming "any equitable profits-focused remedy into a penalty."[138]

Finally, courts must deduct legitimate business expenses before ordering a disgorgement award.[139] Net profits, not gross profits, is the correct measure of disgorgement. Unless the "entire profit of a business or undertaking results from the wrongdoing,"[140] or the expenses are merely wrongful gains "under another name,"[141] failing to account for expenses pushes disgorgement beyond the limits of traditional equity practice.[142]

Like its predecessor *Kokesh*, *Liu* answered one question while leaving several others unanswered. While the SEC's authority to seek disgorgement is intact, the Court described several significant limitations to the practice as it exists today. Consequently, practitioners and the courts are now left to determine whether a disgorgement award is properly calculated by taking into account legitimate expenses, whether the deposit of disgorgement proceeds in the Treasury is ever a permissible practice, and the extent to which the SEC may impose joint and several disgorgement liability on wrongdoers.

---

135. Liu, 140 S. Ct. at 1949. This practice most commonly occurs with enforcement actions targeting insider trading. *See*, for example, SEC v. Contorinis, 743 F. 3d 296, 302 (2d Cir. 2014); SEC v. Whittemore, 659 F. 3d 1, 10 (D.C. Cir. 2011); SEC v. Clark, 915 F. 2d 439, 454 (9th Cir. 1990).

136. Honeycutt v. United States, 137 S. Ct. 1626, 1631 (2017).

137. *See* Belknap, 161 U.S. at 25-26.

138. Liu, 140 S. Ct. at 1949.

139. Id. at 1949-50.

140. Root, 105 U.S. at 203.

141. Rubber Co. v. Goodyear, 76 U.S. (9 Wall.) 788, 803 (1869).

142. Liu, 140 S. Ct. at 1950.

6. IMPLICATIONS FOR FCPA ENFORCEMENT

The Defense Bar rushed over itself to summarize and analyze *Liu* and its implications.[143] Most commentators agreed broadly that imposing and obtaining disgorgement will become increasingly challenging for the SEC, given the limitations outlined by the Court in *Liu*. Interestingly, no published analysis claimed that the decision would have a negligible impact on FCPA enforcement,[144] although colorable arguments can be made to that effect.

FCPA enforcement rarely takes place in the courts.[145] Companies faced with an FCPA investigation almost exclusively settle their cases by means of Deferred-Prosecution Agreements and Non-Prosecution Agreements ("DPA's" and "NPA's").[146] A DPA is a vehicle for resolving a case against a

143. *See*, for example, King & Spalding, *What's New After Liu: Unsettled Questions Surrounding SEC Disgorgement* (July 10, 2020) (available at https://www.kslaw.com/attachments/000/008/060/original/ca071020.pdf?1594396587); Foley & Lardner, *Supreme Court Recognizes, Limits SEC's Disgorgement Power* (June 24, 2020) (available at https://www.foley.com/en/insights/publications/2020/06/supreme-court-recognizes-secs-disgorgement-power); White & Case, *Liu v. SEC: Supreme Court Affirms SEC's Disgorgement Authority But Imposes Limitations* (June 24, 2020) (available at https://www.whitecase.com/publications/alert/liu-v-sec-supreme-court-affirms-secs-disgorgement-authority-imposes-limitations); Cadwalader, *Disgorgement's Role in SEC Enforcement Actions: An Analysis of the Supreme Court's Decision in Liu v. SEC* (June 24, 2020) (available at https://www.cadwalader.com/resources/clients-friends-memos/disgorgements-role-in-sec-enforcement-actions-an-analysis-of-the-supreme-courts-decision-in-liu-v-sec).

144. Perhaps this is unsurprising, since identifying risks drives business.

145. Andrew Weissmann & Alixandra Smith, *Restoring Balance: Proposed Amendments to the Foreign Corrupt Practices Act*, U.S. Chamber Institute for Legal Reform at 3 (Oct. 2010) ("[T]he primary statutory interpretive function is still being performed almost exclusively by the DOJ Fraud Section and the SEC...the DOJ effectively serves as both prosecutor and judge in the FCPA context, because it both brings FCPA charges and effectively controls the disposition of the FCPA cases it initiates.").

146. The propriety of N/DPA's has been extensively discussed by commentators. Without adopting a particular stance on the rapid proliferation of N/DPA's, it suffices for the purposes of this article to note that they are the norm for FCPA enforcement against companies. For a more extensive review of N/DPA's, as well as varied viewpoints, *see generally* Jennifer Arlen & Marcel Kahan, *Corporate Governance Regulation through Nonprosecution*, 84 U. CHI. L. REV. 323 (Winter 2017); Wulf A. Kaal & Timothy A. Laci, *The Effect of Deferred and Non-Prosecution Agreements on Corporate Governance: Evidence from 1993-2013*, 70

company where the government will bring charges against the company but not move forward on those charges.[147] In exchange, the company must abide by certain conditions that are negotiated between the company and government.[148] An NPA is similar, but no charges are filed against the company. If a company violates the terms of an NPA or DPA, the government can then reinstate the case and bring charges.[149]

Liu addressed the SEC's authority to seek disgorgement in district court, not its ability to privately negotiate and settle FCPA claims with alleged wrongdoers. Companies are typically extremely hesitant to challenge an FCPA enforcement action in court.[150] Since the DOJ and SEC share FCPA enforcement authority, the threat of an indictment often hangs over the head of companies during settlement negotiations. For many companies, a criminal conviction is viewed as the equivalent of a "death sentence," despite some empirical evidence to the contrary.[151] Given the arguably uneven bargaining table at which companies subject to an FCPA enforcement action sit, the argument could be made that *Liu* might have little to no impact on FCPA settlement negotiations. The SEC might still seek disgorgement in the manner

---

THE BUSINESS LAWYER 61 (Winter 2014-15); David M. Uhlmann, *Deferred Prosecution and Non-Prosecution Agreements and the Erosion of Corporate Criminal Liability*, 72 MD. L. REV. 1295 (2013); Andrew Weissmann et. al, *Reforming Corporate Criminal Liability to Promote Responsible Corporate Behavior*, U.S. CHAMBER INSTITUTE FOR LEGAL REFORM (October 2008).

147. Michael Yangming Xiao, *Deferred/Non Prosecution Agreements: Effective Tools to Combat Corporate Crime*, 23 CORNELL J. L. & PUB. POL'Y 233, 240-43 (2013).

148. If the company abides by the terms of the DPA, the government will drop the charges. Some typical DPA conditions include appointing an independent monitor, making improvements to the corporate compliance program, or firing the employees responsible for the misconduct.

149. Xiao, *supra* note 147, at 240-43.

150. Not a single company fought its FCPA charges in court in 2019. *See* Richard L. Cassin, *The Top Three FCPA Stories of 2019*, THE FCPA BLOG (Dec. 30, 2019 7:18am) (accessible at https://fcpablog.com/2019/12/30/the-top-three-fcpa-stories-of-2019/).

151. Gabriel Markoff, *Arthur Andersen and the Myth of the Corporate Death Penalty: Corporate Criminal Convictions in the Twenty-First Century*, 15 U. PENN. J. BUS. L. 797 (2013) (reviewing database of organizational convictions and finding that no publicly traded company failed because of a conviction between 2001 and 2010).

it has done so for years, and companies will begrudgingly enter into settlement agreements rather than risk a day in court.

Despite this argument, there is reason to believe that the limitations from *Liu* will substantially alter future FCPA investigations and resolutions. Companies subject to investigation will no doubt be aware of these new disgorgement limitations, and may feel more equipped to challenge SEC calculations that are inconsistent with *Liu*. In addition, the SEC has already stated its intent to acquiesce to the new limitations.[152] If companies assert, and the SEC adheres to, *Liu's* limitations, the SEC's FCPA enforcement authority will potentially be curtailed in several ways.[153]

a. Disgorgement in FCPA Cases Will Be Limited by the Challenge of Identifying the Victims of the Fraud.

Historically, a disgorgement order "imposed a constructive trust on wrongful gains for wronged victims."[154] Under § 78(u)(d)(5), a court may provide equitable relief "for the benefit of investors."[155] Taken together, the Court in *Liu* cast doubt on the SEC's practice of depositing the proceeds of fraud in the Treasury.[156] While the SEC suggested that it is often "infeasible" to distribute disgorged funds to harmed investors, the Court indicated that the

152. *See* Adam Liptak, *Supreme Court Limits S.E.C.'s Power to Recoup Ill-Gotten Gains*, N.Y. TIMES (June 22, 2020) (available at https://www.nytimes.com/2020/06/22/us/supreme-court-sec.html). ("Today's decision," the agency said in a statement, "allows us to continue to strip wrongdoers of their ill-gotten gains and return money to its rightful owners, ***following the court's direction to ensure that our efforts embody principles of equity and fairness***.").

153. Any curtailment to the SEC's disgorgement power may also result in a corresponding increase in DOJ disgorgement. This recent pretrial diversion program, where the DOJ declines to bring charges against a company but nonetheless orders the company to disgorge wrongfully obtained profits, presents its own set of legal and theoretical issues. *See* Karen Woody, *Declinations with Disgorgement in FCPA Enforcement*, 51 U. MICH. J.L. REFORM 269 (2018) (criticizing the program both in practice and as a "misuse of the legal lexicon." If the DOJ declines to bring charges against a company but orders disgorgement of ill-gotten gains, the transaction looks more like either corporate bribery or governmental extortion.).

154. Liu, 140 S. Ct. at 1944.

155. 15 U.S.C. § 78u(d)(5).

156. *Id.* at 1946.

SEC "must do more" than benefit the public merely by depriving fraudsters of their ill-gotten gains.[157] In future enforcement actions, the SEC will have to specifically identify the victims of the fraud in order to seek disgorgement. This poses unique challenges in FCPA enforcement.

Identifying the victim in an FCPA matter is no easy task, as there are arguably several discrete groups of victims. One group of victims may be the shareholders of the company that paid the bribe to a foreign government official. After all, § 78(u)(d)(5) authorizes a court to provide equitable relief "for the benefit of investors," and they are the investors. However, shareholders of a company that bribes a foreign government official are not victims of fraud in the same way as are investors duped by a Ponzi scheme, or those whose funds are misappropriated by an unscrupulous investment adviser. The fraud in an FCPA case is the payment or promise of payment of a bribe, and one could argue that the fraud typically benefits that company's investors (at least, until it is discovered by the authorities) by securing contracts, concessions, or licenses not otherwise available. Bribes are made with the end goal of increasing revenues and improving a company's bottom line. In that way, shareholders of a company that pays a bribe are not victims, but rather beneficiaries, of the fraudulent act.[158] They only suffer pecuniary loss to the extent that a subsequent enforcement action damages the company's reputation and share price.

Another set of potential victims are the citizens of the foreign country in which the bribe is paid. As the DOJ and SEC note in their FCPA Resource Guide, bribery of foreign government officials "undermines the rule of law, empowers authoritarian rulers…and threatens…sustainable development."[159] Relatedly, legislation introduced in the House last year would use FCPA proceeds "to aid foreign states to prevent and fight public corruption and

---

157. *Id.* at 1948.

158. Surely there are indirect, attenuated risks and costs associated with owning shares of a company that engages in illegal activity. But, at least in the immediate sense, a shareholder is arguably not harmed by the payment of a bribe. To put it another way, the victim of a Ponzi scheme is relieved when the government brings an enforcement action. Shareholders of a company are aggrieved when the government brings an FCPA enforcement action.

159. U.S. Dep't of Justice and U.S. Sec. & Exch. Comm'n, *A Resource Guide to the U.S. Foreign Corrupt Practices Act Second Edition*, Foreword (July 2020) (available at https://www.justice.gov/criminal-fraud/file/1292051/download) (*hereinafter* "FCPA Resource Guide").

develop rule of law-based governance structures."[160] But none of that really answers the question of whether the foreign country, or its citizens, are victims of the fraud for purposes of disgorgement. They are not "investors" for purposes of § 78(u)(d)(5), and, if sending disgorged proceeds to the Treasury is problematic, sending it overseas is perhaps even more so.

The most fitting victim of a bribe that helps a company to obtain government business that it otherwise would not have obtained may be the competitor of the bribe-paying company – the company that would have received the government business but-for the illicit payment. Much like investors are deprived of money when a fraudster misappropriates their investment, a competitor company is deprived of revenue when it does not receive government business that it would likely have received absent the fraudulent conduct of the bribe payor. But there are two problems with this theory. First, competitor businesses do not fit neatly within § 78(u)(d)(5)'s use of the term "investor." Second, and more fundamentally, how would the SEC determine who would have been next in line? It is hard to foresee a corrupt foreign government official providing, or even knowing, this information. And if companies could assert the claim on their own, the SEC would be left to design and administer a quasi-bid protest system,[161] a job the agency surely lacks the capacity to do.

The challenges in identifying investor victims in FCPA cases were acknowledged by both Liu's counsel[162] and the government[163] during oral

---

160. CROOK Act, H.R. 3843 116th Cong. § 6 (2019).

161. *See generally* Daniel I. Gordon, *Constructing a Bid Protest Process: Choices Every Procurement Challenge System Must Make*, 35 Pub. Cont. L. J. 3 (2006).

162. Transcript of Oral Argument at 34-35, Liu v. SEC, 140 S. Ct. 1936 (2020) (No. 18-1501) ("[I]n many cases that [the SEC] use[s] the [disgorgement] power, they don't even believe that it's appropriate to return the money to investors. And I would point to the Foreign Corrupt Practices Act cases as the biggest example of that. In theory, you know, could they find them? They apparently do find it difficult in many cases because, in many cases, the money goes to the Treasury, but there are many cases in which it is currently applied under which none of this rationale would -- would apply at all, including nine- and ten-figure recoveries against private companies that are basically just money taken from the investors and put to the Treasury because they -- because that's how they -- because they -- they want to use it as a deterrent. They want to use it as a deterrent and a punishment and to make an example out of the violators of the securities laws.

163. *Id.* at 34-35 ("Now there is a category of cases like the FCPA cases, the Foreign Corrupt Practices Act cases, where sometimes we do get big judgments. They're not returned to investors because there really is no obvious universe of individual

argument. Despite the SEC's argument that it should not have to return funds to investors if not feasible, the Court described as "an open question" whether the SEC's practice of depositing disgorged funds with the Treasury satisfies the statutory command to award relief "for the benefit of investors."[164] Further, in a footnote, the Court noted that, if the feasibility of identifying and returning funds to victims is even relevant, lower courts are equipped "to evaluate…feasibility."[165]

In future cases, the SEC will almost certainly continue to seek disgorgement in FCPA cases, while arguing that returning disgorged funds to harmed investors is not feasible. In so doing, the SEC will seek to keep the remedy within the bounds of traditional equity principles. But, even putting aside the *Liu* Court's less than approving language about the practice, there is an apparent theoretical flaw in the SEC's argument. In *Kokesh*, the Court explained that a remedy can either be used to compensate, or it can be used to deter.[166] Moreover, if a remedy serves both a compensatory and a deterrent purpose, it is considered a penalty, not an equitable remedy.[167] If the SEC seeks disgorgement, while acknowledging that funds cannot or will not be returned to actual investors, it cannot also argue that it is seeking disgorgement for purely compensatory purposes. In those cases, disgorgement only operates as a deterrent. Put simply, the SEC, in trying to avoid a *Liu* problem, may create for itself a more fundamental *Kokesh* problem. A remedy with a solely deterrent purpose is a penalty, and accused wrongdoers will be on strong footing to invoke *Kokesh* and challenge disgorgement.

---

victims from an FCPA violation -- an FCPA violation. But, in cases where individual victims can be located and the money can be distributed, it's our general practice to do so… with respect to the FCPA, there just is no obvious universe of investors.").

164. Liu, 140 S. Ct. at 1948.

165. *Id.* at 1948 n.5.

166. Kokesh, 137 S. Ct. at 1644.

167. *Id.* at 1645; *see also* United States v. Halper, 490 U.S. 435, 448 (1989) ("[A] civil sanction that cannot fairly be said solely to serve a remedial purpose, but rather can only be explained as also serving either retributive or deterrent purposes, is punishment, as we have come to understand the term.").

b. By Holding U.S. Companies Strictly Liable for the Misconduct of Their Foreign Subsidiaries, the SEC Imposes *De Facto* Joint and Several Disgorgement Liability, a Practice in Tension with *Liu*.

In *Liu*, the District Court ordered the petitioners jointly and severally liable for the full disgorgement award. In other words, both Charles Liu and his wife were individually responsible for the entire $27 million disgorgement order. That order, in the Supreme Court's view, was in tension with the general rule of disgorgement, that defendants are only responsible for the profits they personally obtain.[168] As the Court noted, unless two persons or entities are engaged in "concerted wrongdoing," imposing joint and several liability risks transforming "any equitable profits-focused remedy into a penalty."[169]

As of September 30, the SEC has completed five corporate FCPA enforcement actions in 2020.[170] Each action involved misconduct by a foreign subsidiary, rather than the parent company.[171] The theory of liability in each case was that the foreign subsidiary paid a bribe (or bribes), maintained inaccurate books and records that did not reflect those illegal payments, and then the parent company consolidated the subsidiary's books and records into its own financial statements.[172] In no case did the SEC allege that the parent company knew of the bribes and knowingly falsified its own books and records.[173] The SEC, then, imposes *de facto* joint and several liability on parent

---

168. *See* Belknap, 161 U.S. at 25-26.

169. Liu, 140 S. Ct. at 1949.

170. Admin. Proc. Order, In the Matter of World Acceptance Corporation, Exchange Act Release No. 89489 (Aug. 6, 2020); Admin. Proc. Order, In the Matter of Alexion Pharmaceuticals, Inc., Exchange Act Release No. 89214 (July 2, 2020); Admin. Proc. Order, In the Matter of Novartis AG, Exchange Act Release No. 89149 (June 25, 2020); Admin. Proc. Order, In the Matter of Eni S.p.A., Exchange Act Release No. 88679 (Apr. 17, 2020); Admin. Proc. Order, In the Matter of Cardinal Health, Inc., Exchange Act Release No. 88303 (Feb. 28, 2020).

171. *See id.* at 2; Alexion Pharmaceuticals, Exchange Act Release No. 89214 at 2; Novartis AG, Exchange Act Release No. 89149 at 2; Eni S.p.A., Exchange Act Release No. 88679 at 2; Cardinal Health, Exchange Act Release No. 88303 at 2.

172. *See id.*; Alexion Pharmaceuticals, Inc., Exchange Act Release No. 89214 at 2; Novartis AG Exchange Act Release No. 89149 at 3; Eni S.p.A. Exchange Act Release No. 88679 at 4; Cardinal Health Exchange Act Release No. 88303 at 3.

173. Also in these cases are there no allegations that the subsidiary passed wrongfully obtained profits up to the parent company. What these cases involve, in the simplest terms, is a subsidiary that pays a bribe and then describes that bribe on

companies under a strict liability theory.[174] It holds parent companies liable for the conduct of their "affiliates" in the absence of evidence of wrongdoing by the parent.

This practice is arguably violative of the principle that joint and several disgorgement liability should only be ordered in cases of "concerted wrongdoing."[175] The *Liu* Court noted the existence of a "wide spectrum of relationships between participants and beneficiaries of unlawful schemes—from equally culpable co-defendants to more remote, unrelated tipper-tippee arrangements."[176] Although joint and several disgorgement liability may be appropriate in some of these schemes, the remedy may be punitive in others.[177]

In the *Liu* case, the petitioners were married.[178] Liu's wife "held herself out as the president, and a member of the management team, of an entity to which Liu directed misappropriated funds."[179] There was no evidence introduced to suggest that "one spouse was a mere passive recipient of profits…that their finances were not commingled, or that one spouse did not enjoy the fruits of the scheme." Nevertheless, the *Liu* Court did not determine whether or not Charles Liu and his wife were engaged in "concerted

---

its financial statement as something other than a bribe (a "consulting fee," perhaps). Then, the parent company obtains and consolidates this inaccurate description of the expense into its own financial reporting. The parent company, by unknowingly reproducing misinformation, violates the FCPA's recordkeeping provisions.

174. *See, e.g.*, Gregory M. Williams, *The Alcoa FCPA Settlement: Are We Entering Strict Liability Anti-Bribery Regime?*, HLS FORUM ON CORP. GOVERNANCE AND FIN. REGULATION (Feb. 5, 2014) ("An issuer's responsibility to maintain accurate books and records encompasses the financial records of the subsidiaries of which the parent holds 50% or more of the voting power. Accordingly, a parent company may be held strictly liable for its subsidiary's violations of the FCPA accounting provisions."); Olesya Sidorkina, *Establishing Corporate Parent Liability for FCPA Violations*, 14 U.C. DAVIS BUS. L.J. 89, 102 (2013) ("Unlike the book and records provisions (where a strict liability standard appears to have evolved for majority-owned subsidiaries, or minority-owned subsidiaries where the parent exercised operational control), the anti-bribery provisions of the FCPA fail to provide a bright-line rule for parent companies based on ownership or operational control.").

175. Liu, 140 S. Ct. at 1949.

176. *Id.*

177. *See id.*

178. *Id.*

179. *Id.*

wrongdoing," instead leaving it to the Ninth Circuit to determine whether the "petitioners can, consistent with equitable principles, be found liable for profits as partners in wrongdoing or whether individual liability is required."[180]

In the FCPA context, a parent and subsidiary are part of a corporate family, for lack of a better term. In that regard, the relationship is not dissimilar to that of the petitioners in *Liu*. However, the SEC's recent enforcement actions are not suggestive of "equally culpable codefendants."[181] In each case, the misconduct was perpetrated by the subsidiary, rather than the parent. If a parent company is unaware of a bribe paid by one of its subsidiaries to obtain business, it looks much more like a "passive recipient of funds,"[182] if it receives funds at all.[183] Concerted wrongdoing implies that two persons or entities act in coordination. Applying the *Liu* Court's didactic propositions to the SEC's FCPA enforcement activity in 2020, the cases fall on the side of the spectrum "where an equitable profits remedy might be punitive when applied to multiple individuals."[184]

In sum, the SEC's imposition of disgorgement on a strict liability basis effectively achieves the same result as the use of joint and several liability without the SEC having to satisfy *Liu's* requirements or the principles of disgorgement. The SEC would likely argue that to hold a parent company strictly liable for the conduct of its subsidiary is not to impose joint and several liability. And in the purest sense, it is not. The SEC does not hold both parent and subsidiary liable for the full disgorgement award. But the practical effect is the same. In *Liu*, the Court reinforced one of disgorgement's fundamental restraints, that it is inequitable for one party to be held responsible for profits they do not personally obtain.[185] That restraint is arguably discarded when the SEC holds a parent company strictly liable for profits obtained by its subsidiary. The SEC cannot make Party A pay for Party B's profits and call it

180. *Id.*

181. *Id.*

182. *Id.*

183. *See* note 172, *supra*.

184. *Id.*

185. *See Liu*, 140 S. Ct. at 1949 ("That practice…runs against the rule to not impose joint liability in favor of holding 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." (*citing Belknap*, 161 U. S., at 25-26).

disgorgement. It is not.[186] Rote application of strict liability ignores the nuance necessary to stay within disgorgement's narrow confines.[187] The SEC seeks to use an axe while disgorgement requires a scalpel.[188]

None of this is to suggest that dicta in *Liu* has dismantled *respondeat superior*, the principle that "a company is liable for the acts of its agents, including its employees, undertaken within the scope of their employment and intended, at least in part, to benefit the company."[189] Rather, targets of future SEC FCPA enforcement actions might reasonably question whether that doctrine, manifested through the imposition of *de facto* joint and several liability on parent companies that have not engaged in wrongdoing, is consistent with the traditional equity principles of disgorgement. At the very least, *Liu* has outlined three ways by which companies can challenge the imposition of this *de facto* joint and several liability: by demonstrating that the parent company was a "mere passive recipient of profits,"[190] that there was no commingling of finances between the parent and subsidiary,[191] and that the parent company "did not enjoy the fruits of the scheme."[192] Much like the challenges associated with identifying the victims of fraud,[193] the Court in *Liu* left it to lower courts in future cases to determine when joint and several disgorgement liability is permissive, and when it is punitive.

---

186. *See* Elizabeth v. Pavement Co., 97 U.S. 126, 140 (1877) (concluding that, in patent infringement case where only one of three defendants profited from the infringement, only that defendant was liable for those profits).

187. There may indeed be many cases where *de facto* joint and several disgorgement liability is appropriate. The SEC's error is in not identifying those cases, but rather imposing strict liability across the board.

188. Even if this SEC practice is not *per se* joint and several liability, the imposition of strict liability would still often violate the principle that disgorgement should not exceed a party's net profits. If a subsidiary's wrongfully obtained profits are not shared with the parent company, a disgorgement order against the parent company would necessarily exceed that parent company's net profits.

189. *FCPA Resource Guide* at 28.

190. Liu, 140 S. Ct. at 1949.

191. *Id.*

192. *Id.*

193. *See* Section 6(a), *supra*.

c. Determining Legitimate Deductible Expenses in FCPA Cases Will Result in Protracted Negotiations, Further Limiting SEC Disgorgement.

The final limitation explicated by the Court in *Liu* will further impede the SEC's ability to seek disgorgement. Courts may not order disgorgement awards in an amount that exceeds "the gains made upon any business or investment, when both the receipts and payments are taken into the account."[194] By deducting legitimate expenses before ordering disgorgement under § 78u(d)(5), courts properly keep the remedy within its traditional limits.[195] Net profits, not gross profits, is the correct measure of disgorgement.[196]

In *Liu*, the SEC sought a disgorgement award totaling the entire sum obtained from investors, one that did not factor into account any potentially legitimate expenses by the petitioners.[197] This practice, seeking gross profits obtained from wrongdoing, is commonplace in securities enforcement actions.[198] The *Liu* Court, noting that at least "some expenses from petitioners'

194. *Id.* at 1949-50.

195. *Id.*

196. *Id.* at 1946.

197. *Id.* at 1942.

198. *See* SEC v. Brown, 658 F.3d 858, 861 (8th Cir. 2011) ("[T]he overwhelming weight of authority hold[s] that securities law violators may not offset their disgorgement liability with business expenses."); SEC v. JT Wallenbrock & Assocs., 440 F.3d 1109, 1114 (9th Cir. 2006) ("[I]t would be unjust to permit the defendants to offset against the investor dollars they received the expenses of running the very business they created to defraud those investors into giving the defendants the money in the first place."); SEC v. United Energy Partners, Inc., 88 F. App'x 744, 746 (5th Cir. 2004) ("Disgorgement deprives wrongdoers of ill-gotten gains; and a person remains unjustly enriched by what was illegally received, whether he retains the proceeds of his wrongdoing."); SEC v. Banner Fund Int'l, 341 U.S. App. D.C. 175, 211 F.3d 602, 617 (2000) ("Disgorgement is an equitable obligation to return a sum equal to the amount wrongfully obtained…an order to disgorge establishes a personal liability, which the defendant must satisfy regardless whether he retains the selfsame proceeds of his wrongdoing."); SEC v. Shapiro, 494 F.2d 1301, 1309 (2d Cir. 1974) ("The district court required appellant to disgorge not the actual profits realized when he sold shares in Harvey's after February 18, but the "paper" profits which had accrued as of February 18. Since the price of Harvey's stock dropped after February 18 appellant had to surrender more than he actually made. The district court's approach was reasonable. HN6 A violator of the securities laws should

scheme went toward lease payments and cancer-treatment equipment," characterized the SEC's practice as beyond the limits of traditional equity principles.[199]

What constitutes legitimate business expenses will surely be disputed in various forms of subsequent securities enforcement, but these calculations will be particularly murky in the FCPA context. On the one hand, the SEC might argue that FCPA cases fall into the narrow exception where the "entire profit of a business of undertaking" is a result of the fraud.[200] In those cases, allowing a wrongdoer to offset any amount of business expenses is inequitable.[201] If a company only obtains business from a foreign government as a result of an illicit payment, the SEC might argue that all of its profits are attributable to the fraud, and no expenses may be deducted from the disgorgement calculation.

This is a dubious hypothetical argument. Profits made on an illegally obtained foreign government contract are due not to the proscribed payment,[202] but rather the company's performance of the contract. The ***contract*** is obtained by fraud, but ***profits*** will only be realized if the company can successfully perform under the terms of that contract. The *Liu* Court recognized that, although the petitioners obtained the funds fraudulently, at least some of the money was spent in a potentially legitimate manner.[203] Similarly, when a company pays a bribe to obtain business from a foreign government, it must incur operating expenses in order to provide the goods or services required by that agreement. Courts also distinguish between legitimate companies that engage in fraud and those that are created for the sole purpose of fraud.[204]

---

disgorge profits earned by trading on non-public information. Once public disclosure is made and all investors are trading on an equal footing, the violater [sic] should take the risks of the market himself.".

199. Liu, 140 S. Ct. at 1950.

200. *Id.* at 1945 (*citing* Root, 105 U.S. at 203).

201. *See id.* at 1945-46.

202. Unless the bribe is such that the company is awarded an inflated contract not commensurate with the value of goods or services provided.

203. Liu, 140 S. Ct. at 1950 ("[S]ome expenses from petitioners' scheme went toward lease payments and cancer-treatment equipment. Such items arguably have value independent of fueling a fraudulent scheme.").

204. *See* JT Wallenbrock & Assocs., 440 F.3d 1114-15 ("Their entire business enterprise and related expenses were not legitimate at all…the defendants here seek an offset for entirely illegitimate expenses incurred to perpetuate an entirely fraudulent operation.").

Companies subject to FCPA enforcement actions are the former. Even the operation in *Liu*, which appeared to be driven almost exclusively by fraud, incurred business expenses which the Court deemed arguably deductible.[205]

On the other hand, unconscionable expenses cannot be used to offset a wrongdoer's profits.[206] In *Rubber Co. v. Goodyear*, a patent infringement case, the Court refused to deduct from the disgorgement award the exorbitant salaries paid by the infringer, as well as "materials bought for the purposes of the infringement."[207] The Court there recognized that these expenses were merely wrongful gains "under another name."[208] Similarly, the *Liu* Court stated that expenses made to "fuel a fraudulent scheme" are illegitimate and cannot be deducted from a disgorgement award.[209]

These principles will implicate the use of third parties in many FCPA enforcement actions. Companies frequently engage third party intermediaries and consultants in the foreign countries in which they operate. Third parties can play a valuable role by providing "entirely legitimate advice regarding local customs and procedures and…facilitat[ing] business transactions."[210] But third parties are also often used to discreetly funnel bribes to foreign government officials.[211] Of the SEC's five corporate enforcement actions so far in 2020,[212] four involved the use of third parties to make illicit payments to foreign government officials.[213]

In future enforcement actions, the SEC will have to determine which payments to third parties are legitimate, and which are made merely to "fuel a

---

205. Liu, 140 S. Ct. at 1950.

206. Rubber Co. v. Goodyear, 76 U.S. (9 Wall.) 788, 803 (1869).

207. *Id.*

208. *Id.*

209. Liu, 140 S. Ct. at 1950.

210. *FCPA Resource Guide* at 22.

211. *See*, for example, United States v. Société Générale S.A., No. 18-CR-00253 (E.D.N.Y. 2018); United States v. Mace, No. 17-cr-618 (S.D. Tex. Oct. 19, 2017).

212. Through September 30, 2020.

213. *See* World Acceptance Corporation, Exchange Act Release No. 89489 at 3; Alexion Pharmaceuticals, Exchange Act Release No. 89214 at 4; Novartis AG, Exchange Act Release No. 89149 at 7; Cardinal Health, Exchange Act Release No. 88303 at 5.

fraudulent scheme."[214] While a bribe would not be considered a deductible expense,[215] this task will be complicated by the fact that some third parties are initially engaged to provide legitimate services, and only later are used to make payments to foreign government officials. Other third parties are engaged solely as a vehicle to pay bribes.

As a result, and somewhat counterintuitively, the SEC will have to make judgments about *mens rea* while enforcing a strict liability offense. A company might actively participate in, tacitly authorize, be aware of, or be unaware of a proscribed payment through a third party. These varying levels of culpability might well influence the SEC's characterization of the company's other payments to that third party, and other third parties. The SEC's enforcement actions this year are illustrative of these issues.

In the Novartis matter, the company's subsidiary in Korea paid $16.3 million to medical journals over a five-year span.[216] Much of these expenses were legitimate, covering advertising fees for Novartis products in the journals.[217] However, some of the funds were passed on by the journals to healthcare providers to induce them to prescribe Novartis products.[218]

A Turkish subsidiary of Alexion Pharmaceuticals paid $1.3 million to an outside consultant.[219] These payments included both consulting fees as well as sham "expense reimbursements," which the consultant passed on to Turkish health officials.[220] As a result of these bribes, the company received regulatory approval of its primary drug, Soliris.[221]

---

214. Liu, 140 S. Ct. at 1950.

215. Transcript of Oral Argument at 32-33, Liu v. SEC, 140 S. Ct. 1936 (2020) (No. 18-1501) ("In Foreign Corrupt Practices cases…the wrong is that the defendant company has obtained a contract by paying a bribe to the public official, and the SEC would say, in those cases, the proper measure of disgorgement is net profits earned on the contract…The defendant would be allowed to deduct its operating expenses, but we wouldn't allow the defendant to count the bribe itself as a cost of doing business, as a deductible expense. That, in our view, wouldn't be allowed in computing the amount of disgorgement that would be ordered.").

216. Novartis AG, Exchange Act Release No. 89149 at 7-8.

217. *Id.*

218. *Id.*

219. Alexion Pharmaceuticals, Exchange Act Release No. 89214 at 3-4.

220. *Id.*

221. *Id.*

World Acceptance Corporation's subsidiary in Mexico paid cash bribes through intermediaries so that "government entities and worker unions representing government employees" would enter into loan agreements with the company.[222] There is no evidence in the settlement agreement to suggest these intermediaries performed any legitimate function.[223] Similarly, the Cardinal Health settlement notes that the company's subsidiary in China "channeled funds through complicit third-party vendors" to government healthcare providers who had influence over purchasing decisions.[224]

As these four cases indicate, payments to third parties fall on a spectrum of legitimacy. Some third parties provide legitimate services, some serve both legitimate and illegitimate functions, and some are engaged solely to obfuscate bribery. Further complications might arise when a third party is hired initially as a method of shielding illicit payments, but later provides some form of legitimate services to the company. Or when a company engages third party sales agents and offers them exorbitant commissions to obtain government business for the company, and those sales agents use a portion of their commissions to pay bribes.[225] The SEC could be expected to argue that these expenses are illegitimate, likening them to the "materials bought for the purpose of infringement" in *Rubber Co. v. Goodyear*.[226]

The company subject to the investigation would surely disagree. Suffice it to say that future FCPA enforcement negotiations will be increasingly contentious and protracted, as the SEC and accused wrongdoers debate the relative merits of any and all expenses overseas. This by itself will hamper SEC enforcement and disgorgement. The SEC, like most government agencies, is strained for resources – the headcount in the Division of Enforcement was almost 9% lower in Fiscal Year 2019 than in Fiscal Year 2016.[227] The SEC estimates that the *Kokesh* decision caused the agency to forego $1.1 billion dollars in disgorgement, but that "the actual impacts of

222. World Acceptance Corporation, Exchange Act Release No. 89489 at 2-3.

223. *Id.*

224. Cardinal Health, Exchange Act Release No. 88303 at 5.

225. *See* United States v. Société Générale S.A., No. 18-CR-00253 (E.D.N.Y. 2018). In this case, a French bank engaged a third-party sales agent to obtain business in Libya, ultimately paying the agent over $90 million in commissions. The sales agent used part of these payments to bribe Libyan government officials, resulting in the placement of approximately $3.66 billion in assets with the financial institution.

226. Rubber Co., 76 U.S. (9 Wall.) at 803.

227. *2019 Enforcement Report* at 22.

Kokesh are likely far greater than this number reflects…because…the Division has shifted its resources to those investigations which hold the most promise for returning funds to investors."[228]

The *Liu* decision will likely have an even greater impact on the allocation of SEC enforcement resources than *Kokesh*. *Kokesh* forced the SEC to prioritize "those investigations which hold the most promise for returning funds to investors."[229] But the SEC can more readily ascertain which cases have identifiable victims at the outset of an investigation. Deciding whether a payment to a third party is legitimate or illegitimate is not at all a threshold question; it typically requires much more extensive investigation. Similarly, a decision about the imposition of joint and several liability, discussed in Section 6(b), cannot be made at the start of an investigation. Finding evidence of "concerted wrongdoing" takes considerable time and effort. While *Kokesh* foreclosed from enforcement an entire class of wrongdoers,[230] *Liu* will make enforcement against the remaining class of wrongdoers more labyrinthine, burdensome and resource-intensive.

7. CONCLUSION

After *Liu*, the SEC can conceivably pursue one of three courses of action: deprioritize FCPA enforcement, ignore *Liu's* dicta altogether while negotiating settlements with accused wrongdoers, or continue FCPA enforcement apace while crafting disgorgement to the remedy's historical limits. The third outcome is the most likely, but also is the most problematic for the SEC. Depositing disgorged funds in the Treasury is no longer a sanctioned practice, but identifying specific victims of an FCPA violation is particularly tricky. Imposing joint and several disgorgement liability, a norm in FCPA enforcement, may only now be permissible in instances of concerted wrongdoing. Finally, prolonged disputes over the validity of overseas expenses will further strain the Commission's enforcement resources. The Supreme Court may have left the SEC's disgorgement power intact, but, at least in the context of FCPA enforcement, it has been diluted.

228. *Id.* at 21.

229. *Id.*

230. Those whose fraud occurred at least five years prior to the SEC's filing of a complaint.

AN INVESTOR'S FINRA RULE 12200 ARBITRATION RIGHT SHOULD SUPERSEDE CONTRARY FORUM-SELECTION AGREEMENTS

*Luke Colle**

INTRODUCTION

A. *A Brief History of Predispute Arbitration Agreements*

Predispute arbitration agreements (PDAAs) have a precarious history. In the early United States, courts rarely enforced PDAAs.[1] Parties could revoke them, and judges would only recognize nominal damages for breach of contract.[2] However, in the 1920s, as part of a movement for procedural reform,[3] Congress passed the Federal Arbitration Act (FAA) to make PDAAs as enforceable as other contracts.[4] Although, Courts were still hesitant to enforce them: for instance, in 1953, the Supreme Court found a PDAA unenforceable, holding that it waived compliance with a Securities Act provision.[5] The Supreme Court only overruled that decision in the late-1980s

---

*I would like to thank Professor Birgitta Siegel of Cornell Law School for her guidance and support as I wrote this Article. Luke Colle is a J.D. Candidate at Cornell Law School and a member of Cornell's Securities Law Clinic. Upon graduation, Colle will join Ropes & Gray LLP as an Associate.

1. *See* LAURA J. COOPER ET AL., ADR IN THE WORKPLACE 31 (2000) ("Traditionally, courts have been hostile to arbitration, viewing it as an institution that would deprive the courts of their jurisdiction.").

2. *See, e.g.*, Munson v. Straits of Dover S.S. Co., 102 F. 926, 928 (2d Cir. 1900) (awarding only nominal damages for a breach of a PDAA, reasoning that judicial process is "theoretically at least, the safest and best devised by the wisdom and experience of mankind").

3. IAN R. MACNEIL, AMERICAN ARBITRATION LAW: REFORMATION, NATIONALIZATION, INTERNATIONALIZATION 174 (1992).

4. 9 U.S.C. §§ 2–4; Sandra F. Gavin, *Unconscionability Found: A Look at Pre-Dispute Mandatory Arbitration Agreements 10 Years after Doctor 's Associates, Inc. v. Casarotto*, 54 CLEVELAND STATE L. REV. 249, 252–53 (2006).

5. Wilko v. Swan, 346 U.S. 427, 438 (U.S. 1953). The Court held that PDAAs violated Securities Act § 14. *Id.* § 14 provides that "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any

in *Rodriguez de Quijas v. Shearson/American Exp., Inc*.[6] Since *Rodriguez*, PDAAs have become more frequent, which has led to a rise in surrounding regulation. For example, in 1999, the National Association of Securities Dealers (NASD), a self-regulatory organization (SRO) which regulated broker-dealers, amended its rules to require broker-dealers to (a) highlight all predispute arbitration clauses in contracts with customers and (b) provide each affected customer with a separate confirmation-document.[7] The NASD wanted these disclosure-requirements to guarantee that each customer understood when they had agreed to arbitrate.[8] Today, the NASD's successor, the Financial Industry Regulatory Authority (FINRA), maintains the NASD's concerns about fair disclosure to customers.[9] So, FINRA Rule 2268 maintains the NASD's disclosure-requirements regarding PDAAs.[10]

Regulators have refrained from outlawing PDAAs. FINRA has asserted that "whether PDAAs should be prohibited is a policy question for Congress and the [Securities and Exchange Commission (SEC)][11] to decide."[12] But, Congress has also "kicked the can"—the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) directed the SEC to study PDAAs and gave the SEC express authority to prohibit them.[13]

---

provision of this subchapter or of the rules and regulations of the Commission shall be void." 15 U.S.C. § 77n.

6. Rodriguez de Quijas v. Shearson/American Exp., Inc., 490 U.S. 477 (1989).

7. Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Amendments to NASD Rule 3110(f) Governing Use of Predispute Arbitration Agreements With Customers, SEC Release No. 34-42160 (Nov. 19, 1999).

8. *Id.*

9. *See* FINRA, RULE 2268 (2011).

10. *Id.*

11. The SEC is an independent agency that Congress created to oversee and regulate securities markets. *See* SEC. & EXCH. COMM'N, *About the SEC*, SEC.GOV (Nov. 22, 2016), https://www.sec.gov/about.shtml.

12. FINRA Dispute Resolution Task Force, *Final Report and Recommendations of the FINRA Dispute Resolution Task Force*, at 46 (2015), https://www.finra.org/sites/default/files/Final-DR-task-force-report.pdf.

13. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 921(a), 124 Stat. 1376, 1841 (2010).

A special predispute arbitration agreement is FINRA Rule 12200, a FINRA regulation which gives customers the right to arbitrate disputes with broker-dealers.[14]

B. *The Customer's Historical Arbitration Right*

Since the late 19th century, customers have maintained the right to compel broker-dealers to arbitrate.[15] "In 1869, the New York Stock Exchange (NYSE) amended its constitution to expressly provide [] investors the right to demand arbitration of disputes with [exchange-member] firms."[16] The NYSE intended for the amendment to protect customers, as NYSE arbitration was speedy and inexpensive.[17] The NYSE later incarnated the amendment as NYSE Rule 600(a).[18] In 1935, the SEC Chairman (only one year after Congress created the SEC) endorsed the customers' right to arbitrate, saying in a memorandum to the NYSE: "The right to arbitration before the arbitration committee of the exchange is at present granted to any customer regardless of the contract between the member and the customer."[19] In 1972, the NASD also recognized customers' right to invoke arbitration via NASD Rule 10301.[20] More recently, in 2007, the SEC approved a merger of the NYSE and NASD's arbitral forums

14. FINRA, RULE 12200 (2008).

15. *See* Constitution and By-Laws of the New York Stock Exchange, at 35 (1869).

16. *Id.*

17. *See* FRANCIS L. EAMES, THE NEW YORK STOCK EXCHANGE 69–70 (1894) (describing NYSE arbitration in the 1880s).

18. FINRA, *NYSE Arbitration Rules (Rules 600A–639)* (2007), https://www.finra.org/sites/default/files/ArbMed/p117075.pdf.

19. SEC Release No. 34-131 at 3 (Mar. 21, 1935). Furthermore, the SEC recommended that the NYSE offer customers more arbitral bodies, such as arbitration before non-NYSE tribunals, but the NYSE did not implement the recommendation*. Id. See* Jill Gross, *The Historical Basis of Securities Arbitration as an Investor Protection Mechanism*, 2016 J. DISPUTE RESOLUTION 171, 180 (2016).

20. NAT'L ASS'N OF SEC. DEALERS, NASD Notice to Members, Proposed Amendments to By-Laws, Rules of Fair Practice and the Code of Arbitration Procedure, at 1 (July 23, 1971). *See* Jill Gross, *The Customer's Nonwaivable Right to Choose Arbitration in the Securities Industry*, 10 BROOK J. CORP. FIN. & COM. L. 383, 397 (2016).

into FINRA arbitration; thus, NYSE Rule 600(a) and NASD Rule 10301 consolidated into FINRA Rule 12200.[21]

C. *FINRA Rule 12200*

FINRA Rule 12200 requires parties to arbitrate a dispute if (1) either the customer requests it or a written agreement requires it, (2) the dispute is between a customer and either a FINRA-member or a FINRA-member's associate, and (3) "the dispute arises in connection with the member's business activities."[22] Generally, a customer is one, aside from a broker-dealer, who "purchases a [commodity] or [service] from the FINRA-member in the course of the member's business activities."[23] In some Circuits, the person must receive more than mere financial advice.[24] Regardless, courts generally interpret the term "customer" using its everyday meaning.[25] The dispute must involve the "investment banking or securities business" rather than some unrelated business.[26] FINRA members are those who FINRA has admitted to membership.[27]

Although Rule 12200 is not statutory, the SEC's approval gives Rule 12200 the force of law.[28] The Securities Exchange Act of 1934 (Exchange Act) § 78o-3 requires the SEC to supervise and regulate SROs like FINRA,[29] and

---

21. *See* Press Release, Fin. Indus. Regulatory Auth., NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority – FINRA (July 30, 2007).

22. FINRA, RULE 12200 (2008).

23. FINRA, RULE 12100(k); Goldman Sachs & Co. v. City of Reno, 747 F.3d 733, 740 (9th Cir. 2014); *see* Morgan Keegan & Co. v. Silverman, 706 F.3d 562, 566 (4th Cir. 2013); *see also* UBS Financial Services, Inc. v. Carilion Clinic, 706 F.3d 319, 325 (4th Cir. 2013).

24. Fleet Boston Robertson Stephens, Inc. v. Innovex, Inc., 264 F.3d 770, 773 (8th Cir. 2001).

25. *See also UBS Financial Services, Inc.*, 706 F.3d at 325; *see also City of Reno*, 747 F.3d at 740.

26. *UBS Financial Services, Inc.*, 706 F.3d at 325.

27. FINRA, RULE 0160 (2019).

28. *See* 15 U.S.C. § 78s(b).

29. 15 U.S.C. § 78o-3.

the SEC authorized FINRA to exercise "regulatory oversight over all securities firms that do business with the public."[30] Rule 12200 underwent a number of official channels before the SEC could approve it: FINRA had to solicit comments on the rule from the public, pass SEC review, satisfy secondary rounds of comments, and FINRA eventually published formal notice in the Federal Register.[31] Consequently, FINRA must sanction members who violate Rule 12200, and those sanctions can involve suspension or expulsion from FINRA.[32] This is significant because all U.S. securities dealers must have a SRO-membership to operate.[33] Therefore, if a dispute satisfies Rule 12200's criteria, then the aggrieved customer can haul their broker-dealer into arbitration;[34] if the broker-dealer refuses, FINRA can effectively close the business.[35] As opposed to litigation, a customer may sometimes find arbitration "[less] costly, more expedient, and equally fair" which facilitates their recovery.[36]

---

30. Self-Regulatory Organizations; Order Approving Proposed Rule Change to Amend the Bylaws of NASD to Implement Governance and Related Charges to Accommodate the Consolidation of the Member Firm Regulatory Functions of the NASD and NYSE Regulation, Inc., 72 Fed. Reg. 42169-01 (Aug. 1, 2007).

31. For a more detailed explanation of this process, see the section titled "Rule 12200 Imposes A Regulatory Obligation on FINRA Members.".

32. FINRA, *Enforcement*, Finra.org, https://www.finra.org/rules-guidance/enforcement (last visited Nov. 21, 2020).

33. SEC. & EXCH. COMM'N, *Broker-Dealer Registration: Where to File*, SEC.gov, https://www.sec.gov/fast-answers/answersbrkrdlrhtm.html (last updated July 25, 2013).

34. FINRA, RULE 12200 (2008).

35. SEC. & EXCH. COMM'N, *Broker-Dealer Registration: Where to File*, SEC.gov, https://www.sec.gov/fast-answers/answersbrkrdlrhtm.html (last updated July 25, 2013).

36. Kevin Carroll, *Securities Arbitration System Works Effectively and to the Benefit of Investors*, SIFMA, https://www.sifma.org/resources/news/securities-arbitration-system-works-effectively-and-to-the-benefit-of-investors/ (last visited Nov. 21, 2020); *see Arbitration and Mediation: Overview*, FINRA, http://www.finra.org/arbitration-mediation/overview (last visited Nov. 21, 2020). Many argue that arbitration offers parties "significant benefits []that are not available in court." Securities Arbitration System, Hearings Before the Subcomm. on Capital Markets, Insurance & Government Sponsored Enterprises of the H. Comm. on Financial Services, 109th Cong. 67 (2005) (statement of Marc E. Lackritz, President, Sec. Indus. Ass'n). However, parties may find litigation advantageous, hence why some

Recently, some broker-dealers have sought to dodge Rule 12200 arbitration between themselves and large, institutional customers.[37] This scenario has involved instances where broker-dealers and customers detailed their relationship's terms in a long, often complex agreement (Customer Agreement). Some broker-dealers, when drafting Customer Agreements for these large, institutional customers, have included a forum-selection clause which designates a court in which to litigate.[38] While perhaps these broker-dealers had not considered FINRA Arbitration when drafting the Customer Agreements, when disputes ultimately arose, several firms have asserted that the institutional customer waived the ability to compel arbitration under Rule 12200 upon signing these Customer Agreements.[39]

---

broker-dealers want to avoid arbitration in some disputes. For instance, the broker-dealer may, in some instances, find that statutory and case law favors their opponent, but such laws would not necessarily bind an arbitrator's decision-making. *See The Advantages and Disadvantages of Arbitration v. Court Litigation*, TUCKER ARENSBERG ATTORNEYS (Feb. 13, 2015), https://www.tuckerlaw.com/2015/02/13/advantages-disadvantages-arbitration-vs-court-litigation/. Moreover, some reports claim that many broker-dealers fail to pay customers' arbitration awards. *See* Hugh D. Berkson, *Unpaid Arbitration Awards: A Problem the Industry Created — A Problem the Industry Must Fix*, PIABA.ORG, at 37, https://piaba.org/system/files/pdfs/Unpaid%20Arbitration%20Awards%20-%20A%20Problem%20The%20Industry%20Created%20%20A%20Problem%20The%20Industry%20Must%20Fix%20%28February%2025%2C%202016%29.pdf. Nevertheless, "the main component of legal costs associated with both arbitration and [litigation] is attorney's fees," so the expected length of each route should greatly influence the customer's decision. Alaina Gatskova, *Mend It, Don't End It: How to Improve Securities Arbitration in the United States*, 41 FORDHAM INT'L L. J. 1043, 1084 (2017).

37. *See, e.g.*, Goldman, Sachs & Co. v. Golden Empire Schools Financing Authority, 764 F.3d 210 (2d Cir. 2014).

38. *Id.*

39. *Id.* at 212. The broker-dealer industry has historically defended PDAAs, which suggests that FINRA arbitration reduces broker-dealers' costs. Barbara Black, *Can Behavioral Economics Inform Our Understanding of Securities Arbitration*, 12 TENN. J. BUS. L. 107, 115 (2011). This does not necessarily mean that arbitration is unfair for customers: FINRA maintains that the customer's option to invoke arbitration is necessary to protect some small claims investors. *Id.* at 121. However, in the cases this paper examines, the broker-dealers tried to avoid arbitrating claims involving large, institutional investors; so, broker-dealers must find economic disadvantage in arbitrating those claims. *Id.* at 121. Interestingly, a 2011 paper predicted that when broker-dealers find arbitration disadvantageous, the industry will "mount opposition to [FINRA] Rule 12200." *Id.*

However, such a waiver raises key issues. As this Article will discuss below, the Circuit Courts of Appeals are split as to whether the parties must arbitrate or litigate, when the customer invokes their Rule 12200 right to arbitration, but that customer and their broker-dealer have already contracted to a forum-selection provision that has designated a court for litigation.[40] In each relevant case, a large, institutional customer and FINRA-member entered into a Customer Agreement.[41] Each Customer Agreement contained a substantially similar forum-selection clause, each which generally provided:

> The parties agree that all actions and proceedings arising out of this [Customer] Agreement or any of the transactions contemplated hereby shall be brought in the United States District Court in [a specific venue] and that, in connection with any such action or proceeding, submit to the jurisdiction of, and venue in, such court.[42]

D. *The Circuit Split*

The Second Circuit, in *Goldman Sachs & Co. v. Golden Empire Schools Financing Authority*, held that the Customer Agreement's forum-selection clause superseded Rule 12200.[43] The circuit noted that although federal policy presumptively favors arbitration, the presumption only holds when an arbitration agreement unambiguously covers the dispute.[44] Although the Circuit conceded that Rule 12200 constituted a written agreement to arbitrate, the Circuit believed the issue was whether the customer's Rule 12200 arbitration right remained in force, so the Circuit did not apply the presumption which would have favored arbitration.[45] Then, the Circuit argued that the forum-selection clause's language, in covering "all actions and proceedings,"

40. *Compare* Goldman Sachs & Co v. Golden Empire Schools Financing Authority, 764 F.3d 210 (2d Cir. 2014) *with* UBS Financial Services, Inc. v. Carilion Clinic, 706 F.3d 319 (4th Cir. 2013).

41. *Golden Empire Schools*, 764 F.3d at 212.

42. *Id.*

43. *Id*. at 217.

44. *Id.* at 215.

45. *Id.*

plainly superseded Rule 12200 arbitration, and thus required the parties to litigate in the designated court.[46]

Similarly, the Ninth Circuit, in *Goldman Sachs & Co v. City of Reno*, also held that the forum-selection clause superseded Rule 12200.[47] The court emphasized that arbitration is strictly a matter of consent between parties, and so parties can agree not to arbitrate.[48] While federal policy presumptively favors arbitration, the broker-dealer contested whether the customer's Rule 12200 arbitration survived rather than the scope of that right; so, like the Fourth Circuit, the Ninth Circuit did not presumptively favor arbitration.[49] Moreover, the Circuit reasoned that the forum-selection clause's language—"all actions and proceedings"—included FINRA arbitration because the Supreme Court, state courts, and FINRA Rules have all referred to arbitrations as "proceedings," and an agreement to bring a dispute to court is incompatible with bringing it to arbitration.[50] Therefore, Ninth Circuit found that the forum-selection clause had "sufficiently specific" language to alert the customer that it waived Rule 12200 arbitration.[51]

Contrarily, in *UBS Financial Services, Inc. v. Carilion Clinic*, the Fourth Circuit held that Rule 12200 superseded the forum-selection clause.[52] In short, the Fourth Circuit found that because the forum-selection clause's language failed to mention arbitration, it could only, at best, impliedly waive Rule 12200; therefore, the clause was insufficient to notify the customer that it waived Rule 12200 arbitration.[53] Indeed, the Fourth Circuit concluded that the forum-selection clause's "all actions and proceedings" language only included *all litigation.*[54] Note that because the Fourth Circuit's argument rested entirely on the forum-selection clause's imprecision, the opinion leaves future broker-

---

46. *Id.* at 217.

47. Goldman Sachs & Co. v. City of Reno, 747 F.3d 733, 747 (9th Cir. 2014).

48. *Id.* at 741.

49. *Id.* at 742.

50. *Id.* at 746.

51. *Id.* at 743.

52. UBS Financial Services, Inc. v. Carilion Clinic, 706 F.3d 319, 330 (4th Cir. 2013).

53. *Id.* at 329.

54. *Id.* This is also, in part, because this case's forum-selection clause mentioned "jury trials." *Id.*

dealers an opportunity to draft more precise clauses and thus avoid Rule 12200 in favor of forum-shopping.[55]

Likewise, in *Reading Health System v. Bear Sterns & Co.*, the Third Circuit held that Rule 12200 superseded the forum-selection clause.[56] The Third Circuit relied on two principles: (1) "a party signing a waiver must know what rights it is waiving" and (2) federal policy favors arbitration.[57] The Third Circuit found that the forum-selection clause was not "sufficiently specific" to notify the customer that it waived Rule 12200 arbitration.[58] Uniquely, the Circuit held that Rule 12200 is not a contractual right, but a regulatory right: "finding an implicit waiver would 'erode investors' ability to use an efficient and cost-effective means of resolving allegations of misconduct in the brokerage industry and thus undermine FINRA's ability to regulate, oversee, and remedy any such misconduct."[59]

55. *See id.* at 328.

56. Reading Health Sys. v. Bear Sterns & Co., 900 F.3d 87, 104 (3d Cir. 2018).

57. *Id.* at 103.

58. *Id.* at 102.

59. *Id.* at 103.

I. EXCHANGE ACT § 29(A) LIKELY VOIDS THE FORUM-SELECTION CLAUSE

A. *On Its Face § 29(a) Voids the Forum-Selection Clause*

The Courts of Appeals have not thoroughly addressed a statute which may provide a rule of decision.[60] The Securities Exchange Act of 1934 § 29(a), titled "Validity of Contracts" (as Dodd-Frank[61] amended in 2010) reads:

> SEC. 29. (a) Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder, or of *any rule of a self-regulatory organization*, shall be void[62] (emphasis added).

In short, if one reads § 29(a) at face-value, because FINRA is a SRO, the statute's plain meaning voids every contract-provision which waives compliance with FINRA Rule 12200—including the forum-selection clause.[63]

---

60. A Westlaw search reveals only one obvious reference to § 29(a) in any of the four aforementioned Circuit-court decisions. In a footnote, the Third Circuit held that it "need not" address whether § 29(a) voids the forum-selection clause because Rule 12200 is an unwaivable regulatory right. Reading Health Sys. v. Bear Sterns & Co., 900 F.3d 87, 104 n.83 (3d Cir. 2018). However, in a District Court case, *J.P. Morgan Securities LLC v. Quinnipiac University*, the Southern District of New York noted that the Second Circuit briefly addressed § 29(a) in a post-argument letter to *Golden Empire*, but the Circuit did not address § 29(a) in its official opinion. This led the Southern District to conclude that § 29(a) did not control. But, in the post-argument letter, the Second Circuit held that § 29(a) does not apply because *McMahon* stands for the principle that § 29(a) "only prohibits waiver of the substantive obligations imposed by the Exchange Act." J.P. Morgan Securities LLC v. Quinnipiac University, No. 14 Civ. 429 (PAE), 2015 WL 2452406, at *5 (S.D.N.Y. May 22, 2015).

61. *See infra* Section C, titled "Dodd-Frank's Legislative History and Purposes Support Voiding the Forum-Selection Clause[,]" for a discussion on how Dodd-Frank affects one's reading of the rule.

62. Securities Exchange Act of 1934, 15 U.S.C. § 78cc (2010). The regulation, which Congress amended in 2010, originally read "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this or of any rule or regulation thereunder, *or of any rule of an exchange required*, shall be void." *Id.* (emphasis added).

63. *Id.* Professor Jill Gross of Pace Law School claims "To the extent courts have held in the past that parties could contract around FINRA rules, that line of cases seems to be vitiated by amended § 29(a)." *Second Circuit Holds Forum Selection Clause Trumps FINRA Arbitration Requirement*, INDISPUTABLY (Aug. 21, 2014),

The statute does not limit which SRO-rules or investors it covers.[64] If Congress did intend to limit the statute's broad language, it left that work to the Courts and the SEC.[65]

B. *McMahon's Holding and Underlying Concerns Suggest That § 29(a) Voids the Forum-Selection Clause*

The Supreme Court's 1987 decision *Shearson/American Exp., Inc. v. McMahon* is the most significant case in § 29(a)'s jurisprudence.[66] In *McMahon*, the parties signed a PDAA whereby they would arbitrate Exchange-Act claims between them.[67] The agreement created tension because Exchange Act § 27 gave District Courts exclusive jurisdiction over Exchange Act claims.[68] However, the Court held that § 29(a) "only prohibits waiver of the [Exchange Act's] substantive obligations;" that is, the Exchange Act's "[duties] with which [broker-dealers] must 'comply.'"[69] The Court concluded

---

http://indisputably.org/2014/08/second-circuit-holds-forum-selection-clause-trumps-finra-arbitration-requirement/.

64. Securities Exchange Act of 1934, 15 U.S.C. § 78cc (2010).

65. This Article will provide more information on the SEC's interpretation in the subsection titled "Dodd-Frank's Legislative History and Purposes Support Voiding the Forum-Selection Clause." For information about Courts' recent interpretations, see *supra* note 60.

66. *See, e.g.*, J.P. Morgan Securities v. Quinnipiac University, No. 14 Civ. 429 (PAE), 2015 WL 2452406, at *5 (S.D.N.Y. 2015) (observing that the *McMahon* Court said § 29(a) "only prohibits waiver of the substantive obligations imposed by the Exchange Act" and concluding that § 29(a) presents no barrier to contracting-around Rule 12200).

67. Shearson/American Exp., Inc. v. McMahon, 482 U.S. 220, 228 (1987).

68. *Id.* at 227.

69. *Id.* Some lower courts lend support to this reading. *See, e.g.*, Gay v. CreditInform, 511 F.3d 369, 385 (3d Cir. 2007) (Echoing "Because § 27 does not impose any statutory duties, its waiver does not constitute a waiver of 'compliance with any provision' of the Exchange Act under § 29(a)"). But some of *McMahon*'s progenies exempt choice of forum from the "substantive rights" the Exchange Act affords. *See, e.g.*, Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 628 (U.S. 1985) ("By agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum"). However, Rule 12200 is not

that § 27 did not create any broker-dealers' duty for the PDAA to waive, so the PDAA did not waive "compliance" with any Exchange-Act obligation.[70]

Although some Courts disagree,[71] the *McMahon* holding suggests that the Customer Agreement's forum-selection clause violates § 29(a) as amended in 2010.[72] Unlike waiver of § 27, which implicated no Exchange-Act obligation (defined as a "duty with which [broker-dealers] must comply,") § 78s(g) requires FINRA to enforce broker-dealers' compliance with Rule 12200.[73] Rule 12200 obligates broker-dealers to arbitrate at their customers' request.[74] Thus, broker-dealers cannot evade Rule 12200 arbitration without waiving compliance with an Exchange-Act obligation in violation of § 29(a).[75]

Moreover, the *McMahon* Court also expresses two underlying concerns which suggest applying § 29(a) to void contractual waivers of Rule 12200.

---

a mere forum-selection clause: it is a duty the broker agreed to undertake in exchange for its FINRA membership, which the Exchange Act demands FINRA enforce. 15 U.S.C. § 78s(g)(1).

70. *McMahon*, 482 U.S. at 228. This holding caused the SEC to repeal Rule 15c2-2, which declared it fraudulent for Customer Agreements to include mandatory-arbitration provisions. *See* FINRA, *Notice to Members 83-73: SEC Adopts Rule 15c2-2 Governing Binding Arbitration Clauses in Customer Agreements*, FINRA, https://www.finra.org/rules-guidance/notices/83-73 (last visited Nov. 21, 2020).

71. This paper's interpretation is controversial. For instance, the Second Circuit (generally) only applies § 29(a) to void "blanket releases of liability" which is narrower than this Article's interpretation of § 29(a) suggests. Pasternack v. Shrader, 863 F.3d 162, 171 (2d Cir. 2017). For a brief on how Circuits have applied § 29(a) to waivers of Rule 12200, see *supra* note 60.

72. *Id.* at 238.

73. *See* 15 U.S.C. § 78s(g)(1). The Exchange Act expressly allows the SEC to relieve SROs from enforcing compliance with their rules. 15 U.S.C. § 78s(g)(2). The SEC has not relieved FINRA from its Rule 12200 enforcement-obligation concerning contractual waivers of Rule 12200.

74. FINRA, RULE 12200 (2008).

75. *McMahon*, 482 U.S. at 238. This paper's interpretation is controversial. For instance, the Second Circuit (generally) only applies § 29(a) to void "blanket releases of liability" which is narrower than this Article's interpretation suggests. Pasternack v. Schrader, 853 F.3d 162, 171 (2d Cir. 2017). However few Courts have examined how § 29(a) interacts with waivers of Rule 12200. For a brief primer on those decisions, see *supra* note 60.

First, the *McMahon* Court intended to further the "federal policy favoring arbitration" whereby Courts "rigorously [enforce] agreements to arbitrate."[76] Indeed, the FAA created a "liberal federal policy favoring arbitration."[77] The weight of jurisprudence agrees that Rule 12200 constitutes a written agreement to arbitrate at the customer's request.[78] Consequently, voiding the forum-selection clause to enforce Rule 12200 would advance a federal policy *McMahon* embraced.[79]

Second, the *McMahon* Court reasoned that § 29(a) attempts to void clauses which "weaken[] [a party's] ability to recover under the Exchange Act."[80] While *McMahon* argued that litigation and arbitration afford customers identical "rights to which [they are] entitled," *McMahon* did not suggest that the forums afford customers identical procedures.[81] For instance, a customer

---

76. *McMahon*, 482 U.S. at 226.

77. CompuCredit Corp. v. Greenwood, 565 U.S. 95, 98 (2012).

78. *See* Waterford Inv. Serv., Inc. v. Bosco, 682 F.3d 348, 353 (4th Cir. 2012). *See also* Washington Square Sec., Inc., v. Aune, 385 F.3d 432, 435 (4th Cir. 2004) (where the National Association of Securities Dealers' Rules constituted a written agreement to arbitrate); *see also* UBS Financial Serv., Inc. v. West Virginia University Hosp., Inc., 660 F.3d 643, 649 (2d Cir. 2011); *see also* Goldman Sachs & Co v. Golden Empire Schools Fin. Auth., 764 F.3d 210, 213 (2d Cir. 2014) (assuming that FINRA Rule 12200 is a written agreement to arbitrate). While parties can generally contract out of arbitration, in our scenario, the broker-dealer's obligation to arbitrate at the customer's request arises out of the broker-dealer's FINRA membership-filings, not out of contract with the customer. Thus, the customer and broker-dealer cannot contract out of it. *See* FINRA, UNIFORM APPLICATION FOR SECURITIES INDUSTRY REGISTRATION OR TRANSFER (FORM U–4), SECTION 15A (2009) (page 15), https://www.finra.org/registration-exams-ce/broker-dealers/registration-forms/form-u4.

79. *McMahon*, 482 U.S. at 276.

80. *See id.* at 230–31. Whether a waiver "weakens [a party's] ability to recover under the Exchange Act" is the crux of the Second, Third, and Ninth Circuits' § 29(a) analysis. *See* Harsco Corp. v. Segui, 91 F.3d 337, 343 (2d Cir. 1996); *see also* AES Corp. v. Dow Chemical Co., 325 F.3d 174, 179 (3d Cir. 2003); *see also* Facebook, Inc v. Pacific Northwest Software, Inc., 640 F.3d 1034, 1041 (9th Cir. 2011) (focusing on whether an agreement "[purports] to limit or waive [one's] right to sue.").

81. *McMahon*, 482 U.S. at 231. In *McMahon*, the Court agreed with the SEC as amicus curiae which argued that "arbitration procedures proscribed by SROs are adequate to enforce the rights of customers against brokerage firms." Brief for the Securities and Exchange Commission as Amicus Curiae Supporting Petitioners,

with limited need for discovery-procedures might find FINRA's limited discovery-procedures advantageous, considering the extensive discovery-procedures that a court of law would afford the broker-dealer.[82] Similarly, a customer with evidence inadmissible in federal court may prefer arbitration because federal evidence rules do not bind FINRA tribunals.[83] In addition, arbitration is an equitable forum, and customers, especially those with compelling equitable arguments, "likely [] benefit from equitable, rather than legalistic, resolution of their disputes."[84] In short, by foreclosing the customer's access to arbitration, a waiver of Rule 12200 weakens a customer's ability to recover insofar as arbitration would have afforded the customer comparative procedural advantages to litigation.[85] On the other hand, a broker-dealer might also find arbitration advantageous; for example, the broker-dealer might know the arbitrator.[86] Nevertheless, Rule 12200 grants each customer procedural power to choose arbitration when it comparatively benefits them under the circumstances, thereby facilitating their recovery under the Exchange Act.[87]

Shearson/American Exp., Inc. v. McMahon, 482 U.S. 220 (1987) (No. 86-44), 1986 WL 727882 at 13.

82. *See* Irene C. Warshauer, *Electronic Discovery*, 2 THE NEUTRAL CORNER: THE NEWSLETTER FOR FINRA NEUTRALS (2011).

83. FINRA, RULE 12604 (2008).

84. Barbara Black, *The Irony of Securities Arbitration Today: Why Do Brokerage Firms Need Judicial Protection?*, 72 U. CIN. C. L. 415, 454 (2003).

85. FINRA RULE 2268(d) suggests that FINRA concurs with this position. "(d) No [PDAA] shall include any condition that: (1) limits or contradicts the rules of any self-regulatory organization; (2) limits the ability of a party to file any claim in arbitration; (3) limits the ability of a party to file any claim in court . . ." *See* FINRA, RULE 2268 (2011). The SEC approval order to Rule 2268 also agrees, stating that "The Commission believes that the new provision . . . benefits investors" in part, because it prevents "limit[ing] SRO forums otherwise available to parties." *See* Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc., National Association of Securities Dealers, Inc., and the American Stock Exchange, Inc., Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, 54 Fed. Reg. 21144-03 (May 16, 1989).

86. *See* Barbara Black, *Is Securities Arbitration Fair to Investors?*, 25 PACE L. REV. 1, 7 (2004).

87. *See* FINRA, RULE 12200 (2008).

C. *Dodd-Frank's Legislative History and Purposes Support Voiding the Forum-Selection Clause*

The *McMahon* Court noted that Congress's intent to preclude waiver "will be deducible from the statute's . . . legislative history" or from a conflict between waiver and "the statute's underlying purposes."[88]

An analysis of § 29(a)'s legislative history and purposes reveals that Congress likely intended for the statute to void waivers of Rule 12200.[89] The Senate Report to the 2010 Amendment stated that the amendment's purpose was to "provide[] equal treatment for the rules of all SROs under [§] 29(a)."[90] Indeed, Congress passed the 2010 Amendment, in part, to prevent broker-dealers from dodging FINRA regulations.[91] In so doing, albeit in reference to

88. Shearson/American Exp., Inc. v. McMahon, 482 U.S. 220, 227 (1987).

89. *See* S. REP. NO. 111-176, at 244 (2010).

90. *Id.* Congress likely intended for the provision—not only to regulate broker-dealers' conduct—but as one of many reforms to bolster and streamline financial-sector regulations. *See, e.g.*, *Regulatory Restructuring and Reform of the Financial System: Hearing Before the Committee on Financial Services*, 110th Cong., 110-143 (2008) (statement of Joseph E. Stiglitz, Professor, Colombia University) (saying "The rules need to be . . . simple . . . and transparent [enough], so that everybody, including Congress, can see on an ongoing basis whether there is enforcement."). *See also, e.g.*, *Committee on Senate Financial Crisis Inquiry Commission*, 111th Cong. (2010) (statement of Denise Voigt Crawford, President, North American Security Administrators Association) (declaring that "Deregulation is no longer the presumptive policy prescription; indeed today, the sense is that the current crisis was deepened by excessive deregulation."). Furthermore, allowing broker-dealers to waive certain FINRA rules would have arguably unconscionable effects; for example, firms could waive their Rule 2165 supervisory obligations designed to protect seniors from growing threats of financial exploitation. FINRA, *2165. Financial Exploitation of Specified Adults*, FINRA.org, https://www.finra.org/rules-guidance/rulebooks/finra-rules/2165 (last visited Nov. 21, 2020).

91. *See* S. REP. NO. 111-176, at 244 (2010) (stating vaguely that Title IX, Subtitle B, of which § 29(a) is a part, "relates to enforcement issues.").

PDAAs, the Executive Branch,[92] Congress,[93] and the Exchange Act[94] itself all sought to prohibit broker-dealers from forum-selecting via customer contracts. They all advocated for the customer's choice to select a judicial forum,[95] but many Customer Agreements are adhesive,[96] thus one can expect customers' Rule 12200 right to promote the customer-choice more frequently than customers' often-empty freedom to negotiate a forum-selection provision. Although large, sophisticated investors have plenty of bargaining power, Congress likely intended for the 2010 Amendment to benefit investors of all

---

92. The Obama Administration's Treasury Department took a firm stance against broker-dealers forum-selecting via PDAAs. *See* Dep't of the Treasury, *Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation*, 72 (2009), https://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf (recommending "The SEC should study the use of mandatory arbitration clauses in investor contracts. . . . [M]andating a particular venue and up-front method of adjudicating disputes – and eliminating access to courts – may unjustifiably undermine investor interests. We recommend legislation that would give the SEC clear authority to prohibit mandatory arbitration clauses in broker-dealer and investment advisory accounts with retail customers."); *see also* Dep't of the Treasury, *Fact Sheet: Administration's Regulatory Reform Agenda Moves Forward Legislation for Strengthening Investor Protection Delivered to Capitol Hill* (July 10, 2009), https://www.treasury.gov/press-center/press-releases/Pages/tg205.aspx (echoing that "mandating a particular venue and up-front method of adjudicating disputes – and eliminating access to courts – may unjustifiably undermine investor interests.").

93. *See, e.g.*, 156 Cong. Rec. H5233-01 (2010) (arguing that "[S]ecurities industry practices have deprived investors of a choice when seeking dispute settlement, too. In particular, pre-dispute mandatory arbitration clauses inserted into contracts have limited the ability of defrauded investors to seek redress." – Rep. Barney Frank (D-MA)).

94. *See* S. REP. NO. 111-176, at 109–10 (2010) (adding 15 U.S.C. § 78o(o) to the Exchange Act, which gave the SEC greater authority to restrict mandatory arbitration provisions that brokers insert into Customer Agreements).

95. *Supra* notes 92–94.

96. *See* Richard E. Spidel, *Contract Theory and Securities Arbitration: Whither Consent?* 62 BROOK. L. REV. 1335, 1349–50 (1996). An adhesive contract is as contract where "a contracting party with superior bargaining strength presents a standardized form agreement to a party of lesser bargaining power and requires that party to either accept or reject its terms without an opportunity for negotiation." Ilan v. Shearson/American Express, Inc., 632 F.Supp. 886, 890 (S.D.N.Y. 1985).

sizes: the Congressional record is strewn with references to Bernie Madoff[97] (who had recently defrauded banks, hedge funds and individual investors via the largest Ponzi Scheme in history).[98] Therefore, when a Court limits the application of § 29(a)'s plain text as to exclude Rule 12200, the Court ignores Congress's implicit intent.[99]

Both Congress[100] and the Executive Branch[101] also intended for Dodd-Frank to close regulatory gaps. Towards this end, Dodd-Frank primarily sought to address the "fragmentation" of federal responsibility for consumer protection across multiple agencies.[102] So, § 913 "direct[ed] the SEC to . . . study . . . whether there are legal or regulatory gaps or overlap in legal or regulatory standards in the protection of retail customers."[103] In the SEC's study, the Commission concluded that § 29(a) prohibits waiver of the broker-dealer's "business conduct obligations."[104] But, the Commission, in a footnote,

97. *See* 156 Cong. Rec. H5233-01 (2010) (wherein Congresspeople mentioned Madoff nine times); *see also* S. REP. NO. 111-176 (wherein Congresspeople mentioned Madoff forty-eight times).

98. For information about the Madoff Scandal, see *Bernie Madoff*, BRITANNICA, http://www.britannica.com/biography/Bernie-Madoff (last visited Nov. 26, 2020).

99. *See* S. REP. No. 111-176, at 114 (2010).

100. *See also* Jennifer Liberto, *SEC Investigation: We Missed Madoff*, CNN MONEY (Sep. 2, 2009), https://money.cnn.com/2009/09/02/news/economy/Madoff_SEC_investigation/index.htm (quoting Senator Chris Dodd, "The inspector general's report [of the Madoff Scandal] lays out the string of massive regulatory failures and incompetent investigations at the SEC that led to unimaginable loss for so many.").

101. Elise B. Walter, Commissioner, Securities and Exchange Commission, Principles to Help Guide Financial Regulatory Reform (Mar. 2, 2009) (arguing that "[It is not] sensible for a regulatory system to incorporate unnecessarily duplicative jurisdiction."). *See also*, Inspector General H. David Kotz, *Report of Investigation: Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme, U.S. Securities and Exchange Commission, Office of the Inspector General*, 22 (Aug. 31, 2009), https://www.sec.gov/files/oig-509-exec-summary.pdf (concluding that "the SEC never properly examined or investigated Madoff's trading and never took the necessary, but basic, steps to determine if Madoff was operating a Ponzi scheme.").

102. *See* S. Rep. No. 111-176, at 10 (2010).

103. *Id.* at 105.

104. Sec. & Exch. Comm'n, *Study on Investment Advisors and Broker-Dealers*, 51 (Jan. 2011), https://www.sec.gov/news/studies/2011/913studyfinal.pdf. "Broker-dealers are subject to a comprehensive set of statutory, Commission and SRO

added a broad addendum: "Dodd-Frank Act . . . amended [§] 29(a) to make it applicable to *any waivers* relating to rules . . . of an SRO."[105] The study provided no further explanation about the footnote,[106] but the footnote's breadth accords with some of the SEC's previous statements, suggesting § 29(a) voids waivers of Rule 12200.[107]

Regardless, if § 29(a) controls, the customer's right to Rule 12200 arbitration supersedes the forum-selection and the Circuits' debate is likely over: the customer can likely invoke their Rule 12200 right.[108] So, the following discussion will presume—*in arguendo*—that § 29(a) does not control.[109]

II. RULE 12200 IS UNWAIVABLE

Some Courts—plus FINRA—hold that Rule 12200 is an unwaivable regulatory right rather than (or in addition to) an agreement to arbitrate.[110]

---

requirements that are designed to promote business conduct that, among other things, protects investors from abusive practices, including practices that are not necessarily fraudulent." *Id.*

105. *Id.* (emphasis added).

106. *Id.*

107. For instance, examine the approval order to FINRA Rule 2268(d), which stated that "The Commission believes that [Rule 2268] . . . benefits investors" in part, because it prevents "limit[ing] SRO forums otherwise available to parties." *See* Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc., National Association of Securities Dealers, Inc., and the American Stock Exchange, Inc., Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, 54 Fed. Reg. 21144-03 (May 16, 1989). *See also* Brief of the Securities and Exchange Commission, Amicus Curiae, Roney & Co. v. Goren, 875 F.2d 1218 (2d Cir. 1988) (No. 88-1874) (noting "If broker-dealers are allowed to avoid the application of SRO arbitration rules by enforcing conflicting provisions written into customer contracts, the customer protections afforded by those rules and the SRO arbitration system will be undermined and investor confidence in the system will be eroded.").

108. *See* Securities Exchange Act of 1934, 15 U.S.C.A § 78cc.

109. *See id.*

110. Reading Health System v. Bear Sterns & Co., 900 F.3d 87, 103 (3d Cir. 2018) (noting that "[the customer's] right to arbitrate is not contractual in nature, but rather arises out of a binding, regulatory rule that has been adopted by FINRA and

Under this view, the customer can invoke their Rule 12200 right to arbitrate despite signing the Customer Agreement.[111]

A. *FINRA's Interpretation of Rule 12200's May Control*

Some limited case law suggests that FINRA's interpretation of Rule 12200 may control: the cases denote where a Circuit Court deferred to an SEC-supervised SRO's interpretation of the SRO's own rule.[112] For instance, in 1996, the Second Circuit deferred to the NASD when the Circuit prohibited NASD-members from forcing employees to waive their arbitration rights.[113] The Circuit reasoned that when the SEC approves an SRO-rule, the rule expresses federal policy.[114] The Second Circuit reaffirmed its "obligation" to defer to SROs as recently as 2009.[115] Likewise, in the 1970's, the Fifth Circuit deferred to AMEX-interpretations of AMEX-rules to "keep with the Congressional purpose of making the Exchange a self-regulatory body."[116]

---

approved by the SEC"). FINRA, *Regulatory Notice 16-25: Forum Selection Provisions* (July 2016). The Sixth Circuit has not directly weighed in but appears to support this theory. Wilson-Davis & Co., v. Mirgliotta, 721 Fed. App'x. 425, 427 (6th Cir. 2018) ("FINRA Rules 'create the right of parties to compel a FINRA-member firm to arbitrate even in the absence of a direct transactional relationship with the firm."'). Further, prior to *Goldman, Sachs & Co.* the Second Circuit appeared to support this theory. *See* Thomas James Assocs. v. Jameson, 102 F.3d 60 (2d Cir. 1996) (holding that parties cannot waive SRO-granted arbitration rights).

111. FINRA, *Regulatory Notice 16-25: Forum Selection Provisions* (July 2016) ("the mandatory nature of the FINRA rules' requirement that FINRA arbitration must be available upon the customer's request, even in the absence of an agreement to arbitrate.").

112. *See, e.g.*, Thomas James Assocs. v. Jameson, 102 F.3d 60, 66 (2d Cir. 1996).

113. *See id.*

114. *Id.*

115. Heath v. SEC, 586 F.3d 122, 139 (2009) ("we acknowledge our obligation to afford some level of deference to [the SEC and NYSE's] interpretation of the NYSE rules.").

116. Intercontinental Industries, Inc. v. American Stock Exchange, 452 F.2d 935, 940 (5th Cir. 1971).

This short line of cases reasoned that, if a court substitutes Congressional will with its own will, the court will undermine Congress's regulatory scheme.[117]

The most noteworthy case on this topic is a 2011 decision: *Charles Schwab & Co. Inc. v. FINRA*, wherein a District Court situated in the Ninth Circuit conflated the SEC and FINRA.[118] This case involved the interpretation of FINRA Rule 2268(d), which provides that "(d) No [PDAA] shall include any condition that: (2) limits the ability of a party to file any claim in arbitration."[119] Contrary to FINRA's interpretation, the plaintiff argued that Rule 2268(d) did not prohibit class-action waivers within customer agreements.[120] The Court rejected this argument, referring to FINRA and the SEC collectively as an agency, before deferring to FINRA and the SEC's combined "expertise . . . regarding resolution of customer disputes with the broker-dealers that FINRA regulates."[121] It analogized the SEC-FINRA relationship to the relationship between Administrative Law Judge proceedings and an agency's internal appeals-like review.[122] The Court acknowledged that FINRA might misinterpret the rule, but noted that "the court of appeals has the final word and can correct any error."[123]

If a court conflates the SEC and FINRA, then *Kisor v. Wilkie* becomes relevant.[124] *Kisor* established that a Court must defer to an agency's interpretation of the agency's own regulation when (1) the regulation is genuinely ambiguous, (2) the agency's interpretation is official, and (3) and the interpretation reflects "fair and considered" judgment.[125]

First, Rule 12200 is genuinely ambiguous. A statute is genuinely ambiguous, if ambiguity exists after considering its "text, structure, history,

117. *See* Blank v. New York Stock Exchange, Inc., No. 80 Civ. 1297 & 1280, 1980 WL 1415 (S.D.N.Y. 1980); *see also* Zuckerman v. Yount, 362 F. Supp. 858, 863 (N.D. Ill., 1973). Congress's own statements support this assumption. *See* S. Rep. No. 94-75, at 24 (1975).

118. *See generally* Charles Schwab & Co. v. FINRA, 861 F. Supp. 2d 1063 (N.D. Cal. 2012).

119. FINRA Rule 2268 (2011).

120. *Charles Schwab & Co.*, 861 F. Supp. 2d at 1064.

121. *Id.* at 1078.

122. *Id.* at 1071.

123. *Id.* at 1077.

124. Kisor v. Wilkie, 139 S. Ct. 2400 (2019).

125. *Id.* at 2415–18.

and purpose."[126] While this Article advances that Rule 12200 is an unambiguous regulatory right,[127] Circuits have come to split conclusions about Rule 12200's nature when weighing the rule's "text, structure, history, and purpose."[128]

Second, FINRA's interpretation is official. FINRA outlined its official interpretation in Regulatory Notice 16-25: "any member firm's denial, limitation or attempt to deny or limit a customer's right to request FINRA arbitration, even if the customer seeks to exercise that right after having agreed to a forum selection clause specifying a venue other than a FINRA arbitration forum, would violate FINRA Rules 2268 and 12200."[129]

Third, FINRA's interpretation reflects "fair and considered" judgment. An agency's interpretation is "fair and considered" unless the agency formed its position as "merely a convenient litigation position" or as a means to "defend an agency position against attack."[130] The interpretation also cannot create "unfair surprise" to regulated parties.[131] Here, FINRA formed its conclusion apart from litigation, and FINRA has never held a contrary position.[132]

---

126. *Id.*

127. *See infra*, Section IIB, titled "Rule 12200 Imposes A Regulatory Obligation on FINRA Members.".

128. *Compare* holdings which emphasize legislative history, such as *Goldman Sachs & Co v. Golden Empire Schools Financing Authority*. 764 F.3d 210, 214 (2d Cir. 2014) (citing legislative history to conclude that " Rule 12200 is a written agreement to arbitrate with customers . . . enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract") *with* holdings that emphasize procedural history like *Reading Health Sys. v. Bear Sterns & Co.* 900 F.3d 87, 103 (3d Cir. 2018) (noting that "[the customer's] right to arbitrate is not contractual in nature, but rather arises out of a binding, regulatory rule that has been adopted by FINRA and approved by the SEC").

129. FINRA, *Regulatory Notice 16-25: Forum Selection Provisions* (July 2016); *see also* FINRA, *Regulatory Notice 21-16: FINRA Reminds Members About Requirements When Using Predispute Arbitration Agreements for Customer Accounts* (April 2021).

130. *Kisor*, 139 S. Ct. at 2417.

131. *Id.*

132. FINRA, *Regulatory Notice 16-25: Forum Selection Provisions* (July 2016). FINRA also articulated their opinion on this subject over a decade ago, noting that "Fail[ure] to submit a dispute for arbitration under the Code as required by the Code" constitutes "conduct inconsistent with just and equitable principles of trade and a

Admittedly, SRO-deference is harder to justify than agency-deference.[133] Courts justify agency-deference because agencies have expertise in the subject-matters they regulate, and democratic forces—namely, the President—can hold agencies politically accountable.[134] For instance, the President can hold the SEC accountable by hiring SEC Commissioners, or firing them for "inefficiency, neglect of duty, or malfeasance in office."[135] Although SROs have similar expertise as agencies, SROs are not politically accountable.[136] For example, FINRA's Board of Governors is accountable to the industry, the company each member represents, and the Board itself: one can become a Governor only if (1) certain industry-members elect them or (2) the Board of Governors appoints them.[137] No publicly-elected actor can remove FINRA Governors.[138]

B. *Rule 12200 Imposes A Regulatory Obligation on FINRA Members*

---

violation of Rule 2010 for a member or a person associated with a member." *See* FINRA, IM-2200 (2008).

133. Courts may also find that contrary, binding authorities override FINRA's opinion. *See, e.g.*, New York Bay Capital, LLC v. Cobalt Holdings, Inc., 456 F. Supp. 3d 564, 573 (S.D.N.Y. 2020) (stating that "The Court must follow binding precedent, even if it conflicts with FINRA guidance on the issue"). *See, e.g.*, Goldberg v. Bruderman Bros., LLC, Nos. 159280/2019, 65979/2019, 2020 WL 6161619, at *6 (N.Y. 2020) ("This court's preference is to respect . . . the United States Court of Appeals for the Second Circuit and the United States District Court for the Southern District of New York . . . notwithstanding FINRA's self-promulgated rules.").

134. Emily Hammond, *Double Deference in Administrative Law*, 116 COLUMBIA L. REV. 1705, 1757 (2016).

135. *See* Free Enter. Fund v. Public Co. Acct. Oversight Bd., 561 U.S. 477, 487 (2010). *But see The SEC Is Not an Independent Agency*, 126 HARV. L. REV. 781, 786 (2013) (noting that the Exchange Act is silent on whether the President requires cause to fire SEC Commissioners; arguing that the President can fire Commissioners at-will).

136. *See Free Enterprise Fund*, 561 U.S. at 487.

137. FINRA, *FINRA Board of Governors*, https://www.finra.org/about/governance/finra-board-governors (last visited Jan. 13, 2021).

138. *Id.*

Rule 12200 is regulatory in nature because (1) Rule 12200 had to pass a number of official channels before binding FINRA-members, (2) Congress, through the Exchange Act, made FINRA rules unwaivable and regulatory, and (3) waiver of Rule 12200 will frustrate the Exchange Act's purposes.

First, FINRA Rule 12200 underwent a number of official channels, which all FINRA rules must undergo.[139] Specifically, FINRA first solicited comments on the rule to revise it.[140] Then, FINRA filed the proposed rule to the SEC for review.[141] The SEC then determined whether the rule was consistent with the Exchange Act, and either amended the rule or asked FINRA to adjust it accordingly.[142] When the SEC approved the rule, the SEC announced the rule in the Federal Register.[143] The SEC then subjected the rule to another public comment period, and the SEC either required FINRA to respond to comments or amend the rule.[144] When the SEC approved the final rule, it published notice in the Federal Register.[145] Per Exchange Act § 19(b), when the SEC approves FINRA rules, those rules have the force of federal law,[146] and parties to a contract cannot waive federal laws.[147]

Second, Congress made FINRA Rules unwaivable and regulatory through the Exchange Act.[148] In fact, if broker-dealers can waive FINRA Rules,

---

139. *See* FINRA, *FINRA Rulemaking Process*, https://www.finra.org/rules-guidance/rulemaking-process (last visited Nov. 21, 2020).

140. *See id.*

141. *See id.*

142. *See id.* "The SEC almost never disapproves a rule; the 'understanding' is that SEC review is deferential." Emily Hammond, *Double Deference in Administrative Law*, 116 COLUMBIA L. REV. 1705, 1736 (2016). The SEC only rejected one FINRA Rule between 2009 and 2011. *Id.* at 1737-1738.

143. FINRA, *FINRA Rulemaking Process*, https://www.finra.org/rules-guidance/rulemaking-process (last visited Nov. 21, 2020).

144. *See id.*

145. *See id.*

146. 15 U.S.C. § 78s(b)(1).

147. SEC-approved SRO rules preempt state law. *See* Credit Suisse First Boston Corp. v. Grunwald, 400 F.3d 1119, 1128 (9th Cir. 2005).

148. *See* James C. Treadway Jr, Commissioner, Securities and Exchange Commission, Remarks to the American Law Institute, *Philosophizing About Self-Regulation in a Deregulatory Environment*, ABA Conference on Broker-Dealer Regulation (Jan. 12, 1984) (saying that Congress intended for the Exchange Act to

Congress suggested that the Exchange Act will fail.[149] A Senate report on the Exchange Act (which the *McMahon* court expressly endorsed)[150] noted:

> The [SROs] must exercise governmental-type powers if they are to carry out their responsibilities under the Exchange Act. When a member violates the Act or a [SRO's] rules, the organization must be in a position to impose appropriate penalties or to revoke relevant privileges.[151]

Regarding FINRA, Congress specifically noted that, if FINRA cannot enforce its rules against FINRA-members, it would undermine the Exchange Act's function of properly regulating and overseeing brokerage firms.[152]

In fact, Congress passed § 19(g) which *demands* that FINRA enforce its rules.[153] As the statute says, in part,

> [FINRA] shall comply with . . . its own rules, and . . . absent reasonable justification or excuse enforce compliance— (B) . . . with such provisions[.][154]

§ 19(g) requires FINRA to enforce Rule 12200.[155] It does not distinguish which rules it obligates FINRA to enforce: the language is broad on its face.[156]

"[let] the exchanges take the leadership with government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well-oiled, cleaned, ready to use but with the hope that it would never have to be used.").

149. S. Rep. No. 94-75, at 24 (1975).

150. Shearson/American Exp., Inc. v. McMahon, 482 U.S. 220, 230 (1987).

151. S. Rep. No. 94-75, at 24 (1975).

152. FINRA, *Regulatory Notice 16-25: Forum Selection Provisions* (July 2016). The Third Circuit has echoed this sentiment. Reading Health System v. Bear Sterns & Co., 900 F.3d 87, 103 (3d Cir. 2018).

153. 15 U.S.C. § 78s(g)(1).

154. *Id. See also* Commissioner Luis A. Agular, *The Need for Robust SEC Oversight of SROS*, SEC. & EXCH. COMM'N (May 18, 2013), https://www.sec.gov/news/public-statement/2013-spch050813laahtm ("SROs are [] required to enforce compliance by their members with the federal securities laws, and discipline their members for violations of such laws and the SRO's own rules.").

155. *See* 15 U.S.C. § 78s(g)(1).

156. *Id.* Although, no private action arises when an SRO fails to follow statutes or rules, except in instances of fraud or bad faith. Brawer v. Options Clearing Corp., 807 F.2d 297, 299 (2d Cir. 1986).

Furthermore, Courts often defer to the SEC,[157] and the SEC has indicated support for a broad reading of § 19(g).[158] In this light, if a Court would permit private parties to contract-around Rule 12200, it would also permit them to contract-around the Congressional mandate that FINRA enforce the Rule.[159]

Third, Congress passed the Exchange Act, in part, to "protect investors."[160] But, waivers of Rule 12200 frustrate the Exchange Act's investor-protection capacity.[161] Historically, both the SEC and brokerage firms have asserted that, when customers cannot access arbitration, the comparative cost of litigation will sometimes deter them from bringing small yet meritorious claims.[162] Although the Circuit split involves large customers with large claims, the

---

157. Because the statute is silent on which rules it covers, if the SEC would pass an interpretative rule that favors a broad reading, the Court would grant the SEC *Chevron* deference. Then, the interpretation would hold as long as it is reasonable. *See* Stryker v. S.E.C., 780 F.3d 163, 165 (2d Cir. 2015); *see also* Digital Realty Tr., Inc. v. Sommers, 138 S. Ct. 767, 773 (2018) (noting that Dodd-Frank granted "power, assistance, and money" to the SEC, but withholding deference because the statue resolved the issue on its face).

158. The SEC wants to prevent SROs from "being less inclined to enforce rules vigorously against financially supportive members, issuers, and shareholders." Commissioner Agular, *supra* note 154.

159. *See* 15 U.S.C. § 78s(g)(1).

160. *Id.*

161. *See* FINRA, *Regulatory Notice 16-25: Forum Selection Provisions* (July 2016); *see also* Brief of the Securities and Exchange Commission, Amicus Curiae, Roney & Co. v. Goren, 875 F.2d 1218 (2d Cir. 1988) (No. 88-1874) (noting "If broker-dealers are allowed to avoid the application of SRO arbitration rules by enforcing conflicting provisions written into customer contracts, the customer protections afforded by those rules and the SRO arbitration system will be undermined and investor confidence in the system will be eroded.").

162. *See White Paper on Arbitration in the Securities Industry*, at 1, SEC (Oct. 2007), at https://www.sifma.org/wp-content/uploads/2017/03/White-Paper-on-Arbitration-in-the-Securities-Industry-October-2007.pdf; *see also* Brief for Respondent, at *17, Rodriguez de Quijas v. Shearson/American Express, 490 U.S. 447 (1989) (No. 88-385) 1988 WL 1026310 (appearing before the Supreme Court, the broker-dealer argued that "The Court in *McMahon* was justified in relying on the SEC's oversight jurisdiction in ruling that SRO arbitration forums are adequate to resolve federal securities law disputes."); *see also* Brief for the Securities and Exchange Commission, Roney & Co. v. Goren, 875 F.2d 1218 (6th Cir. 1989).

literature affirms that both small[163] and large[164] customers will often, but not always, find FINRA arbitration advantageous. This is, in large part, due to the aforementioned procedural differences between litigation and arbitration.[165]

Congress also passed Exchange Act § 15A(b), in part, to "promote just and equitable principles of trade."[166] But, when broker-dealers defy or ignore their Rule 12200 obligations, they also violate their binding duty to comply with just trade principles.[167] FINRA has established that:

> [A] failure to . . . arbitrate [per Rule 12200] violate[s] FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade).[168]

FINRA's conclusion echoes its predecessor, the NASD, which held a similar position:

> The NASD's Board of Governors has determined to interpret actions by members requiring associated persons to waive the arbitration of disputes as conduct inconsistent with just and equitable principles of trade and thus a violation of Article III, section 1 of the Rules of Fair Practice.[169]

---

163. For a discussion of the comparative costs of arbitration and litigation, see *supra* note 36.

164. The cases in the Circuit split evidence broker-dealers' intent to avoid fighting large claims in FINRA arbitration: for those claims, broker-dealers find arbitration against their financial interest. *See* Barbara Black, *supra* note 39, at 121. Conversely, arbitration benefits the sophisticated customers who bring those large claims. Indeed, in the Circuit split, the knowledgeable customers (who know whether arbitration is in their best financial interest) *want* to arbitrate; *see id.*

165. *Supra* notes 82–87.

166. 15 U.S.C. § 78o–3(b)(7).

167. Amicus Curiae Brief of Public Investors Arbitration Bar Association in Support of Plaintiff-Appellee, Reading Health System v. Bear Sterns & Co., 900 F.3d 87 (3d Cir. 2018) (No 16-4234), 2017 WL 2255647.

168. FINRA, *Regulatory Notice 16-25: Forum Selection Provisions* (July 2016).

169. Self-Regulatory Organizations; Proposed Rule Change by National Association of Securities Dealers Relating to Amendments to Code of Arbitration Procedure, 52 Fed. Reg. 9232-01, 9232 (Mar 23, 1987). When relying on the NASD's conclusion, Second Circuit once reasoned that "When a self-regulatory association of securities firms, under direct federal supervision, ordains that its members may not require their employees to waive arbitration rights, it would be inappropriate for us to enforce such a waiver." Thomas James Assocs., Inc. v. Jameson, 102 F.3d 60, 66 (2d Cir. 1996).

FINRA and the NASD's conclusion is particularly dangerous for broker-dealers because a broker-dealer's obligation to "comply with just and equitable principles of trade" relates to the broker-dealer's duty of fair dealing to the investing public.[170] When approving FINRA Rule 12200, the SEC found that:

> FINRA's arbitration rules [are] "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, . . . and, in general, to protect investors and the public interest."[171]

In short, the broker-dealer jeopardizes many of its binding obligations when it demands that customers waive their rights under Rule 12200. As noted above, Congress passed § 15A(b) to promote "just and equitable principles of trade."[172] But, when a broker-dealer has their customer waive Rule 12200, the broker-dealer violates its duty to comply with "just and equitable principles of trade,"[173] undermining Congressional intent and also undermining its duty of fair dealing with the investing public.[174]

Regardless, if Rule 12200 is an unwaivable regulatory right, then the customer can invoke it despite signing the Customer Agreement.[175] Furthermore, the weight of jurisprudence[176] agrees that Rule 12200 is *at least*

---

170. SEC. & EXCH. COMM'N, *Guide to Broker-Dealer Registration*, SEC.GOV (2008), https://www.sec.gov/reportspubs/investor-publications/divisionsmarketregbdguide htm.html.

171. Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change, as Modified by Amendment No. 1., Relating to the Adoption of NASD Rules 4000 Through 1000 Series and the 12000 through 14000 Series as FINRA Rules in the New Consolidated FINRA Rulebook, 73 F.R. 57174 (Sep. 25, 2008).

172. 15 U.S.C. § 78o–3(b)(7).

173. FINRA, *Regulatory Notice 16-25: Forum Selection Provisions* (July 2016).

174. SEC. & EXCH. COMM'N, *supra* note 170.

175. FINRA, Regulatory Notice 16-25: Forum Selection Provisions (July 2016). ("the mandatory nature of the FINRA rules' requirement that FINRA arbitration must be available upon the customer's request, even in the absence of an agreement to arbitrate.").

176. In *Goldman Sachs & Co v. Golden Empire Schools Financing Authority*, no party disputed whether FINRA Rule 12200 was a written agreement to arbitrate, so the court presumed it was a written agreement to arbitrate. 764 F.3d 210, 213 (2d Cir. 2014). Other Courts have affirmatively held that Rule 12200 is a written agreement to arbitrate. *See* Waterford Inv. Serv., Inc. v. Bosco, 682 F.3d 348, 353 (4th Cir. 2012); *see also* Washington Square Sec., Inc. v. Aune, 385 F.3d 432, 435

a written arbitration agreement between the Broker-Dealer and FINRA,[177] so the next section will analyze an implication of that conclusion.

III. WAIVER VIOLATES THE BROKER-DEALER'S IMPLIED DUTY OF GOOD FAITH & FAIR DEALING TO FINRA

Even though Courts generally agree that Rule 12200 is a written agreement to arbitrate,[178] no Court has considered FINRA's reasonable expectations of that agreement when assessing whether a broker-dealer may bargain to waive it.[179]

The implied duty of good faith prevents the broker-dealer from evading Rule 12200.[180] "Every contract imposes upon the parties a duty of good faith and fair dealing in its performance and enforcement."[181] This includes a duty "not to act as to [interfere with] the reasonable expectations of the other party regarding the fruits of the contract."[182] Generally, what contracts promise defines what constitutes interference with those reasonable

(4th Cir. 2004) (where the National Association of Securities Dealers' Rules constituted a written agreement to arbitrate); *see also* UBS Financial Serv., Inc. v. West Virginia University Hosp., Inc., 660 F.3d 643, 649 (2d Cir. 2011); *see also Golden Empire Schools Fin. Auth.*, 764 F.3d at 213 (assuming that FINRA Rule 12200 is a written agreement to arbitrate).

177. The customer is a third-party beneficiary to FINRA Rule 12200. Goldman, Sachs & Co. v. City of Reno, 747 F.3d 733, 749 (9th Cir. 2014) (Battaglia, concurring in part); Kiddler, Peabody & Co. v. Zinsmeyer Tr, P'ship, 41 F.3d 861, 864 (2d Cir. 1994); J.P. Morgan Securities, LLC v. Louisiana Citizens Property Ins., Corp., 712 F. Supp. 2d 70 (S.D.N.Y. 2010); Hunsinger v. Carr, No. 14-2302, 2016 WL 2996782 (E.D. Penn. May 24, 2016).

178. *See, e.g.*, Goldman Sachs & Co. v. City of Reno, 747 F.3d 733, 747 (9th Cir. 2014).

179. *See id.* at 743; *see also Golden Empire Schools*, 764 F.3d at 217. To consider FINRA's interests a federal court may have to enjoin FINRA. FED. R. CIV. P. 19(a)(1)(B)(i).

180. Alabama v. North Carolina, 560 U.S. 330, 351 (2010) (establishing relevancy to this discussion insofar as the nation's highest court recently mentioned that "every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement.").

181. *Id.*

182. Metcalf Constr. Co. v. United States, 742 F.3d 984, 991 (Fed. Cir. 2014).

expectations.[183] Notably, every broker-dealer operating in the United States must promise to uphold Rule 12200 at least twice before signing any Customer Agreement.

First, Rule 12200 is itself a written promise which gives FINRA reason to expect the broker-dealer to maintain the customer's arbitration right.[184] Rule 12200 expressly promises the customer a right to invoke arbitration—a right that good faith demands the broker-dealer leave alone.[185] The right to arbitrate is a longstanding right which the securities industry has recognized for over a century.[186] FINRA even issued a regulatory notice to warn member-firms that it expects them to maintain the customer's right, asserting that "FINRA rules do not permit member firms to require associated persons to waive their right to arbitration under FINRA's rules in a predispute agreement."[187]

Second, each broker-dealer, in its FINRA-membership application, must promise the SEC—with FINRA's knowledge—that it will uphold FINRA Rule 12200.[188] As part of the application, FINRA requires each person associated with the applicant-broker-dealer to sign and submit a Form U–4 (a contract)[189] to the SEC.[190] In such form, each associated person[191] promises:

---

183. *Id.*

184. *See generally FINRA Application Process*, FINRA.org., https://www.finra.org/sites/default/files/external_apps/p129282.html (last visited Nov. 21, 2020).

185. FINRA, RULE 12200 (2008).

186. *See* CONSTITUTION AND BY-LAWS OF THE NEW YORK STOCK EXCHANGE 35 (1869).

187. FINRA, *Regulatory Notice 16-25: Forum Selection Provisions* (July 2016).

188. *See generally* FINRA, RULE 1013.

189. *See, e.g.*, Thomas James Associates, Inc. v. Jameson, 102 F.3d 60, 62 (2d Cir. 1996).

190. *Id.*

191. The term "Associated Person" is extremely broad. It "means (1) a natural person registered under FINRA rules; or (2) a sole proprietor, or any partner, officer, director, branch manager of the Applicant, or any person occupying a similar status or performing similar functions; (3) any company, government or political subdivision or agency or instrumentality of a government controlled by or controlling the Applicant; (4) any employee of the Applicant, except any person whose functions are solely clerical or ministerial; (5) any person directly or indirectly controlling the Applicant whether or not such person is registered or exempt from registration under the FINRA By-Laws or FINRA rules; (6) any person engaged in investment banking or securities business controlled directly or indirectly

> [To] submit to the authority of the jurisdictions and SROs and *agree to comply with all* provisions, conditions and covenants of the statutes, constitutions, certificates of incorporation, by-laws and *rules and regulations of the* jurisdictions and *SROs* as they are or may be adopted, or amended from time to time.[192]

In other words, FINRA requires each person associated with the broker-dealer to independently promise the SEC that the person will comply with all FINRA rules—including Rule 12200.[193] Ergo, each associated person also promises to uphold FINRA Rule 2010.[194] This rule requires "[Each] member, in the conduct of its business, [to] observe high standards of commercial honor and just and equitable principles of trade."[195] Both FINRA and common sense suggest that a commercially honorable firm would not attempt to sidestep a FINRA rule that the firm's members promised to obey.[196] One should also note that every brokerage firm, (rather than the firm's associated persons), also files a Form BD with the SEC when registering with FINRA.[197] In the Form BD, the brokerage firm has to disclose whether an SRO ever found the firm to have violated an SRO-rule.[198] Presumably, the SEC and FINRA want this information to guarantee that, if registered, the firm will not violate other SRO-rules in the future.[199] Admittedly, FINRA monitors its members to enforce their compliance with rules—which is a sign that FINRA does not expect *every* single firm to comply with them—but FINRA can nevertheless reasonably expect individual member-firms, along with their associated individuals, to uphold their U–4 promises and BD guarantee.[200]

---

by the Applicant whether such person is registered or exempt from registration under the FINRA By-Laws or FINRA rules; or (7) any person who will be or is anticipated to be a person described in (1) through (6) above." FINRA, RULE 1011 (2008).

192. FINRA, FORM U-4, *supra* note 78 (emphasis added).

193. *See generally* FINRA, RULE 1013 (2020).

194. *See* FINRA, FORM U-4, *supra* note 78.

195. FINRA, RULE 2010 (2008).

196. FINRA, *Regulatory Notice 16-25: Forum Selection Provisions* (July 2016).

197. SEC, UNIFORM APPLICATION FOR BROKER-DEALER REGISTRATION (FORM BD).

198. *Id.*

199. *See id.*

200. "FINRA monitors the activities of FINRA firms . . . for compliance with FINRA's rules . . . . FINRA conducts more than one thousand on-site firm and branch office examinations each year." "If apparent violations of rules and

Given that every FINRA-member broker-dealer, through its own promises, leads FINRA to reasonably expect that the broker-dealer will maintain Rule 12200, the duty of good faith and fair dealing prohibits any FINRA-member brokerage firm from interfering with that expectation by bargaining for waiver.[201] In fact, in the cases before the Circuit Courts, even the customers had no notice that they had potentially waived Rule 12200.[202]

IV. THE CIRCUIT CASES' FORUM-SELECTION CLAUSES ARE TOO VAGUE TO WAIVE RULE 12200

A party signing a waiver must know which rights they are waiving because waiver is a voluntary act.[203] However, the Customer Agreement's forum-selection clause phrase "all actions and proceedings" is too ambiguous to alert a reasonable customer that they are waiving their Rule 12000 arbitration right.[204] Specifically, (1) the term "action" only includes litigation[205] and (2) the term "proceeding" is ambiguous.[206]

---

regulations are discovered FINRA may initiate a disciplinary action." FINRA, *Interacting With FINRA*, https://www.finra.org/registration-exams-ce/manage-your-career/interacting-finra (last visited Nov. 21, 2020). For violations of the Member Agreement, FINRA fines the firm between $2,000 and $77,000, and may suspend or expel the firm from FINRA. FINRA, SANCTIONS GUIDELINES 44 (2020), https://www.finra.org/sites/default/files/Sanctions_Guidelines.pdf.

201. Metcalf Construction Co. v. U.S., 742 F.3d 984, 991 (Fed. Cir. 2014).

202. *See, e.g.*, Reading Health Sys. v. Bear Sterns & Co., 900 F.3d 87, 103 (3d Cir. 2018).

203. *Reading Health Sys.*, 900 F.3d at 103. Even the 9th Circuit has accepted this principle. Royal Air Properties, Inc. v. Smith, 333 F.2d 568, 571 (9th Cir. 1968); Lawson v. Klondex Mines Ltd., 450 F. Supp. 3d 1057, 1080 (D. Nev. 2020). The Second Circuit accepts it too, but in *Golden Empire* held that the forum-selection clause does not have to mention arbitration to alert the customer that they were waiving arbitration. Goldman Sachs & Co v. Golden Empire Schools Financing Authority, 764 F.3d 210, 215 (2d Cir. 2014).

204. *See, e.g.*, *Action*, BLACK'S LAW DICTIONARY (10th ed. 2014).

205. *See, e.g.*, *id.*

206. Compare *Proceeding*, BLACK'S LAW DICTIONARY (10th ed. 2014) to *Proceeding*, BALLENTINE'S LAW DICTIONARY (3d ed. 2010).

First, the term "action" only includes litigation and not arbitration. Black's Law Dictionary defines an "action" as, "A civil or criminal judicial proceeding."[207] According to this definition, an action does not include FINRA arbitration.[208] Ballentine's Law Dictionary's agrees, defining an "action" as, "A judicial proceeding, either in law or in equity, to obtain relief at the hands of a court."[209] The Cornell Legal Information Institute (LII) also agrees, defining an "action" as "primarily [a reference] to the act of bringing a lawsuit, prosecution, or judicial proceeding."[210] These legal dictionaries unanimously confirm that the term "action" cannot alert a reasonable customer that they are waiving FINRA arbitration.

Second, the term "proceeding" has an ambiguous scope.[211] For example, Black's Law Dictionary contains two conflicting definitions of "proceeding."[212] On one hand, it defines a "proceeding" as, "The regular and orderly progression of a lawsuit, including all acts and events between the time of commencement and entry of judgment."[213] This definition equates a proceeding with the business of litigation.[214] On the other hand, Black's also defines a "proceeding" as "Any procedural means for seeking redress from a tribunal or agency."[215] This definition suggests that a "proceeding" includes an arbitral tribunal.[216] Likewise, LII also contains conflicting definitions of "proceeding." On one hand, it defines "proceeding" as, "A procedure through which one seeks redress from a court or agency."[217] This definition includes

---

207. *See Action*, BLACK'S LAW DICTIONARY (10th ed. 2014).

208. *Id.*

209. *Action*, BALLENTINE'S LAW DICTIONARY (3d ed. 2010) (emphasis added).

210. *Legal Action*, Legal Information Institute, https://www.law.cornell.edu/wex/legal_action (last visited Nov. 21, 2020).

211. *See Proceeding*, BLACK'S LAW DICTIONARY (10th ed. 2014).

212. *Id.*

213. *Id.*

214. *Id.* The commentary to the definition reads "'Proceeding' is a word much used to express the business done in courts." *Id.*

215. *Id.*

216. *Id.*

217. *Proceeding*, Legal Information Institute, https://www.law.cornell.edu/wex/proceeding (last visited Nov. 21, 2020).

litigation.[218] On the other hand, LII defines "proceeding" as, "A filing, hearing, or other step that is part of a larger action."[219] Contrarily, this definition includes arbitral tribunals, which accept filings and conduct hearings.[220] Notably, Ballentine's Law Dictionary asserts that arbitration is not a "proceeding": "[Proceeding includes] all methods of invoking the action of courts and applicable generally to any step taken by a suitor to obtain the interposition or action of a court."[221] But, because one cannot confirm whether a "proceeding" includes arbitration without cherry-picking Ballentine's definition (which denies that an arbitration is a proceeding) the term "proceeding" is insufficient to alert the customer about whether they are waiving Rule 12200 arbitration.[222]

In short, a reasonable customer (who is prudently using a contemporary legal dictionary) would likely have believed, when signing the Customer Agreement, that they did not waive their Rule 12200 right.[223] Therefore, such a waiver is invalid.[224]

CONCLUSION

Although broker-dealers have only sought to waive large, institutional customers' Rule 12200 arbitration rights; a broker-dealer cannot force any customer to waive Rule 12200 arbitration for three broad reasons, the first which no Circuit has considered in detail, and the third which no Circuit has considered at all.

---

218. *Id.*

219. *Id.*

220. *Id.*

221. *Proceeding*, BALLENTINE'S LAW DICTIONARY (3d ed. 2010). This definition cited Bowers v. New York & Albany Lighterage Co., 273 U.S. 346 (1927) (holding that "It is clear that the meaning of 'proceeding' as used in the clause of limitation in section 250(d), Revenue Act of 1921, cannot be restricted to steps taken in a suit; it includes as well steps taken for the collection of taxes by distraint.").

222. *See Proceeding*, BLACK'S LAW DICTIONARY (10th ed. 2014).

223. *See generally* UBS Fin. Serv., Inc. v. Carilion Clinic, 706 F.3d 319 (4th Cir. 2013).

224. *See* Reading Health Sys. v. Bear Sterns & Co., 900 F.3d 87, 103 (3d Cir. 2018); *see also* Royal Air Prop., Inc. v. Smith, 333 F.2d 568, 571 (9th Cir. 1968).

First, § 29(a), as Dodd-Frank amended in 2010, likely voids any contractual waiver of Rule 12200.[225] The statute voids any waiver via a facial reading, for which both the SEC[226] and the *McMahon* Court[227] indicate support. Moreover, an examination of Dodd Frank's legislative history confirms that, like *McMahon*,[228] Dodd-Frank sought to enforce broker-dealers' Exchange-Act duties.[229] Dodd-Frank sought to enforce those duties, in part, by "provid[ing] equal treatment for the rules of all SROs under [§] 29(a)."[230] In so doing, Congress sought to protect investors of all sizes,[231] while both

225. *See supra* Section 1(C) for a discussion on how Dodd-Frank affects one's reading of the rule.

226. *See, e.g.*, SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISORS AND BROKER-DEALERS 50 (Jan. 2011).

227. *See, e.g.*, Shearson/American Exp., Inc. v. McMahon, 482 U.S. 220, 231 (1987).

228. *Id.* at 228.

229. *See* S. REP. NO. 111-176, at 244 (2010) (stating vaguely that Title IX, Subtitle B, of which § 29(a) is a part, "relates to enforcement issues.").

230. *Id. See, e.g.*, *Regulatory Restructuring and Reform of the Financial System: Hearing Before the Committee on Financial Services*, 110th Cong. (2008) (statement of Joseph E. Stiglitz, Professor, Colombia University) (saying "The rules need to be . . . simple . . . and transparent [enough], so that everybody, including Congress, can see on an ongoing basis whether there is enforcement."). *See also, e.g.*, *Committee on Senate Financial Crisis Inquiry Commission*, 111th Cong. (2010) (statement of Denise Voigt Crawford, President, North American Security Administrators Association) (declaring that "Deregulation is no longer the presumptive policy prescription; indeed today, the sense is that the current crisis was deepened by excessive deregulation.").

231. *See* 156 Cong. Rec. H5233-01 (2010) (wherein Congresspeople mentioned Madoff nine times); *see also* S. REP. NO. 111-176 (wherein Congresspeople mentioned Madoff forty-eight times).

Congress[232] and the Executive[233] expressed concerns about broker-dealers—rather than customers—enjoying their choice of forum.

Second, FINRA holds that Rule 12200 is unwaivable, and courts of law may owe FINRA's opinion some deference.[234] Regardless, Rule 12200 underwent a number of official channels before FINRA enacted it,[235] and Congress indicated that any waiver of SRO-rules would frustrate the Exchange-Act's regulatory scheme.[236]

Third, the implied duty of good faith applies to all contracts, and all FINRA broker-dealers have promised twice—once through FINRA Rule 12200, and again to the SEC (with FINRA's knowledge) in their FINRA membership-application—that they will uphold the customer's Rule 12200 arbitration right.[237] The broker-dealers necessarily made these promises prior to signing any Customer Agreement.[238] In other words, every FINRA-member broker-dealer led FINRA to reasonably expect that they would not evade their Rule 12200 obligations.[239]

Finally, even if Rule 12200 were waivable, the cases before the Circuit Courts do not waive it. When consulting multiple objective legal dictionaries, one cannot determine whether the forum-selection clause's phrase "all actions

232. *See, e.g.*, 156 Cong. Rec. H5233-01 (2010) (arguing that "[S]ecurities industry practices have deprived investors of a choice when seeking dispute settlement, too. In particular, pre-dispute mandatory arbitration clauses inserted into contracts have limited the ability of defrauded investors to seek redress." – Rep. Barney Frank (D-MA)).

233. *See, e.g.*, SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISORS AND BROKER-DEALERS 51 (Jan. 2011).

234. *See, e.g.*, Charles Schwab & Co. v. FINRA, 861 F. Supp. 2d 1063 (N.D. Cal. 2012).

235. FINRA, *FINRA Rulemaking Process*, https://www.finra.org/rules-guidance/rulemaking-process (last visited Nov. 21, 2020).

236. S. Rep. No. 94-75, at 24 (1975).

237. *See* FINRA, RULE 12200 (2008). *See also* FINRA, FORM U-4, *supra* note 78, SECTION 15A (2009).

238. *See* FINRA, RULE 1013; *see generally*, *FINRA Application Process*, *supra* note 184.

239. *See* FINRA, RULE 12200 (2008); *see also* FINRA, FORM U-4, *supra* note 78, SECTION 15A (2009).

and proceedings" includes FINRA arbitration.[240] Therefore, the phrase cannot alert a reasonable customer that the phrase waives Rule 12200 arbitration.[241]

Going forward, it is unclear if, when, and how Courts will resolve the Rule 12200-waiver Circuit split concerning Rule 12200 in the face of a competing forum-selection clause. The Supreme Court has given no indication that it will resolve it.[242] The Supreme Court's only relevant action was their denial of the City of Reno's Petition for a Writ of Certiorari from the Ninth Circuit.[243] Given that this issue does not involve substantial numbers of investors, and only a few Circuits have weighed-in,[244] the Supreme Court may have other priorities for now.[245] Regardless, the Circuit split needs resolution to provide lower courts, (large) investors, broker-dealers, regulators, and legislators with clear, workable standards.[246]

---

240. Compare *Proceeding*, BLACK'S LAW DICTIONARY (10th ed. 2014) to *Proceeding*, BALLENTINE'S LAW DICTIONARY (3d ed. 2010).

241. *Id.*

242. The issue is absent from websites which follow the Supreme Court. *See* Calendar of Events, Supreme Court of the United States Blog, http://www.scotusblog.com/events/ (last visited Dec. 9, 2020).

243. *See* Petition for a Writ of Certiorari, City of Reno v. Goldman, Sachs & Co., 574 U.S. 991 (U.S. 2014) (No. 14-176), 2014 WL 3919597. City of Reno, Nevada v. Goldman, Sachs & Co., 574 U.S. 991 (U.S. 2014) (No. 14-146) (denying certiorari with no explanation).

244. Recently, in a Seventh Circuit case, *INTL FCStone Financial Inc. v. Jacobson*, the District Court below did not decide whether Rule 12200 superseded the forum-selection clause, and the Seventh Circuit refused to answer the threshold question for the first time on appeal. INTL FCStone Financial Inc. v. Jacobson, 950 F.3d 491, 503 (2020).

245. "The Court receives approximately 7,000-8,000 petitions for a writ of certiorari each Term. The Court grants and hears oral argument in about 80 cases." SUPREME COURT OF THE UNITED STATES, *About the Court*, https://www.supremecourt.gov/about/faq_general.aspx (last visited Dec. 9, 2020).

246. *See, e.g.*, *Regulatory Restructuring and Reform of the Financial System: Hearing Before the Committee on Financial Services*, 110th Cong. (2008) (statement of Joseph E. Stiglitz, Professor, Colombia University) (saying "The rules need to be . . . simple . . . and transparent [enough], so that everybody, including Congress, can see on an ongoing basis whether there is enforcement.").

TIME FOR A NEW SECURITIES REGULATOR?: A LOOK AT ERISA, ITS RECENT ABUSES AND WHERE TO GO FROM HERE

Eli Weingast[*]

I. Introduction

Since its formation in 1913, the Department of Labor ("DOL") has become increasingly involved in investor protection. The DOL, and its sub-agency, the Employee Benefit Security Administration ("EBSA"), accomplishes this through the authority granted by the Employee Retirement Income Security Act of 1974 ("ERISA"). ERISA built upon previous standards for retirement plans, created duties for plan fiduciaries, and gave the DOL authority to make rules that further define those duties. Recent trends, however, suggest that the DOL should not have the power to pass such rules, as it is subject to too much Presidential control and defers to the laxer standards for other financial professionals, set forth by the Securities Exchange Commission ("SEC"). This article will provide the historical context underlying the creation of ERISA, summarize several of the most common types of retirement plans, and compare the standards to which different financial professionals are held. It will explore recent changes and rules issued by the DOL and will consider several changes that should be made to ensure that current and future retirees receive the proper protections.

II. History of the Department of Labor and its Role in Investor Protection

A. Pre-ERISA

The first private pension plan in the Unites States was formed in 1875 by the American Express Company.[1] Nearly 40 years later, in 1913, the DOL was

*J.D. Candidate 2021, St. John's University School of Law. The author would like to thank Professor Christine Lazaro for her generous assistance with this article, as well as his wife, Arielle, for being a constant source of inspiration and support throughout law school.

1. *See* History of PBGC, PENSION BENEFIT GUARANTY CORP., https://www.pbgc.gov/about/who-we-are/pg/history-of-pbgc (last visited Dec. 5, 2020).

formed,[2] and a Cabinet position for the Secretary of the DOL was created.[3] However, at the time of its formation, the DOL did not oversee any of the growing number of pension plans.[4] By 1919, there were over 300 pension plans that covered approximately 15% of all salaried employees in the United States.[5] With the passing of the Revenue Acts of 1921 and 1926, the Internal Revenue Service ("IRS") became the first "regulator" of pension funds by imposing certain conditions, such as funding requirements and that a certain percentage of employees be covered by the plan, in order to receive favorable tax treatment.[6] By 1940, 4.1 million private-sector workers were covered by a pension plan.[7] Two years later, the Revenue Act of 1942 was passed and began imposing stricter participation requirements and mandating certain disclosures regarding the plan.[8] It was not until 1958 (when nearly 18.7 million private-sector workers, accounting for almost 41% of all private-sector workers, were covered by pensions plans)[9] that Congress passed the Welfare and Pension Plans Disclosure Act ("WPPDA"), directing the DOL to begin regulating pension plans.[10]

---

2. 29 U.S.C. § 551 (2018).

3. Any future reference to the Secretary refers to the Secretary of the DOL, unless otherwise noted.

4. At that time, the DOL consisted of the U.S. Conciliation Service, the Bureau of Labor Statistics, the Bureau of Immigration, the Bureau of Naturalization, and the Children's Bureau. *A Brief History: The U.S. Department of Labor*, U.S. DEP'T OF LABOR, https://www.dol.gov/general/aboutdol/history/dolhistoxford (last visited Dec. 17, 2020).

5. Workplace Flexibility 2010, Georgetown University Law Center, *A Timeline of the Evolution of Retirement in the United States*, *in* MEMOS AND FACT SHEETS (2010). 50. https://scholarship.law.georgetown.edu/legal/50.

6. *History of EBSA and ERISA*, EMP. BENEFITS SEC. ADMIN., https://www.dol.gov /agencies/ebsa/about-ebsa/about-us/history-of-ebsa-and-erisa (last visited Dec. 5, 2020).

7. Workplace Flexibility 2010, *supra* note 5.

8. History of EBSA and ERISA, *supra* note 6.

9. Workplace Flexibility 2010, *supra* note 5.

10. Welfare and Pension Plans Disclosure Act (WPPDA), Pub. L. 85-836, §§ 2-12, 72 Stat. 997, 1003 (1958) (amended 1962), *repealed by* Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. 93-406, Title I, § 111(a)(1), 88 Stat. 851.

Congress passed the WPPDA because the pension plans were inadequately disclosing information to the participants.[11] The WPPDA gave limited powers to the DOL, primarily focusing on its authority to require financial disclosures by pension plans.[12] In 1962, the WPPDA was amended to give the DOL additional authority, including enforcement, interpretative, and investigatory powers.[13] However, with the failure of the Studebaker Corporation's pension plan a mere 19 months later,[14] it was clear that this was not enough and, in 1974, Congress repealed the WPPDA and passed ERISA in its place.

B. ERISA

When ERISA was passed, Congress's main concern shifted from disclosure of plan information to ensuring that plans were adequately funded and that retirees received their benefits.[15] This was accomplished by setting minimum requirements for employer contributions,[16] and, for the first time, creating standards of conduct for plan fiduciaries.[17]

---

11. WPPDA § 2 (repealed 1974).

12. *Id.* §§ 2-12 (repealed 1974).

13. Welfare and Pension Plans Disclosure Act Amendments of 1962, Pub. L. No. 87-420, 76 Stat. 35.

14. On December 9, 1963, the Studebaker Corporation closed its South Bend, Indiana plant. Of the 10,500 covered employees, only the 3,600 that were already retired or were at retirement age (60, at the time) received their pension benefits. The remaining 6,900 employees received between nothing and 15 cents on the dollar for their pension interests. *ERISA 40 Timeline Alternate*, U.S. DEP'T OF LABOR, https://www.dol.gov/featured/erisa40/timeline/alternative (last visited Dec. 5, 2020).

15. This is apparent when comparing the "Congressional Findings" in § 2 of the WPPDA to those in § 2 of ERISA. While a significant portion of the text from the WPPDA was recycled in ERISA, there is added language regarding the lack of "adequate safeguards" concerning plan operations, as well as, needing to create minimum standards as plans were getting terminated prior to "requisite funds hav[ing] been accumulated." Employee Retirement Income Security Act of 1974 (ERISA) § 2(a), 29 U.S.C. § 1001(a) (2018).

16. *See* ERISA §§ 301-306.

17. *Id.* § 404.

ERISA is split into four sections. Title I created protections for employees, such as plan participation and vesting, minimums for employer funding, reporting and disclosure requirements, and duties of plan fiduciaries.[18] Title II, under the jurisdiction of the IRS, codified amendments and additions to the Internal Revenue Code ("Code") and created requirements similar to Title I in order for plans to receive favorable tax treatment.[19] Additionally, Title II created certain standards of conduct for fiduciaries of accounts not covered by Title I, such as the Individual Retirement Account ("IRA").[20] Title III addresses the respective jurisdictional, administrative, and enforcement powers of the DOL and IRS.[21] Title IV created the Pension Benefit Guaranty Corporation ("PBGC"), establishing insurance for pension plans, as well as procedures for terminated plans.[22]

C. Employee Benefits Security Administration

The EBSA is one of several sub-agencies within the DOL.[23] The EBSA, by and through the DOL, is responsible for administering and enforcing the provisions of Title I.[24] An Assistant Secretary leads the EBSA, reporting directly to the Deputy Secretary of the Department of Labor.[25]

---

18. *See id.* §§ 2-514; History of EBSA and ERISA, *supra* note 6.

19. *See* ERISA §§ 1001-2008; History of EBSA and ERISA, *supra* note 6.

20. 26 U.S.C. § 4975 (2020). There are, however, some employer-sponsored IRAs that are covered by ERISA, such as the Simplified Employee Pension Plans (SEP-IRA) and the Savings Incentive Match Plan for Employees (SIMPLE IRA).

21. *See* ERISA §§ 3001-3043; History of EBSA and ERISA, *supra* note 6.

22. *See* ERISA §§ 4001-4023; History of EBSA and ERISA, *supra* note 6.

23. The EBSA was formed in 1970 and was known as the Pension Welfare Benefits Program. In 1986 it changed its name to the Pension Welfare Benefits Program Administration and again changed it in 2003 to the Employee Benefit Security Administration, when it was upgraded to a sub-cabinet position. History of EBSA and ERISA, *supra* note 6.

24. History of EBSA and ERISA, *supra* note 6.

25. *Organizational Chart*, U.S. DEP'T OF LABOR. https://www.dol.gov/general/aboutdol/orgchart (last visited Dec. 5, 2020).

D. Common Types of Retirement Plans

1. Defined Benefit Plans

In a defined benefit plan, more commonly referred to as a pension plan, the employer makes contributions (although in some cases, the employee must or may also make contributions) and, upon an employee's retirement, the plan will pay out a pre-established benefit.[26] The total benefit received by the employee is generally based on several factors, such as the employee's ending salary and years of service, and it can usually be paid in the form of an annuity or a lump-sum payment.[27] Because the employer is responsible for payments and the employee has no control over any of the plan's assets, the employer bears all investment, management, and payment obligation risk.[28] However, the employee is at risk of the employer terminating the plan. While this is often difficult to implement and expensive, a company can terminate its plan and stop making payments to beneficiaries, or "freeze" any additional accrual or contribution of assets.[29]

For over a century following the American Express Corporation's first private pension plan, the number of plans and private-sector workers covered by them continued to grow. In 1970, there were 26.3 million private-sector workers (45% of all private-sector workers) covered by defined benefit plans.[30] By 1980, this increased to 35.9 million private-sector workers (46% of all private-sector workers).[31] The number of covered private-sector employees continued to rise, reaching 39.5 million by 1990 and increasing to, 40.1 million

---

26. *Choosing a Retirement Plan: Defined Benefit Plan*, U.S. INTERNAL REVENUE SERVICE, https://www.irs.gov/retirement-plans/choosing-a-retirement-plan-defined-benefit-plan (last visited Dec. 5, 2020).

27. *Defined-Benefit Plan*, INVESTOPEDIA, https://www.investopedia.com/terms/d/definedbenefitpensionplan.asp (last visited Dec. 5, 2020).

28. John Broadbent, Michael Palumbo & Elizabeth Woodman, The Shift from Defined Benefit to Defined Contribution Pension Plans - Implications for Asset Allocation and Risk Management, at 7 (Dec. 2006) (unpublished) (https://www.bis.org/publ/wgpapers/cgfs27broadbent3.pdf).

29. *Id.* at 4. However, it should be noted that there are now different processes for voluntary and involuntary plan terminations and the PBGC may take an underfunded plan into receivership.

30. Workplace Flexibility 2010, *supra* note 5.

31. *Id.*

by 2000.[32] However, after the passage of the Revenue Act of 1978 and § 401(k) of the Code, defined contribution plans became the more popular retirement plan offered by employers. By 2006, only 20% of private-sector workers were covered by a defined benefit plans,[33] and by 2019, that number dropped to only 12%.[34]

2. Defined Contribution Plans

In a defined contribution plan, an employee will defer a portion of his or her salary, subject to the IRS maximum,[35] usually on a tax-deferred basis.[36] The deferred income is placed into a self-directed account where the employee has control over the assets and can choose from a range of investment alternatives (most often mutual funds) offered by the plan.[37] Although, if the plan allows, the employee's account can be managed by a professional, for a fee. In many cases, employers will match a portion of the employees' contribution.[38]

Because participation in a defined contribution plan is voluntary and self-directed, the employee bears the investment risk and there is no guarantee as to what the account value will be at retirement.[39] A defined contribution plan is always fully funded by employee contributions (and sometimes, if applicable, an employer's) so there is no risk of receiving nothing at

---

32. *Id.*

33. *Id.*

34. U.S. BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, BULL. 2791, NATIONAL COMPENSATION SURVEY: EMPLOYEE BENEFITS IN THE UNITED STATES, at Table 2 (2019).

35. 26 U.S.C. § 402(g) (2020).

36. There are defined contribution plans that are funded with post-tax income, such as a Roth 401(k); however, these plans are functionally the same.

37. *Defined-Contribution Plan*, INVESTOPEDIA, https://www.investopedia.com /terms/d/definedcontributionplan.asp (last visited Dec. 20, 2020).

38. *Id.* ("More than three-fourths of companies contribute to employee 401(k) accounts based on the amount the participant contributes.").

39. Broadbent, Palumbo & Woodman, *supra* note 28, at 7.

retirement, subject to investment losses. This differs from a defined benefit plan that can be terminated or frozen, with the employer stopping payments.[40]

Since the enactment of § 401(k) of the Code in 1978, defined contribution plans "have become the fastest growing type of retirement plan in the United States."[41] In just over a decade after the passing of § 401(k), 11.5 million private-sector workers were enrolled in defined contribution plans.[42] By 2000, that number grew to over 60 million,[43] and by 2019, 47% of all private-sector workers were enrolled in a defined contribution plan.[44]

3. Individual Retirement Accounts

A third common retirement plan is the IRA, which (as its name suggests) is an account that is established by an individual. An IRA is most often funded by a rollover of a defined contribution plan[45] or with pre-tax income.[46] IRAs are similar to defined contribution plans in that they are voluntary and self-directed. However, because IRAs are generally unrelated to an employer and are opened and maintained by an individual, they are not covered by Title I of ERISA.[47] Instead, they are governed by § 4975 of the Code. However, the interpretive and enforcement authority regarding several provisions of § 4975, including the provision that defines a fiduciary's prohibited transactions, was transferred to the DOL.[48]

---

40. *Id.* at 6.

41. Employee Benefit Research Institute, *History of 401(k) Plans: An Update*, FAST FACTS, Nov. 2018.

42. Workplace Flexibility 2010, *supra* note 5.

43. *Id.*

44. NATIONAL COMPENSATION SURVEY: EMPLOYEE BENEFITS IN THE UNITED STATES, *supra* note 34.

45. A rollover is when funds from one retirement account, such as a 401(k), are transferred to an IRA. *IRA Rollover*, INVESTOPEDIA, https://www.investopedia.com/terms/i/ira-rollover.asp (last visited Dec. 20, 2020).

46. There are Roth IRAs, which are funded with post-tax dollars, but are otherwise functionally the same.

47. As stated above, there are SEP-IRAs and SIMPLE IRAs, which are employer-sponsored and are, therefore, covered by ERISA.

48. *See* Reorganization Plan No. 4 of 1978, Section 102.

E. Fiduciary Standards Under ERISA

Saving for retirement is essential since Social Security retirement benefits usually accounts for only one-third of a retired employee's income.[49] On average, income from Social Security replaces only about 40% of an employee's pre-retirement income; it is estimated that retirees need about 70% of their pre-retirement income per year.[50] This situation requires that employees rely on other means of retirement income, such as employer-sponsored plans and IRAs. Because of their important role, it is essential to impose certain standards of conduct upon those with control or oversight over such plans.

1. ERISA Standards Compared to Standards for Brokers, Dealers, and Registered Investment Advisers

Referring to fiduciary duties, Chief Justice Cardozo famously said, "[n]ot honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."[51] This idea has been expanded for ERISA fiduciaries and the Ninth Circuit recently reiterated the sentiment that ERISA fiduciary duties are "the highest known to law."[52] However, a fiduciary standard is not the only standard of conduct imposed on financial professionals.

There are several standards of conduct that financial institutions and professionals must adhere to, depending on their role and the services they provide. Brokers and dealers are generally not subject to any fiduciary standards, although they do have to abide by the standards set forth in the Securities Exchange Act,[53] its associated regulations, and FINRA Rules. When taken together, these create several general duties that can be summarized as: (i) the duty of fair dealing, (ii) the duty to make suitability assessments for

---

49. SOCIAL SECURITY ADMINISTRATION, FACT SHEET: SOCIAL SECURITY (2020).

50. ANDREW G. BIGGS & GLENN R. SPRINGSTEAD, SOCIAL SECURITY BULLETIN, VOL. 68, NO. 2, ALTERNATE MEASURES OF REPLACEMENT RATES FOR SOCIAL SECURITY BENEFITS AND RETIREMENT INCOME (2008).

51. Meinhard v. Salman, 249 N.Y. 458, 464 (1928).

52. Tibble v. Edison Int'l, 843 F.3d 1187, 1197 (9th Cir. 2016) (internal citations omitted).

53. Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. §§ 78a-78qq (2018).

clients, (iii) the duty of best execution, and (iv) the duty to disclose some conflicts of interest.[54]

On the other hand, Registered Investment Advisers ("RIAs") (those who register under the Investment Advisers Act[55]) are considered fiduciaries.[56] As fiduciaries, RIAs are held to higher standards than brokers and dealers. Under the Investment Advisers Act and SEC interpretations, RIAs have the following duties: (i) the duty to disclose material facts, (ii) the duty to not engage in transactions that involve a conflict of interest, unless the conflict is adequately disclosed to the client, (iii) the duty to inquire and determine the suitability of investment recommendations, (iv) the duty of best execution, and (v) the duty of loyalty.[57]

Fiduciaries under ERISA are held to an even higher standard. In addition to being required to act with "care, skill, prudence, and diligence under the circumstances," a fiduciary under ERISA has (i) a duty of loyalty, by acting for the "exclusive purpose" of providing benefit to plan participants and their beneficiaries while limiting costs, (ii) a duty to diversify to minimize losses, and (iii) a duty to follow plan documents.[58]

2. Who is a Fiduciary Under ERISA

There are several different ways to become a fiduciary under ERISA; the most recognized one is the "Investment Advice" fiduciary, defined as someone that "renders investment advice for a fee."[59] In 1975, shortly after

---

54. David C. Kaleda, *A Matter of Trust: Standards of Conduct Under ERISA, the Exchange Act, and the Advisers Act: Part 1 of 2*, THE INVESTMENT LAWYER, VOL. 20, NO. 2 (2013) [hereinafter Kaleda, *Part 1*] (summarizing duties of brokers and dealers).

55. Investment Advisers Act of 1940 (Investment Advisers Act), 15 U.S.C. §§ 80b-1 to -21 (2018).

56. *See* SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963) (reading a fiduciary duty into the Investment Advisers Act antifraud provision).

57. Kaleda, *Part 1 of 2*, *supra* note 54 (summarizing duties of RIAs).

58. ERISA § 404(a)(1); David C. Kaleda, *A Matter of Trust: Standards of Conduct Under ERISA, the Exchange Act, and the Advisers Act: Part 2 of 2*, THE INVESTMENT LAWYER, VOL. 20, NO. 4 (2013) (summarizing duties of ERISA fiduciaries).

59. ERISA § 3(21)(A) states

> a person is a fiduciary . . . to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or

ERISA was passed, the DOL issued a rule that created a five-part test that deemed a person to be "render[ing] investment advice" if that person (1) makes recommendations regarding the advisability of buying, selling, or retaining securities, (2) on a regular basis, (3) pursuant to a mutual agreement, arrangement, or understanding, (4) that such services shall serve as the primary basis for investment decisions with respect to plan assets, and (5) such advice is individualized to the plan taking into account factors such as investment policies, investment strategies, the plan's overall portfolio, or diversification of plan investments.[60]

This test stood until 2016, when the DOL, under the Obama administration, issued several new regulations, including a new definition for Investment Advice fiduciary (the "2016 Fiduciary Rule").[61] However, these regulations were short-lived. One of the first things that the Trump administration tried to accomplish in 2017 was to roll back the 2016 Fiduciary Rule.[62] After several failed attempts to block the 2016 Fiduciary Rule, in 2018 the Fifth Circuit vacated it, effectively reinstating the 1975 five-part test.[63]

> exercises any authority or control respecting management or disposition of its assets, (ii) he *renders investment advice for a fee* or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.

(Emphasis added).

60. *See* 29 C.F.R. § 2510.3-21(c)(1) (2020). The same day that this regulation was passed, the IRS passed an identical regulation that defined who was a fiduciary for IRAs. 26 C.F.R. § 54.4975-9(c) (2020).

61. Definition of the Term "Fiduciary"; Conflict of Interest Rule-Retirement Investment Advice, 81 Fed. Reg. 20,946 (Apr. 8, 2016) (codified at 29 C.F.R. pt. 2510) (vacated Mar. 15, 2018).

62. Definition of the Term "Fiduciary"; Conflict of Interest Rule-Retirement Investment Advice, 82 Fed. Reg. 12,319 (proposed Mar. 17, 2017) (delaying the 2016 Fiduciary Rule and other regulations).

63. *See* Chamber of Commerce of the United States v. U.S. Dep't of Labor, 885 F.3d 360 (5th Cir. 2018). On July 7, 2020, the DOL officially reimplemented the prior five-part test. Conflict of Interest Rule-Retirement Investment Advice: Notice of Court Vacatur, 85 Fed. Reg. 40,589 (July 7, 2020) (codified at 29 C.F.R. pts. 2509, 2510).

III. 2020 Changes

Over the past several decades, the DOL has not made many significant rules, changes, or proposals related to fiduciary conduct, other than the 2016 Fiduciary Rule.[64] However, the Trump administration took a starkly different approach. In the second half of 2020 alone, it made several significant changes. In June 2020, the DOL issued an Information Letter allowing private equity investments in defined contribution plans (the "Private Equity Information Letter").[65] The DOL also issued three new rules. In November 2020, it issued a rule clarifying what factors can and cannot be considered when selecting a plan investment (the "Financial Factors Rule").[66] The DOL then rushed to finalize two other rules. First, a rule regarding the fiduciary duties involved in proxy voting and shareholder rights for plan investments (the "Proxy Voting Rule").[67] Second, a rule that reinterprets parts of the five-part test and allows fiduciaries to qualify for certain prohibited transaction exemptions (the "Prohibited Transactions Exemption Rule").[68]

---

64. However, the DOL has, on several occasions, issued new interpretations or guidance (some of which are discussed in more detail later in this section). Additionally, in 2010 the DOL issued a rule proposal that would have changed the interpretation of a fiduciary, but it was ultimately abandoned and never became a final rule. It did, however, lay the groundwork for the 2016 Fiduciary Rule.

65. U.S. DEP'T OF LABOR, EMP. BENEFITS SEC. ADMIN., Information Letter (June 3, 2020) [hereinafter Information Letter].

66. Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72,846 (Nov. 13, 2020) (to be codified at 29 C.F.R. pt. 2550).

67. Fiduciary Duties Regarding Proxy Voting and Shareholders Rights, 85 Fed. Reg. 81,658 (Dec. 16, 2020) (to be codified at 29 C.F.R. pt. 2550) [hereinafter Proxy Voting Final Rule].

68. Prohibited Transaction Exemption 2020–02, Improving Investment Advice for Workers & Retirees, 85 Fed. Reg. 82,798 (Dec. 18, 2020) (to be codified at 29 C.F.R 2550).

A. Private Equity Information Letter

The June 3, 2020 Private Equity Information Letter sparked the DOL's flurry of activity.[69] In that letter, the DOL answered an inquiry as to whether private equity investments could be offered in defined contribution plans, such as a 401(k). After "coordinating its consideration of [the] request with the Chairman of the [SEC],"[70] the DOL answered this question in the affirmative, subject to certain restrictions. The DOL stated it would allow plans to give participants the option of investing in either a fund that invests a portion of its assets directly in private equity investments or a target-date fund[71] that invests in a private equity investment fund. However, in its answer, the DOL drew a distinction and did not approve of plan participants having the ability to invest directly in a private equity investment.

Private equity investments have always been common to defined benefit plans,[72] but they never made their way into defined contribution plans. Although allowing private equity investments may allow for further diversification and, potentially, increase returns,[73] the language used in the Private Equity Information Letter gives considerable insight as to the genesis

---

69. An Information Letter is the DOL's official response to an inquiry for interpretations under ERISA and its accompanying regulations. The letter "is informational only and is not binding on the department with respect to any particular factual situation." *Filing Requests For ERISA Advisory Opinions: ERISA Procedure 76-1*, EMP. BENEFITS SEC. ADMIN., Section 11, https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/advisory-opinions/filing-requests-for-erisa-aos (last visited Dec. 21, 2020).

70. Information Letter, *supra* note 65 at 1 n.1.

71. A target-date fund is a type of fund-of-funds, which invests its assets only in other mutual funds and changes the composition and weighting of its investments based on the fund's "target date" (year) for retirement. *Target-Date Funds*, INVESTOPEDIA, https://www.investopedia.com/terms/t/target-date_fund.asp (last visited Dec. 20, 2020).

72. *See* Information Letter, *supra* note 65, at 1 n.3 (referencing a 2018 study that found "defined benefit plans that invest in private equity investments hold, on average, 19% of their assets in private market investments").

73. The Private Equity Information Letter cites to studies that show the benefits to diversifying in private equity investments. *Id.* at 1 n.2 (referencing The Evolution of Target Date Funds: Using Alternatives to Improve Retirement Outcomes, Georgetown University Center for Retirement Initiatives, Policy Report 18-01 (June 2018)).

of the DOL's decision. The letter states that SEC Chairman Clayton "urged" the DOL to address this issue as it was "impeding" fiduciaries from considering private equity investments.[74] Based on this language, it appears that the DOL is being influenced by the SEC in allowing more capital to flow into private equity investments.[75]

B. Financial Factors Rule

As stated previously, ERISA fiduciaries have the responsibility to act with "care, skill, prudence, and diligence under the circumstances."[76] With the Financial Factors Rule, the Trump administration intended to use this standard to prevent environmental, social, and corporate governance ("ESG") investing. This new rule renders meaningless the intent of the DOL's original ruling in Interpretive Bulletin 94-1 ("IB 94-1"), issued in 1994. IB 94-1 states that "economically targeted investments" (what would today be called ESG investments) could only be invested in if returns from such investments were expected to be equal to alternative investments, with similar risks.[77] IB 94-1 was later replaced by Interpretive Bulletin 2008-01, which was then replaced by Interpretive Bulletin 2015-01. Yet, through all these iterations, the "emphasis on the primacy of plan participants' economic interests has stayed constant."[78]

---

74. *Id.* at 1 n.1.

75. In June 2019, the SEC issued a rule proposal to increase the number of individuals who would be considered "accredited investors" and thereby able to invest in private securities offerings. In the final ruling, the SEC stated that it was estimated that, prior to the rule change, 16 million households (representing approximately 13% of all households) qualified as accredited investors and although the SEC was "unable to provide more precise estimates of how many individuals will become newly eligible accredited investors," it estimated that up to an additional 4.3% of households may qualify. Accredited Investor Definition, 85 Fed. Reg. 64,234, 64261 (Oct. 9, 2020) (codified at 15 C.F.R. pts. 230, 240).

76. ERISA § 404(a)(1)(B).

77. *See* Financial Factors in Selecting Plan Investments, *supra* note 66, at 72,846 (summarizing IB 94-1).

78. *Id.* at 72,847.

In the Financial Factors Rule, the DOL reiterated its "longstanding and consistent position" that "non-pecuniary" factors may not be considered.[79] In making this rule, the DOL attempts to undermine the extent to which ESG factors may be considered when plan fiduciaries are making investment choices. On its face, this is not inherently a bad thing as maximizing financial benefits is central to the role of a fiduciary.[80] However, this fails to take into account that "[t]he preponderance of industry and academic studies have shown ESG investing does not inherently necessitate a sacrifice in returns versus an appropriate broad benchmark; and many have shown incorporating ESG factors leads to lower risks."[81]

C. Proxy Voting Rule

The Proxy Voting Rule was similarly meant to employ ERISA's fiduciary standards to further the Trump administration's goal of minimizing ESG investing. With this rule, the DOL seeks to "clarif[y]" how to satisfy ERISA's fiduciary standards when voting in proxies, by amending the Investment Duties regulation.[82] Like the Financial Factors Rule, guidance on this topic has gone through numerous changes over the past several decades.

Approximately 35 years ago, in an Opinion Letter to Avon Products, Inc., the DOL stated that the fiduciary duty to manage plan assets includes the responsibility of voting proxies.[83] This was commonly understood to mean that

---

79. *Id.*

80. *See* Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409 (2014) (stating that ERISA § 404(a)(1)(A)(i), which requires "providing benefits to participants," should be read as referring to "*financial* benefits" as opposed to "nonpecuniary benefits") (emphasis in original).

81. Fidelity Investments, Comment Letter on Proposed Rule Financial Factors in Selecting Plan Investments (July 30, 2020) https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95/00673.pdf (citing several studies showing the increased benefits of ESG investing).

82. Proxy Voting Final Rule, *supra* note 67, 81,684. ERISA's Investment Duties regulation is found at 29 C.F.R. § 550.404a-1.

83. U.S. DEP'T OF LABOR, Opinion Letter (Feb. 23, 1988).

fiduciaries had to vote in all proxies.[84] In the proposal for the Proxy Voting Rule, the DOL stated it was attempting to move away from "these continued fiduciary breaches."[85]

However, at its heart, the Proxy Voting Rule was simply advancing the Trump administration's agenda of derailing ESG goals. The proposal states:

> The [DOL] is now concerned that some fiduciaries and proxy advisory firms—in part relying on the Avon Letter—may be acting in ways that *unwittingly allow plan assets to be used to support or pursue proxy proposals for environment, social or public policy agendas that have no connection to increasing the value of investments used for the payment of benefits or plan administrative expenses*, and in fact may have unnecessarily increased plan expenses.[86]

(Emphasis added). The DOL even went so far as to say that "[i]t is likely that many of these proposals have little bearing on share value or other relation to plan interests."[87]

D. Prohibited Transactions Exemption Rule

Of all the rules passed by the DOL under the Trump administration, the Prohibited Transactions Exemption Rule was likely the most controversial and the greatest example of how the DOL was rather attempting to limit the fiduciary responsibilities imposed under ERISA and align its rules with the weaker standards set forth by the SEC. There are numerous types of transactions that are prohibited to ERISA fiduciaries.[88] However, the DOL can issue exemptions to these prohibited transactions, if the exemption is "(1) administratively feasible, (2) in the interests of the plan and of its participants and beneficiaries, and (3) protective of the rights of participants and beneficiaries of such plan."[89]

---

84. Fiduciary Duties Regarding Proxy Voting and Shareholders Rights, 85 Fed. Reg. 55,219, 55,220 (proposed Sept. 4, 2020) (citing articles that discus how the Avon Letter created a duty to vote in all proxies).

85. *Id*. at 55,223.

86. *Id*. at 55,222.

87. *Id.*

88. ERISA § 406.

89. *Id.* § 408(a); *see also* 26 U.S.C. § 4975(c)(1) (allowing the Secretary of the Treasury to issue exemptions to prohibited transactions).

Under the Prohibited Transactions Exemption Rule, the DOL grants an exemption to prohibited transactions if a Financial Institution[90] or Investment Professional[91] adheres to certain requirements. The Financial Institution or Investment Professional must (i) comply with Impartial Conduct Standards, (ii) provide written disclosures, prior to the transaction, acknowledging fiduciary status under ERISA or the Code, (iii) establish, maintain, and enforce written policies and procedures prudently designed to ensure compliance with the Impartial Conduct Standards, and (iv) conduct an annual retrospective review.[92]

The Impartial Conduct Standards has a four part test.[93] First, the advice must be in the "best interest" of the client, meaning that the financial institution or investment professional cannot place their own interest first, or subordinate the interest of the client to their own.[94] The DOL states that this "Best Interest Standard" is "based on longstanding concepts in [ERISA] and the high fiduciary standards developed under the common law of trusts."[95] While this statement suggests that the standard aligns with ERISA's fiduciary duty standard, it is misleading as it is almost immediately contradicted by language stating that the Best Interest Standard is to be "interpreted and applied consistently with the standard set forth" in the SEC's Regulation Best Interest

---

90. A Financial Institution is to be defined as including brokers, dealers, and RIAs. Prohibited Transaction Exemption 2020–02, Improving Investment Advice for Workers & Retirees, *supra* note 68, at 82,865.

91. An Investment Professional is to be defined as any Investment Advice fiduciary that is employed by a Financial Institution. *Id.* at 82,866.

92. *Id.*

93. The final rule states and lists the three parts to the Impartial Conduct Standard, however, it discusses at least one additional requirement that is not part of the list.

94. Advice will be considered in a client "Best Interest" if

> such advice reflects the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor, and does not place the financial or other interests of the Investment Professional, Financial Institution or any affiliate, related entity, or other party ahead of the interests of the Retirement Investor, or subordinate the Retirement Investor's interests to their own.

Id. at 82,865.

95. *Id.* at 82,821.

("Reg BI"),[96] which is *not* a fiduciary standard.[97] Second, the Financial Institution or Investment Professional must charge only reasonable compensation.[98] Third, the financial institution or investment professional must seek best execution for the transaction, given the circumstances.[99] The DOL states that these two standards will be met by adhering to already existing federal securities laws and regulations, such as FINRA Rules 2121 (Fair Prices and Commissions) and 5310 (Best Execution and Interpositioning).[100] Lastly, there can be no materially misleading statements about the transaction or relevant matters.[101]

The second prong for the exemption requires providing written disclosure, prior to the transaction, acknowledging fiduciary status in regard to the advice and a description of the service to be provided and any material conflicts of interest.[102] This requirement can be satisfied "through any disclosure, or combination of disclosures, required to be provided by other regulators so long as the disclosure required [by the proposal] is included."[103] This, presumably, is also referring to the requirements of Reg BI. The third prong requires implementing policies and procedures for mitigating conflicts and ensuring

96. *Id.* at 82,821.

97. In the final rule notice for Reg BI, the SEC stated that

> although our standard draws from key fiduciary principles, for various reasons, including to emphasize that Regulation Best Interest is tailored to the broker-dealer relationship and distinct from the investment adviser fiduciary duty, *we are not referring to Regulation Best Interest as a "fiduciary" standard, and we emphasize that Regulation Best Interest is separate from any common law analysis of whether a broker-dealer has fiduciary duties.*

Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318, 33,333 (July 12, 2019) (codified at 17 C.F.R. pt. 240) (emphasis added).

98. *Id.* at 82,863. This standard requires that the "compensation not be excessive, as measured by the market value of the particular services, rights, and benefits the Investment Professional and Financial Institution are delivering." *Id.* at 82,824.

99. *Id.* at 82,863.

100. *Id.* at 82,825.

101. *Id.* at 82,863.

102. *Id.*

103. *Id.* at 82,826.

compliance with the Impartial Conduct Standards.[104] The final requirement, an annual retrospective review, must be "reasonably designed to assist . . . in detecting and preventing violations of, and achieving compliance with, the Impartial Conduct Standards"[105] and is "based on FINRA rules governing how broker dealers supervise associated persons."[106]

IV. How the Regulatory Scheme Can be Improved

Since ERISA's passage in 1974, the financial industry has changed significantly, both generally and as it applies to retirement accounts. Where once defined benefit plans were the mainstay of retirement income, there are now significantly more defined contribution plans and IRAs holding the majority of participants' retirement assets. Despite the many changes in the financial markets, the law has yet to adequately catch up to provide adequate protections to investors. One way to create such protections would be to establish a unifying structure, overseen by an independent agency, ensuring all retirement plans are regulated in the same manner and shielded from the political whims of the executive branch.

A. Unifying the Regulations for All Types of Plans

When ERISA was passed, Congress was concerned with protecting retirees, due to a lack of vesting provisions in plans, termination of plans prior to them being fully funded, and inadequate disclosure and reporting of the financial wellbeing of plans.[107] This was at a time when retirement assets totaled only $370 billion, with defined benefit plans accounting for the largest portion, $130 billion.[108] Since then, retirement assets have increased almost a hundredfold. At the end of the third quarter of 2020, there was an estimated

104. *Id.* at 82,863.

105. *Id.*

106. *Id.* at 82,838.

107. ERISA § 2.

108. *Retirement Market, Third Quarter 2020*, INVESTMENT COMPANY INSTITUTE, https://www.ici.org/research/stats/retirement/ret_20_q3 (last visited Dec. 21, 2020) (historical data is found on the "The US Retirement Market, Third Quarter 2020" Microsoft Excel spreadsheet linked to at the bottom of the article).

$33.1 trillion of retirement assets, representing over one-third of all household assets.[109] Of the $33.1 trillion, approximately $11.3 trillion was held in IRAs, $9.3 trillion in defined contribution plans and $3.4 trillion in defined benefit plans.[110]

Despite that IRAs now hold over one-third of all retirement assets and that their underlying investments are similar to other types of retirement plans, they are not entitled to the heightened protections afforded by ERISA. When enacting ERISA, Congress expressed concerns regarding the "well-being and security of millions," which it found to be a "national public interest."[111] Those principles apply equally to IRAs. Because of the increased use of IRAs and a commensurate growth in their assets, there is a greater need for the unified regulation of retirement plans. Holding all financial professionals who work with plans, or have some form of control over their assets, to the same standards is paramount to the goal of investor protection.

B. Independent Agency as the Regulator

The DOL should no longer continue in its current role of administering and enforcing ERISA as its stance is subject to the political position of each presidential administration. Because the DOL is an executive agency serving under the executive branch, the Secretary is in fact the "alter ego" of the President.[112] Thus, any rules and guidance offered by the DOL are often directly influenced by the whims of the President. This results in plan fiduciaries needing to continually learn and adapt to new standards. It is also expensive to the investor participants (current or future retirees) that they serve because the increased costs to the fiduciaries are ultimately borne by the plans they serve. Because of this, the power ERISA has over the financial industry should be recognized and the agency in charge of its enforcement should be afforded the same shielding of presidential influence received by other securities regulators.[113]

---

109. *Id.*

110. *Id.*

111. ERISA § 2(a).

112. *See* Myers v. United States, 272 U.S. 52, 133 (1926).

113. The two main securities regulators are the SEC and the Commodities and Futures Trading Commission ("CFTC").

1. SEC as a Possibility

When ERISA was passed, jurisdiction of its four Titles was split between the DOL, the IRS, and the PBGC. But the SEC, the agency that had been regulating fiduciary conduct of RIAs under the Investment Advisers Act for almost 35 years,[114] was left out of this regulatory scheme. In 2017, it was even suggested by members of Congress and industry professionals that the SEC is best suited to craft rules regulating some ERISA fiduciaries.[115]

Granting the SEC, an independent regulatory agency, authority to administer and enforce fiduciary conduct, may lead to more stability and consistency in the rules. Since 1887, with the formation of the Interstate Commerce Commission, Congress has intended to shield independent agencies from the President's "coercive influence" when administering laws governing commerce, communications, and the capital markets.[116] Additionally, "[b]y insulating agencies from short-term political pressures, independent agencies with decision-making autonomy have the freedom to pursue legislated goals, resulting in a reduction in policy errors stemming from short-term temptations which imperil long-term objectives."[117] This shielding is usually accomplished through the use of set terms for members of a multi-

114. *See* Investment Advisers Act, 15 U.S.C. §§ 80b-1 to -21; SEC v. Capital Gains Research Bureau, *supra* note 56.

115. In 2017, during a Committee on Financial Services, U.S. House of Representatives hearing discussing the impact of the 2016 Fiduciary Rule, five financial industry representatives came together and (all but one) agreed with several members of the committee and testified that the SEC is the "expert regulator" and should craft rules regulating standards for individualized advice. *Impact of the DOL Fiduciary Rule on the Capital Markets: Hearing Before the Subcomm. on Capital Mkts., Secs., and Invs. of the H. Comm. on Fin. Servs.*, 115th Cong. 115-29 (2017).

116. Aulana L. Peters, *Independent Agencies: Governments Scourge or Salvation*, 1988 Duke L.J. 286 at 290-91 (1988) (quoting Morrison v. Olson, 487 U.S. 654 (1988)).

117. Valerie J. Pelton, *Agency Independence: A Case Study of the Federal Aviation Administration*, 19 Tex. Tech. Admin. L.J. 151 (2017) (internal quotations omitted).

member, bipartisan board[118] and for-cause removal protections.[119] Further, independent agencies are exempt from certain Executive Orders.[120]

However, simply granting the SEC jurisdiction over ERISA may not be enough. As discussed earlier, the standard of conduct that brokers, dealers, and RIAs are normally subjected to is inferior to that which ERISA requires. The SEC would more likely seek efficiency and converge the standards rather than hold different fiduciaries to different standards. A converged standard would likely not meet ERISA's fiduciary duties that are the "highest known to law."[121]

2. Separation of the EBSA from the DOL

Arguably, the DOL itself is an impactful securities regulator, given that ERISA grants it significant authority to regulate financial markets and securities professionals.[122] However, through its interpretive and enforcement powers over Title I of ERISA, it is the EBSA that is truly the regulator. Thus, another similar option would be to remove the EBSA as a subagency of the DOL. The EBSA could then be restructured as an independent regulatory agency, thus shielding it from the "coercive influence" of the President and allowing it to receive the protections afforded other securities regulators.[123]

---

118. *E.g.,* 15 U.S.C. § 78d(a) (2019) (creating a five-member commission for the SEC with each Commissioner serving a five-year term).

119. *E.g.,* Morrison v. Olson, 487 U.S. 654 (1988); Mistretta v. United States, 488 U.S. 361 (1989).

120. *E.g.,* Exec. Order No. 12,866, 58 Fed. Reg. 51,735 (1993). Executive Order 12866 requires centralized review of rulemaking by OIRA; however, as independent agencies are exempt from this process, the President does not have this review process to influence what the final rule may look like.

121. Tibble v. Edison Int'l, *supra* note 52.

122. *See* Anita K. Krug, *The Other Securities Regulator: A Case Study in Regulatory Damage*, 92 Tul. L. Rev. 339 (2017) (arguing that the DOL is "fundamentally shaping how the securities markets operate.").

123. In addition to the SEC, the CFTC plays a role in the regulation of financial markets. Like the SEC, the CFTC also has the characteristics of an independent regulatory agency, such as set terms for the Commissioners on its bipartisan Commission. 7 U.S.C. § 2(2) (2018),

Separating the EBSA would be preferable because there is more to ERISA than just the fiduciary conduct provisions. In Title I of ERISA, administered by the EBSA, there are also requirements regarding employer funding, plan disclosure, and the participation and vesting of employees, among other provisions,[124] that involve fiduciary duties.[125] By keeping the administration and enforcement of all of Title I within the EBSA, Congress' stated goals of "increas[ing] the efficiency of the operations of" agencies can be accomplished.[126] This solution will allow the EBSA, which has over 45 years of experience regulating fiduciary conduct and administering and enforcing the other equally important provisions of Title I, to remain at the helm.

V. Conclusion

The United States has come a long way since the first private pension was introduced in 1875. However, the laws regulating pension plans, and a growing number of other retirement plans, have not kept pace with the evolving changes in the financial industry. This situation is exacerbated by the DOL's recently enacted rules that are not meeting the high standard that ERISA imposes on its fiduciaries. This has led to different and disparate standards imposed on professionals managing retirement accounts. There needs to be a change in the way retirement accounts are regulated. The best way to do this may be to unify the law, so that all retirement plans are held to the same high standards that ERISA requires of plan fiduciaries. Further, there should be an independent regulator not subject to the whims of the executive branch, which enforces that law. The EBSA's role as a "securities regulator" needs to be recognized; and it should be separated from the DOL and become an independent regulatory agency, insulated from executive branch influence. In this way, the true goal of investor protection can be accomplished.

---

124. *See* ERISA §§ 2-514.

125. *E.g.*, 29 C.F.R. § 2550.404a-5.

126. 5 U.S.C. § 901(a)(3) (2018). One example of this already being applied to ERISA was with Reorganization Plan No. 4, *supra* note 48.

BUSINESS DEVELOPMENT COMPANIES – THE BASICS

Christine Lazaro[1]

Business Development Companies ("BDCs") are a type of closed end fund. They were created by Congress in 1980, through amendments to the Investment Company Act of 1940 (the "1940 Act").[2]

BDCs were first created when a venture capital pool manager lobbied Congress to make it easier to invest in venture capital pools and private equity investments.[3] While there was early interest in BDCs, their popularity waned through the 1990s.[4] Since 2000, they have once again regained their popularity.[5]

BDCs provide funding to small and mid-sized businesses. Following the financial crisis, BDCs were able to provide loans to businesses that may not have been able to receive financing from more traditional sources.[6] In 2009, the first non-traded public BDCs were issued, raising almost $100 million that year.[7]

This article will describe the regulations that govern BDCs: federal, state, and SRO. Next, the article will examine recent enforcement actions concerning the sale of BDCs by broker-dealers. Finally, the article will discuss concerns raised by the sale of non-traded BDCs to investors.

---

1. Christine Lazaro is a Professor of Clinical Legal Education and the Director of the Securities Arbitration Clinic at St. John's University School of Law=. The author wishes to thank David Marron ('20, St. John's University School of Law) for his research assistance with this article.

2. Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980).

3. *See* Matt Forstenhausler, *Business development companies in the spotlight*; EY (2012), https://us.eversheds-sutherland.com/portalresource/RecentAccounting andTaxDevelopments.

4. *Id.*

5. *Id.*

6. *Id.*

7. *See* Bruce Kelly, *Nontraded BDC Sales in Worst Year Since 2010*, INVESTMENT NEWS (Nov. 22, 2017), https://www.investmentnews.com/article/20171122/FREE/171129954/nontraded-bdc-sales-in-worst-year-since-2010.

I. BDC Structure and Regulation

a. Federal Securities Acts

BDCs are defined in the 1940 Act as closed end funds that meet certain criteria.[8] BDCs must elect to be regulated by the SEC as a business development company,[9] and are restricted in terms of the types of investments the fund may make, with at least 70% of the fund assets invested in "eligible" assets.[10] Eligible assets may include "a domestic issuer that either does not have any class of securities listed on a national securities exchange, or has a class of equity securities listed on a national securities exchange, but has an aggregate market value of outstanding voting and non-voting common equity of less than $250 million."[11]

BDCs must register their securities with the SEC under the Securities Exchange Act of 1934.[12] BDCs may be public exchange traded or non-traded securities, or they may be offered as private offerings. As public companies, BDCs are still required to make the appropriate filings with the SEC on a regular basis whether they are traded or non-traded.[13]

b. Internal Revenue Code

BDCs may elect to be treated as a "regulated investment company" ("RIC") under the Internal Revenue Code.[14] To qualify as an RIC, the BDC must meet three main requirements. First, the BDC must derive at least 90% of its income from dividends, interest, gains from the sale or exchange of securities and other qualifying income associated with the business of

8. *See* 15 U.S.C. § 80a-2(48).

9. *See* 15 U.S.C. § 80a-53.

10. *See* 15 U.S.C. § 80a-54.

11. Kevin Mahn, *The ABCs of Business Development Companies*, FORBES (Dec. 1, 2014), https://www.forbes.com/sites/advisor/2014/12/01/the-abcs-of-business-development-companies/#523304f969db.

12. *See* 15 U.S.C. § 80a-53.

13. *See* Fortenhausler, *supra* note 3. A BDC may register as a private placement as well; however, this paper will focus on public BDCs.

14. *See* 26 U.S.C. § 851.

investing in securities.[15] Second, BDCs must invest at least 50% of its assets in cash items, securities of other RICs, government securities or other securities. However, any investment in any one security may not exceed 5% of the BDC's total assets, and may not be more than 10% of the outstanding voting shares of any single issuer.[16] A BDC may not invest any more than 25% of its assets in (1) any single issuer (other than US Government securities or other RICs); (2) any two or more issuers controlled by the BDC and engaged in the same or similar businesses; or (3) one or more "qualified publicly traded partnerships."[17] Finally, the BDC must distribute at least 90% of its annual taxable income to shareholders as dividends.[18] The benefit of qualifying as an RIC is the exemption of corporate level taxes.

c. FINRA Rules

Under the FINRA rules, BDCs are regulated as Direct Participation Plans or Programs ("DPPs").[19] DPPs are any "program which provides for flow-through tax consequences regardless of the structure of the legal entity or vehicle for distribution. . ."[20] There are a number of different types of DPPs, including MLPs and REITs.

Broker-dealers are not permitted to underwrite or participate in a public offering of a BDC unless certain conditions have been met, including both the BDC and the broker-dealer establishing suitability standards; the broker-dealer making certain disclosures; and the BDC having reasonable expenses.[21] These conditions are described in further detail below.

The BDC itself must have established standards of suitability which are disclosed in the program's prospectus.[22] In addition to the broad suitability

---

15. *See* 26 U.S.C. § 851(b)(2).

16. *See* 26 U.S.C. § 851(b)(3)(A).

17. *See* 26 U.S.C. § 851(b)(3)(B).

18. *See* 26 U.S.C. § 852.

19. *See Direct Participation Program (DPP)*, INVESTOPEDIA, https://www.investopedia.com/terms/d/dpp.asp (last visited Apr. 23, 2021).

20. FINRA Rule 2310.

21. *See* FINRA Rule 2310(b).

22. *See* FINRA Rule 2310(b)(2)(A).

requirements contained within FINRA Rule 2111[23] or the care obligations contained within Regulation Best Interest,[24] a broker must also satisfy the stricter suitability rules for selling non-traded DPPs if recommending a non-traded BDC, which may go beyond those set forth by the BDC itself.[25] For example, the broker must have reasonable grounds to believe that the customer is "in a financial position appropriate to enable him to realize to a significant extent the benefits described in the prospectus, including the tax benefits where they are a significant aspect of the program;" and that the customer has the net worth to sustain the level of risk in the BDC, including the loss of the investment and the lack of liquidity.[26] There is also a books and record requirement; the broker must maintain documents that explain how suitability was determined for each customer.[27]

If a broker-dealer is planning on participating in a public offering of a BDC, it must "have reasonable grounds to believe, based on information made available to him by the sponsor through a prospectus or other materials, that all material facts are adequately and accurately disclosed and provide a basis for evaluating the program."[28] The broker-dealer must receive at a minimum, facts relating to: "(i) items of compensation; (ii) physical properties; (iii) tax aspects; (iv) financial stability and experience of the sponsor; (v) the program's conflict and risk factors; and (vi) appraisals and other pertinent reports."[29]

When recommending the purchase of a BDC, the broker must tell the customer "all pertinent facts relating to the liquidity and marketability of the program."[30] Pertinent facts include whether the sponsor of the BDC has offered prior programs that had a planned liquidation date and whether the prior programs actually liquidated during that time period.[31]

---

23. FINRA Rule 2111 applies to recommendations to purchase BDCs made prior to June 30, 2020.

24. *See* Regulation Best Interest, 17 C.F.R. § 240.15l-1 (2021). The Regulation Best Interest care obligations apply to recommendations made on or after June 30, 2020.

25. *See* FINRA Rule 2310(b)(2)(B).

26. *See id.*

27. *See id.*

28. FINRA Rule 2310(b)(3).

29. FINRA Rule 2310(b)(3)(B).

30. FINRA Rule 2310(b)(3)(D).

31. *See id.*

Brokers are also required to consider the expenses of the BDC if it is participating in the underwriting or public offering of the program. Brokers may not participate if the organization and offering expenses are not fair and reasonable.[32] FINRA provides guidance for firms, explaining that the expenses are unfair and unreasonable if: (i) the organization and offering expenses exceed 15% of the gross offering amount; (ii) total compensation exceeds 10% of the proceeds; (iii) compensation is to be paid out of the proceeds of the offering before the proceeds are released from escrow; (iv) compensation includes any of the following: a percentage of the management fee, a profit sharing arrangement, brokerage commissions, an over-riding royalty interest, a net profits interest, a percentage of revenues, a reversionary interest, a working interest, a security or right to acquire a security having an indeterminate value; (v) the program charges to reinvest dividends; or (vi) firms are reimbursed for due diligence expenses no included in a detailed and itemized invoice.[33]

FINRA also restricts the non-cash compensation that a broker or broker-dealer may receive for selling BDCs. FINRA does permit the following types of non-cash compensation: (i) gifts that do not exceed $100 and are not conditioned on achievement of a sales target; (ii) an occasional meal or event ticket so long as they are not frequent or extensive; and (iii) payment for training or educational meetings so long as attendance is not conditioned on achievement of a sales target and the location is appropriate for the purpose of the meeting – meaning it cannot be in an exotic locale.[34]

FINRA has also expressed concerns about the valuation of BDCs on customer account statements. In 2014, FINRA filed a proposed rule change with the SEC to address this issue.[35] In October 2014, the SEC approved the proposal.[36] In its approval, the SEC stated:

> The proposal, as amended, is designed to address longstanding concerns with the current industry practice of displaying a DPP [BDC] or REIT security's immutable offering price as its per share estimated

32. *See* FINRA Rule 2310(b)(4)(A).

33. *See* FINRA Rule 2310(b)(4)(B).

34. *See* FINRA Rule 2310(c)(2).

35. *See* Notice of Filing of Proposed Rule Change Relating to Per Share Estimated Valuations for Unlisted DPP and REIT Securities, 79 Fed. Reg. 9,535 (Feb. 19, 2014).

36. *See* Order Approving SR-FINRA-2014-006, as Modified by Amendment No. 1, 79 Fed. Reg. 62,489 (Oct. 17, 2014).

> value on customer account statements throughout the offering period (which can last several years), despite the fact that the value of the DPP [BDC] or REIT security fluctuates. FINRA's proposed rule change would require members to include in customer account statements per share estimated values of unlisted DPP [BDC] and REIT securities that are developed in a manner reasonably designed to ensure they are reliable. The Commission believes that the proposal would, therefore, greatly improve the accuracy and transparency of the value of DPP [BDC] and REIT securities and, in turn, better protect the investing public.[37]

Under the amended rule, firms may only report values of BDCs based on one of two methodologies: (1) the net investment value; or (2) the appraisal value. The net investment methodology provides that, within 150 days of the second anniversary of the program breaking escrow, the firm may use the "net investment" value disclosed by the issuer's most recent periodic or current report.[38] For the appraisal value methodology, the firm may use a per share estimated value reflecting an appraised valuation disclosed in the issuer's most recent periodic or current report, which is consistent with the valuation requirements of the 1940 Act and the rules thereunder.[39]

In addition to the valuation methodologies, broker-dealers also have disclosure obligations. If the firm is using the "net investment" methodology, the firm must include the following statement: "IMPORTANT—Part of your distribution includes a return of capital. Any distribution that represents a return of capital reduces the estimated per share value shown on your account statement."[40] The broker-dealer must also disclose that the BDC is "not listed on a national securities exchange, are generally illiquid and that, even if a customer is able to sell the securities, the price received may be less than the per share estimated value provided in the account statement."[41]

Although the rule amendment was approved in October 2014, it was not effective until April 11, 2016.[42] As a result of this amendment, non-traded

37. *Id.* at 62,491.

38. *See* FINRA Rule 2231(c)(1)(A).

39. *See* FINRA Rule 2231(c)(1)(B).

40. FINRA Rule 2231(c)(2).

41. *Id.*

42. *See* FINRA Reg. Notice 15-02, *DPP and Unlisted REIT Securities; SEC Approves Amendments to FINRA Rule 2310 and NASD Rule 2340 to Address Values*

BDCs were revalued on customer account statements by April 2016, sometimes resulting in sharp drops in their valuations, which had been otherwise consistent since purchase.

d. NASAA Guidance

NASAA, the North American Securities Administrators Association, "formulates Model Rules and Statements of Policy for implementation by its members as an ongoing priority to promote and encourage uniformity among its members in the interest of investor protection and to provide a regulatory framework for responsible capital formation."[43] Although NASAA has not adopted a Statement of Policy specifically for BDCs, it has adopted Omnibus Guidelines, which apply to any securities for which NASAA has not developed a specific policy statement.[44]

The Omnibus Guidelines set forth a number of requirements that must be met for a BDC to comply with state blue sky laws. For example, the Omnibus Guidelines mandate a minimum amount of experience that a Sponsor of the BDC must have.[45] The Sponsor must have "at least three years relevant

---

of Direct Participation Program and Unlisted Real Estate Investment Trust Securities (Jan. 2015), https://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-02.pdf.

43. *Regulatory Policy*, NASAA, https://www.nasaa.org/policy/regulatory-policy/ (last visited Apr. 23, 2021).

44. *See Omnibus Guidelines*, NASAA (May 7, 2007), https://www.nasaa.org/wp-content/uploads/2011/07/f-Omnibus_Guidelines.pdf.

45. Sponsor is defined within the Omnibus Guidelines as:

> Any PERSON directly or indirectly instrumental in organizing, wholly or in part, a PROGRAM or any PERSON who will control, manage or participate in the management of a PROGRAM, and any AFFILIATE of such PERSON. Not included is any PERSON whose only relation with the PROGRAM is that of an independent manager of a portion of PROGRAM assets, and whose only compensation is as such. "SPONSOR" does not include wholly independent third parties such as attorneys, accountants, and underwriters whose only compensation is for professional services rendered in connection with the offering of PROGRAM INTERESTS. A PERSON may also be deemed a SPONSOR of the PROGRAM by:
>
> > (a) taking the initiative, directly or indirectly, in founding or organizing the business or enterprise of the PROGRAM, either alone or in conjunction with one or more other PERSONS;

experience demonstrating the knowledge and experience to acquire and manage the type of assets being acquired."[46] With respect to net worth, the Sponsor must have a net worth that is the greater of either (i) $100,000, or (ii) 5% of the first $20 million of this offering and any DPP offerings within the prior 12 months, and 1% of any amount in excess of $20 million.[47]

The Omnibus Guidelines also set forth program suitability requirements, requiring that investors have (i) a minimum annual income of $70,000 and a minimum net worth of $70,000; or (ii) a minimum net worth of $250,000.[48]

Both the Sponsor and the broker must determine that the BDC is a suitable and appropriate investment for the investor.[49] The suitability requirements are similar to those set forth by FINRA Rule 2310. Either the Sponsor or the broker must determine that the prospective investor (i) meets the minimum income and net worth standards; (ii) can benefit from participation in the program; (iii) is able to bear the economic risk of the investment; and (iv) understands the risks of the investment, including that the investor may lose their investment, the lack of liquidity, the restrictions on transferring the BDC, and the tax consequences.[50]

The Omnibus Guidelines also set forth content requirements and restrictions with respect to the BDC's subscription agreements. For example, the Sponsor may require that an investor make the following representations in the subscription agreement: (i) the investor meets the income and net worth

---

> (b) receiving a material participation in the PROGRAM in connection with the founding or organizing of the business of the PROGRAM, in consideration of services or property, or both services and property;
>
> (c) having a substantial number of relationships and contacts with the PROGRAM;
>
> (d) possessing significant rights to control PROGRAM properties;
>
> (e) receiving fees for providing services to the PROGRAM which are paid on a basis that is not customary in the industry; or
>
> (f) providing goods or services to the PROGRAM on a basis which was not negotiated at arm's length with the PROGRAM.

Id. § I.B.27.

46. *See id.* § II.A.

47. *See id.* § II.B.

48. *See id.* § III.B.1.

49. *See id.* § III.C.1.

50. *See id.* § III.C.2.

standards; (ii) the investor has received a copy of the prospectus; and (iii) the investor knows the investment is illiquid.[51]

The Sponsor may not require that investor make any representations which are "subjective or unreasonable" that would cause the investor to believe they have given up rights they have under federal or state law, or shift the burden to determine suitability to the investor.[52] Additionally, the Sponsor may not require that the investor make any of the following representations: (i) the investor understands or comprehends the risks associated with the investment; (ii) the investment is suitable; (iii) the investor has read the prospectus; or (iv) the investor relied solely on the prospectus and not any representations from any person (such as the broker).[53]

Finally, Sponsors may earn reasonable management compensation; however, for BDCs, such compensation is limited to participation of net gains.[54]

Many states' blue sky regulations contain an explicit adoption of the NASAA Statements of Policy. For example, Kansas adopted the Omnibus Guidelines as well as a number of other statements.[55] Certain states, including Kansas, have also adopted additional suitability requirements:

> In addition to the income and net worth standards and other suitability requirements contained within the NASAA guidelines and statements of policy adopted under subsection (b), the administrator may require that the registration statement include a statement that recommends or requires each purchaser to limit the purchaser's aggregate investment in the securities of the issuer and other similar investments to not more than 10 percent of the purchaser's liquid net worth. For purposes of this subsection, liquid net worth shall be defined as that portion of the purchaser's total net worth that is comprised of cash, cash equivalents, and readily marketable securities, as determined in conformity with GAAP.[56]

It is important to check the relevant state's blue sky regulations to determine whether the NASAA Omnibus Guidelines apply to the purchase of a particular BDC.

---

51. *See id.* § III.D.2.

52. *See id.* § III.D.4.

53. *See id.* § III.D.5.

54. *See id.* § IV.D.2.(a).

55. *See* KAN. ADMIN. REGS. § 81-7-2(b)(10).

56. KAN. ADMIN. REGS. § 81-7-2(c).

II. BDC Enforcement Actions

There are not many enforcement actions related to the sale of BDCs due to their relatively recent increase in popularity. However, in 2016, FINRA issued a targeted examination letter seeking information from firms regarding their sales of non-traded BDCs and their due diligence practices.[57] FINRA requested information about the BDCs each firm sold; the firm's role in the offering; which other broker-dealers had selling agreements for the BDCs; how many customers purchased the BDC; and the firm's due diligence procedures.[58] Additionally, in 2014, FINRA conducted a review of firms selling non-traded REITs and BDCs to ensure customers had received volume discounts.[59] FINRA has not released the results from these examinations and reviews.

In addition to the targeted examinations and reviews, FINRA has also fined several firms for their BDC sales practices. Two FINRA enforcement actions focused on issues with concentration limits. First, FINRA fined Berthel Fisher $775,000 in part because it did not have adequate procedures to ensure the firm complied with concentration levels for BDCs. Berthel did not appropriately identify BDCs as alternative investments for purposes of calculating the account concentration levels. [60] It also did not train its supervisory staff to analyze state suitability standards.[61]

FINRA also fined LPL $950,000 in part for failing to have adequate procedures to ensure the firm complied with both internal concentration limits, as well as limits set by the BDCs or the states.[62] LPL was also fined by the

---

57. *See* Press Release, FINRA, Targeted Examination Letter on Non-Traded Business Development Companies (Aug. 2016), https://www.finra.org/rules-guidance/guidance/targeted-exam-letter/non-traded-business-development-companies.

58. *See id.*

59. *See* Gopi Krishna Vungarala, Disciplinary Proceeding No: 2014042291901, 11, NAC Decision (FINRA Oct. 2, 2018), http://www.finra.org/sites/default/files/NAC_2014042291901_Vungarala_100218_0.pdf.

60. *See* Berthel Fisher & Company Financial Services, Inc. and Securities Management & Research, Inc., Disciplinary Proceeding No. 2012032541401, Letter of Acceptance, Waiver and Consent (FINRA Dec. 2013), http://www.finra.org/sites/default/files/fda_documents/2012032541401_FDA_DM7X1975.pdf.

61. *See id.*

62. *See* LPL Financial LLC, Disciplinary Proceeding No. 2011027170901, Letter of Acceptance, Waiver and Consent (FINRA Jan. 2014), http://www.finra.org/sites/

Arkansas Securities Commissioner because it inconsistently classified non-traded BDCs and REITs as equities rather than alternative investments.[63]
The final case concerns sales of non-traded REITs and BDCs to a Native American Tribe. With respect to the firm, Purshe Kaplan Sterling Investments (PKS), FINRA found that:

> FINRA found that from July 2011 through at least January 15, 2015, [Gopi Krishna] Vungarala was the tribe's PKS registered representative and also the tribe's Treasury Investment Manager responsible for managing the tribe's investment portfolio. PKS failed to adequately review the risks inherent in that relationship or establish procedures designed to mitigate the risks. FINRA found that as a result of these supervisory failures, Vungarala was able to misrepresent to the tribe that neither PKS nor he would receive commissions on its purchases, and he was therefore able to induce the tribe to invest more than $190 million in non-traded REITs and BDCs. In fact, Vungarala personally received at least $9 million in commissions from the tribe's investments.
>
> FINRA also found that PKS failed to identify that more than 200 of the tribe's purchases were eligible for discounts based on the volume of the purchases. FINRA found that Vungarala's commissions would have been reduced to approximately $6 million if the tribe received the volume discounts for which it was eligible; however, Vungarala misrepresented to PKS that the tribe did not want to receive the volume discounts. PKS failed to take reasonable steps to verify this statement even after it received inquiries about the missed discounts from a REIT issuer and FINRA staff.
>
> In addition, FINRA found that, between April 2009 and October 31, 2014, PKS failed to maintain and enforce an adequate supervisory system and written supervisory procedures to ensure compliance with the securities laws and FINRA rules when it sold non-traded REITs and BDCs. PKS did not have procedures that were reasonably designed to identify accounts that were eligible for volume discounts, and did not provide any guidance to its representatives or supervisors

---

default/files/fda_documents/2011027170901_FDA_D823266.pdf.

63. *See* In the Matter of LPL Financial LLC, Case No. S-16-0069 (Ark. Sec. Comm'r Jan. 2019), http://www.securities.arkansas.gov/!userfiles/LPL%20Financial%20 LLC%20S-16-0069-19-OR02(1).pdf.

regarding how to ensure that the sales volume discounts were applied appropriately.[64]

FINRA fined the firm $750,000 and ordered restitution in the amount of $3,373,303.68.[65] Additionally, FINRA barred the broker for the fraudulent misrepresentations and omissions he made with respect to his receipt of commissions on the trades, and the Tribe's eligibility to receive volume discounts.[66] FINRA also ordered that the broker disgorge the $9,682,629 he received in commissions on the trades.[67]

In 2021, FINRA issued a regulatory notice reminding firms of their obligations to ensure customers receive sales charge discounts and waivers, often based on volume.[68] FINRA noted that non-traded BDCs may offer volume discounts.[69] FINRA also pointed out that the initial threshold to receive such a discount was often substantially higher than that of a mutual fund, with the thresholds being between $150,000 and $500,000.[70] Following its examinations and from its insight into enforcement actions, FINRA found that firms had failed to establish or maintain supervisory systems designed to identify customers eligible for such discounts.[71] For example, FINRA found that firms had not identified applicable volume discounts and did not have systems in place to identify customers eligible for discounts.[72] Moreover,

---

64. Press Release, FINRA, FINRA Orders Purshe Kaplan Sterling Investments to Pay $3.4 Million in Restitution to Native American Tribe; Firm Also Fined $750,000 for Failures to Supervise (Feb. 22, 2017), https://www.finra.org/media-center/news-releases/2017/finra-orders-purshe-kaplan-sterling-pay-34-million-native-american; Dep't of Enforcement v. Purshe Kaplan Sterling Investments and Gopi Krishna Vungarala, Disciplinary Proceeding No. 2014042291901, Order Accepting Offer of Settlement (FINRA Feb. 21, 2017), http://www.finra.org/sites/default/files/PKSI_action_022217.pdf.

65. *See id.*

66. *See supra* note 59 at 45.

67. *See id.*

68. *See* FINRA Reg. Notice 21-07, *FINRA Provides Guidance on Common Sales Charge Discounts and Waivers for Investment Company Products* (Mar. 4, 2021), https://www.finra.org/rules-guidance/notices/21-07.

69. *See id.* at 2.

70. *See id.*

71. *See id.* at 4.

72. *See id.*

FINRA found that firms that did not implement such procedures also did an inadequate job of supervising broker's recommendations for compliance with suitability.[73] These deficiencies were compounded when firms allowed brokers to sell funds that were held directly with the funds' transfer agents.[74] The notice set forth questions a firm can ask to evaluate the adequacy of its supervisory system.[75]

III. BDC Concerns

Non-traded BDCs raise many of the same concerns as non-traded REITs. BDCs are structured very similarly to REITs, both a form of DPP. They have high costs, liquidity concerns, and transparency issues.[76] BDCs are raising less money each year. When non-traded BDCs were first sold in 2009, they raised almost $100 million.[77] The following year, sales more than tripled to $369 million. Non-traded BDCs hit their peak in 2014, raising $5.5 billion. In 2020, broker-dealers sold only $362.3 million of non-traded BDCs, the lowest volume since 2010.[78]

Non-traded BDCs, like non-traded REITs, have high expenses. Broker-dealers may receive 10% of the offering proceeds for selling shares,[79] making them a very lucrative investment for the firm. Under the FINRA rules, the startup costs are considered unreasonable if they exceed 15%, so it is not unusual to see such high levels of initial expenses. This means that for a $10 investment, only $8.50 is being invested.

When FINRA changed the statement valuation rules in 2016, this affected both non-traded BDCs and non-traded REITs. Overnight, investors saw the values of their holdings decline, sometimes dropping 15% or more. In

---

73. *See id.*

74. *See id.* at 5.

75. *See id.* at 6-10.

76. *See* Daniel Kurt, *What Are Nontraded BDCs?*, INVESTOPEDIA (Oct. 24, 2018), https://www.investopedia.com/articles/retirement/051616/what-are-nontraded-bdcs-and-should-you-stay-away-them.asp.

77. *See* Kelly, *supra* note 7.

78. *See* Bruce Kelly, *BDC sales tank in 2020 after product performs poorly*, INVESTMENT NEWS (Feb. 3, 2021), https://www.investmentnews.com/bdc-sales-tank-in-2020-after-product-performs-poorly-202270.

79. *See* Kelly, *supra* note 7.

anticipation of this rule change, "shareholders withdrew $25.7 million from non-traded BDCs in the second quarter of 2015 and another $47.3 million in the third quarter."[80] Some BDCs, such as Business Development Corp. of America, froze redemptions.[81]

Both non-traded BDCs and REITs also suffer similar liquidity concerns. They do not trade on an exchange, so beyond the redemption programs offered by the BDC itself, there may be limited opportunities to sell shares on a secondary market. As stated above, the redemption programs are also often subject to suspension. The BDCs often hold illiquid investments, so there are limitations on redemptions built into the prospectus. Accordingly, if a BDC suspends redemptions, investors may be stuck holding the BDC for years.

Non-traded BDCs may also retain discretion as to the payment of interest. While BDCs are obligated to pay out 90% of their taxable income to retain their status as RICs, if it is an unprofitable year, there may be no income to pay out. Distributions may be suspended, leaving investors with an illiquid investment that is not generating any yield at all.

CONCLUSION

BDCs have been around for decades, but they were not used much during the 1990s and only recently have surged in popularity. Although BDCs are closed-end funds, they are very similar to non-traded REITs. As the recent enforcement actions demonstrate, non-traded BDCs and non-traded REITs raise many of the same concerns. Although they may appear to be high yield investments, they come with a lot of risks.

80. *See id.*

81. *See id.*

2021 UPDATED STUDY ON FINRA EXPUNGEMENTS: A SERIOUSLY FLAWED PROCESS THAT SHOULD BE FIXED NOW TO PROTECT THE INTEGRITY OF THE PUBLIC RECORD

David P. Meyer, Jason R. Doss, and Lisa Braganca
On Behalf of PIABA and The PIABA Foundation

ABOUT THE GROUPS AND ACKNOWLEDGMENTS

The Public Investors Advocate Bar Association is an international bar association whose members represent investors in disputes with the securities industry. Currently, there are members from 44 states, Puerto Rico, and Japan. The mission of PIABA is to advocate for equal access to justice for investors in all forums. PIABA works to promote fairness in the rules governing dispute resolution for investor claims against securities and commodities brokerage firms, registered investment advisory firms, and their associated representatives. PIABA also works toward creating, improving, and enforcing statutes, rules, regulations, case law, and policies designed to promote investor rights and to prevent misconduct by those who sell investments to the public. www.piaba.org @piabanews

The PIABA Foundation is a 501(c)(3) charitable organization that was formed in 2012 by attorneys who are devoted to representing investors in disputes with brokers and brokerage firms in FINRA arbitrations. The Foundation's mission is to promote investor protection through investor education. The Foundation's research and work to release this Study was performed by attorney volunteers with experience in representing parties in FINRA's arbitration process and the funds to purchase the data for this Study were paid for through charitable donations. The Foundation would like to thank our donors for making this important Study a reality.

PIABA and the PIABA Foundation would like to thank Peter Mougey, Richard Frankowski, Jennifer Shaw, Richard Lewins, Sam Edwards and Thomas Mauriello as well as the members of the PIABA Board for your input and support. Special thanks to Michael Edmiston and Benjamin P. Edwards for your input and edits. Also special thanks to the students in the 2021 Public Policy Clinic at the University of Nevada, Las Vegas William S. Boyd School of Law for sharing insights they gained by representing non-party customers in expungement hearings.

BROKERCHECK AND EXPUNGEMENT

FINRA's BrokerCheck tool provides critical information about brokers that helps investors make informed decisions about who they allow to manage their life savings. Accurate and complete complaint history on brokers is also critical to preserve the ability of state and federal securities regulators to identify bad brokers to help these regulators perform their regulatory functions.

For years, PIABA and the PIABA Foundation ("Foundation") have documented and studied how FINRA's expungement arbitration process has allowed brokers and brokerage firms to erase valid complaints from their publicly available complaint histories. The findings of those studies are documented in reports published in 2013, 2019, and now in 2021.

In 2013, PIABA released a report that analyzed approximately 1,600 arbitration awards rendered in cases initiated by investors against brokerage firms and/or brokers for cases filed during the five-year time period between January 1, 2007 and December 31, 2011. Most of these arbitration awards were rendered by a panel of three arbitrators and expungement requests were made in the underlying customer arbitrations. That "2013 Study" showed that arbitrators granted expungement requests approximately 90% of the time ("2013 Study"). A copy of PIABA's 2013 Study can be found on the Foundation's website at www.piabafoundation.org.

At that time, brokers and brokerage firms were gaming the expungement process by conditioning settlements with investors on their agreement not to oppose expungement requests in the underlying customer disputes. PIABA recommended that FINRA prohibit its members from conditioning settlements on investors' agreement not to oppose expungements. PIABA also recommended that FINRA provide additional arbitrator training to try and solve the problem of arbitrators granting expungement requests too frequently.

2013 AND 2019 FINDINGS & FINRA CHANGES

After the release of the 2013 Study, FINRA changed the rules to prohibit its members from conditioning settlement on an investor's agreement not to oppose subsequent expungement requests. FINRA's current guidance on expungements states in pertinent part:

Effective July 30, 2014, FINRA Rule 2081 prohibits firms and registered representatives from conditioning settlement of a customer dispute on—or otherwise compensating a customer for—the customer's agreement to consent to, or not to oppose, the firm's or representative's request to expunge such information from CRD.[1]

FINRA also committed to provide additional expungement training to arbitrators to try and ensure only appropriate expungement requests were granted, thus reducing the number of expungements being granted. Additional training did not work. Moreover, brokers and brokerage firms found new ways to game the expungement process.

In October 2019, the Foundation released a study which examined 1,078 expungement arbitration awards from January 1, 2015 to July 31, 2019 ("2019 Study"). The 2019 Study found that beginning in 2014-2015, brokers changed tactics from requesting expungement in underlying customer arbitrations to waiting until the conclusion of customers' dispute and filing a new separate arbitration solely against their brokerage firm requesting expungement of the customer claims, i.e., straight-in expungements. A straight-in expungement case is an arbitration initiated by a broker against their current or former brokerage firm solely for the purpose of seeking expungement. The customer who made the complaint is not a party.

Brokers and brokerage firms also started gaming FINRA's arbitration process by including a bogus demand for $1.00 in damages to reduce the number of arbitrators considering expungement requests from a panel of three arbitrators to a single arbitrator. The "$1.00 trick" also saved brokers and brokerage firms thousands of dollars per case. The 2019 Study found that by allowing its members to file these cases, FINRA lost over $6 million in revenue.

The 2019 Study also found that not much had changed: brokers requested that over 2,000 customer complaints be expunged from their records and arbitrators granted those requests in over 80% of the cases. Clearly, despite more training, expungement requests were not treated as an extraordinary remedy.

SUMMARY OF 2021 UPDATED STUDY FINDINGS

PIABA and the Foundation provide this updated Study ("2021 Updated Study"), which analyzes seven hundred (700) additional expungement awards from August 1, 2019 to October 31, 2020.

The results are clear. Arbitrators have continued to grant expungement requests 90% of the time, and the data shows that FINRA's arbitration process

1. See https://www.finra.org/arbitration-mediation/notice-arbitrators-and-parties-expandedexpungement-guidance.

allows brokers and brokerage firms to make expungement requests to arbitrators that are unopposed the vast majority of the time.

FINRA's expungement process does not provide those with an interest in the outcome of the expungement request, e.g., securities regulators and the customers who submitted the complaints, a meaningful opportunity to present evidence opposing expungement when appropriate.

The solution is simple. To effectively prevent expungements of valid customer complaints, FINRA must provide a meaningful opportunity for those with an interest in the outcome of the expungement request, e.g., securities regulators and the customers who submitted the complaints, to present evidence opposing expungement, when appropriate. FINRA's current expungement arbitration process provides no notice to state regulators until after an award granting expungement is issued and broker seeks to have a final arbitration award confirmed by a court of law. In addition, FINRA's arbitration rules do not provide a way for state regulators to participate in the expungement arbitration where they can review the validity of the claim and present evidence opposing the expungement request.

While the current expungement process provides notice to customers so they can appear, it does not have safeguards to ensure that customers can participate in a meaningful way.

While FINRA's current rule proposal purports to stop some of the abusive tactics used by brokers and brokerage firms in the arbitration proceedings that were identified in the 2019 Study, the proposed changes will not decrease the high percentage (90%) of expungements being granted. Without an opposing party in the expungement arbitrations, brokers and brokerage firms will continue to obtain expungements of customer complaints that are valid and valuable to securities regulators and the investing public.

The Securities Exchange Commission ("SEC") is currently considering whether to approve FINRA's proposed rule changes. The deadline for the SEC to approve FINRA's proposed rule change is May 28, 2021.

While PIABA and the Foundation appreciate FINRA efforts to improve its process, the data all from all three PIABA/Foundation studies, which analyzed a total of 3,378 expungement awards over a period spanning fourteen (14) years, shows that FINRA's current proposed plan to require a panel of three randomly selected arbitrators from a special roster will not significantly reduce the percentage of expungement requests. This is because the proposed rule will still allow brokers to present unopposed expungement requests. More training will not work. As the data conclusively demonstrates, since FINRA implemented enhanced expungement training in 2014, expungements are still being granted approximately 90% of the time. The data strongly indicates that arbitrators are granting expungement requests 90% of the time because they are being provided with one-sided presentations about the merits of the customer complaints, not because of lack of training.

This Updated Study also provides an example in a currently pending straight in expungement arbitration of gamesmanship used by brokers and brokerage firms that demonstrate that the process is not designed for customers to meaningfully participate and oppose expungement requests without an attorney willing to handle the case pro bono.

If the SEC approves FINRA's current proposed incremental rule changes, it will likely be several more years until this issue is revisited. In the meantime, brokers and brokerage firms will find new ways to game the system and thousands of additional valid customer complaints will be wrongfully erased from the public record. These erasures not only hurt the investing public who need accurate background information on brokers when selecting a trusted financial professional, but it also will harm securities regulators' ability to perform their critical regulatory functions.

Now is the time to fix the systemic problem and craft a solution that ensures that arbitrators treat expungement as an extraordinary remedy. The time has come for state securities regulators and customers to have a meaningful opportunity to participate in these expungement proceedings directly or through an advocate so that, when appropriate, evidence opposing expungement can be presented to arbitrators.

Finally, recognizing the reality that customers are not going to pay an attorney to represent them in these expungement proceedings, the Foundation started a program that coordinates with attorneys and law school clinics to represent customers who wish to participate and oppose expungement requests pro bono. The costs necessary to administer this pro bono program and the expenses for customers and attorneys to participate in these expungement proceedings in arbitration, (e.g., court reporter costs) will also be funded through charitable donations. If you wish to support this important work, please visit our website, www.piabafoundation.org.

CRD AND STANDARD FOR GRANTING EXPUNGEMENT

The Financial Industry Regulatory Authority ("FINRA") works with state securities regulators to maintain a database, known as the Central Registration Depository ("CRD"), of information on individuals working as current and former registered representatives in the brokerage industry. Complaints by investors, for example, are included in the CRD records. Those records can be accessed by the public through FINRA's BrokerCheck tool on FINRA's website, as well as obtained from some state securities regulators. FINRA and state and federal securities regulators actively encourage investors to use FINRA's BrokerCheck tool and look for customer complaints when deciding whether to hire a particular broker to manage the customer's life savings. Therefore, as FINRA recognizes, it is important that the information on the CRD system, and by extension BrokerCheck, be complete and accurate.

To remove customer complaint information from the CRD system, a broker must request that the information be expunged. A broker can request expungement in the customer arbitration if one is filed. A broker also may request expungement in a separate case. If an arbitration panel grants the request and the broker obtains court confirmation of the arbitration award, FINRA removes the information from the CRD system. FINRA instructs arbitrators that customer complaints should be removed from a broker's CRD only in extraordinary circumstances. FINRA instructs arbitrators to grant the extraordinary remedy of expungement only after they make an affirmative finding that:

(A) the claim, allegation or information is factually impossible or clearly erroneous;

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

(C) the claim, allegation or information is false.

Over time, FINRA has expanded the type of customer complaints that must be reported on a broker's CRD. In May 2009, FINRA expanded its rules to require CRD reporting of customer complaints even if the financial advisor is not named as a party to the arbitration. That change resulted in a drastic increase in the number of complaints being reported, and in turn, a drastic increase in the number of expungements being sought. Since then, advocates for and against the expungement process have debated the best way to effectively balance the competing interests of full and complete disclosure and protection of brokers' reputations.

The 2019 Study illustrated that FINRA's expungement arbitrations were being systematically gamed, exploited and abused with one-sided hearings. The gamesmanship also involved the manipulation of arbitrator selection, the expungement of large groups of customer complaints in one arbitration proceeding and included abusive conduct by the brokers and broker-dealer respondents to such an extent that the Foundation recommended that the entire process be frozen until it could be repaired.

CURRENT FINRA PROPOSAL

After the release of the 2019 Study, FINRA proposed changes to the expungement process that, if approved, it claims would correct many of the problems identified in the 2019 Study. The Securities Exchange Commission ("SEC") is currently considering whether to approve FINRA's proposed rule changes and the current deadline for the SEC to make a decision on whether to approve FINRA's proposed changes is May 28, 2021.

PIABA and the Foundation appreciate FINRA efforts to incrementally improve the process. However, the data illustrated below shows that FINRA's proposed changes will not fix the systemic problem of arbitrators continuing to grant expungement requests too frequently, because the expungement process does not provide state regulators and customers, who have a vested interest in the outcome of the expungement requests, a meaningful opportunity to participate and present evidence opposing the expungement.

FINRA concedes that arbitrators historically have not treated expungement requests as an extraordinary remedy. FINRA's current proposed solution is to create a roster of specially trained expungement arbitrators from the chair-qualified arbitrator roster to decide expungement cases and require a panel of three (3) randomly selected arbitrators from that roster to decide expungement requests. As explained below, an analysis of historical arbitration awards going back more than a decade demonstrates that these methods have already been tried and have failed. These changes will not reduce the percentage of expungement requests being granted.

DATA SHOWS FINRA PROPOSAL IS NOT THE SOLUTION

A summary of the pertinent data showing why FINRA's proposal is fatally flawed is below:

I. Summary of Findings

A. Number of Expungement Requests Remains High

2019 Study:

The 2019 Study showed that there was an explosive increase in the filing of what are known as straight-in expungement cases, which rose 924% from 59 in 2015 to 545 in 2018. As explained above, a straight-in expungement case is an arbitration initiated by a broker against their current or former brokerage firm solely for the purpose of seeking expungement. The customer who made the complaint is not a party.

2021 Update Study:

The updated data finds that the number of expungement requests per year remains very high. For example, there were 700 expungement awards from August 1, 2019 to October 31, 2020.

B. Average Number of Complaints Sought to be Expunged per Case Remains Steady

2019 Study:

The 2019 Study showed that the number of customer complaints requested to be expunged increased by 1016% from 102 in 2015 to 1,026 in 2018. For example, brokers requested that 2,194 customer complaints be expunged in 1,078 arbitration awards issued during the time-period analyzed, an average of two complaints per case. In 2018, the highest number of customer complaints put at issue in one case was thirteen (13).

2021 Updated Study:

The updated data shows that the number of expungement requests per case continues to be high. For example, brokers requested that 1,360 customer complaints by expunged in the 700 awards, approximately two complaints per case. The highest number of complaints sought to be expunged in a single case was twenty-nine (29).

C. Brokerage Firms Continue to Consent to Expungement Requests by Brokers

2019 Study:

The 2019 Study showed that expungement proceedings are rarely adversarial. Of the 1,078 cases analyzed, the respondent brokerage firm did not object or otherwise oppose the individual broker's expungement request 1,055 times – over 98% of the time. This demonstrated that brokers and their firms have a common interest in erasing customer complaints from the brokers' records and, as a result, are not truly in opposition to each other in a straight-in expungement case.

2021 Updated Study:

The updated data shows that straight-in expungements have continued as nonadversarial proceedings and that broker-dealer respondents continued not to oppose expungement requests 98% of the time.

D. Customer Participation in Expungement Proceedings Remains Low

2019 Study:

The 2019 Expungement Study shows that of the 1,078 expungement cases filed between 2015 and 2019, customers appeared to oppose the expungement requests only 141 times – approximately 13% of the time.

2021 Updated Study:

The updated data shows that customers continue not to participate in the vast majority of expungement proceedings. Customers appeared to oppose the expungement requests of brokers only 106 times – approximately 15% of the time. Arbitrators are routinely deciding expungement requests without input from anyone other than the broker and brokerage firm, which have a common interest in expungement.

E. Whether One Arbitrator or Three Arbitrators – FINRA Expungements Are Granted at About the Same Rate

2019 Study:

The 2019 Study showed that overall, expungement requests were granted 81% of the time. A panel of three arbitrators was only slightly more likely to deny expungement requests than a single arbitrator. The data showed that in 2018, panels of three arbitrators granted expungement 88% of the time, and single arbitrator panels granted expungement 87% of the time.

2021 Updated Study:

The updated data shows that from July 2019 to October 31, 2020, expungement requests were granted in part in 90% of the straight-in expungement cases and a panel of three arbitrators is only slightly more likely to deny expungement requests than a single arbitrator. The data shows that panels of three arbitrators grant expungement 89% of the time and single arbitrator panels grant expungement 84% of the time.

F. FINRA's Proposal of Three-Arbitrator Panels of Specialists Will Not Solve the Problem

FINRA's proposed rule seeks to reduce the rate at which expungements are granted by requiring that the cases be heard by a panel of three arbitrators, instead of a single arbitrator. The 2019 and 2021 data show that a panel of three arbitrators is only slightly less likely to grant expungement as a single arbitrator. The systemic problem is that the expungement requests are treated by the parties and arbitrators as unopposed motions.

This conclusion is further supported by PIABA's 2013 Expungement Study, which analyzed approximately 1,600 expungement requests rendered in customer initiated arbitrations or as a separate straight-in cases filed during the five-year time period between January 1, 2007 and December 31, 2011. Most, if not all, of these arbitration awards were rendered by a panel of three arbitrators and the data showed that expungement requests were granted approximately 90% of the time. In the 2013 Study, PIABA recommended that FINRA provide additional training with the hope that more training would reduce the high rate of expungements being granted. FINRA did provide more expungement training to arbitrators, but as shown in the 2019 Study and 2021 Updated Study, additional training has not reduced the high rate of expungements being granted.

G. Arbitrators Are Much More Likely to Deny Expungement Requests When Interested Parties Oppose the Request.

2019 Study:

The 2019 Study showed that arbitrators are 4 times more likely to deny expungement requests when customers oppose expungement. The 2019 Expungement Study shows that of the 1,078 expungement cases filed between 2015 and 2019, customers appeared to oppose the expungement requests only 141 times – approximately 13% of the time. Over the entire period analyzed, the study found, however, that when customers opposed expungement, arbitrators denied the requests 36% of the time. In contrast, when customers did not object or participate, arbitrators denied the expungement request only 9% of the time. Based on this data, the 2019 Expungement Study concluded that arbitrators are 4 times more likely to deny an expungement request when customers object.

2021 Updated Study:

The updated data shows that arbitrators are 5.4 times more likely to deny expungement when the respondent brokerage firm opposes expungement and are 4.3 times more likely to deny expungement when customers oppose expungement.

RECOMMENDATION: ESTABLISH AN INVESTOR ADVOCATE

FINRA should provide a meaningful opportunity for those with an interest in the outcome of the expungement request, such as state securities regulators and customers who lodged complaints at issue, to present evidence opposing the request, when appropriate. FINRA's current rule proposal does not solve the systemic problem that arbitrators do not treat expungement requests as an extraordinary remedy.

Expungement is a regulatory decision that should be placed in the hands of regulators. If the expungement process is going to remain in FINRA arbitration, however, PIABA and the Foundation recommend that FINRA and the SEC create and embed an advocate ("Advocate") into the expungement process similar to the role that a guardian ad litem serves in a court case. The purpose of the Advocate would be to protect the integrity of CRD data, which are state records and which the investing public is encouraged to rely on as current and accurate.

At this time, state securities regulators are not notified when a broker files a petition for expungement. FINRA should provide state securities regulators with notice of the expungement request at the time that the petition for expungement is filed ***and give them a meaningful opportunity to participate in the arbitration proceeding –either by permitting them to intervene in the arbitrations directly or permitting them to participate indirectly through the Advocate.***

Under the current system, the notice FINRA provides to state regulators – through NASAA, the association representing state regulators – is provided only after a petition for expungement has been granted and the broker seeks to confirm that arbitration award in a court of law. At that time, states must very quickly decide whether to intervene and oppose expungement without having adequate information to make that decision.

Under FINRA's current proposal, FINRA would notify NASAA within thirty (30) days of when a "complete" expungement request is filed in arbitration, which is earlier in the process. But, as NASAA explained in its comment letter in response to the proposed rule change, earlier notice to state securities regulators is meaningless if the regulators are not provided a meaningful opportunity to participate in the expungement arbitration proceeding. NASAA explains this problem in its comment letter as follows:

> While it is true that NASAA would receive earlier notice, this notice alone would not address the fact that NASAA members would have no opportunity to intervene during the arbitration hearing. Although states would be notified that a broker is requesting an expungement and the occurrence number, there would be no meaningful disclosure of information on which to assess the expungement request, nor would there be a legal mechanism to facilitate regulator involvement, the critical part of our 2018 framework that is missing from the current Proposal. The bottom line is that the Proposal fails to provide a pathway to contest the expungement relief request during the arbitration should a state determine it is appropriate to do so. Without NASAA's members having a legal mechanism to intervene at this stage of the arbitration, notice is either meaningless or could force an investigation into every situation in which a broker requests expungement. While NASAA appreciates FINRA's willingness to give it earlier notice of expungements, NASAA strongly prefers this relief be deferred to a proposal that would allow states to act on it.[2]

The Advocate, acting independently or through state securities regulators, would serve to advocate for the integrity of the CRD regulatory record and would be responsible for investigating the validity of the customer complaint, obtaining and reviewing relevant documents, as well as interviewing the customer, customer's counsel, and any other relevant witnesses. The Advocate would assist those customers who want to appear and oppose the request, when appropriate. The Advocate could also participate in the expungement hearing by making an opening statement, cross examining the individual broker, presenting testimony and documents, and providing a written report with a recommendation to the arbitration panel on whether expungement should be granted. Logistically, this could be accomplished in several ways. The Advocate role could be embedded into the arbitration process to assist the arbitrators in gathering information and making a recommendation on whether to grant expungement. The Advocate could assist customers interested in opposing expungement as well. Alternatively, the Advocate could work with state securities regulators to help them decide whether to participate in and oppose expungement.

For those customers who settled their cases, there is the real risk of the broker or brokerage firm suing them for breach of confidentiality or non-

2. See NASAA Comment Letter dated October 22, 2020 at https://www.sec.gov/comments/srfinra-2020-030/srfinra2020030-7936105-224674.pdf.

disparagement provisions in their settlement agreements and potentially forfeiting their settlement payments. FINRA's rules do not allow brokerage firms to condition settlement on a customer's agreement not to oppose expungement, but it not reasonable to believe that a customer without an attorney could find that rule and navigate other the legal considerations of opposing expungement. As a result, without an Advocate, pro se customers will largely continue to choose not to participate in expungement proceedings regardless of when they are notified that a petition for expungement has been filed.

Rather than create a mechanism through state regulators and/or an Advocate to present evidence opposing expungement request, FINRA's rule proposal places the burden solely on arbitrators to investigate and oppose expungement when appropriate. Arbitrators are required to be neutral, not advocates for or against a position. Imposing such a burden on arbitrators in unopposed straight-in expungements is wholly inconsistent with their role as neutral factfinders and decisionmakers. As a result, the solution is not (1) to increase the number of arbitrators per case or (2) to blur the traditional roles of arbitrator and advocate or (3) to require additional training or (4) to create a special roster of arbitrators as FINRA has proposed. The data shows that arbitrators are treating straight—in expungement requests like unopposed motions. The solution is to have someone like the Advocate represent stakeholders in the integrity of the CRD system. The Advocate and/or state securities regulators must have a meaningful opportunity to inquire into facts indicating that expungement should be denied and present those facts in the expungement proceeding.

In further support of this recommendation, in October 2019, the Foundation created a pro bono expungement program where attorneys who are experienced in FINRA arbitrations volunteer to represent customers in opposing expungement. The Foundation is pleased to announce it has successfully represented several customers in opposing expungements. The Foundation is also grateful for the insights of students and faculty from The University of Nevada, Las Vegas, William S. Boyd School of Law's Public Policy Clinic, which also provided pro bono representation of customers opposing expungement.

The Foundation has found the process to be rewarding not only through obtaining awards denying expungement requests, but also in gaining a better understanding of the obstacles to customers being able to oppose expungement requests. Expense is the greatest obstacle. Because the expungement process is simply too daunting for the vast majority customers to represent themselves pro se (it is opaque and difficult for attorneys to navigate), customers who want to oppose expungement are facing having to spend thousands of dollars to retain an attorney to represent them. FINRA's Revised Proposal for earlier notice to customers does not cure this problem.

If the SEC approves FINRA's current proposed rule changes, it will likely be several more years until this issue is revisited. In the meantime, thousands of additional customer complaints will be wrongfully erased from public records. These erasures not only hurt the investing public who need accurate background information on brokers when selecting a trusted financial professional but erasing records harm securities regulators' ability to perform their regulatory functions.

STUDY METHODOLOGY

In preparing this 2021 Updated Study, the Foundation supplemented its data from the 2019 Study and reviewed data that it requested Securities Arbitration Commentator (SAC) to provide with respect to all arbitration awards issued in straight-in expungement cases filed from July 1, 2019 through October 31, 2020 (the "Review Period"). The data from 2019 Study is listed below along with the new updated data to better demonstrate long-term trends.

The Foundation requested that SAC extract the following information for each award and for each case:

(a) Docket No;
(b) Venue;
(c) Date Case Filed;
(d) First Date of Evidentiary Hearing;
(e) Date Award Issued;
(f) Name of Respondent(s);
(g) Name of Respondents' Attorney (Firm);
(h) Name of Claimant Broker;
(i) Name of Broker's Attorney (Firm);
(j) Whether Respondent BD Objected to Expungement;
(k) Whether Customer Objected to Expungement;
(l) Number of customer complaints requested to be expunged;
(m) Name of broker requesting expungement;
(n) Name of Arbitrator;
(o) Number of Hearing Sessions.

See SAC Spreadsheet #1 attached as Exhibit A (http://bit.ly/2021ExhibitA)

To prepare the report, the Foundation used the information from Exhibit A (http://bit.ly/2021ExhibitA) to create a Consolidated Spreadsheet, which is attached as Exhibit B (http://bit.ly/2021ExhibitB).

DETAILED FINDINGS

I. Expungements Are Not Treated As An Extraordinary Remedy, As They Were Intended.

1. FINRA has always taken the position that expungement is an extraordinary remedy and should only be granted in appropriate circumstances.[3] Yet, from 2015 to mid-2019, FINRA arbitrators granted expungement requests over 80% of the time. The updated data from August 1, 2019 - October 31, 2020 ("Updated Data") further supports that expungements are not being treated as an extraordinary remedy, showing that expungement requests were granted at least in part in 636 out of 700 awards, a rate of 90%.

Year	Expungements Granted (%)
2015	93
2016	81
2017	81
2018	81
Updated Data	**90**

Once these complaints are expunged, they disappear completely from the CRD system and BrokerCheck – making them no longer visible to investors.

II. The Number of Straight-In Expungements Has Skyrocketed Since January 1, 2015.

2. The number of straight-in expungements filed with FINRA continues to increase.

Year	Cases Filed
2015	59
2016	135
2017	339
2018	545
Updated Data	**700**

3. FINRA Regulatory Notice 12-42 ("It has been FINRA's long-held position that expungement of customer dispute information is an extraordinary measure, but it may be appropriate in certain circumstances.") https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17- 42.pdf.

III. Multiple Customer Complaints Are Being Expunged Per Case.

3. Individual brokers frequently request that multiple customer complaints be expunged in a single expungement case. As a result, the 2019 Study showed that while the total number of straight-in expungement cases for the 2015-2018 period was 1,078, the number of customer complaints that the brokers asked be expungement was 2,194, which is an average of approximately two (2) customer complaints per case.

The updated data shows that the number of expungement requests per case continues to be high. Brokers requested that 1,360 customer complaints by expunged in the 700 awards, i.e., again approximately two (2) complaints per case.

4. The number of customer complaints that brokers requested be expunged from CRD increased significantly.

Year	Number of customer complaints brokers requested be expunged
2015	102
2016	300
2017	756
2018	1036
Updated Data	**1360**

In the Updated Data, one broker in a single expungement case asked for the erasure of twenty-nine (29) customer complaints from their CRD record.

IV. Expungement Requests are Rarely Opposed by Brokerage Firms or Customers

A. Expungement Requests Are Not Opposed by Respondent Brokerage Firms 98% Of The Time.

5. Brokerage firms very rarely oppose brokers' requests for expungement. The 2019 Study showed that of the 1,078 cases, the respondent brokerage firm did not object or otherwise oppose the individual broker's expungement request 1,055 times out of 1,078 – over 98% of the time. Brokerage firms objected to these expungement requests in only 21 of the 1,078 total requests. That is less than 2% of the time.

6. The 2021 Updated Study reflected similar results. In the seven hundred (700) awards issued between August 1, 2019 to October 31, 2020, the

respondent brokerage firm did not object or otherwise oppose the individual broker's expungement request 684 times out of 700 awards – over 98% of the time. Brokerage firms objected to these expungement requests in only 16 of the 700 total requests. Again, that is approximately 2% of the time.

B. Customers Rarely Participate and Oppose Expungement Requests.

7. Customers are not named parties in straight-in expungement cases so they are not required to appear. The Foundation does not recommend that customers be named as parties to these cases. Customers should not be required to essentially relitigate cases they have settled or otherwise resolved. The 2019 Study found that of the 1,078 straight-in expungement cases, customers whose complaints are the subject of expungement requests participated and objected to brokers' expungement requests only 141 times, 13% of the time.

8. The 2021 Updated Study found similar results. Of the 700 straight-in expungement cases, customers whose complaints are the subject of expungement requests participated and objected to brokers' expungement requests only 106 times, 15% of the time.

C. Panels of Three Arbitrators Will Not Reduce the High Rates of Expungements Being Granted.

9. Expungement rates show that expungement is not treated as extraordinary remedy and three arbitrators are no better than one.

2019 Study	%
% of expungements granted in part (2018)	87
% of expungements granted – 3 Arbitrators	88
% of expungements granted – 1 Arbitrator	87

Updated Data	%
% of expungements granted in part (2018)	90
% of expungements granted – 3 Arbitrators	89
% of expungements granted – 1 Arbitrator	84

10. FINRA's proposed rule seeks to reduce the rate in which expungements are granted by requiring that the cases be heard by three arbitrators, instead of a single arbitrator. Our data shows that a panel of three

arbitrators is just as likely to grant expungement as a single arbitrator. The systemic problem is that the expungement requests are treated by the parties and arbitrators as unopposed motions.

D. Arbitrators Are Significantly More Likely to Deny Expungement Requests When Someone Objects.

11. The 2019 Study found that, even though respondent brokerage firms opposed expungement less than 2% of the time, when brokerage firms opposed expungement, arbitrators denied the expungement request 48% of the time. In contrast, when brokerage firms did not object, arbitrators denied the expungement request only 11% of the time. Therefore, arbitrators are 4.36 times more likely to deny expungement requests when a brokerage firm objects to the expungement request.

12. Even though customers opposed expungements only 13% of the time, when customers opposed expungement, arbitrators denied the requests 36% of the time. In contrast, when customers did not object, arbitrators denied the expungement request only 9% of the time. Arbitrators are four (4) times more likely to deny an expungement request when a customer objects.

13. The 2021 Update Study results show similar results. The updated data shows that arbitrators are 5.4 times more likely to deny expungement when the broker-dealer respondent opposes expungement and are 4.3 times more likely to deny expungement when customers oppose expungement.

14. This data supports the conclusion that the most effective way to reduce the rate in which arbitrators grant expungement is to present the arbitrators with evidence opposing the request.

E. Without an Opposing Party, There Are No Procedural Safeguards to Prevent Brokers and Brokerage Firms from Presenting One Sided and/or False Information to Arbitrators.

15. Brokers and brokerage firms are the only parties to straight-in expungement cases, and both have an incentive to expunge customer complaints from brokers' CRD records. The customers whose complaints are the subject of the expungement request are not parties to the straight-in expungement arbitration and if they participate, their role is akin to a fact witness. They cannot conduct discovery, engage in motion practice, or have the other due process rights given a party to an arbitration.

16. Since brokerage firms do not oppose brokers' expungement requests 98% of the time and customers oppose expungement in only 13%-15% of cases, it logically follows that there should be procedural safeguards in place to prevent brokers from presenting one-sided, false or misleading information to arbitrators, who are ethically required to remain neutral in the pending arbitration.

17. FINRA puts the burden of ensuring that only valid expungement requests are granted on arbitrators. But imposing such a burden on arbitrators in unopposed straight-in expungement cases is wholly inconsistent with their role as neutral factfinders and decisionmakers.

18. In fact, FINRA's arbitrator training materials prohibit arbitrators from conducting their own independent investigations into the validity of the underlying customer complaints. FINRA Dispute Resolution Arbitrator's Guide states in pertinent part:

> **Questions by Arbitrators and Factual Investigations**
>
> Each case must be judged solely on the written and testimonial evidence presented at the hearing. Each arbitrator has a right to question witnesses. Even though it is proper for an arbitrator to ask questions, every effort should be made to avoid taking over a hearing or becoming an advocate. Parties and their attorneys should be permitted to try their own cases. Generally, arbitrators should refrain from questioning a witness until all parties have finished their examination.
>
> Arbitrators should not make independent factual investigations of a case. When arbitrators are in doubt about an issue, legal or otherwise, they should request briefs from the parties. If cases are cited in a party's motion or brief, and the arbitrators wish to read the full court opinions, the arbitrators should ask the parties to supply copies. Arbitrators generally should review only those materials presented by the parties.
>
> *See* FINRA Arbitrator's Guide at page 60 (emphasis added).

19. While FINRA's expungement training materials encourage arbitrators to ask questions during the expungement hearing and request additional documents from the parties, this does not change the fact that arbitrators must remain neutral. As such, arbitrators cannot be the sole gatekeeper to protect the integrity of the CRD database and valid customer complaints from being erased.

F. Brokers and Firms Continue to Find New Ways to Game the Arbitration Process to Obtain Expungement Awards.

20. The example below is happening right now in a currently pending straight-in expungement case where the customer hired attorneys through the Foundation's pro bono expungement program to oppose expungement. This example shows how brokerage firms and brokers engage in gamesmanship and why state regulators need early notice of expungements and the ability to participate directly or through the proposed Advocate. This example also illustrates how FINRA's expungement process is not designed for investors to meaningfully participate without an attorney and why the Foundation's pro bono expungement program provides valuable services.

CASE STUDY

The Foundation's Expungement Project, through which attorneys represent customers opposing expungement on a pro bono basis, has discovered some of the new and innovative tactics that brokers and firms are using in violation of FINRA's directive that customers be permitted to appear and oppose a broker's request to oppose expungement.

For example, in a pending case, the customer filed a FINRA arbitration against the broker-dealer for unsuitable investment recommendations by the firm's broker. The arbitration settled late last year for an undisclosed amount. The customer believed that his dispute was over and dismissed the arbitration proceeding against the broker-dealer. In January 2021, the broker filed a straight-in expungement arbitration against the broker-dealer seeking to expunge the customer's complaint.

The customer retained a pro bono attorney through the Foundation Expungement Project to oppose the straight-in expungement arbitration. Now, the brokerage firm is objecting to the customer using documents the firm produced in the original arbitration that support denial of the expungement relief on the basis that those documents were designated as confidential and could only be used in the original arbitration. In an email exchange attached hereto, the attorney representing the brokerage firm made the following objection:

> … [Firm] objects to you, your firm, or any other individual reviewing any confidential documents and information produced by [Firm] in Customer v. Firm. Given the confidential and proprietary nature of those documents, the parties in the [Customer] matter expressly agreed

> that the documents would be used solely in connection with prosecuting, defending, and settling that matter. Further dissemination of the documents would destroy or diminish the value of such information, causing [Firm] severe and irreparable harm. That concern is heightened by your vague reference below to sharing documents with your "firm [] and other counsel" for [Customer]. Moreover, those documents are irrelevant and beyond the scope of what is necessary to decide the pending expungement claim. The documents potentially responsive to the expungement claim—such as the Statement of Claim, the Answer, the settlement agreement, and [Customer's] account documents—are within [Customer's] possession already.

Here, the brokerage firm attempts to prohibit the customer and his attorneys from using documents the firm produced in the prior case to oppose the expungement relief in the subsequently filed straight-in expungement arbitration. The brokerage firm is also improperly and unilaterally defining what documents and information are relevant to the expungement request.

Simply put, without an attorney, there is no way that customers can effectively represent themselves in these straight-in expungements. Resolving the discovery issue described above will require the filing a motion to compel before the arbitration panel or filing a declaratory judgment action in a court of law. This spurious discovery dispute will likely take hours to resolve and would have cost thousands of dollars in attorney's fees to resolve were the customer not represented on a pro bono basis. Customers cannot and should not be asked to bear that cost.

CONCLUSION

PIABA and the Foundation have conducted studies of FINRA's expungement awards for over a decade and the results are clear. Increasing the number of arbitrators per case and providing arbitrators with more training will not lower the incidence of granting expungement or get arbitrators to treat expungement as an "extraordinary remedy."

The data unquestionably leads to the conclusion that the most effective way to reduce the rate in which arbitrators grant expungement is to stop the practice of arbitrators deciding expungement based on a one-sided presentation of evidence. FINRA should provide a meaningful opportunity for parties with an interest in the outcome of the expungement request, such as state securities regulators and customers who lodged complaints at issue, to present evidence opposing the request, when appropriate.

The data shows that the current system of deciding expungement through straight-in expungement arbitrations requires the establishment of an Investor Advocate, who will be charged with helping to preserve the integrity of CRD data.

RECENT ARBITRATION AWARDS

Melanie Cherdack and Sara Hanley

This issue's featured arbitration awards include cases in which FINRA arbitration panels granted noteworthy relief, including big dollar awards and one wherein the statutory attorney's fees, interest and cost awarded was well in excess of the compensatory damages awarded. Two of the awards contain six figure discovery sanctions—both in cases where no liability was found. There are also a number of awards involving traditionally online firms. One dealt with an operational issue in timely opening an account wherein the panel awarded damages for precluding the Claimant from participating in a market run up. Another involved large damages awarded to a number of Claimants as a result of high frequency trading issues. In another, a *Pro Se* Claimant was awarded $300,000 after only a two-day hearing. These cases may portend things to come, as more online and discount trading firms are offering more services to their customers.

Beverly B. Schottenstein, Individually and as a Co-Trustee under the Beverly B. Schottenstein Revocable Trust U/A/D April 5, 2011, as Amended v. J.P. Morgan Securities, LLC, Evan A. Schottenstein, Avi Elliot Schotenstein

Case No. 19-02053
Boca Raton, Florida
Hearing Dates: October 2020- January 2021
Award Date: February 4, 2021
Counsel:
- Counsel for Claimants:
  - Scott C. Ilgenfritz, Esq. and Guy Burns, Esq., Johnson Pope Bokor Ruppel & Burns LLP, Tampa Florida.
- Counsel for Respondents:
  - Gabrielle L. Gould, Esq., Elizabeth Zito, Esq. and Melissa Brumer, Esq., Goodwin, Procter LLP, New York, New York and for Respondent J.P. Morgan Securities, LLC and Carl S. Burkhalter, Esq., Peter S. Fruin, Esq., Jonathan J. Brennan, Esq. and Grace J. Posey, Esq., Maynard, Cooper, Gale, New York, New York for Respondent Evan A. Schottenstein and Avi Elliot Schottenstein.

Arbitration Panel:

Donna Greenspan Solomon, Presiding Chairperson, James M. Scutti, Public Arbitrator, and David Rich, Public Arbitrator

Investments at Issue:

Multiple auto-callable structured notes and various other securities for which Respondent JPM was a market maker, including Apple stock, as well as initial public offerings and follow-on offerings.

Claimants' Causes of Action in Statement of Claim:

(1) Constructive Fraud/Abuse of Fiduciary Duty
(2) Fraudulent Misrepresentations and Omissions
(3) Violation of Chapter 415, Fla. Statutes.

Relief Requested:

(1) Compensatory damages in excess of $10,000,000;
(2) Punitive damages in the amount of at least three times the compensatory damages awarded;
(3) Interest;
(4) Rescission of the investment in the Coatue;
(5) Disgorgement of all commissions and revenues received by Respondent JPM from all trading activity;
(6) Costs of the arbitration;
(7) Attorneys' fees;
(8) Filing fees;
(9) Expert witness fees;
(10) Arbitrator fees;
(11) Any other costs; and such relief as deemed just and proper by the Panel.

Relief Requested Post Hearing:

(1) $69,185,860.00

Award:

(1) Respondents JPM, EAS and AES are liable on the counts of constructive fraud/abuse of fiduciary duty and fraudulent misrepresentations and omissions.
(2) Respondents JPM and EAS are further liable for elder abuse in violation of Chapter 415, Fla. Statutes.
(3) Respondent JPM is liable for and shall pay to Claimants the sum of $4,708,550.00 in compensatory damages, plus interest at the Florida legal rate that begins to accrue as of the date of service of this Award.
(4) Respondent EAS is liable for and shall pay to Claimants the sum of $9,000,000.00 in compensatory damages, plus interest at the Florida legal rate that begins to accrue as of the date of service of this Award.

(5) Respondent EAS is liable for and shall pay to Claimants the sum of $602,251.00 in compensatory damages, plus interest at the Florida legal rate that begins to accrue as of the date of service of this Award.
(6) Claimants' request for rescission of the Coatue investment is granted. As such, in addition to the amount awarded in Paragraph 3 above, Respondent JPM shall rescind the Coatue investment and pay Claimant $4,291,450.00, plus interest at the Florida legal rate that begins to accrue as of the date of service of this Award.
(7) Pursuant to Section 415.1111, Fla. Stat., Respondent JPM is liable for and shall pay to Claimants costs in the amount of $172,630.50.
(8) Pursuant to Section 415.1111, Fla. Stat., Respondent EAS is liable for and shall pay to Claimants costs in the amount of $172,630.50.
(9) Pursuant to Section 415.1111, Fla. Stat., Respondent JPM is liable for and shall pay to Claimants one-half of their attorneys' fees, in an amount to be determined by a court of competent jurisdiction.
(10) Pursuant to Section 415.1111, Fla. Stat., Respondent EAS is liable for and shall pay to Claimants one-half of their attorneys' fees, in an amount to be determined by a court of competent jurisdiction.
(11) Respondent AES's (CRD Number 5708665) request for expungement of his CRD records in denied.
(12) Any and all claims for relief not specifically addressed herein, including any requests or punitive damages, are denied.

Analysis:

This intra-family dispute resulted in a noteworthy award to Claimants for significant recovery of both compensatory and rescission damages as well as an award of attorneys' fees, costs and interest. Interestingly, the Award specifies that two of the Respondents, EAS and JPM, were to each pay half of Claimants' attorneys' fees and costs. Also of note is that this case was conducted virtually over Zoom Video Conference over Respondents' objection. Ultimately, after 43 hearing sessions, the Panel found Respondents liable on the counts of constructive fraud/abuse of fiduciary duty, fraudulent misrepresentations and omissions and elder abuse in violation of Chapter 415, Fla. Statutes. The Panel awarded attorneys' fees and costs pursuant to Florida Statute Section 415.1111.

Guillermo Lopez Perez v. OFS Securities, Inc. and Oriental Financial Services Corp.

Case No. 16-02549

San Juan, Puerto Rico

Hearing Dates: January 18, 2021- February 8, 2021

Award Date: February 12, 2021

Counsel:

Counsel for Claimants:

Peter J. Mougey, Esq. and Michael Bixby, Esq., Levin, Papantonio, Thomas, Mitchell, Rafferty & Proctor, P.A., Pensacola, Florida and John F. Nevares, Esq., John F. Nevares & Associates, Attorneys at Law, San Juan, Puerto Rico.

Counsel for Respondents:

Alfredo Fernandez Martinez, Esq., Pedro Hernandez-Freire, Esq. and Carlos Baralt Suarez, Esq., Delgado Fernandes, LLC, San Juan, Puerto Rico.

Arbitration Panel:

Erika Deutsch Rotbart, Presiding Arbitrator, John G. Sciandra, Public Arbitrator, and Robert Sullivan Tyler, Public Arbitrator

Investments at Issue:

Puerto Rican securities and closed-end bond funds.

Claimant's Causes of Action in Statement of Claim:

(1) Breach of fiduciary duty;
(2) Violation of industry rules;
(3) Breach of contract;
(4) Negligence;
(5) Fraud;
(6) Violation of § 12(a)(2) of the Securities Act of 1933;
(7) False inducements to inaction;
(8) Negligent supervision;
(9) Violation of Article 1802 of the Civil Code of Puerto Rico, 31 Laws of Puerto Rico Annotated [L.P.R.A.]§§5141, 3020 and 3021.

Relief Requested:

(1) $15,000,000.00;
(2) Interest on Claimant's losses or any award made herein;
(3) Costs;
(4) Reasonable legal fees and expenses;
(5) Punitive damages; and
(6) Additional damages and relief (whether disgorgement of profits, unjust enrichment, rescission, restitution, non-monetary, declaratory

judgement, equitable or otherwise) which the Panel deems just and equitable.

Award:

(1) Respondents' Motion to Dismiss Claimant's Statement of Claim was granted with prejudice as to the counts for Fraud, Violation of § 12(a)(2) of the Securities Act of 1933; False Inducement to Inaction, Negligent Supervision and Violation of Article 1802 of the Civil Code of Puerto Rico, 31 Laws of Puerto Rico Annotated [L.P.R.A.]§§5141, 3020 and 3021.

(2) Respondents' Motion to Dismiss Claimant's Statement of Claim is denied as to the counts for Breach of Fiduciary Duty, Violation of Industry Rules, Breach of Contract and Negligence. However, the Panel found no liability for these claims.

(3) The Panel felt strongly regarding Respondents' spoilation of evidence. Therefore, although the Panel did not find Respondents liable for Claimant's claims in the matter, it is clear that Respondents' conduct should not go unnoticed or unaddressed accordingly. Having previously found gross negligence and willful misconduct by Respondents in connection with spoilation of evidence and prolonged discovery abuse, the Panel hereby assesses sanctions pursuant to Rules 12511 and 12212 of the Code. Specifically, Respondents are jointly and severally liable and shall pay to Claimant the sum of $195,000.00 in attorneys' fees and $45,000.00 in costs for all work associated with Claimant's various Motions to Compel Discovery and the August 28, 2020 Motion for Sanctions. As an additional penalty and in recognition of Respondents' flagrant discovery violations and spoilation of evidence, Respondents' are assessed all of FINRA's fees associated with this matter, including all pre-hearing and evidentiary hearing session fees.

(4) Any and all claims for relief not specifically addressed herein, including any requests for punitive damages and other related attorneys' fees and costs are denied.

Analysis:

This award is noteworthy because of the significant discovery sanctions and procedural history of discovery abuses set forth by the Panel in the Award. Claimant filed a Motion for Sanctions Regarding Respondents' Spoilation of Evidence asserting that Respondents deliberately destroyed more than 10,000,000 emails from the time-period relevant to this matter. Claimant requested a default judgment and assessment of all fees relating to the Motion to Respondents, or, alternatively, that the Panel draw adverse inferences against Respondents and assess substantial monetary sanctions against them.

In their response, Respondents asserted, among other things, that they had a systematic approach to document preservation and document retention that was followed without individual intervention to willfully destroy any relevant evidence. Following oral argument by the parties, the Panel issued an Order that granted Claimant's Motion. Specifically, the Panel ordered any and all reasonable attorneys' fees and costs associated with Claimant's Motions to Compel Discovery relating to electronically stored information and the spoilation of the same be assessed 100% to Respondents, including, but not limited to, those fees and costs associated with the neutral auditor involved in this matter.

Claimant next filed a Motion to Preclude Respondents from Offering Evidence and Testimony at the final hearings asserting that because of Respondents' spoilation, Claimant would be left handicapped and without access to the most significant evidence necessary to establish Respondents' wrongdoing or rebut Respondents' arguments. Respondents argued that granting the Motion would give preferential treatment to Claimant and would carry the most severe penalty of denying Respondents of their due process right to a final hearing. The Panel denied Claimant's Motion, without prejudice, specifically maintaining its discretion of excluding evidence and/or making any adverse inferences as may be necessary at the final hearing. The order further stated that the evidence, testimony and/or lack thereof may also allow the Panel to further determine the scope of the sanction award, given the Panel's prior findings and rulings. Ultimately the Panel ruled that Respondents' conduct, which was no less than clear and convincing as to its spoilation of evidence and prolonged discovery abuses, should not go unnoticed and it assessed sanctions pursuant to Rules 12511 and 12212 of the Code against Respondents in the amount of $195,000.00 in attorneys' fees and $45,000.00 in costs for all work associated with Claimant's various Motions to Compel Discovery and Motion for Sanctions.

JC McCall Revocable Trust by Trustee JC McCall v. First Standard Financial Company LLC, William C. Gennity, Philip J. Sparacino, Robert F. Spiegel, Jeffrey Baber, Jodi Fauci, Jonathan Stanley McCormack and Carmine Berardi
Case No. 18-04014
Des Moines, Iowa
Hearing Dates: December 8-10, 2020
Award Date: February 3, 2021
Counsel:
  Counsel for Claimants:
    Gail E. Boliver, Esq., Boliver Law Firm, Marshalltown, Iowa.
  Counsel for Respondent:
    Craig A. Riha, Esq., Finkelstein & Feil, P.C., Bohemia New York for Respondents First Standard Financial Company LLC, and William C. Gennity, Philip J. Sparacino, Robert F. Speigel, Jeffrey Baber, Jodi Fauci, and Jonathan Stanley McCormack. Martin H. Kaplan, Esq. and Robyn D. Paster, Esq. for Gusrae Kaplan Nusbaum PLLC New York, New York for Respondent Carmine Berardi.
Arbitration Panel:
  Alain Frecon (Sole Public Arbitrator)
Investments at Issue:
  Unsuitable trading activity, including churning of shares in Chesapeake Energy Corp., AK Steele, Transocean Ltd., Seadrill and Energous.
Claimants' Claims:
  Causes of Action in Statement of Claim:
    (1) Breach of Fiduciary Duty;
    (2) Unauthorized trading;
    (3) Negligence;
    (4) Breach of Contract;
    (5) Misrepresentation, including negligent misrepresentation;
    (6) Constructive fraud;
    (7) Fraudulent non-disclosure;
    (8) Failure to Supervise/respondeat superior;
    (9) Violation of industry standards;
    (10) Respondeat superior and control person liability.
Relief Requested:
  (1) $90,198 compensatory damages;
  (2) interest;
  (3) attorneys' fees;
  (4) costs and expert fees; and
  (5) such other relief as the arbitrator may decide is appropriate.

Relief Requested Post Hearing:

(1) $127,000 in compensatory damages; and

(2) at least $1,000,000.00 in punitive damages.

Award:

(1) First Standard, Gennity, Sparacino, Spiegel, McCormack, and Berardi are jointly and severally liable for and shall pay to Claimant the sum of $100,000.00 in compensatory damages.

(2) First Standard, Gennity, Sparacino, Spiegel, McCormack, and Berardi are jointly and severally liable for and shall pay to Claimant the sum of $14,157.55 in costs for expert fees.

(3) First Standard, Gennity, Sparacino, Spiegel, McCormack, and Berardi are jointly and severally liable for and shall pay to Claimant the sum of $225.00 in costs as reimbursement for the non-refundable portion of Claimant's filing fee.

(4) Claimant's request for specific bankruptcy language in the Award is denied.

(5) William Christian Gennity's (CRD Number 4913490) request for expungement of the above-captioned arbitration (Occurrence Number 2010695) from his CRD records is denied.

(6) Philip Joseph Sparacino's (CRD Number 3243960) request for expungement of the above-captioned arbitration (Occurrence Number 2011471) from his CRD records is denied.

(7) Robert Frank Spiegel's (CRD Number 5861656) request for expungement of the above-captioned arbitration (Occurrence Number 2010696) from his CRD records is denied.

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

Analysis:

This award is noteworthy because Claimant alleged that the annual turnover for the account was 34.26 and the annualized costs to equity was 103.50%. Claimant was awarded a large percentage of the claimed compensatory damages as well as expert fees. Interestingly, in Claimant's Post-Hearing Written Closing Argument and Trial Brief, Claimant requested that the Award include language as follows: "The Award entered in this proceeding is a debt for the violation of securities laws or any S.E.C., regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. § 523(a)(19)." Claimant's request for specific bankruptcy language in the Award was denied despite Claimant prevailing on his claims. Also interesting in this case is the assessment of fees in this matter. Respondents in this case filed a Motion to Dismiss, which was denied. Respondents then filed a Motion to Reargue and Request for Oral Argument on the Motion to Dismiss, which was also denied. Respondents were Ordered to pay Claimant for defense of the Motion to Reargue. Claimant's request for a virtual hearing was also granted over Respondents' objections.

Howard Barron, individually and as trustee of the Howard Barron Revocable Living Trust U/A/D 10/11/95, and Howard B. Young, as trustee of the Restated Howard B. Young Revocable Trust Dated 6/28/93 v. Arete Wealth Management, LLC

Case No. 19-01143
Detroit, Michigan
Hearing Dates January 11-14, 2021
Award Date: January 28, 2021
Counsel:
  Counsel for Claimants:
    Brian Levin, Esq., Levin Law, P.A. and Jeffrey B. Kaplan, Esq., Dimond Kaplan & Rothstein, P.A., Miami, Florida
  Counsel for Respondent:
    Linda Ieleja Gerstman, Esq. and UnBo Chung, Esq. Arete Wealth Management LLC, Chicago, Illinois
Arbitration Panel:
  Patrick R. Sughroue, Presiding Chairperson, Raymond J. Sterling, Public Arbitrator, and Frank Todd Aiello, Non-public Arbitrator
Investments at Issue:
  GPB Automotive Portfolio, LP
Claimants' Causes of Action in Statement of Claim:
  (1) Negligence;
  (2) Breach of Fiduciary Duty;
  (3) Negligent Supervision;
  (4) Breach of Contract; and
  (5) Violation of Michigan Securities Act.
Relief Requested:
  (1) Compensatory damages of $225,000;
  (2) Prejudgment interest on all such damages at the statutory rate;
  (3) Reasonable attorneys' fees; and
  (4) Punitive damages in an amount sufficient to punish a corporation with Respondent's net worth and income.
Relief Requested Post Hearing:
  (1) $105,305.05 in compensatory damages to Howard Barron;
  (2) $31,118.55 in statutory interest to Howard Barron;

(3) $81,333.24 in compensatory damages to HBY Trust; and
(4) $27,656.41 in statutory interest to HBY Trust.

Award:

(1) Barron having tendered back to Respondent the investments at issue as of January 15, 2021, Respondent is liable for and shall pay to Barron the sum of $105,306.05 in compensatory damages.
(2) HBY Trust having tendered back to Respondent the investments at issue as of January 15, 2021, Respondent is liable for and shall pay to HBY Trust the sum of $81,333.24 in compensatory damages.
(3) Respondent is liable for and shall pay to Barron statutory interest in the amount of $31,118.55.
(4) Respondent is liable for and shall pay to HBY Trust statutory interest in the amount of $27,656.41.
(5) Respondent is liable for and shall pay to Claimants the sum of $258,775.00 in attorneys' fees, allocated among Claimants in proportion to their respective compensatory damages plus interest awards, pursuant to MCL 451.2509 of the Michigan Uniform Securities Act.
(6) Respondent is liable for and shall pay to Claimants the sum of $10,582.73 in costs, allocated among Claimants in proportion to their respective compensatory damages plus interest awards.
(7) Respondent is liable for and shall pay to Claimant $300.00 to reimburse Claimant for the non-refundable portion of the filing fee previously paid to FINRA Dispute Resolution Services.

Analysis:

This award is noteworthy because the total amount of attorney's fees, costs and interest awarded under the Michigan Uniform Securities Act (over $328,132.73) dwarfed the total amount of compensatory damages ($186,640.00) awarded to the two Claimants. Additionally, the panel noted that the investments for which they awarded compensatory damages were tendered back to the Respondents. Also interesting is that an additional Trust, Settlor and Beneficiary of that Trust were added as a Claimant over Respondent's objection at the final hearings. It is also noteworthy that the Panel awarded each Claimant the exact amount of their respective demands for compensatory damages and interest.

Gladys Veronica Anton and Alberto Jose Nieves v. Insight Securities, Inc., Pershing LLC and Carlos Legaspy

Case No. 19-00474

New York, New York

Hearing Dates: August 17-28, 2020, November 1-5, 2020, December 28-30, 2020 and February 24, 2020

Award Date: March 20, 2021

Counsel:

Counsel for Claimants:

Jenice L. Malecki, Esq. and Darryl J. Bouganim, Esq., Malecki Law, New York, New York

Counsel for Respondent:

Sean G. Rohan, Esq. O'Hangan Meyer, LLC Chicago, Illinois for Respondent Insight Securities, Inc. and Thomas M. Farrell, Esq. and Jeffrey J. Chapman, Esq. McGuire Woods, LLP, New York, New York.

Arbitration Panel:

Edmund Timothy Donovan, Presiding Chairperson, Jack Friedman, Public Arbitrator, and Mary Ellen Burns, Public Arbitrator

Investments at Issue:

Biscayne Notes and other unspecified securities

Claimants' Causes of Action in Statement of Claim:

(1) Breach of Contract;
(2) Violation of FINRA Rules 2010- Commercial Honor and Good Faith, 3110-Supervision, 2090 Know your Customer;
(3) Common law and statutory fraud;
(4) Aiding and abetting;
(5) Breach of fiduciary duty;
(6) Aiding and abetting breach of fiduciary duty;
(7) Negligence;
(8) Gross negligence;
(9) Failure to supervise; and
(10) Negligent supervision.

Relief Requested:

(1) Compensatory damages of $2,765,000.00;
(2) Statutory interest at a rate of 9% per annum;
(3) Punitive damages;
(4) Lost interest;
(5) Attorneys' fees; and
(6) Costs

Award:

(1) Claimants' claims are denied in their entirety.
(2) Respondent Pershing is liable for and shall pay to Claimant $250,000 in discovery sanctions.
(3) Any and all claims for relief not specifically addressed herein, including any requests for punitive damages and attorneys' fees, are denied.

Analysis:

This award is noteworthy because Claimants filed a Motion for Sanctions against Pershing for discovery abuse prior to the final hearing. After due deliberation, the Panel determined that it would entertain the Motion for Sanctions during the hearings when deemed appropriate. After approximately 14 days of the final hearing, Claimants filed a Notice of Settlement and Voluntary Dismissal with respect to Respondents Insight and Legaspy. The final hearing continued against Pershing. Thereafter, Claimant filed a Renewed Motion for Discovery Sanctions against Respondent Pershing. In the final award, the Panel denied Claimant's claims against Pershing but granted Claimant's Motion for Sanctions. Significantly, Pershing was required to pay Claimants' $250,000 in discovery sanctions despite the Panel denying Claimants' claims against it.

Cynthia Jo Gruchalski (Claimant) vs. Charles Schwab & Co., Inc. (Respondents)

Case No. 20-01474

Milwaukee, Wisconsin

Hearing Dates: March 2, 2021 – March 3, 2021 via videoconference

Award Date: March 24, 2021

Counsel:

Counsel for Claimant:

Timothy J Andriga, Esq., Cramer, Multhauf & Hammes, LLP Waukesha, Wisconsin.

Counsel for Respondent:

Kevin H. Lewis, Esq., Charles Schwab & Co., Inc., San Francisco, California and Samantha D. Parrish, Esq., Keesal, Young & Logan, Long Beach, California.

Arbitration Panel:

Leon Fox, Sole Public Arbitrator

Investments at Issue:

The causes of action relate to Charles Schwab's failure to timely transmit the paperwork for Claimant's IRA rollover, resulting in an almost two-month delay in Claimant's ability to access the funds in her account and causing the majority of her account to remain in cash during a market run-up.

Claimants' Claims:

In the Statement of Claim, Claimant requested $69,410.63 in compensatory damages, attorneys' fees, and filing costs.

Additional Relief Sought at Hearing:

Claimant requested compensatory damages in the amount of $90,500.00 for the loss of expected investment value, filing fees, and attorneys' fees.

Relief Requested:

(1) Loss of expected investment value;
(2) Filing Fees; and
(3) Attorneys' fees.

Award:

(1) Respondent is liable for and shall pay to Claimant the sum of $35,000 in compensatory damages.
(2) Respondent is liable for and shall pay to Claimant the sum of $225.00 in costs as reimbursement for the non-refundable portion of the filing fee previously paid to FINRA Dispute Resolution Services.
(3) Any and all claims for relief not specifically addressed herein, including any requests for punitive damages, treble damages, and attorneys' fees, are denied.

Analysis:

This award is noteworthy because it awarded a type of "speculative" damages not often seen in FINRA arbitration. While the Claimant, an IRA account holder, did not actually invest in any securities, this operational snafu by Schwab, which caused an almost two month delay in the opening of the rollover retirement account, was deemed enough to tag Schwab with a $35,000 damage award.

Stephen W. Apt, Pamela N. Apt, Benjamin Capdevielle, Emilie Dawson, Bryce J. Dawson, Nadine Dawson, Tony Eason, Christine Eason, Brandon Ehrlich, Natasha Ehrlich, Patricia Hamilton, Carol Hilton, Ian Hilton, Joann LaCanfora, Robert LaCanfora, Irene Leon Guerrero, Peter Leon Guerrero, Shannon A. McQuery, David Miller, Carrie Miller, Stephen Naramore, Diana Naramore, Holly Robinson, Eugene T. Rogers, Gary Wyatt and Martha Wyatt (Claimants) v. Charles Schwab & Co. Inc. and Interactive Brokers LLC. (Respondents)

Case No. 19-03250

Seattle, Washington

Hearing Dates: November 30, 2020-December 11, 2020, December 14, 2020, December 17, 2020 and March 10-11, 2021

Award Date: March 26, 2021

Counsel:

Counsel for Claimants:

Timothy B. Fitzgerald, Esq. and Gregory J. Hollon, Esq., McNaul Ebel Nawrot & Helgren PLLC, Seattle, Washington; John A. Bender, Esq., Bender Law PLLC, Seattle, Washington.

Counsel for Respondents:

For Respondent Charles Schwab Kevin H. Lewis, Esq. San Francisco, California; For Respondent Interactive Brokers: David Luger, Esq., Katten Muchin Rosenman, LLP, Chicago, Illinois.

Arbitration Panel:

Katherine H. O'Neil, Presiding Chairperson, David Gonzalez, Public Arbitrator Frederick Allan Kaseburg, Public Arbitrator (dissenting)

Investments at Issue:

The causes of action relate to an alleged high-frequency trading strategy in unspecified securities within Claimants' retirement accounts.

Claimants' Claims:

(1) Breach of contract;
(2) Breach of Covenant of Good Faith and Fair Dealing;
(3) Negligence;
(4) Unsuitability;
(5) Violations of the Washington Consumer Protection Act; and
(6) Violations of the Washington State Securities Act.

Relief Requested:

(1) On the breach of contract cause of action: an order requiring Respondents to pay monetary damages in an amount to be determined at the hearing plus interest;
(2) On the breach of covenant of good faith and fair dealing, negligence and unsuitability causes of action: an order requiring Respondents,

jointly and severally, to pay compensatory damages in an amount to be determined at the hearing plus interest;

(3) On the violations of Consumer Protection Act, RCW 48.30, et seq., cause of action:
- An order requiring Respondents, jointly and severally, to pay compensatory damages in an amount to be determined at the hearing plus interest;
- An order requiring Respondents, jointly and severally, to pay exemplary damages in an amount to be determined at the hearing plus interest; and
- An order requiring Respondents, jointly and severally, to pay attorneys' fees and costs as permitted under the Consumer Protection Act in an amount to be determined at the hearing plus interest;

(4) On the violations of Washington State Securities Act, RCW 21.20, et seq. cause of action:
- An order requiring Respondents jointly and severally, to pay compensatory damages in an amount to be determined at the hearing plus interest; and
- An order requiring Respondents, jointly and severally, to pay costs and reasonable attorneys' fees in an amount to be determined at the hearing plus interest.

(5) The total requested monetary damages and compensatory damages against all Respondents in an amount to be determined at the hearing but no less than $4,000,000.00, plus interest; and

(6) Whatever additional relief the Panel deems just and proper.

Award:

(1) Interactive Brokers is liable for and shall pay to Claimants the sum of $2,727,394.65 in compensatory damages.

(2) Interactive Brokers is liable for and shall pay to Claimants interest on the above-stated sum at the rate of 12% per annum from the date Award is issued through and including the date the Award is paid in full.

(3) Charles Schwab is liable for and shall pay to Claimants the sum of $606,087.70 in compensatory damages.

(4) Charles Schwab is liable for and shall pay to Claimants interest on the above-stated sum at the rate of 12% per annum from the date Award is issued through and including the date the Award is paid in full.

(5) Interactive Brokers is liable for and shall pay to the Leon Guerrero Claimants the sum of $835,300.41 in attorneys' fees pursuant to: Washington Consumer Protection Act, RCW 19.86.080; RCW

19.86.090; Interactive Brokers Advisor Client Agreement; and RCW 4.84.330.

(6) Interactive Brokers is liable for and shall pay to the Naramore Claimants the sum of $149,056.58 in attorneys' fees pursuant to: Washington Consumer Protection Act, RCW 19.86.080; RCW 19.86.090; Interactive Brokers Advisor Client Agreement; and RCW 4.84.330.

(7) Charles Schwab is liable for and shall pay to the Leon Guerrero Claimants the sum of $278,433.47 in attorneys' fees pursuant to: Washington Consumer Protection Act, RCW 19.86.080; RCW 19.86.090; Charles Schwab Account Application Agreement; and RCW 4.84.330.

(8) Charles Schwab is liable for and shall pay to the Naramore Claimants the sum of $49,685.52 in attorneys' fees pursuant to: Washington Consumer Protection Act, RCW 19.86.080; RCW 19.86.090; Charles Schwab Account Application Agreement; and RCW 4.84.330.

(9) Respondents are jointly and severally liable for and shall pay to Claimants $600.00 as reimbursement for the non-refundable portion of the filing fee previously paid to FINRA Dispute Resolution Services.

(10) Any and all claims for relief not specifically addressed herein are denied.

Analysis:

This seven-figure award is significant both for its size as well as its claim for damages resulting from a high frequency trading strategy. Claimants were awarded compensatory damages of over $3 million against Interactive Brokers and over $800,000 against Charles Schwab as a result of losses caused by the strategy in their accounts. Additionally, an attorneys' fee award totaling approximately $1.3 million was assessed against the Respondent firms. One arbitrator (Kaseburg) dissented without comment.

Janet Anderson et al (Claimants) v. Purshe Kaplan Sterling Investments and TD Ameritrade, Inc. (Respondents)

Case No. 19-00519

Phoenix, Arizona

Hearing Dates: January 18-21, 2021, February 16-17, 2021, February 19, 2021 and February 22-23, 2021.

Award Date: April 8, 2021

Counsel:

Counsel for Claimants:

Adam J. Gana, Esq., Gana Weinstein LLP, New York, New York.

Counsel for Respondent/Crossclaimant PKS:

Sanay B. Panchal, Esq., O'Hagan Meyer, LLC, Newport Beach, California.

Counsel for Respondent/Crossclaimant TD Ameritrade:

Neil S. Baritz, Esq., Baritz & Colman, LLP, Boca Raton, Florida.

Arbitration Panel:

Richard D. Fincher, Presiding Chairperson, Delores Manwar, Public Arbitrator, Kenneth Layne Morrill, Public Arbitrator

Investments at Issue:

The causes of action relate to alleged fraudulent, unsuitable and excessive trading of unspecified securities within Claimants' accounts.

Claimants' Claims against Respondent PKS:

(1) Suitability;
(2) Misrepresentations and omissions in violation of federal law, Arizona's blue sky laws, and FINRA Rules 2020 and 2210;
(3) Violation of Arizona Consumer Legal Remedies Act;
(4) Violation of FINRA Rule 2010 and IM-2310-2;
(5) Respondeat superior; and
(6) Failure to supervise

Claimants' Claims against Respondent TD Ameritrade:

(1) Failure to supervise;
(2) Misrepresentations and omissions in violation of federal law, Arizona's blue sky laws, and FINRA Rules 2020 and 2210;
(3) Violation of Arizona Consumer Legal Remedies Act; and
(4) Violation of FINRA Rule 2010 and IM-2310-2.

PKS' Crossclaims against Respondent TD Ameritrade:

(1) Failure to supervise under FINRA Rule 2360
(2) Fraud;
(3) Negligence; and
(4) Equitable indemnity.

Relief Requested:
Claimants requested the following relief from Respondents:

(1) Compensatory damages for a sum to be determined at hearing;
(2) Interest at the statutory rate;
(3) Attorneys’ fees;
(4) Expert fees;
(5) Forum fees;
(6) Punitive damages; and
(7) Such other and further relief the Panel deems just and proper.

PKS requested the following relief from TD Ameritrade:

(1) Compensatory damages in an amount determined by the Panel;
(2) Punitive damages;
(3) Attorneys’ fees; and
(4) Pre-judgment and post-judgment interest at the Arizona statutory rate.

TD Ameritrade requested the following relief against PKS:

(1) Dismissal of the Crossclaim in its entirety;
(2) Attorneys’ fees and costs under the doctrine of “tort of another”.

Award:

(1) PKS Investments’ Crossclaim is denied in its entirety.
(2) PKS Investments is liable for and shall pay to TD Ameritrade the sum of $400,000.00 in attorneys’ fees and costs pursuant to Arizona’s exception to the American Rule for “tort of another” and pursuant to other provisions of Arizona law providing for attorney’s fees awards.
(3) Any and all claims for relief not specifically addressed herein, including requests for punitive damages, are denied.

Analysis:

While the core claims of this case against the two Respondents were all settled by the time of Claimants’ pre-hearing, PKS’s Crossclaims against TD Ameritrade went to a final hearing. Because the panel found in favor of TD Ameritrade, it assessed $400,000 in attorney’s fees against PKS under Arizona’s “tort of another” doctrine. This doctrine allows a party to shift fees where another is responsible for the actions causing harm. This is noteworthy in that many advisors use platforms of larger firms such as TD Ameritrade to conduct their business. While it appears from the award that TD Ameritrade settled its claims with the customer, this particular state statute allowed it to recover fees from another firm involved in the underlying transactions forming the basis of the arbitration.

Richard Trust (Claimant) v. TD Ameritrade, Inc. (Respondent)
Case No. 18-04020
San Francisco, California
Hearing Dates: February 11-12, 2021
Award Date: March 5, 2021
Counsel:
  Counsel for Claimant: Pro Se
  Counsel for Respondent: James J. Vihstadt, Esq., TD Ameritrade, Inc., Omaha, Nebraska.
Arbitration Panel:
  Daniel M. Yamshom, Presiding Chairperson
  Herb Schwartz, Public Arbitrator
  Rosalind Ramsey Tyson, Public Arbitrator
Investments at Issue:
  Unauthorized trading in unspecified securities.
Claimants' Claims:
(1) Breach of contract
(2) Breach of fiduciary duty;
(3) Unauthorized trading;
(4) Churning;
(5) Negligence;
(6) Negligent misrepresentation;
(7) Equitable lien;
(8) Unjust enrichment;
(9) Violation of California Business and Professional Codes § 17200 and § 17500;
(10) Promissory estoppel;
(11) Constructive trust;
(12) Fraud;
(13) Promissory fraud;
(14) Constructive fraud;
(15) Conversion;
(16) Violation of NASD Rule 2510;
(17) Violation of FINRA rules 2010, 2020, and 4512;
(18) Violation of 17 CFR § 240.10b-5;
(19) Violation of the unfair competition law; and
(20) Violation of Consumers Legal Remedies Act.

Relief Requested:
(1) Unspecified compensatory damages to place Claimant in the same position as if the unauthorized trading had not occurred;
(2) Treble damages;

(3) Attorneys' fees;
(4) Punitive damages;
(5) Statutory damages;
(6) Interest;
(7) Declaratory relief;
(8) Injunctive relief;
(9) Costs; and
(10) Such other relief as the Panel may deem proper.

Award:

(1) Respondent is liable for and shall pay to Claimant the sum of $298,400.00 in compensatory damages.
(2) Any and all claims for relief not specifically addressed herein, including any requests for treble damages, attorneys' fees, and punitive damages, are denied.

Analysis:

In this arbitration, a *pro se* claimant was awarded almost $300,000.00 by the panel after a hearing that lasted only two days. While only compensatory damages were awarded, this is a large *pro se* result. The question is whether the Claimant might have received other types of damages (including punitive or interest) if an attorney had been representing him in this case.

CASES & MATERIALS

Jason Burge

The Ninth Circuit holds that in determining whether federal courts have diversity jurisdiction over an action seeking enforcement of a third-party subpoena issued by arbitrators, courts can consider benefit to plaintiff in assessing the amount in controversy.

Maine Community Health Options v. Albertsons Companies, Inc., --- F.3d ---- (9th Cir. March 31, 2021):

Parties in arbitration can obtain discovery from third parties through arbitral subpoenas, but with limited exceptions, arbitrators are unable to enforce subpoenas issued to third parties. Instead, § 7 of the Federal Arbitration Act ("FAA") gives federal courts the ability to compel compliance with arbitral subpoenas and to punish third parties for contempt if they ignore arbitral subpoenas. *See* 9 U.S.C. § 7. The FAA does not confer federal jurisdiction, however, so to obtain relief under § 7 a party seeking to enforce a subpoena must establish that there is federal subject matter jurisdiction over the action. *See, e.g., Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 25 n. 32 (1983). If a party attempts to establish diversity jurisdiction, the question arises how to calculate the "amount in controversy" under 28 U.S.C. § 1332 for the action to enforce the subpoena.

Maine Community Health Options ("Health Options"), a health insurer, was arbitrating with Navitus Health Solutions ("Navitus"), a pharmacy benefits manager, over alleged billing improprieties. --- F.3d ----, at *1. After Navitus claimed not to have relevant information, Health Options obtained a subpoena from the arbitrators to get the information directly from Albertsons Companies, Inc. ("Albertsons"). *Id.* When Albertsons objected to the subpoena, Health Options filed an action in district court seeking to enforce the subpoena under § 7 of the FAA. Health Options asserted diversity jurisdiction, claiming that the parties to the enforcement action were from different states and the amount in controversy exceeded $75,000. *Id.* at *1. Albertsons responded that the cost of compliance with the subpoena was $1,400, and Health Options was unable to dispute that estimate. *Id.* at *2. The district court thus held that Health Options failed to prove the amount in controversy exceeded $75,000 and dismissed the enforcement action for lack of subject matter jurisdiction. *Id.* at *1. Health Options appealed.

The Ninth Circuit began by noting that when parties seek non-monetary relief—such as a response to a subpoena—the amount in controversy "is measured by the value of the object of the litigation." *Id.* at *2 (citing *Hunt v. Washington State Apple Advert. Comm'n,* 432 U.S. 333, 347, (1977)). Pursuant to the "either viewpoint" rule, "if the value of the thing to be accomplished is equal to the dollar minimum of the jurisdictional amount requirement to anyone concerned in the action, then jurisdiction is satisfied." *Id.* (citing *Ridder Bros. Inc. v. Blethen*, 142 F.3d 395, 399 (1944)). Therefore, although the cost of compliance with the subpoena was clearly less than $75,000 from Albertsons' viewpoint, the Ninth Circuit held that the jurisdictional amount could be satisfied from "Health Options' viewpoint." *Id.*

The Ninth Circuit noted that in considering the value to a plaintiff of an arbitration subpoena, the court should consider "the value of the subpoenaed information to the plaintiff in the underlying arbitration dispute." *Id.* Health Options' total claim in the arbitration was $17 million, and the alleged billings related to Albertsons exceeded $1.7 million. *Id.* While the Ninth Circuit concluded that the recovery of the information sought in the subpoena would not likely lead to the recovery of the entire $1.7 million, "Health Options does plausibly allege that the subpoenaed information will likely affect more than $75,000 of its claims against Navitus." *Id.* In support of that allegation, Health Options had submitted an expert declaration that the subpoenaed information "will likely document more than $75,000 in Health Options' alleged damages." The Ninth Circuit concluded that based on these "plausible good faith allegations, it does not appear to *a legal certainty* that the claim is really for less than the jurisdictional amount," thus federal jurisdiction was established. *Id.* (emphasis in original).

Judge Watford concurred in the opinion on alternative grounds. He would have evaluated federal subject matter jurisdiction of the enforcement action based on whether the district court would have subject matter jurisdiction over the controversy in the underlying arbitration, under the theory that a § 7 petition is simply an adjunct to the "underlying substantive controversy" between the parties in arbitration. *Id.* at 4. Thus, because Health Options and Navitus were of diverse citizenship and the dispute met the amount-in-controversy requirement, he would have held that the district court had jurisdiction under § 7 to enforce third party subpoenas regardless of whether there was diversity jurisdiction between Health Options and any third party. *Id.* He noted that his approach appeared to be favored by the Second and Seventh Circuits. *Id.* (citing *Stolt-Nielsen SA v. Celanese AG*, 430 F.3d 567, 572-73 (2d Cir. 2005); *Amgen, Inc. v. Kidney Ctr. of Delaware Cty., Ltd.*, 95 F.3d 562, 567 (7th Cir. 1996)).

The Second Circuit rules that domestic securities transaction was nonetheless "so predominantly foreign" that it was outside the reach of Section 10(b) of the Securities Exchange Act.

***Cavello Bay Reinsurance Ltd. v. Shubin Stein*, 986 F.3d 161 (2d Cir. 2021):**

Section 10(b) of the Securities Exchange Act does not apply beyond U.S. borders. But in the modern global economy, many claims will have both a foreign and a domestic component. Thus, courts are often called to resolve when a securities transaction is sufficiently foreign that it is no longer subject to Section 10(b). "Unless a security is listed on a domestic exchange, a domestic transaction is a necessary element of a §10(b) claim." 986 F.3d at 165. But the element of a domestic transaction alone is not sufficient. The Second Circuit has held that a claim must not be so "predominantly foreign as to be impermissibly extraterritorial." *Id.* (citing *Parkcentral Glob. Hub Ltd. v. Porsche Auto. Holdings SE*, 763 F.3d 198, 216 (2d Cir. 2014)).

In *Cavallo Bay Reinsurance Ltd. v. Shubin Stein*, a Bermudan corporation bought $5 million worth of shares in a Bermudan holding company that operates out of New York and invests in U.S. insurance services. *Id.* at 163. The seller of the shares, Spencer Capital, was a Bermudan private holding company with a principal place of business in New York. *Id.* at 164. It maintains a portfolio of U.S. insurance-related assets, which is managed by Spencer Management, a related entity formed under Delaware law. *Id.* Both Spencer entities were controlled by Shubin Stein. *Id.* Spencer Capital allegedly approached the plaintiff with a private offering of shares in its portfolio. *Id.* The plaintiff signed the subscription agreement in Bermuda, the seller signed the agreement in New York, and the closing was held in Bermuda. *Id.* The subscription agreement provided that it was governed by New York law and the shares were issued in accordance with the Securities Act of 1933. *Id.* Shubin Stein pitched the investment from his office in New York, including through use of a PowerPoint sent to the plaintiff in Bermuda which misrepresented Spencer Managements fee arrangement. *Id.* As a result of the misrepresentation, the plaintiff was unaware that Spencer Management earned $4.4 million in fees during a period when the portfolio was operating at a loss. *Id.* After the plaintiff sued for securities exchange act violations, the district court dismissed the action, concluding that the transaction was not domestic, and the claims were "so predominantly foreign as to be impermissibly extraterritorial." *Id*. The Plaintiff appealed.

The Second Circuit began by noting that the transaction "arguably took place in the United States." *Id.* at 165. Because the contract was signed both in Bermuda and New York, it was unclear where the meeting of the minds occurred. *Id.* Indeed, the Second Circuit noted that "locating the 'meeting of the minds' can be arranged or confused by the parties or can become enmeshed in state contract law." *Id.* Accordingly, the Second Circuit assumed that it was a domestic transaction and proceeded to consider whether it was, nevertheless, too predominantly foreign. *Id.*

The Second Circuit then reviewed its prior jurisprudence on the application of the securities laws to partially foreign transactions. The Court noted that its prior "conduct and effects test"—which had considered "(1) whether the wrongful conduct occurred in the United States, and (2) whether the wrongful conduct had a substantial effect in the United States or upon United States citizens"—had been criticized and ultimately supplanted by the Supreme Court. *Id.* at 165-66. In *Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. 247, 266 (2010), the Supreme Court had replaced the conducts and effects test with a bright-line rule that "limits § 10(b)'s reach to transactions in securities listed on domestic exchanges, and domestic transactions in other securities." *Morrison* directs courts to use the 'focus' of the statute to determine whether the case involves a domestic application of § 10(b), and the focus of the securities laws are "upon purchases and sales of securities in the Unites States," not "upon the place where the deception originated." *Id.* "Put differently, courts must evaluate whether the domestic activity involved implicates the 'focus' of the statute." *Cavallo Bay*, 986 F.3d at 166 (citing *Prime Int'l Trading, Ltd. V. BP P.L.C.*, 937 F.3d 94, 102 (2d Cir. 2019)). The Second Circuit noted that the focus should be "on the transaction rather than the surrounding circumstances," and the courts must consider "whether a claim—in view of the security and the transaction as structured—is still predominantly foreign." *Id.* at 166-67.

Applying that standard to the claim at hand, the Second Circuit noted that the claim is based on a "private offering between a Bermudan investor and a Bermudan issuer" and they are "listed on no U.S. exchange and are not otherwise traded in the United States." *Id.* at 167. While the subscription agreement required a registration with the SEC should the plaintiff wish to sell the shares, this clause set up only a "future invocation of U.S. law" and the Court found "no reason to think an SEC registration requirement—contingent and future—triggers some U.S. interest or other interest that the statute is meant to protect." *Id.* The Court also noted that the designation of New York law in the contract was "neither here nor there." *Id.* As to the Plaintiff's allegations that the investment manager "made the misstatement from New York," "planned to use the funds to invest in U.S. insurance services," was based in New York, and "managed by a U.S. company," the Court found reliance on these facts a vestige of the "now-defunct conduct and effects test." *Id.* Similarly, acts evincing contract formation in the U.S. were not sufficient to change the analysis. *Id.* at 167-68. The Court concluded that "the contacts that matter are those that relate to the purchase and sale of securities." *Id.* at 167.

The Second Circuit also noted the policy implications of this rule:

> Cavello Bay seeks access to a domestic forum and judicial resources; but the transaction is structured to avoid the bother and expense (and taxation) of U.S. law. If either of these sophisticated institutional investors had wanted the regulatory hand of U.S. law, they could have bargained for it and structured a U.S. transaction. The transaction implicates only the interests of two foreign companies and Bermuda. Although Spencer Capital allegedly solicited some U.S. investors, that means no more than that someone (else) might have an appropriately domestic claim.
>
> Providing a domestic forum ought to enhance confidence in U.S. securities markets or protect U.S. investors. Here it would do neither.
>
> *Id.* (citations omitted).

The Ninth Circuit rules that broad arbitration clause does not require arbitration of unrelated claims against future affiliate of signatory, creating a circuit split with the Fourth Circuit.

***Revitch v. DIRECT TV, LLC*, 977 F.3d 713 (9th Cir. 2020):**

Modern compulsory consumer arbitration often involves extremely broad arbitration clauses requiring arbitration of all disputes involving not only the counterparty, but also its affiliates. If a consumer contracts with a large conglomerate, like a multinational bank, tech company, or mobile phone carrier, the scope of such an arbitration clause is potentially limitless, particularly given continuous consolidation in these industries through mergers and acquisitions. When can a defendant, who has no direct arbitration clause with a plaintiff, nonetheless enforce a broad arbitration agreement the plaintiff executed years earlier with a corporate affiliate in an unrelated context?

The Plaintiff asserted a class action against Direct TV under the Telephone Consumer Protection Act, alleging that DIRECTV made unsolicited rerecorded marketing calls to his cellphone. *Revitch*, 977 F.3d at 715. The Plaintiff had no previous contact with DIRECTV. *Id.* Nonetheless, DIRECTV discovered that Revitch was a cellphone customer of AT&T Mobility and had executed an arbitration agreement when he upgraded his mobile service in 2011. That arbitration agreement covered "all disputes and claims … arising out of or relating to any aspect of the relationship" between the Plaintiff and AT&T Mobility. *Id.* The contract also defined AT&T Mobility to include its "affiliates." *Id.* In 2015, DIRECTTV was acquired by AT&T Mobility's parent company, AT&T, hence at the time the lawsuit was filed, DIRECTV and AT&T Mobility were "affiliates." *Id.* DIRECTV filed a motion to compel arbitration, arguing it could "piggyback" onto the arbitration clause. *Id.* That motion was denied by the district court, which found that "the contract between [Plaintiff] and AT&T Mobility did not reflect an intent to arbitrate the claim that [Plaintiff] asserts against DIRECTV." *Id.* at 715-16. An appeal to the Ninth Circuit followed.

The Ninth Circuit defined the issue as, "Does a valid agreement to arbitrate exist between [Plaintiff] and DIRECTV?" *Id.* at 716. The Ninth Circuit turned to state contract law to answer that question. *Id.* at 716-17. Notably, focusing on the existence of an arbitration agreement, rather than its scope, avoided the rule that "any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration." *Id.* at 719. There is no similar presumption when considering the existence of an arbitration agreement. *Id.*

In California, as in many other states, "a contract must be interpreted to give effect to the mutual intention of the parties as it existed at the time of contracting," determined based on the "written terms of the contract alone, so long as the contract language is clear and explicit and does not lead to absurd results." *Id.* at 717 (citing Cal. Civ. Code § 1636 and *Kashmiri v. Regents of Univ. of Cal.*, 67 Cal. Rptr. 3d 635, 652 (Cal. App. 4th 2007)). The Ninth Circuit had no trouble concluding that, at the time the suit was filed, DIRECTV and AT&T Mobility were affiliates. *Id.* Nonetheless, the Ninth Circuit concluded that "absurd results follow" from the interpretation that the Plaintiffs would be "forced to arbitrate any dispute with any corporate entity that happens to be acquired by AT&T, Inc., even if neither the entity nor the dispute has anything to do with providing wireless services to [the Plaintiff]." *Id.* The Ninth Circuit concluded that the reasonable expectation of the parties at the time of the contract could not have included that the Plaintiff would be forced to arbitrate a dispute with a future affiliate regarding an unrelated dispute. *Id.* at 717-18 And the Ninth Circuit noted that the contract contained no forward-looking language, such as "any affiliates, both present and future," that would suggest such an expectation. *Id.* at 718.

The Ninth Circuit acknowledged that the Supreme Court has held that state law contract defenses that "have a disproportionate impact on arbitration agreements" or "disfavor[] arbitration" are preempted by the Federal Arbitration Act. *Id.* But the Ninth Circuit noted that the absurd results canon was not a defense, but rather a rule of interpretation, used to "discern the mutual intent of the parties based on their reasonable expectations at the time of contact." *Id.* Accordingly, it was not preempted.

The Ninth Circuit acknowledged that the Fourth Circuit had ruled in favor of DIRECTV in a recent case with similar facts involving an identical arbitration clause. *Id.* at 720 (citing *Mey v. DIRECTV*, 971 F.3d 284 (4th Cir. 2020)). Accordingly, this decision opened a circuit split on the question of whether "anything less than the most explicit 'infinite language' in a consumer services agreement [can] bind the consumer to arbitrate any and all disputes with (yet-unknown) corporate entities that might later become affiliated with the service provider—even when neither the entity nor the dispute bear any material relation to the services provided under the initial agreement?" *Id.* That circuit split remains to be resolved by the Supreme Court on another day.

Judge O'Scannlain, who wrote the majority opinion, also signed a separate concurrence noting that if the Court had considered the issue of contract scope, he would still have affirmed the denial of the motion to compel arbitration because the dispute in this case "simply does not 'arise out of' [the Plaintiff's] contract with AT&T Mobility." *Id.* at 721 (citing 9 U.S.C. § 2). He argues that the FAA "does not require the enforcement of an arbitration clause to settle a controversy that does *not* arise out of the contract or transaction," although he admitted that he had not located any case that had relied on the "arising out of" language in 9 U.S.C. § 2 in this way. *Id.* at 721-22 (emphasis in original).

Judge Bennett dissented. He argued that there was undisputedly a valid arbitration agreement between the Plaintiff and all affiliates of AT&T Mobility, and nothing in the arbitration clause or "the dictionary definition of the word 'affiliate' confers any type of temporal scope to the term so that 'affiliates' should be read to refer only to *present* affiliates." *Id.*at 725 (emphasis in original). Rather than focusing on the existence of an arbitration agreement, he argued the issue was solely one of whether the present dispute was within the scope of the arbitration agreement; since the agreement covered "all disputes and claims," the inquiry should end there. *Id.* He also noted that the majority's "absurd results" analysis only reached an absurd result by presuming that arbitration was "inferior" to litigation, otherwise there is nothing absurd about a party agreeing to "a very broad, forward-looking arbitration clause." *Id.* at 728. He argued this was contrary to the Supreme Court's guidance against applying rules that disfavor arbitration. *Id.* (citing *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333, 341-42 (2011)).

Notes & Observations