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VOLUME 30 | 2023 | NO. 1

In this Issue

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DETECTING PONZI SCHEMES AND DODGING PROFESSIONAL AND INVESTOR LIABILITY

Kathy Bazoian Phelps[1]

A Ponzi scheme is a fictitious investment program with little to no underlying legitimate business operation to which the investment is connected, and returns are paid to earlier investors from new funds coming in from later investors. These fraudulent schemes invariably implode when the perpetrator loses the ability to lure in new investors to fund the fraud. Attorneys, auditors, brokers, financial institutions, and even the victims themselves can become unwitting participants in the fraudulent scheme, having been duped by the perpetrator and having failed to detect the fraud. Or, with some knowledge of the perpetrator's misconduct, those professionals and investors may find themselves jointly liable with the primary violator once the Ponzi scheme is busted.

Ponzi schemes unfortunately thrive because of a combination of the victims' unquestioning trust and a lack of due diligence by everyone in contact with the scheme. Ponzi perpetrators tend to prey upon people with whom they have an affinity or trusting connection and design their fraudulent schemes to lure in people in those groups. The intentionally targeted victims, therefore, have a heightened sense of trust in the Ponzi perpetrator, who has likely tailored the investment product to that particular group.

Professionals sometimes get caught in that same web of trust and deception. The perpetrator carefully choreographs a façade to appear credible and engaged in a legitimate and successful business. That often involves hiring well respected attorneys and auditors, among other types of professionals. The perpetrator will hide behind apparent wealth by, for example, making grandiose charitable contributions, living an extravagant lifestyle, hiring well-known professionals, and using reputable financial institutions. The perpetrator will also pay back just enough money to earlier investors to instill confidence that the business is making money.

Meanwhile, the victims, and sometimes the professionals, simply trust too much and investigate too little. Victims, who can range from unsophisticated

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1. Kathy Bazoian Phelps is a partner in the Los Angeles office of Raines Feldman LLP and the co-author of *The Ponzi Book: A Legal Resource for Unraveling Ponzi Schemes*. She represents bankruptcy trustees, federal equity and state court receivers, handles complex fraud litigation, and files whistleblower complaints for defrauded victims.

family and friends to sophisticated hedge fund investors often do not ask the hard but necessary questions, or may not ask any questions at all. Professionals may rely upon historical relationships or the reputation of their client in failing to do their job properly. The perpetrator generally appears so successful and confident that both the victims and professionals may be discouraged from confronting the perpetrator with questions or doubts. Rather, human nature kicks in and people are pleased to be in association with a successful person and business as they trust that they will receive their promised returns or hefty professional fees.

Once a scheme has been revealed – usually landing in a bankruptcy or receivership case – the scramble to find money to pay back the victims' losses begins. Two significant sources of potential recovery are: (1) fraudulent transfer claims against those who profited by the scheme; and (2) tort claims, such as negligence, fraud, or aiding and abetting liability theories, against the professionals who assisted the scheme.

To mitigate liability and navigate the minefields of Ponzi schemes, professionals are best served by conducting significant due diligence, heeding red flag warning signs of fraud, educating themselves on possible risks and exposure, advising their clients early and often of their risks and exposures. Investors, and their counsel, must remain mindful of the risks for investors that may arise once a Ponzi scheme is revealed, since investors could become targets of a fraudulent transfer or tort claim by a bankruptcy trustee, receiver, or other victims.

I. PONZI SCHEMES

A. Definition

Fundamentally, a Ponzi scheme is a financial scheme by which a fraudster steals money from his victims. There is not one definitive definition of a Ponzi scheme. Regulators and courts have crafted different variations on the definition. For example, the Securities and Exchange Commission describes a "Ponzi scheme" as follows:

> A Ponzi scheme is an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors. Ponzi scheme organizers often solicit new investors by promising to invest funds in opportunities claimed to generate high returns with little or no risk. In many Ponzi schemes, the fraudsters focus on attracting new money to make promised payments to earlier-stage investors and to use for personal expenses, instead of engaging in any legitimate investment activity.[2]

B. Common Characteristics and Red Flag Warning Signs

Sometimes a Ponzi scheme is a fraudulent scheme from its inception, with no intention to run a legitimate business. In other instances, the promoter sets out believing it has a legitimate business, but either it could not get the business off the ground as planned or the legitimacy of the business was lost in the wake of the fraudulent scheme. Yet other schemes involve both legitimate and illegitimate business operations. In each scenario, the seeds that motivate the fraud are generally greed and ego.

The facts considered by courts to determine whether a Ponzi scheme exists range in scope. One court created a four-factor analysis that many other courts have relied upon:

> (1) deposits were made by investors; (2) the Debtor conducted little or no legitimate business operations as represented to investors; (3) the purported business operations of the Debtor produced little or no profits or earnings; and (4) the source of payments to investors was from cash infused by new investors.[3]

The SEC has published red flag warning signs which many Ponzi schemes share in common:

- **High investment returns with little or no risk**. Every investment carries some degree of risk, and investments yielding higher returns typically involve more risk. Be highly suspicious of any "guaranteed" investment opportunity.

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2. *Ponzi Schemes — Frequently Asked Questions*, SEC, https://www.investor.gov/introduction-investing/investing-basics/glossary/ponzi-schemes.

3. Rieser v. Hayslip (In re Canyon Sys. Corp.), 343 B.R. 615, 630 (Bankr. S.D. Ohio 2006) (citation omitted).

- **Overly consistent returns**. Investments tend to go up and down over time. Be skeptical about an investment that regularly generates positive returns regardless of overall market conditions.
- **Unregistered investments**. Ponzi schemes typically involve investments that are not registered with the SEC or with state regulators. Registration is important because it provides investors with access to information about the company's management, products, services, and finances.
- **Unlicensed sellers**. Federal and state securities laws require investment professionals and firms to be licensed or registered. Most Ponzi schemes involve unlicensed individuals or unregistered firms.
- **Secretive, complex strategies**. Avoid investments if you don't understand them or can't get complete information about them.
- **Issues with paperwork**. Account statement errors may be a sign that funds are not being invested as promised.
- **Difficulty receiving payments**. Be suspicious if you don't receive a payment or have difficulty cashing out. Ponzi scheme promoters sometimes try to prevent participants from cashing out by offering even higher returns for staying put.[4]

II. TYPES OF DUE DILIGENCE

A lack of reasonable due diligence, especially in the face of red flag warning signs, is the primary reason that Ponzi scheme perpetrators are successful in scamming investors. Investors seeking to avoid Ponzi schemes when considering alternative investments, and professionals accepting assignments from sponsors who offer investments programs, should undertake due diligence, and might model their efforts on the types of due diligence conducted by a financial institution considering a large commercial loan:

A. Investigate Company's Auditor

- Is the auditor for the investment truly independent?
- Is the size of the audit shop proportionate to the size of the investment?
- Talk to the auditors

4. *Ponzi Schemes —Ponzi scheme "red flags*", SEC, https://www.investor.gov/protect-your-investments/fraud/types-fraud/ponzi-scheme.

B Financial Statements

- Review audited financial statements
- Review tax returns
- Check for accuracy and completeness
- Call the auditor

C. Public Information About the Company

- Investigate negative news coverage
- Conduct nationwide litigation search
- Conduct criminal background check

D. The Business Model

- Investigate the need for investor funds
- Is there a plausible, sustainable investment strategy?
- Is there independently verifiable performance?
- Are there unusual legal provisions?

E. Complicated Corporate Structure

- Who are the principals?
- Are there multiple levels of corporate ownership?
- Are there affiliated companies in the same business?
- Are there intercompany purchases and sales?

F. Operational Issues

- Investigate accounting and reporting systems
- Investigate reports made to customers
- Are operations consistent with reports?
- Is there micro management by owner?
- Is there turnover at significant financial positions?

G. Red Flags from Financial Transactions

- Customers who provide insufficient or suspicious information
- Customers who are reluctant to comply with reporting or record-keeping requirements
- Funds transferred to or from a financial secrecy haven
- Unusual transfers of funds between related entities
- Sudden inconsistencies in currency transaction patterns and shell company activities
- Significant increases in the number or amount of transactions
- Transactions that are not consistent with the customer's business or income level
- Transactions designed to lose the paper trail
- Circumvention of internal control procedures

- Lavish lifestyle of customers, which should not be supported by present income
- Customers with multiple accounts
- Diversion of funds to personal accounts
- Increases in the number or amount of transactions
- Transactions not consistent with company's business or income level
- Transactions designed to lose the paper trail
- Circumvention of internal control procedures.
- Irregular documentation
- Suspicious Intra-Company Transfers

III. POTENTIAL TORT THEORIES FOR PROFESSIONAL LIABILITY

When the primary violator's assets have disappeared, parties must look to litigation claims in order to recover lost funds and recoup damages. Third party tort claims can be pursued against a variety of targets on numerous tort, statutory, and equitable theories available under federal and state laws. A few of the more common theories are discussed below.

Perpetrators of fraudulent schemes often solicit the assistance of attorneys, accountants, auditors, salespeople, and other professionals to give their fraudulent business an air of legitimacy. For example, the perpetrator asks counsel to prepare the offering materials and private placement memoranda. Or the auditor is asked to prepare audited financial statements so that the company can then distribute that documentation to its investors to solicit more investments. Those professionals often later find themselves the targets of malpractice lawsuits for the services they provided before the fraudulent scheme collapsed. Their defense, of course, is that they obtained fraudulent information from their client so they should not be blamed. The question then becomes whether it was reasonable for them to rely upon their client without conducting due diligence or heeding red flags.

A. Fraud

In some circumstances, professionals may have knowingly and actively agreed to participate in the fraudulent activity themselves. In addition to claims for conspiracy, or aiding and abetting liability, discussed below, those defendants may find they have potential liability for fraud. To establish a claim of fraud (sometimes called "fraudulent misrepresentation") under California law, the plaintiff must establish: "(a) misrepresentation (false representation, concealment, or nondisclosure); (b) knowledge of falsity (or 'scienter'); (c) intent to defraud, i.e., to induce reliance; (d) justifiable reliance; and (e) resulting damage."[5]

Knowledge of the fraud on the part of the professional is a key element in imposing liability on that professional. In connection with the *Madoff* Ponzi scheme, the court dismissed a fraud claim against the auditor because the complaint did "not allege facts from which the court could infer that the auditor actually knew about and ignored most of these warning signs."[6] The court noted:

> But an unseen red flag cannot be heeded. Hence courts in this Circuit have consistently dismissed fraud claims against auditors-including against auditors of BMIS feeder funds-that have not sufficiently alleged that an auditor knew of red flags. *See In re Beacon Assoc. Litig.*, No. 09-CV-777, 2010 WL 3895582, at *22 (S.D.N.Y. Oct. 5, 2010) ("Plaintiffs allege a litany of red flags, but fail to allege sufficiently that Friedburg ever became aware of them. . . . Such allegations do not support a strong inference that Friedburg was aware of red flags and acted with scienter.").[7]

B. Aiding and Abetting Fraud and Breach of Fiduciary Obligations

Aiding and abetting theories of recovery may provide for relief against third parties who have been involved in a fraudulent scheme. To prove aiding and abetting fraud, the plaintiff must establish these three elements: (1) the existence of a fraud; (2) the defendant's knowledge of the fraud; and (3) that the defendant provided substantial assistance to advance the fraud's commission.[8]

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5. Lazar v. Superior Court, 909 P.2d 981, 984 (Cal. 1996).

6. Stephenson v. PricewaterhouseCoopers LLP, 768 F. Supp. 2d 562, 575 (S.D.N.Y. 2011).

7. *Id.*

8. Lerner v. Fleet Bank, N.A., 459 F.3d 273, 292 (2d Cir. 2006); Lawrence v. Bank of America, N.A., 455 Fed. App'x 904, 906 (11th Cir. 2012).

The elements of a claim of aiding and abetting a breach of fiduciary duty are: (1) a breach of fiduciary duty; (2) knowing participation or substantial assistance in that breach by the defendant; and (3) damages.[9]

1. The Knowledge Requirement

The first of the two elements required to establish aiding and abetting liability, knowledge (defendant's knowledge of the fraud or of the breach of fiduciary obligation), must be demonstrated by actual knowledge; constructive knowledge is insufficient.[10] In the Ponzi scheme case of Reed Slatkin, the court noted, "while aiding and abetting may not require a defendant to agree to join the wrongful conduct, it necessarily requires a defendant to reach a conscious decision to participate in tortious activity for the purpose of assisting another in performing a wrongful act."[11] At a minimum, the defendant must have knowledge of the perpetrator's wrongful conduct, even if not specifically of the fraud on the particular victim.[12]

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9. Terry v. SunTrust Banks, Inc., 2012 WL 2511066, at *8 (4th Cir. 2012) (affirming the dismissal of plaintiff's aiding and abetting breach of fiduciary duty claim, finding that the plaintiff failed to allege facts showing a fiduciary duty); LaSala v. Bordier et Cie, 519 F.3d 121, 130 (3d Cir. 2008) (applying Delaware law); Facciola v. Greenberg Traurig LLP, 2011 U.S. Dist. LEXIS 61785, at *34 (D. Ariz. June 9, 2011); Fine v. Sovereign Bank, 2011 WL 2134380, at *2 (D. Mass. 2011); Mandelbaum v. Fiserv, Inc., 787 F.Supp.2d 1226, 1242 (D. Colo. 2011).

10. Neilson v. Union Bank, N.A., 290 F. Supp. 2d 1101, 1118-19 (C.D. Cal. 2003) ("knew or should have known" allegations were insufficient).

11. *Id.* (citation omitted); *but see* Marcelos v. Dominguez, 2008 U.S. Dist. LEXIS 91155, at *26 (N.D. Cal. July 18, 2008) (finding actual knowledge despite plaintiff having included the phrase "knew or should have known" because plaintiff pled facts demonstrating actual knowledge).

12. Chang v. JPMorgan Chase Bank, N.A., 845 F.3d 1087, 1097 (11th Cir. 2017) ("Even if Chang has no explicit allegation that Padgett-Perdomo knew about Gordon's fraud, such a direct allegation was unnecessary because Chang's allegations support an inference that Padgett-Perdomo knew that Gordon was misappropriating money.") (applying Florida law).

2. The Substantial Assistance Requirement

In additional to actual knowledge of the debtor's fraud or of an insider's breach of fiduciary duty, there must also be substantial assistance in the fraud, or inducement or participation in the breach of fiduciary duty.[13] "Substantial assistance" and "participation" have been found "to exist where a defendant 'affirmatively assists, helps conceal, or by virtue of failing to act when required to do so enables the fraud to proceed.'"[14]

C. Malpractice and Professional Negligence

Malpractice, whether by an accountant or an attorney, is founded in state law and is based on a negligence theory of liability.[15] Under most state laws, the plaintiff must prove the following elements to establish a claim for professional negligence: "that the defendant failed to use the skill and care that a reasonably careful professional operating in the field would have used in

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13. *See* Sharp Int'l Corp. v. State Street Bank & Trust Co. (In re Sharp Int'l Corp.), 403 F.3d 43, 52-53 (2d Cir. 2005) (concluding that it was unnecessary to resolve the issue of the defendant's knowledge because there was insufficient evidence of substantial assistance, and that even if the defendant knew of the fraud, it had no separate duty to disclose it).

14. Cromer Finance Ltd. v. Berger, 137 F. Supp. 2d 452, 470 (S.D.N.Y. 2001) (citations omitted); *see also* Lautenberg Found. v. Madoff, 2009 U.S. Dist. LEXIS 82084, at *50 (D.N.J. Sept. 9, 2009) (rejecting defendant's assertion that complaint asserted only mere inaction and finding allegations sufficient that defendant provided substantial assistance "by failing to maintain and enforce a system of internal controls, as he was required to do in his role as BMIS's compliance officer"). Under California law, courts have found that "'ordinary business transactions' that a bank performs for a customer can satisfy the substantial assistance element of an aiding and abetting claim if the bank actually knew those transactions were assisting the customer in committing the specific tort." Casey v. U.S. Bank N.A., 127 Cal. App. 4th 1138, 1145 (2005); *see also* Henry v. Lehman Commercial Paper, Inc. (In re First Alliance Mortg. Co.), 471 F.3d 977, 994-95 (9th Cir. 2006) (noting that, while the definition of "substantial assistance" is not clear under California law, even "ordinary business transactions" can constitute substantial assistance).

15. Seitz v. Detweiler, Hershey and Assocs., P.C. (In re CitX Corp.), 448 F.3d 672, 677 (3d Cir. 2006).

similar circumstances, and that the defendant's failure proximately causes damage to plaintiff."[16]

Generally, an attorney or an accountant for a client perpetrating a fraudulent scheme owes duties only to the client and does not owe any duty to the investors of its client.[17] However, an investor may bring a claim against the perpetrator's professional in instances of fraud, or for conduct equivalent to fraud, such as gross negligence, when the investor relies on the professional's work product.[18]

D. Negligent Misrepresentation

A claim for negligent misrepresentation may similarly be brought against professionals who misrepresented information upon which others relied upon in doing business with the wrongdoing defendant.

> The elements of a negligent misrepresentation claim are (1) the misrepresentation of a past or existing material fact, (2) without reasonable ground for believing it to be true, (3) with intent to induce another's reliance on the fact misrepresented, (4) justifiable reliance on the misrepresentation, and (5) resulting damage.[19]

As is the case with a malpractice claim, a claim for negligent misrepresentation may be brought by an investor only in limited circumstances. "The general rule is that a professional owes a duty to a third party only if that third party is within the 'limited group of persons for whose benefit and guidance [the defendant] intends to supply the information or knows that the recipient intends to supply it.'"[20] Other courts have found that,

16. *See, e.g*., Mosier v. Stonefield Josephson, Inc., 2011 U.S. Dist. LEXIS 124058, at *18 (C.D. Cal. Oct. 25, 2011) (citations omitted).

17. International Strategies Group, Ltd. v. Greenberg Traurig, LLP, 482 F.3d 1 (1st Cir. 2007).

18. Silverman v. KPMG LLP (In re Allou Distributors, Inc.), 395 B.R. 246, 259-60 (Bankr. E.D.N.Y. 2008) (citation omitted) ("A refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely on the balance sheet.").

19. Thomson v. Canyon, 198 Cal. App. 4th 594, 604 (2011).

20. *Facciola*, 2011 U.S. Dist. LEXIS 61785, at *34; *see also* Duke v. Touche Ross & Co., 765 F. Supp. 69, 77 (S.D.N.Y. 1991) (investors stated negligent misrepresentation claim against accounting firm that prepared private placement

"To state a claim for negligent misrepresentation against a professional defendant, the plaintiff must be in privity with the defendant or in a relationship so close to approach that of privity."[21]

In the right circumstances, other negligence claims may also succeed. In *Lautenberg Foundation v. Madoff*, the court declined to dismiss a negligence claim against a corporate director based on the court's holding that the complaint adequately alleged a fiduciary duty and breach of that fiduciary duty.[22] In that case, the plaintiff alleged a fiduciary duty to safeguard money entrusted to the debtor against fraud, misappropriation or other wrongdoing by the debtor, and that this duty was breached by the defendant, causing the plaintiff's loss.[23]

E. Deepening Insolvency

Trustees, receivers, and even investors, under some circumstances, can assert claims for damages to the corporate entity based on a "deepening insolvency" theory, either as a direct claim for relief or as a theory of damages. Deepening insolvency has been defined as "an injury to the Debtors' corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life."[24] In *Lafferty*, the creditors' committee brought an action against the debtor's officers, directors and outside professionals, alleging that through mismanagement and participation in a fraudulent Ponzi scheme, the defendants wrongfully prolonged the debtor's life and incurred debt beyond the debtor's ability to pay, ultimately forcing the debtor into bankruptcy.[25]

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memorandums because documentation was distributed to select group of qualified investors, rather than the public at large, and firm allegedly solicited some investors).

21. In re Colonial Ltd. Partnership Litigation, 854 F. Supp. 64, 102 (D. Conn. 1994) (citations omitted) (denying defendant's motion to dismiss and noting that, "plaintiffs allege that Arthur Andersen knew members of the class would rely on the representations contained in the PPMs in deciding whether to invest in the limited partnerships.").

22. *Lautenberg Found*, 2009 U.S. Dist. LEXIS 82084, at *20-25.

23. *Id.*

24. Official Comm. Of Unsecured Creditors v. R.F. Laffferty & Co., 267 F.3d 340, 347 (3d Cir. 2001).

25. *Id.*

Some courts have found that state law in their jurisdiction permits an independent claim for relief based on deepening insolvency, which generally require the following elements to establish the claim: (1) fraud, (2) which causes the expansion of corporate debt, and (3) which prolongs the life of the corporation.[26] Other courts have found that negligence is sufficient to sustain a claim for deepening insolvency.[27] Some courts reject deepening insolvency as an independent cause of action,[28] and other courts recognize deepening insolvency as a theory of damages only.[29] Plaintiffs can allege that the tortuous conduct of the defendant caused the debtor to take on new liabilities which rendered the debtor unable to pay its creditors and the debtor's insolvent position increased over time.[30]

IV. FRAUDULENT TRANSFER CLAIMS

As a Ponzi scheme progresses, the earlier investors are often paid back more money than they invested, receiving fictitious profits that they were promised (often referred to as "net winners"). Broker-dealers are often paid handsome commissions for soliciting the investments. High-powered lawyers and accountants are often engaged to add an air of legitimacy to the fraudulent enterprise. Banks handle the banking of the Ponzi perpetrator and either

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26. Official Comm. Of Unsecured Creditors v. Foss (In re Felt Mfg. Co., Inc.)*,* 371 B.R. 589, 621 (Bankr. D.N.H. 2007).

27. *See, e.g.,* In re LTV Steel Co., Inc., 333 B.R. 397, 421 (Bankr. N.D. Ohio 2005) (either fraudulent or negligent conduct that prolongs the life of corporation, thereby increasing the corporation's debt and exposure to creditors, may give rise to deepening insolvency claim).

28. *See, e.g.,* Wooley v. Faulkner (In re SI Restructuring, Inc.), 532 F.3d 355, 363 (5th Cir. 2008); s*ee also* Torch Liquidating Trust v. Stockstill, 561 F.3d 377 (5th Cir. 2009) (holding that Delaware does not recognize cause of action on behalf of corporation for deepening insolvency); Fehribach v. Ernst & Young LLP, 493 F.3d 905 (7th Cir. 2007) (rejecting a deepening insolvency claim against debtor's auditors because it was not based on an existing legal duty); Trenwick Am. Litigation Trust v. Ernst & Young, LLP, 906 A.2d 168, 204-205 (Del. Ch. 2006), *aff'd*, 931 A.2d 438 (Del. 2007).

29. Thabault v. Chait, 541 F.3d 512, 522 (3d Cir. 2008); *see also Silverman*, 395 B.R. at 264-65; NCP Litig. Trust v. KPMG, 945 A.2d 132 (N.J. Super. Ct. Law Div. 2007).

30. *See, e.g., Silverman*, 395 B.R. at 267.

knowingly or negligently run millions of dollars of stolen investor funds through their accounts. So when the Ponzi scheme is disclosed and lands in an insolvency proceeding, the bankruptcy trustee or receiver will likely consider seeking recovery of, among other things: (1) the funds transferred to the investors (both principal repayments and fictitious profits); (2) commissions paid to the sales people and broker-dealers who solicited the investments for the Ponzi debtor; (3) gifts given to family and friends; and (4) charitable contributions.

To "claw back" the transfers that the Ponzi debtor made to investors, salespeople, friends, family, or others, a trustee or receiver commonly uses the fraudulent transfer laws available under applicable bankruptcy or applicable state law. Claw back claims can be based on either of two theories – actual intent to hinder delay or defraud creditors, or constructive fraudulent transfer.

A. Actual Fraudulent Intent

The most straightforward claw back actions are claims where a trustee can establish actual fraudulent intent in connection with the transfer. Importantly, the "actual fraud" which triggers the availability of claw back is the fraudulent intent of the transferor, here the perpetrator, not the intent of the transferee, the defendant in the claw back action.

There is a unique presumption in Ponzi scheme cases in connection with fraudulent transfer laws. Where a Ponzi scheme has been established by the facts, there is a conclusive presumption that transfers made by a Ponzi debtor were made with the actual intent to hinder, delay, or defraud creditors, which is sufficient to establish the claim to recover the transferred funds.[31]

Courts have found that, among other things, in order to establish a Ponzi scheme, a plaintiff must establish: "(1) deposits were made by investors; (2) the Debtor conducted little or no legitimate business operations as represented to investors; (3) the purported business operations of the Debtor produced little or no profits or earnings; and (4) the source of payments to investors was from cash infused by new investors."[32]

31. *See, e.g.,* Donell v. Kowell, 533 F.3d 762, 770 (9th Cir. 2008); *see also* Barclay v. Mackenzie (In re AFI Holding, Inc.), 525 F.3d 700, 704 (9th Cir. 2008) ("[T]he mere existence of a Ponzi scheme is sufficient to establish actual intent to hinder, delay or defraud") (quotation marks and citation omitted).

32. Rieser v. Hayslip, et al. (In re Canyon Sys. Corp.), 343 B.R. 615, 630 (Bankr. S.D. Ohio 2006).

If a Ponzi scheme cannot be conclusively established, then a plaintiff may try to establish actual fraudulent intent through a more customary "badges of fraud" analysis using circumstantial evidence. The Uniform Fraudulent Transfer Act[33] provides a non-exclusive list of badges of fraud as follows: (1) the transfer was to an insider; (2) the debtor retained possession or control of the property transferred after the transfer; (3) the transfer or obligation was not disclosed or concealed; (4) before the transfer or obligation was made or obligation was incurred, the debtor was sued or threatened with suit; (5) the transfer was of substantially all of the debtor's assets; (6) the debtor absconded; (7) the debtor removed or concealed assets; (8) the value of the consideration received by the debtor was [not] reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred; (9) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred; (10) the transfer occurred shortly before or shortly after a substantial debt was incurred; and (11) the debtor had transferred the essential assets of the business to a lienor who had transferred the assets to an insider of the debtor.[34]

Alternatively, a plaintiff can establish fraudulent intent by relying on an admission of the debtor, usually in a criminal plea agreement, or if the debtor is found criminally liable for fraud.[35]

B. Constructive Fraudulent Transfer

Under a constructive fraudulent transfer theory, a trustee or receiver must establish that the Ponzi debtor did not receive reasonably equivalent value in exchange for the transfers and that the Ponzi debtor was then insolvent or

33. UFTA § 4(a)(1) lists "badges of fraud"; however, UFTA § 4 states that the presence of one or more of the enumerated factors is evidence relevant to the debtor's intent, but does not create a presumption that a fraudulent transfer was made.

34. *See also* In re Lull, 386 B.R. 261, 270 (Bankr. D. Haw. 2008) (actual intent may be established where transfer wears a sufficient number of badges of fraud).

35. *See, e.g.,* Santa Barbara Capital Management v. Neilson (In re Slatkin), 525 F.3d 805, 814 (9th Cir. 2008) ("a debtor's admission, through guilty pleas and a plea agreement admissible under the Federal Rules of Evidence, that he operated a Ponzi scheme with the actual intent to defraud his creditors conclusively establishes the debtor's fraudulent intent under 11 U.S.C. § 548(a)(1)(A) and California Civil Code § 3439.04(a)(1), and precludes relitigation of that issue").

became insolvent as a result of the transfer.[36] A split of authority exists as to the analysis and meaning of "reasonably equivalent value" in a Ponzi case relating to payments made to investors and the analysis can depend on whether those payments were a return of principal or fictitious profits.

1. Issues Pertaining to Investors

Courts have critically distinguished between a transfer that was a return of the principal investment and a transfer that was a profit or "interest" paid in addition to the return of principal. The Ninth Circuit has held that, "Under the constructive fraud theory, the receiver may only recover 'profits' above the initial outlay, unless the receiver can prove a lack of good faith, in which case the receiver may *also* recover the amounts that could be considered return of principal."[37] Most courts find that a transfer to an investor as a return of principal is not recoverable because the transfer partially or fully extinguishes the investor's restitution claim against the debtor (assuming the subjective good faith of the investor), thereby providing value to the debtor.[38]

However, there is a split of authority over the issue of whether the payment to an investor of "interest" or "profits" on its investment was made in exchange for reasonably equivalent value. Some courts find that profits paid to an investor are recoverable as no value could be provided in exchange for the transfer which was made in a fraudulent scheme.[39] On the other hand, some courts have placed their focus not on public policy or an analysis of equity, but rather on the contractual relationship between the investor and the debtor. For example, in *Lustig v. Weisz & Assoc., Inc.* (*In re Unified Commercial Capital, Inc.*), the court found that the debtor's use of investor's funds for a period of time supported the payment of reasonable contractual interest and that courts

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36. *See, e.g.,* 11 U.S.C. § 548(a)(1)(A) and CAL. CIV. CODE § 3439.04(a)(2).

37. Donell v. Kowell, 533 F.3d 762, 771 (9th Cir. 2008).

38. *Barclay*, 525 F.3d at 704.

39. Merrill v. Abbott (In re Independent Clearing House Co.), 77 B.R. 843, 858 (D. Utah 1987) ("To allow an [investor] to enforce his contract to recover promised returns in excess of his [investment] would be to further the debtor's fraudulent scheme at the expense of other [investors]"); *see also* Scholes v. Lehman, 56 F.3d 750, 757 (7th Cir. 1995) ("A profit is not offset by anything; it is the residuum of income that remains when costs are netted against revenues. The paying out of profits . . . conferred no benefit on the [debtors] but merely depleted their resources faster.").

cannot ignore what is clearly value and fair consideration under the fraudulent conveyance statutes.[40]

The debate turns to whether "value" can be provided for profits. The *Independent Clearing House* line of cases finds that the only value was to perpetuate the Ponzi scheme, and no value can be provided if the contract underlying the transaction is illegal. The *Unified Commercial* line of cases looks at the discrete transaction, finding that the court must measure what was given against what was received in that particular transaction, and concluding in some instances that the debtor's use of the investor's funds for a period of time supported the payment of reasonable contractual interest.

2. Issues Pertaining to Salespeople

A transfer that the Ponzi debtor makes to a salesperson as a commission is also potentially recoverable. However, the courts are split on the question of reasonably equivalent value relative to broker's commissions as well, and a plaintiff's success in recovering a commission depends on the case law in the jurisdiction in which the claim is brought.

Some courts have found that because a Ponzi enterprise has no legitimate purpose, there can be no value provided by a broker in furthering or assisting the debtor in perpetrating the fraud. Therefore, the commissions paid to the broker are recoverable as fraudulent transfers.[41] Other courts, however, have looked more narrowly at the relationship between the debtor and the broker and measure "what was given and received" by the debtor and the broker. These courts compare market commission rates with what was paid. As one court observed, "Money is valuable even when used for illegal purposes."[42] This line of cases finds that value can be found in certain circumstances and the court must evaluate the consideration exchanged by the debtor and transferee in the specific transaction which is sought to be avoided, not the transaction's impact on the debtor's overall business.[43]

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40. Lustig v. Weisz & Assoc., Inc. (In re Unified Commercial Capital, Inc.), 260 B.R. 343, 350 (Bankr. W.D.N.Y. 2001).

41. *See, e.g.,* Warfield v. Byron, 436 F.3d 551, 560 (5th Cir. 2006) ("It takes cheek to contend that in exchange for the payments he received, the [debtor's] Ponzi scheme benefited from his efforts to extend the fraud by securing new investments.").

42. In re First Commercial Man. Group, Inc., 279 B.R. 230, 237 (Bankr. N.D. Ill. 2002).

43. In re Churchill Mortgage Inv. Corp., 256 B.R. 664, 680 (Bankr. S.D.N.Y. 2000).

3. Issues Pertaining to Charitable Organizations

Courts have also found that, in some circumstances, no value is exchanged for a charitable contribution and, as such, the contribution is recoverable as a constructively fraudulent transfer.[44] Additionally, in several Ponzi cases, the courts found that the perpetrator's charitable donations were made with actual fraudulent intent.[45]

C. Good Faith Value Defense

Under either an actual fraudulent intent theory or a constructive fraudulent transfer theory of recovery against a transferee, the good faith of the investor-transferee is relevant, assuming value was provided, in establishing a partial or complete defense, depending on the circumstances.[46] The analysis regarding whether value was provided for purposes of a good faith value defense is essentially the same as a reasonably equivalent value analysis in connection with the *prima facie* case.[47]

The focus of a courts' inquiry regarding good faith centers around the state of mind of the transferee -- whether the transferee has knowledge of the debtor's insolvency or fraudulent activity; whether that knowledge is actual or constructive, whether the transferee should have been placed on inquiry notice, and what type of investigation was conducting after the transferee was placed on inquiry notice. Most courts consider whether the transferee objectively

44. *See Scholes*, 56 F.3d at 761 (7th Cir. 1995) ("The statute makes no distinction among different kinds of recipient of fraudulent conveyances.").

45. *See, e.g.,* Hecht v. Malvern Preparatory School, 716 F.Supp.2d 395 (E.D. Pa. 2010); *see also* Liebersohn v. Campus Crusade for Christ, Inc. (In re C.F. Foods, L.P.), 280 B.R. 103, 111-12 (Bankr. E.D. Pa. 2002) (Ponzi-debtor's payments of $1.7 million to charities during the four years prepetition were made as part of the fraudulent scheme to impress investors that the debtor was a profitable and charitable enterprise and were therefore made with intent to defraud).

46. 11 U.S.C. § 548(c). Most state statutes also create an exception for the transferee or obligee who takes the property in good faith and for value. *See, e.g.*, CAL. CIV. CODE § 3439.08(a). Another defense available in fraudulent transfer cases, not discussed herein, is the stockbroker defense under 11 U.S.C. § 546(e).

47. *Barclay*, 525 F.3d at 707 ("We find no reason, in statute or case law, to treat 'reasonably equivalent value' differently for each of the Code provisions [§§ 548(a)(1)(B) and 548(c)].").

knew or should have known of the debtor's fraudulent purpose in making the transfer.[48]

"Certainly, if a defendant knew that the debtor was running a Ponzi scheme when he advanced money to the debtor or knew of the debtor's insolvency at the time of the allegedly fraudulent transfer, that knowledge might indicate a lack of good faith."[49] If the circumstances would place a reasonable person on inquiry of the fraudulent scheme, then good faith will not likely be found.[50] Most courts have found that inquiry notice exists if there were red flags regarding the purpose of the transfer, the underlying fraud of the Ponzi scheme, the unfavorable financial condition of the transferor, the insolvency of the transferor, the improper nature of a transaction, or the voidability of the transfer.[51] Some of the factors which have been found sufficient to constitute "red flags" putting an investor on inquiry notice are:

- A promise of very high or exorbitant returns should put an investor on inquiry notice.[52]
- If the circumstances would place a reasonable person on inquiry notice and a diligent inquiry would have uncovered the fraud, then a finding of a lack of good faith will likely be made.[53]

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48. *See, e.g.,* In re Agricultural Research and Technology Group, Inc., 916 F.2d 528, 535 (9th Cir. 1990).

49. Merrill v. Abbott (In re Independent Clearing House Co.), 77 B.R. 843, 861 (D. Utah 1987).

50. Jobin v. McKay (M & L Business Machine Co.), 84 F.3d 1330, 1338 (10th Cir. 1996).

51. Plotkin v. Pomona Valley Imports (In re Cohen), 199 B.R. 709, 719 (B.A.P. 9th Cir. 1996) ("Such inquiry notice suffices on the rationale that some facts suggest the presence of others to which a transferee may not safely turn a blind eye.").

52. *See*, *e.g*., Jobin v. Lalan (In re M&L Bus. Mach. Co.), 160 B.R. 851, 859 (Bankr. D. Colo. 1993), *aff'd* 167 B.R. 219 (D. Colo. 1994) (a Ponzi-scheme investor did not act in good faith in pursuing a supposedly risk-free investment promising profits of 125 percent to 512 percent); *Scholes*, 56 F.3d at 760 ("Only a very foolish, very naïve, very greedy, or very Machiavellian investor would jump at a chance to obtain a return on his passive investment of 10 to 20 percent a month . . . It should be obvious that such returns are not available to passive investors in any known market, save from the operation of luck.").

53. *Agric. Research*, 916 F.2d at 539; *McKay*, 84 F.3d at 1338-39 (implausible explanation by company officials as to how they could pay such high rates places investor on inquiry notice).

- An investor's education and experience can preclude a finding of good faith.[54]
- If insufficient due diligence was done by the investor, then good faith may not be found.[55]

In the Madoff Ponzi scheme case, the issue of good faith was considered in the case of *Picard v. Katz*, which ultimately settled on the eve of trial.[56] In that case, the trustee advanced two theories to demonstrate a lack of good faith on the part of the defendants. First, the trustee argued "that if the defendants willfully blinded themselves to the fact that Madoff Securities was involved in some kind of fraud, this too might, depending on the facts, constitute a lack of good faith." Second, "defendants were on 'inquiry notice' of the fraud but failed to diligently investigate Madoff Securities and that this also constitutes lack of good faith." The court noted that, "The difference between the inquiry notice approach and the willful blindness approach is essentially the difference between an objective standard and a subjective standard." The court concluded:

> A securities investor has no inherent duty to inquire about his stockbroker, and SIPA creates no such duty. *See generally In re New Times Sec. Servs.*, 371 F.3d 68, 87 (2d Cir.2004). If an investor, nonetheless, intentionally chooses to blind himself to the "red flags" that suggest a high probability of fraud, his "willful blindness" to the truth is tantamount to a lack of good faith. *See United States v. Rodriguez*, 983 F.2d 455, 458 (2d Cir. 1993) ("conscious avoidance," another term for willful blindness, means "that the defendant was aware of a high probability of the fact in dispute and consciously avoided confirming that fact"). But if, simply confronted with suspicious circumstances, he fails to launch an investigation of his broker's internal practices—and how could he do so anyway?—his

54. *See, e.g., McKay*, 84 F.3d at 1333 (No good faith finding where investor attended college for three years, studied business administration and bookkeeping, operated his own construction business, a commercial and industrial real estate business, served as co-trustee for a family trust with assets in excess of $3,000,000, and owned a personal portfolio including a variety of stocks, bonds, mutual funds, raw land and promissory notes).

55. *Lalan*, 160 B.R. at 859 (no good faith where investor "ignored his own initial intuition and plunged headlong into scam because of the huge profits he was promised, and which he received"); *see also* Cuthill v. Kime (In re Evergreen Sec., Ltd.), 319 B.R. 245, 253 (Bankr. M.D. Fla. 2003).

56. Picard v. Katz, 462 B.R. 447 (S.D.N.Y. 2011).

> lack of due diligence cannot be equated with a lack of good faith, at least so far as section 548(c) is concerned as applied in the context of a SIPA trusteeship.

In defining good faith, the court concluded: "If an investor, nonetheless, intentionally chooses to blind himself to the 'red flags' that suggest a high probability of fraud, his 'willful blindness' to the truth is tantamount to a lack of good faith."

V. CONCLUSION

We have all heard that if it sounds too good to be true, it probably is. This cautionary advice applies to investors who are receiving outsized returns, and it also applies to professionals who are getting paid handsome fees and relying on reputation rather than asking questions, to cut corners. Staying on heightened alert, asking the hard questions, and independently verifying information are of paramount importance. We want to make sure that, as professionals, we are doing our jobs to stem the tidal wave of fraudulent schemes and that we are taking steps to detect and stop fraud.

ONLINE/INTERNET TRADING GAMBLING, BD'S NO DUTIES, THIRD-PARTY ACCOUNTS

Douglas J. Schulz CRCP [1]

Introduction

Online broker-dealers who offer a trading platform for self-directed trading claim that they make no recommendations, therefore, they have no duties or extremely limited duties to their customers - simply to properly execute unsolicited trades. This article will challenge that claim.

This article addresses three questions relating to trading and investing at online broker-dealers (BDs) such as Charles Schwab, Interactive Brokers, E*Trade and Robinhood.[2]

1. Is online/internet trading nothing more than legalized, casino gambling?
2. Do online broker-dealers really have no duties for self-directed platforms/online accounts?
3. Are broker-dealers properly opening, managing, and monitoring third-party accounts?

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1. Douglas J. Schulz has worked in the securities industry for 42 years. He is a Certified Regulatory Compliance Professional, CRCP. He has worked as a Registered Representative for such firms as Bear Stearns, Merrill Lynch, and Investors Diversified Services (IDS). He has held numerous securities licenses and has also worked as a Registered Investment Advisor (RIA) and since 1989, Mr. Schulz has been a securities expert witness through his Company, Invest Securities Consulting Inc. which is based in Colorado. This article was edited by Law Journal editors John Sutherland, David E. Robbins, Jason Burge, Elliot Rosenberger, and Makoa Kawabata.

2. Larger Wall Street broker-dealers tend not to make the "No Duty" argument. As reported in "Brokerage Firms Have Different Plans to Protect Investors from Themselves" by Ruth Simon and Rebecca Buckman, The Wall Street Journal, June 7, 1999, "Unlike their discount-online competitors, who generally say they aren't responsible for their customers' trading decisions, Merrill Lynch & Co. and other big firms are being more watchful. In new accounts combining traditional-brokerage services with online access, brokers can monitor customer activity and, in some cases, may even stop what they consider excessive or inappropriate trading.".

Online, Legalized Gambling

The United States has been slow to adopt online or internet gambling. Although 85 countries allow online gambling, for many years the United States has made it illegal to conduct financial transactions online for the purpose of placing a bet or wager with the Interstate Wire Act of 1961.[3] Things changed in 2011, though, when the U.S. Department of Justice limited the Wire Act's applicability to sports betting.[4] This decision gave license to states to regulate other games of chance on the Internet. Indeed, pursuant to the Constitution, regulation of gambling should be reserved to the States.[5] Each state is free to regulate gambling as it sees fit, including online gambling. Yet to date, only six states – Connecticut, Delaware, Michigan, New Jersey, Pennsylvania, and West Virginia – allow online/internet gambling.[6] In these states to varying degrees, residents are permitted to wager over the internet on poker, sports, fantasy sports, lotteries, and horse racing.

With the vast majority of states not embracing online gambling, investors shouldn't feel left out, because the public can simply open an online brokerage account and gamble their life savings away even more easily. Wall Street broker-dealers would have you believe that Las Vegas-style casinos are for gambling, whereas opening a brokerage account is for investing. It is true that casinos are purely for gambling, though many bets can be made where the odds of losing are reduced. But it is a complete falsehood, perpetrated by Wall Street, that brokerage accounts are purely for investing.

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3. 18 U.S.C. § 1084.

4. Virginia A. Seitz, *Whether Proposals by Illinois and New York to Use the Internet and Out-of-State Transaction Processors to Sell Lottery Tickets to In-State Adults Violate the Wire Act, Memorandum Opinion for the Assistant Attorney General, Criminal Division*, U.S. DEPT. JUST. 1 (Sept. 20, 2011), https://www.justice.gov/sites/default/files/olc/opinions/2011/09/31/state-lotteries-opinion.pdf.

5. *See* U.S. CONST. amend. X.

6. *See* Charlie Kelly, *Where is online gambling legal in the USA in 2023?*, N.Y. POST, Jan. 9, 2023, https://nypost.com/article/where-is-online-gambling-legal/.

Investing v. Gambling

Investing is the process of using money and investment capital to seek positive returns; to utilize an asset or money with the goal of generating income and appreciation; to distribute resources in an attempt to generate income and gain profits; to buy assets that increase in value over time and provide returns in the form of income payments or capital gains; to build wealth and outpace inflation; to create a structured plan that includes protection of assets, diversification and long-term goals of a positive return above inflation and taxes.

Gambling is wagering money in an event that has an uncertain outcome in hopes of winning more money; the expected return for gambling is negative for the player—even though some people may get lucky and win[7]; in gambling, people do it mostly for the emotional high they receive from the excitement as opposed to possible return; the probability of losing an investment is usually higher than the probability of winning more than the wager.

Broker-dealers offer more ways to speculate than Las Vegas. There are long options, short naked options, options strangles and straddles, commodities, commodities options, futures, margin trading, shorting, day trading, high-frequency trading, scalping, unregistered securities, cryptocurrencies, junk bonds, leveraged funds, penny stocks, derivatives, private placements, hedge and private equity funds, trendy securities, and momentum trading. Online broker-dealers such as TD Ameritrade, Charles Schwab, E*Trade, Interactive Brokers, and Robinhood offer a similar platform as Las Vegas, but with 10 times the risks.

In an online brokerage account investors can, in a matter of minutes, lose tens of millions of dollars, their entire account value, more than their account value, or their entire net worth and life savings. That's possible in a casino but very hard to accomplish. In an online brokerage account, though, it can be accomplished with a few clicks of a button, all while reclining on the sofa at home in pajamas. Wall Street can call it what it wants and what it wants Americans to believe, but it is often rank speculation.

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7. Steven Nickolas, Thomas Brock, & Kirsten Rohrs Schmitt, *Speculation vs. Gambling: What's the Difference?*, INVESTOPEDIA (Sept. 25, 2021), https://www.investopedia.com/ask/answers/042715/what-difference-between-speculation-and-gambling.asp.

Online Broker-Dealers' Growth Numbers

Online trading at firms such as E*trade, TD Ameritrade, Charles Schwab, Interactive Brokers, and Robinhood[8] experienced significant increases in customer base and assets managed during 2020 and 2021. After completing its purchase of TD Ameritrade, Charles Schwab's customer base grew by 127% between 2020 and 2021.[9] New brokerage accounts at Schwab hit 1.2 million in February 2021, more than 93% higher than the 626,000 new accounts it added in December 2020.[10] Robinhood also prospered, increasing its assets by 80% from $10.9 billion in 2020 to $19.7 billion in 2021 and nearly doubling its customer base.[11] Interactive Brokers saw daily average trades on its platform spike 53% in March 2021 from the same month of 2020.[12]

Like Vegas, Online Broker-Dealers Lure the Public

Casinos in Las Vegas, Atlantic City and other places learned long ago that providing high-dollar, regular gamblers with comps was a win-win situation for both parties. Casino "whales" receive private jets and limousine travel, penthouse suites, higher limits, top-shelf liquor and a dedicated VIP host.

Online broker-dealers offer their own ways of luring investors to their sites, not unlike the tactics employed by casinos. Robinhood made waves back in 2013 by offering zero-commission trading, but today free trading is the norm in the online industry. Online broker-dealers attract new investors with such things as free research, news, trading tools and education, credit cards,

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8. Scottrade Financial was one of the bigger online BDs, but it was purchased by TD Ameritrade in September 2017.

9. Lyle Daly, *The Largest Brokerage Firms in 2022*, THE ASCENT (Dec. 29, 2021), https://web.archive.org/web/20221024214655/https://www.fool.com/the-ascent/research/largest-stock-brokerage-firms/.

10. Declan Harty, *Pandemic retail trading boom remakes brokerage landscape*, S&P GLOBAL MARKET INTELLIGENCE (Apr. 14, 2021), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/pandemic-retail-trading-boom-remakes-brokerage-landscape-63482952.

11. Press Release, Robinhood, Robinhood Reports Fourth Quarter and Full Year 2021 Results (Jan. 27, 2022), https://investors.robinhood.com/news/news-details/2022/Robinhood-Reports-Fourth-Quarter-and-Full-Year-2021-Results.

12. Harty, *supra* note 10.

24/7 and mobile trading, no minimum deposits, higher margin limits and comprehensive trading reports. On December 6, 2022, Robinhood made retirement accounts available to its investors, guaranteeing a 1% match in some instances.[13]

Most states set the legal age for gambling at 21 years of age, but most brokerage firms allow anyone 18 years or older to open an online brokerage account. And whereas it used to be that one would not think about opening a brokerage account without a certain amount of money, now many firms have no minimum deposits. The introduction years ago of fractional trades ushered in a new wave of inexperienced, naive investors. At Robinhood's website, the reader is welcomed with "Investing doesn't have to be that hard."[14] Interactive Brokers counsels, "Our award-winning platforms are powerful enough for professional traders but designed for everyone."[15]

Online broker-dealers flood their clients with opportunities to be educated. As the U.S.'s digital prowess has grown, online broker-dealers have kept pace, introducing webinars, podcasts, articles and a host of digital tools designed to increase client accounts. This is not unlike the tactics employed at casinos. In Las Vegas, many casinos offer daily "gaming classes" on craps, poker and blackjack. Interactive Brokers advertises its "Student Training Lab" designed for college professors and high school teachers to send invitations to their students to open paper trading accounts.[16] The firm also boasts of an online "Campus" which "offers an extensive course catalogue to help traders and investors make more informed investment decisions - from equities, fixed-income, and options…"[17] TD Ameritrade has an Education Center for investors to "expand your investing knowledge with learning tools and then solidify your new skills with practice assessments."[18]

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13. *Introducing Robinhood Retirement*, ROBINHOOD (Dec. 6, 2022), https://blog.robinhood.com/news/introducing-robinhood-retirement.

14. *Commission-free Stock Trading & Investing App*, ROBINHOOD, https://robinhood.com/us/en/invest/.

15. *IBKR Trading Platforms*, INTERACTIVE BROKERS, https://www.interactivebrokers.com/en/trading/trading-platforms.php.

16. *Educators*, INTERACTIVE BROKERS, https://www.interactivebrokers.com/en/accounts/educator.php.

17. *IBKR Campus*, INTERACTIVE BROKERS, https://www.interactivebrokers.com/en/education/tradersu/ibkr-campus.php.

18. *Investing Web Platforms*, TD AMERITRADE, https://www.tdameritrade.com/tools-and-platforms/investing-stock-trading-platforms/online-stock-trading-features.html.

Options are particularly complex, but all online firms have developed option training and education platforms, much of which is free. "Robinhood Learn" provides education on "the ins and outs of option trading."[19] Interactive Broker's "Traders' Academy" provides numerous classes on option trading,[20] and Schwab offers various articles and videos on the subject.[21] TD Ameritrade offers a "four-part Options Strategies virtual workshop."[22]

We Don't Make Recommendations, So We Have No Duties

Claims against one of the online broker-dealers that the trading in the claimant's account was inappropriate or unsuitable is defended with a defense of FINRA Rule 2111 on Suitability. FINRA Rule 2111 has language that the rule applies only when there is a recommendation. The online firms thus claim that they make no recommendations and thus the Rule does not apply.

The online broker-dealers use FINRA Rule 2111 to go even further – they attempt to shoehorn the claimed inapplicability of the Rule to the laundry list other FINRA rules that *do* apply to them. They in essence claim that since FINRA Rule 2111 doesn't apply to them, neither do any of the other rules, hence, they have *no* duties. They act as if the arbitration panel should grant a motion to dismiss or a directed verdict based merely on FINRA Rule 2111.

There is nothing in the FINRA rules to support the argument that if Rule 2111 doesn't apply, *then other rules don't apply.* That is an unsupportable jump in logic.

No Duty - But We Do It Anyway (or The Cake and Eat It, Too Defense)

On the heels of the online BDs' defense to suitability claims that since the trade was unsolicited, they had no duties to determine if the trade was suitable, they often launch into the defense of "But the trades were suitable, nonetheless". This is the "cake and eat it, too" defense.

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19. *Your financial journey starts here | Robinhood Learn*, ROBINHOOD, https://learn.robinhood.com/.

20. *Options*, IBKR CAMPUS, https://ibkrcampus.com/traders-academy/options/.

21. *Options*, CHARLES SCHWAB, https://www.schwab.com/learn/topic/options.

22. *Education*, TD AMERITRADE, https://www.tdameritrade.com/education.html.

The BDs have taken this art of arguing both sides of the same argument/defense to a new level in online trading cases. Based on my experience, the online broker-dealers maintain all kinds of internal monitoring software systems and reports, evidencing that some of the largest online broker-dealers monitor self-directed accounts, even when their brokers are making no recommendations. The reports additionally evidence that these internal monitoring systems are even applied to accounts that are being managed by separate third-party investment advisors, who have power of attorney to trade the accounts for their clients. A major online BD admitted in its prehearing brief in one recent FINRA arbitration "…[The BD] conducted due diligence on the third-party investment advisor, in accordance with its Know-Your-Customer obligations under FINRA Rule 2090."

The SEC has stated that the "continued execution of [an] adviser's orders where a broker-dealer has knowledge of improprieties in an investment adviser's handling of accounts *may subject the broker-dealer to liability* for aiding and abetting a violation of the federal securities laws if the adviser is in fact a primary violator of some provision of those laws."[23]

We Don't Make Recommendations…. We Merely Educate

Another common defense is, "We merely educate; we don't recommend."

Online broker-dealers will not be protected from claims of recommendations the more that their "education" of investors crosses the line into investment *recommendations*. Generally, the more tailored the communication is to the client, the closer to a recommendation it becomes. In their zeal to "educate," many online firms go so far as to offer investment advice. Schwab has a learning center offering clients "real-time trade analysis and decision support from investing professionals."[24]

When does that "decision support" turn into a recommendation? Schwab's "Idea Hub" provides clients "with specific options trade ideas based on whether you're bullish, bearish, or neutral."[25] Schwab even has an "options specialist team [that] is dedicated to using its decades of trading experience to

23. *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, Securities Exchange Act Release No. 19070 (Sept. 21, 1982) (emphasis added).

24. *See Learn to Trade Through Educational Resources*, CHARLES SCHWAB, https://www.schwab.com/trading/education; https://www.schwab.com/trading/tools-and-platforms.

25. *Id.*

help you evaluate and implement your options strategies."[26] How can "specific option trade ideas" not be a recommendation? TD Ameritrade offers an immersive education curriculum "that's built around you."[27] And TD Ameritrade also offers "24/7 support to help answer your option trading questions."[28] And if the option trading question is "Should I purchase option A or B?" and the broker replies, "I would go with option B," is there any doubt that is a recommendation?

Remember that when a recommendation is made, the FINRA Suitability Rule 2111 applies to online firms every bit as much as full-service broker-dealers. As FINRA has stated, "In all cases, the suitability rule applies to recommendations..."[29] Also, when "education" morphs into investment strategy advice, as opposed to specific investment advice, that too could subject an online broker-dealer to a suitability claim. FINRA has clarified that:

> The "investment strategy" language would apply to recommendations to customers to invest in more specific types of securities, such as high dividend companies or the "Dogs of the Dow," or in a market sector, regardless of whether the recommendations identify *particular* securities. It also would apply to recommendations to customers generally to use a bond ladder, day trading, "liquefied home equity," or margin strategy involving securities, irrespective of whether the recommendations mention *particular* securities.[30]

Online broker-dealers' communications with clients, though cloaked in an "education" aura, may well be crossing the line into making recommendations.

Online Option Accounts

There are various examples of specific securities regulations that pierce the defense by the online broker-dealers that they don't have any duties with

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26. *Online Options Trading*, CHARLES SCHWAB, https://www.schwab.com/options.

27. *Immersive Curriculum*, TD AMERITRADE, https://www.tdameritrade.com/education/education-offering/investment-classes.html.

28. *Options Trading Strategies*, TD AMERITRADE, https://www.tdameritrade.com/investment-products/options-trading.html.

29. *FINRA Rule 2111 (Suitability) FAQ*, FINRA, https://www.finra.org/rules-guidance/key-topics/suitability/faq.

30. *Id.*

self-directed or third-party power of attorney accounts where they make no recommendations. I addressed the option regulations in my previous article titled, *Supervision of Third-Party/Power of Attorney Accounts*.[31]

In November 2022, FINRA released a notice addressing option account opening and supervision - **FINRA Provides Update on Sweep: Option Account Opening, Supervision and Related Areas**.[32] The notice addresses

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31. Douglas J. Schulz & Tracy Pride Stoneman, *Supervision of Third-Party/Power of Attorney Accounts*, 23 PIABA Bar J. 145 (2016).

32. FINRA, *FINRA Provides Update on Sweep: Option Account Opening, Supervision and Related Areas*, https://www.finra.org/rules-guidance/guidance/targeted-examination-letters/sweep-update (last visited Feb. 20, 2023):

> Below FINRA poses several questions for firms to consider as they evaluate whether their supervisory systems are reasonably designed to address risks related to supervising the approval of options accounts **– both self-directed and full-service brokerage accounts** – and monitoring the trading activity in options accounts. The questions for consideration in this update are based on FINRA's observations to this point in our review. The questions focus on firms': (1) processes for collecting and reviewing facts about their customers in connection with approving customers to trade options; (2) disclosures about options trading; and (3) supervision of approved options accounts. In addition, the Appendix notes additional guidance FINRA has provided regarding member firms' obligations related to options.
>
> Member firms that offer options trading should be aware of their regulatory obligations pursuant to FINRA Rule 2360 (Options), as well as other relevant obligations, including but not limited to FINRA Rules 2090 (Know Your Customer), 2210 (Communications with the Public), 2220 (Options Communications), 2260 (Disclosures), 2264 (Margin Disclosure Statement), 3110 (Supervision), 4210 (Margin Requirements) and 4512 (Customer Account Information). In addition, members that recommend an options account or an options transaction to a retail customer must comply with the SEC's Regulation Best Interest (Reg BI).
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> * * *
>
> To comply with this obligation, firms may establish processes to, among other things, review options account applications for completeness and accuracy, compare information contained in options applications with other information available to the firm (including information contained in other options applications submitted by the same customer), and verify that customers who change their account profile information continue to be eligible to trade options.
>
> - **Consider whether customers' investment objectives align with their desired options-trading levels (e.g., growth or speculation for higher levels)?**

the BD defenses of no duties and no obligations, especially when the claimant's/investors' accounts are option accounts. From these sections of this FINRA release, it is quite apparent that the defenses of the BDs when it comes to Know Your Customer and option accounts are just flatly false.

On April 9, 2021, FINRA issued **FINRA Regulatory Notice 21-15 Options Account Approval, Supervision and Margin**.[33] This is just one more regulatory example of the fallacy of the broker-dealers' claims they have no duties, especially relating to Know Your Customer, suitability and supervision.

- Impose enhanced requirements for complex options trading (e.g., options spreads, uncovered options writing), such as requiring that customers:
  - Attest to having extensive product knowledge?
  - Have a specified amount of options-trading experience?
  - Meet your firm's requirements for the risk level of the selected option level?
- Comparing the information on the account application with other customer information already held at your firm;
- **Identifying potential logical inconsistencies in the application** (e.g., a 21-year-old applicant who claims to have ten years of option trading experience or an applicant who selects all of the listed investment objectives; a customer who has provided the firm with conflicting information about his investment experience or objectives); or
- Identifying customers whose claimed investment experience, options-trading experience, annual income or liquid net worth, warrants further scrutiny, in light of the customers' age or employment (e.g., a 20-year-old student who claims to have an annual income of $300,000)? (emphasis added).

33. FINRA REGUL. NOTICE 21-15, FINRA REMINDS MEMBERS ABOUT OPTIONS ACCOUNT APPROVAL, SUPERVISION AND MARGIN REQUIREMENTS (May 27, 2021). ("**Regardless of whether the account is self-directed or options are being recommended, members must perform due diligence on the customer and collect information about the customer to support a determination that options trading is appropriate for the customer.** In addition, FINRA reminds members that options accounts are subject to specific supervisory reviews, including, among others, reviewing the compatibility of options transactions with investment objectives and with the types of transactions for which the account was approved, and are subject to other FINRA rules that apply when opening customer accounts, including among others, customer identification requirements under anti-money laundering rules. FINRA also reminds members of the margin requirements for options transactions.") (emphasis added).

FINRA Rule 2090 requires that a member use "reasonable diligence" in regard to the opening and maintenance of each account to know the "essential facts":[34]

> FINRA rules require that each customer must be specifically approved (or disapproved) for options trading prior to the time the member accepts an options order from the customer, **regardless of whether the brokerage account is self-directed** or options are being recommended. The rule sets forth the steps that must be taken as part of that approval. FINRA Rule 2360(b)(16) requires a member to exercise due diligence to ascertain the essential facts relative to the customer. Specifically, the member must seek to obtain and consider detailed customer information, including, among others, the customer's knowledge, investment experience, age, financial situation and investment objectives.
>
> * * *
>
> In addition, members must retain options accounts records to permit timely and periodic supervisory reviews, including, among others, reviewing the compatibility of options transactions with investment objectives and with the types of transactions for which the account was approved. Members also must retain records to permit the review of the size and frequency of options transactions, profit or loss in the account and any undue concentration in the account.[35]

FINRA refers to CBOE Rule 9.1 (Opening of Accounts) and 9.2(j) (Supervision of Accounts) in footnote #2 of the Release.[36] I don't believe I have ever seen broker-dealers refer to the Chicago Board of Options Exchange (CBOE) option rules. As discussed above, the standard practice of the BDs is to only quote FINRA Rule 2111, the Suitability Rule. The BDs really want to

34. *Id*.

35. *Id.* The rule lists the minimum information that members should gather from customers who are natural persons. See FINRA, Rule 2360(b)(16) (B)(i) (2022). The rule also lists specified information that members must retain in a customer's account records, including sources of background information and financial information concerning the customer. See FINRA, Rule 2360(b)(16)(B)(ii) (2022). Information considered in approving an account for options must be reflected in the records of the account. See FINRA, Rule 2360(b)(16)(B)(v) (2022). FINRA encourages members to use a standard account agreement to facilitate obtaining all required information. FINRA also reminds members of the recordkeeping requirements of SEC Rule 17a-3.

36. See CBOE Exchange, Inc., Rule 9.1 (effective Jan. 14, 2021).

ignore the CBOE rules, because the CBOE rules don't limit the requirements for option accounts to only apply if there is a recommendation. And yes, that includes all option accounts; there are no special provisions or exceptions for online brokerage accounts.

FINRA Regulatory Notice 22-08 Complex Products and Options - This is a recent notice from FINRA, which is most illustrative because it repeatedly discusses the regulatory requirements for "Self-Directed Platforms" a.k.a. online accounts:

> Although complex products do not always translate into more investment risk, their complexity may confuse investors who may not adequately understand their features. These concerns may be heightened when a retail customer is accessing these products through a self-directed platform and without the assistance of a financial professional, who may be in a position to explain the key features and risks of the product to the retail investor.
>
> Similar to transactions in complex products, buying or selling options can be risky for retail investors who trade options without understanding their vocabulary, strategies and risks. Like the concerns associated with complex products, these concerns may be heightened when retail investors make self-directed decisions through online platforms without the assistance of a financial professional.
>
> The rules governing options, security futures and warrants impose, among others, account opening requirements irrespective of whether a recommendation has been made; specific suitability requirements when recommending these products, including a reasonable belief that the customer has the knowledge and experience to evaluate the risks involved and the financial ability to bear these risks. [37]

Anti-Money Laundering – AML

The Anti-Money Laundering regulations are another set of regulations that upend this refrain of broker-dealers that they have no duties to online brokerage accounts as it relates to opening the accounts, monitoring and supervising those accounts. Once again, this mantra is undermined by the

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37. FINRA, REGUL. NOTICE 22-08, COMPLEX PRODUCTS AND OPTIONS, FINRA REMINDS MEMBERS OF THEIR SALES PRACTICE OBLIGATIONS FOR COMPLEX PRODUCTS AND OPTIONS AND SOLICITS COMMENT ON EFFECTIVE PRACTICES AND RULE ENHANCEMENTS (March 8, 2022), https://www.finra.org/rules-guidance/notices/22-08.

multitude of serious regulations required to be followed by all broker-dealers, and there are no limitations on those regulations just because the accounts are online, self-directed, or third-party power of attorney accounts. FINRA's Anti-Money Laundering Compliance Program, Rule 3310, has strict protocols for identifying customers and ongoing review. All firms must:

> Include appropriate risk-based procedures for conducting ongoing customer due diligence, to include, but not be limited to:
> (i) Understanding the nature and purpose of customer relationships for the purpose of developing a customer risk profile; and
> (ii) Conducting ongoing monitoring to identify and report suspicious transactions and, on a risk basis, to maintain and update customer information. [38]

But even with these anti-money laundering rules in place broker-dealers, behind the closed doors of arbitration, dare to state in their answers, briefs, and opening statements that even as it relates to the AML rules, they claim they have no duties at all except for proper execution of trades. That argument is insupportable given with FINRA's notice relating to the Anti-Money Laundering (AML) Program:[39]

> *Money Laundering Red Flags*
> FINRA published a list of "money laundering red flags" in Notice to Members 02-21 (NTM 02-21). Since NTM 02-21 was published, guidance detailing additional red flags that may be applicable to the securities industry have been published by a number of U.S. government agencies and international organizations. FINRA is issuing this Notice to provide examples of these additional money laundering red flags for firms to consider incorporating into their AML programs, as may be appropriate in implementing a risk-based approach to BSA/AML compliance.
>
> - The customer is reluctant or refuses to provide the firm with complete customer due diligence information as required by the firm's procedures, which may include information regarding the nature and purpose of the customer's business, prior financial relationships, anticipated account activity, business location and, if applicable, the entity's officers and directors.

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38. *See* 31 CFR 1023.220; FINRA, Rule 3310(b) (2018).

39. *See* FINRA, REGUL. NOTICE 19-18, FINRA PROVIDES GUIDANCE TO FIRMS REGARDING SUSPICIOUS ACTIVITY MONITORING AND REPORTING OBLIGATIONS (May 6, 2019), https://www.finra.org/rules-guidance/notices/19-18.

- The customer refuses to identify a legitimate source of funds or information is false, misleading or substantially incorrect.
- Wire transfers or payments are made to or from unrelated third parties (foreign
- or domestic), or where the name or account number of the beneficiary or remitter has not been supplied.
- There is wire transfer activity that is unexplained, repetitive, unusually large, shows unusual patterns or has no apparent business purpose.

Potential Red Flags in Securities Trading

- The customer, for no apparent reason or in conjunction with other "red flags," engages in transactions involving certain types of securities, such as penny stocks, Regulation "S" stocks and bearer bonds, which although legitimate, have been used in connection with fraudulent schemes and money laundering activity. (Such transactions may warrant further due diligence to ensure the legitimacy of the customer's activity.
- There is a sudden spike in investor demand for, coupled with a rising price in, a thinly traded or low-priced security.
- The customer's activity represents a significant proportion of the daily trading volume in a thinly traded or low-priced security.
- A customer buys and sells securities with no discernable purpose or circumstances that appear unusual.
- A customer accumulates stock in small increments throughout the trading day to increase the price.
- A customer attempts to influence the closing price of a stock by executing purchase or sale orders at or near the close of the market.
- A customer engages in a frequent pattern of placing multiple limit orders on one side of the market at various price levels, followed by the customer entering orders on the opposite side of the market that are executed and the customer canceling the original limit orders (activity indicative of "layering").
- Two or more unrelated customer accounts at the firm trade an illiquid or low-priced security suddenly and simultaneously.
- The customer makes a large purchase or sale of a security, or option on a security, shortly before news or a significant announcement is issued that affects the priceof the security.[40]

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40. *Id.*

Again, the AML rules apply to broker-dealers regardless of whether the account is online, self-directed, or handled by a third-party advisor.

FINRA Rule 2130 - Approval Procedures for Day Trading

Once again, the refrain of the online BDs of "no duty to monitor" fails when we look at the FINRA regulations on the issue of day trading. FINRA defines day trading as: "In general, day traders seek to profit from very small movements in the price of a security. Such a strategy often requires aggressive trading of a brokerage account. As a result, day trading generally requires a significant amount of capital, a sophisticated understanding of securities markets and trading techniques, and high-risk tolerance."[41]

Day trading is one of those investment-related activities like margin, options, private placements, and leveraged ETFs in that FINRA recognizes that these items contain significant risks that investors don't always appreciate, much less fully understand. It is a well-accepted, long-established axiom that short-term trading, scalping, or day trading is a much riskier investment strategy than long-term investing. As a result, FINRA has issued special regulations and regulatory notices to their member BDs, requiring them to have written policies and procedures to protect investors.[42]

Take note of this key language by FINRA: "…..the firm will be required to make a threshold determination that day trading is **appropriate** for the

41. FINRA, REGUL. NOTICE 00-62, SEC APPROVES DAY-TRADING RULES (September 1, 2000), https://www.finra.org/rules-guidance/notices/00-62.

42. FINRA, Rule 2270 discusses the requirements of FINRA on day trading, as does FINRA Notice to Members 00-62. FINRA, REGUL. NOTICE 00-62, SEC APPROVES DAY-TRADING RULES (September 1, 2000), https://www.finra.org/rules-guidance/notices/00-62 ("As part of the account approval process, the firm will be required to make a threshold determination that day trading is appropriate for the customer. . . . **In making this determination, the firm will be required to exercise reasonable diligence to ascertain the essential facts relative to the customer, including his or her: investment objectives; investment and trading experience and knowledge; financial situation; tax status; employment status; marital status and number of dependents; and age. The firm also will be required to prepare a record setting forth the basis on which the firm has approved the customer's account.** Any record or written statement prepared or obtained by the firm pursuant to the rule change will have to be preserved in accordance with NASD Rule 3110(a).") (emphasis added).

customer."[43] The thesaurus' first synonym for "appropriate" is "suitable". And note that nowhere in the rule itself, or in this FINRA NTM, does the requirement of a "recommendation" appear. This is one more example that the "no duty" claim by broker-dealers should fail.

Lastly, broker-dealers often argue that the day trading rules don't apply to them, because they did not promote day trading, they were merely "introducing" and "educating". FINRA addresses that issue in FINRA NTM 00-62.[44]

Margin and Margin Liquidations

Margin and margin liquidations are along the same lines of "no duties" but with a different twist. Many lawyers and experts won't take margin liquidation cases because they know that the margin regulations and the BD policies are stacked in favor of the brokerage firms. It's no wonder that an investor ever opens a margin account because the margin clauses read more like a contract of adhesion, they are so one-sided:

- The BD can change the margin requirements at any time without notice.
- The BD can liquidate all or a portion of an account to meet an initial or maintenance margin call.
- The BD can liquidate whichever securities it wishes, without any input from the client.
- The BD can make margin call liquidations without any prior notice to the client.

The contractual language may discourage lawyers from taking margin liquidation cases. But there have been many instances where arbitration panels

43. FINRA, REGUL. NOTICE 00-62, SEC APPROVES DAY-TRADING RULES (September 1, 2000), https://www.finra.org/rules-guidance/notices/00-62 (emphasis added).

44. *Id*. ("A member will be subject to the day-trading rules if it affirmatively promotes day-trading activities or strategies through advertising, training seminars, or direct outreach programs. For instance, a firm generally will be subject to the new rules if its advertisements address the benefits of day trading, rapid-fire trading, or momentum trading, or encourages persons to trade or profit like a professional trader. A firm also will be subject to the new rules if it promotes its day trading services through a third party. Moreover, the fact that many of a firm's customers are engaging in a day-trading strategy will be relevant in determining whether a firm has promoted itself in this way.").

have found that, despite the contract language, the BD didn't treat the customer fairly, and has awarded damages.

When presenting testimony to an arbitration panel in a margin liquidation case, it is best to admit that the broker-dealer did have a right to sell out the client if you only look at the margin regulations. But when you consider all of the other duties and obligations the broker-dealer has as it relates to the use of margin and margin liquidation, the broker-dealer can't rely solely on the contract language. Broker-dealers' claims of immunity in margin and margin liquidation cases are identical to their claims of no duties relating to suitability and third-party power of attorney claims. But those defenses fail because the securities regulations don't allow for broker-dealers to be "partially responsible". All the rules apply all the time. It is for that reason, clients can be successful in margin liquidation cases.

In a recent FINRA arbitration, the claim was that Ameritrade made improper margin liquidations, many of which involved options. An additional claim was that TD Ameritrade illegally restricted or canceled some of the claimant's option trades. The Panel awarded $2,082,148 on September 22, 2021.[45]

In another FINRA arbitration, the claimant was a professional option trader who had traded complex option strategies (Iron Condors, etc.) for years at TD Ameritrade. The arbitration claim was that TD Ameritrade wrongly restricted the claimant's options trading and made improper and unfair margin liquidations. The panel awarded $6,924,538.[46]

Senior and Elderly Investors

Brokers often claim they have no duties even when the customer is over the age of 65 or has mental or physical impairments. FINRA recently stated, "Older Americans are one of the fastest-growing demographics in the country, with an average of 10,000 Americans turning 65 every day. Con artists tend to target older people, in part because they are more likely to have built up nest eggs...[47] FINRA has continually addressed the needs of seniors through its

45. Elliott v. TD Ameritrade Clearing, Inc., FINRA Case No. 20-00400 (2021).

46. Eliason, et al. v. TD Ameritrade, Inc., FINRA Case No. 09-02054 (2010).

47. *Protecting Seniors from Financial Exploitation*, FINRA (Mar. 17, 2022), https://www.finra.org/investors/insights/senior-financial-exploitation.

Regulatory Notices over the years,[48] and more recently in its report titled, **Protecting Senior Investors 2015 – 2020**.[49]

FINRA has a rule addressing the handling of senior accounts which again, does not exclude or exempt the online firms from complying.[50] Nor are the requirements of this rule adjusted if the trading was solicited or unsolicited. Additionally, the rule is just as applicable to accounts that are being managed by a third party or an individual with power of attorney.

Broker-dealers in arbitration like to interpret FINRA Rule 2165 as saying that it is only to protect these senior investors from non-broker-related individuals. That is not true. And here's just one example of why FINRA doesn't think so:

> Helpline Helps Enforcement Stop Registered Representative who Stole Approximately $200,000 to Purchase Two New York Apartments in His Name.
>
> Helpline staff assisted FINRA Enforcement, which found that the registered representative converted approximately $200,000 from an elderly and legally blind senior investor, coerced him to open a joint account at a non-affiliated bank and used those funds to purchase two apartments in the registered representative's name by taking advantage of the investor's poor eyesight and inability to read

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48. FINRA, REGUL. NOTICE 07-43, FINRA REMINDS FIRMS OF THEIR OBLIGATIONS RELATING TO SENIOR INVESTORS AND HIGHLIGHTS INDUSTRY PRACTICES TO SERVE THESE CUSTOMERS (September 10, 2007), https://www.finra.org/rules-guidance/notices/07-43; FINRA, REGUL. NOTICE 17-11, SEC APPROVES RULES RELATING TO FINANCIAL EXPLOITATION OF SENIORS (September 10, 2007), https://www.finra.org/rules-guidance/notices/07-43; FINRA, REGUL. NOTICE 20-38, FINRA ADOPTS RULE TO LIMIT A REGISTERED PERSON FROM BEING NAMED A CUSTOMER'S BENEFICIARY OR HOLDING A POSITION OF TRUST FOR OR ON BEHALF OF A CUSTOMER (October 29, 2020), https://www.finra.org/rules-guidance/notices/20-38.

49. Seniors make up an increasingly large share of the American population and hold higher levels of wealth than younger generations. These factors, among others, make seniors an attractive target for financial exploitation, with evidence suggesting that such exploitation has been increasing in terms of both scope and magnitude. Most recently, in November 2019, FINRA held a Senior Investor Protection Conference to address issues relating to financial exploitation, diminished capacity, suitability, sales practices, scams, legal requirements and regulatory developments. *See Protecting Senior Investors 2015-2020*, FINRA (April 30, 2020), https://www.finra.org/rules-guidance/key-topics/senior-investors/protecting-senior-investors-2015-2020.

50. FINRA Rule 2165 (2022).

> documents. The registered representative maintained sole ownership of both apartments, including the investor's primary residence, and even rented the second apartment to tenants and collected and retained the rent. **FINRA found that the registered representative violated FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade) and barred him from the industry**.[51] (emphasis added)

FINRA Rule 3110 Supervision

One of the longest and most encompassing of the FINRA securities regulations is FINRA Rule 3110 on Supervision. Once again, we have the broker-dealers' lawyers and defense experts trying to mislead the arbitration panel into believing Rule 3110 doesn't apply to online broker-dealers because they don't have brokers making recommended trades. Au contraire! This 14-page regulation requires all broker-dealers (again no carveout for online broker-dealers or firms that don't make recommendations) to supervise and monitor all their activities, all of their employees, the opening of all their customer accounts, and all the trading activity in those accounts. Supervision and monitoring are key aspects of this regulation.[52]

Arguably, if the online broker-dealers such as TD Ameritrade, Charles Schwab, E*Trade, Interactive Brokers, and Robinhood comply with the "type of business" primarily offered by these firms - providing online trading services and trading platforms to investors and advisors on a non-solicitation basis, then their supervision of that business should be just as rigorous as traditional firms' supervision of accounts.

Red Flags in Monitoring and Supervision

NASD Notice to Members 98-38, **SUBJECT: NASD Reminds Members of Supervisory and Inspection Obligations:**
"Many failure-to-supervise cases involve indicators of misconduct, or "**red flags"** that should immediately alert management to potential wrongdoing. In

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51. *Protecting Seniors from Financial Exploitation*, FINRA (Mar. 17, 2022), https://www.finra.org/rules-guidance/key-topics/senior-investors/protecting-senior-investors-2015-2020.

52. FINRA Rule 3110 (2023).

circumstances where a firm's compliance and supervision system is inadequate to discover the indications of problematic conduct, the personal responsibility for supervision cannot be fulfilled by a supervisor who is simply unaware of the indicators."[53]

If a broker-dealer is not supervising and monitoring all the activity related to its clients' accounts, how can it catch red flags or potential abuses? It can't - that's why the securities regulations require all firms to monitor and supervise all accounts, all activity, and all trading.[54]

In an SEC enforcement case, the SEC wrote: "Supervisors must also respond vigorously to indications of possible wrongdoing. Supervisors must inquire into red flags and indications of irregularities and conduct adequate follow-up and review to detect and prevent future violations of the federal securities laws."[55]

In another SEC enforcement case, the SEC wrote:

> Red flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review. When indications of impropriety reach the attention of those in authority, they must act decisively to detect and prevent violations of the federal securities laws.[56]

FINRA Rule 2090 Know Your Customer – KYC

Pursuant to FINRA Rule 2090 and FINRA Notice to Members 11-02, Brokers are obligated to know the essential facts relative to their customers at the time of account opening and throughout the relationship.[57]

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53. NASD, NOTICE TO MEMBERS 99-38, NASD PROVIDES GUIDANCE ON SUPERVISORY RESPONSIBILITIES (May 1, 1998), https://www.finra.org/rules-guidance/notices/98-38.

54. NASD, NOTICE TO MEMBERS 99-45, NASD REMINDS MEMBERS OF SUPERVISORY AND INSPECTION OBLIGATIONS (June 1, 1999), https://www.finra.org/rules-guidance/notices/99-45.

55. SEC Release No. 34-44956, Order Making Findings and Imposing Remedial Sanctions, September 28, 2001, Securities and Exchange Commission.

56. SEC Initial Decision Release No. 152, Order Instituting Proceedings, Making Findings and Imposing Remedial Sanctions, March 16, 2000, Securities and Exchange Commission.

57. FINRA, Rule 2090 (2012); FINRA, NOTICE TO MEMBERS 11-02, SEC APPROVES CONSOLIDATED FINRA RULES GOVERNING KNOW-YOUR-CUSTOMER AND

Despite the clear mandate that all broker-dealers must know their customers, FINRA licensed broker-dealers, stockbrokers, their attorneys and defense experts often incorrectly claim that:

- The Know Your Customer rule doesn't apply because we do not make any recommendations (the no duty refrain)
- The customer's new account forms are filled out merely as a formality or as a convenience. Or it's extraneous information.

Not only are the Broker-Dealers required under FINRA Rule 2090 to know their customers at account opening, but they are required to continually update information as is required in the SEC Books and Records regulation 17 CFR § 240.17a-3, which requires the brokers to document what they learn under the know your customer rule.

Additional Regulations That Always Apply

Regulators and arbitrators need a reminder, when confronted with the "no duty" claim, that numerous relations apply. Here are just a few more regulations that always apply.

One of those additional regulations is FINRA Rule 2020.[58] This is often referred to as, the FINRA version of the SEC 10B-5, antifraud regulation. The Rule states, no one can make a false statement, a misleading statement, or an omission of a material fact.

One of the most cited rules in FINRA's disciplinary hearings when fining, censuring, and suspending brokers and broker-dealers is FINRA Rule 2010:[59] This rule, which applies to all broker-dealers without exception, requires firms to treat their customers and accounts in a professional, consistent, fair manner in every aspect of their business.

SUITABILITY OBLIGATIONS (January 10, 2011), https://www.finra.org/rules-guidance/notices/11-02.

58. FINRA, Rule 2020 (2008) ("No member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance.").

59. FINRA, Rule 2010 (2009) ("A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.").

In addition, FINRA regulations prohibit any broker-dealer from putting language in a customer agreement that limits or restricts a person's rights.[60]

Too Busy, Too Swamped, Too Many Accounts

It's 1999, markets are booming, and the tech/telecom market bust is about to happen. Americans are opening these newfangled online/internet brokerage accounts by the tens of thousands. And because I had experience as a broker, advisor, and trader trading online starting as early as with Charles Schwab back in the 1970s, I attracted a lot of online securities cases as an expert witness. But there was a problem. These upstart online broker-dealers could not keep up with the demand, not only opening all the new accounts but more importantly handling all the trading and regulatory requirements. Once in arbitration behind closed doors, these firms would often seek sympathy from the arbitration panels that it was almost impossible for them to do everything required due to the onslaught of new accounts and volume of trading. I bring this up now - 24 years later - because this is still a defense/excuse I hear from online broker-dealers.[61]

I wrote one of my first online/internet trading articles in July 1999 called "Internet Trading – Take A Walk On The Wild Side"[62], wherein I addressed a similar problem in a section I titled, "Inadequate Systems And System Failure". FINRA caught wind of these defenses and excuses by the broker-dealers and issued a regulatory notice addressing the responsibilities of online firms.[63]

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60. FINRA, REGUL. NOTICE 21-16, FINRA REMINDS MEMBERS ABOUT REQUIREMENTS WHEN USING PREDISPUTE ARBITRATION AGREEMENTS FOR CUSTOMER ACCOUNTS (April 21, 2021), https://www.finra.org/rules-guidance/notices/21-16.

61. See *supra*, Sec. III, Online Broker Dealer's Growth Numbers.

62. Schulz, *Internet Trading - Take a Walk on the Wild Side* (May 1, 1999), available at https://www.securitiesexpert.com/internet-trading.html.

63. FINRA, NOTICE TO MEMBERS 99-11, NASD REGULATION ISSUES GUIDANCE REGARDING STOCK VOLATILITY (Feb. 1, 1999), https://www.finra.org/rules-guidance/notices/99-11; FINRA, REGUL. NOTICE 21-12, FINRA REMINDS MEMBER FIRMS OF THEIR OBLIGATIONS REGARDING CUSTOMER ORDER HANDLING, MARGIN REQUIREMENTS AND EFFECTIVE LIQUIDITY MANAGEMENT PRACTICES DURING EXTREME MARKET CONDITIONS (Mar. 18, 2021), https://www.finra.org/rules-guidance/notices/21-12.

The Regulators Chime in

In June 2021, FINRA announced the following in a News Release:

FINRA announced today that it has fined Robinhood Financial LLC $57 million and ordered the firm to pay approximately $12.6 million in restitution, plus interest, to thousands of harmed customers. The sanctions represent the largest financial penalty ever ordered by FINRA and reflect the scope and seriousness of the violations[64].

In the settlement of FINRA's Enforcement Action against Robinhood, FINRA found the following:

> "Robinhood is a FinTech firm that offers commission free, *self-directed* trading for retail investors." Thus it is established, that the firm only offers trading on an unsolicited bases, and that the firm does not make any recommendations.
>
> **Failure to exercise due diligence before approving options accounts** – Since Robinhood began offering options trading to customers in December 2017, the firm has failed to exercise due diligence before approving customers to trade options. Although the firm's written supervisory procedures assign registered options principals the responsibility of approving accounts for options trading, the firm, in practice, has relied on computer algorithms—known at Robinhood as "option account approval bots"—with only limited oversight by firm principals. This system suffers from a number of flaws, including the following:
>
> • The bots were programmed to approve options trading based on inconsistent or illogical information, including for customers who were younger than 21 years old but who claimed to have had more than three years' experience trading options.
>
> • The bots approved certain customers with low risk tolerance for options trading, even though the firm's written procedures prohibited the firm from approving those customers from trading options.
>
> • The bots were programmed only to take into account the most recent information provided by customers, meaning that the firm approved for options trading customers whom it had previously rejected for options trading—often only minutes earlier.
>
> As a result of these flaws and Robinhood's overall failure to exercise due diligence before approving customers for options trading, the firm

64. *FINRA Orders Record Financial Penalties Against Robinhood Financial LLC*, FINRA (June 30, 2021), https://www.finra.org/media-center/newsreleases/2021/finra-orders-record-financial-penalties-against-robinhood-financial.

has approved thousands of customers who did not satisfy the firm's eligibility criteria or whose accounts contained red flags that options trading may not be appropriate for them, in violation of FINRA Rules 3110, 2360, and 2010.

Robinhood communicated false and misleading information to customers.

FINRA Rule 2010 requires firms to observe high standards of commercial honor and just and equitable principles of trade in the conduct of their business. Making a negligent misrepresentation or an omission of a material fact to customers violates FINRA Rule 2010, as it is inconsistent with just and equitable principles of trade. FINRA Rules 2210 and 2220 set forth content standards for firms' communications with customers. FINRA Rule 2210 requires, among other things, that communications be "fair and balanced"; not contain any "false, exaggerated, unwarranted, promissory or misleading statement or claim"; and not omit "any material fact . . . if the omission, in light of the context of the material presented, would cause the communications to be misleading." And FINRA Rule 2220, which addresses member firms' communications about options trading, requires firms to "avoid[]" making "broad generalities" about the risks of options trading, and prohibits, among other things, making "any untrue statement or omission of a material fact" or any statement that "is otherwise false or misleading," or that "fails to reflect the risks attendant to options transactions and the complexities of certain options investment strategies." A violation of FINRA Rules 2210 and 2220 also constitutes a violation of FINRA Rule 2010.

FINRA Rule 3110 requires that firms establish and maintain a supervisory system, and establish, maintain, and enforce written supervisory procedures, that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules. A violation of FINRA Rule 3110 also constitutes a violation of FINRA Rule 2010.

Customer 3 deposited more than $14 million into his interactive brokers account - a figure that should have triggered red flags since it was well beyond his stated income or resources. Additionally, customer 3 regularly incurred trading losses of more than $100,000 each month and seemingly replenish this account with fresh deposits that exceeded his stated annual income. The firm consequently did not investigate customer 3 or speak with him to understand the source of

> his deposits or to ask him about his apparent lack of concern regarding his significant monthly trading losses.[65]

The SEC during the same timeframe issued an Order Instituting Administrative and Cease and Desist Proceedings against Interactive Brokers, stating:

> [D]uring the relevant period, IB ignored or failed to recognize numerous red flags, failed to properly investigate certain conduct as required by its written supervisory procedures, and ultimately failed to file SARs on suspicious activity. [66]

In June 2014, FINRA issued an AWC against TD Ameritrade, stating as follows:

> **TDAC's Failure To Maintain Updated Account Records**
>
> SEC rule 17a-3(a))17) requires that a firm create and maintain an account record including, among other things, the accounts investment objective. The rule further requires that, in the event of a change in the customer's investment objective, a firm create and maintain a record that it sent to the customer a copy of the updated account record reflecting the change in the investment objective within 30 days of the change.
>
> Specifically, the data files containing new or updated customer suitability information failed to route to TDAC's printing vendor such that changes in customers' investment objectives were not sent to approximately 300,000 customers, during the period from approximately August 2010 through November 2011. [67]

FINRA also fined E*Trade $350,000 for its rule violations, as follows:

> As set forth below, however, this supervisory system was not reasonably designed with respect to detecting potential manipulative

65. Letter of Acceptance, Waiver and Consent, FINRA Dept'd of Enforcement v. Robinhood Financial LLC, Docket No. 2020066971201 (June 30, 2021).

66. SEC Release No. 89510, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Administrative Proceeding File No. 3-19907 (Aug. 10, 2020), Securities and Exchange Commission.

67. Letter of Acceptance, Waiver and Consent, FINRA Dep't of Enforcement v. TD Ameritrade Clearing, Inc., Docket No. 2011030752701 (July 2, 2014).

> trading involving wash sales, prearranged trading, and marking-the-close. [68]

In late 2021, the State of Massachusetts filed a complaint against Robinhood, alleging that:

> Robinhood used advertising and marketing techniques that targeted younger individuals, including Massachusetts residents, with little, if any, investment experience. The median age of a Robinhood customer has been reported as 31 years old and approximately 68% of Massachusetts customers approved for options trading on the Robinhood platform identified as having no or limited investment experience. [69]

The Complaint further alleges that Robinhood rapidly increased its customer base in 2020 and then encouraged them to trade constantly:

> Once individuals become customers, Robinhood relentlessly bombards them with a number of strategies designed to encourage and incentivize continuous and repeated engagement with its application. The use of these strategies is often referred to as gamification: the application of typical elements of game playing to other activities, typically as a marketing technique to boost engagement with a product or service. Robinhood rewards customers with colorful confetti raining down their screens after executing trades on its application. In 2019, Robinhood rolled out a new cash management feature with an early access waitlist and utilized gamification to reward customers who interacted daily with the application by improving their positions on the waitlist. Customers who did not interact daily with the application watched their position on the waitlist precipitously decline, while those who succumbed to the psychological effects of Robinhood's gamification soared up and up the waitlist.

The Complaint also makes clear that the Massachusetts Securities Division considers providing a list of investments to customers to be a recommendation:

> Robinhood gives customers the platform and tools to make potentially an unlimited number of trades. In an effort to encourage trading, Robinhood provides lists of securities on its application, including

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68. Letter of Acceptance, Waiver and Consent, FINRA Dep't of Enforcement v. E*Trade Securities LLC, Docket No. 2014039952901 (January 10, 2022).

69. Commonwealth of Massachusetts, Office of the Secretary of the Commonwealth Securities Division, In the Matter of: Robinhood Financial, LLC, Respondent, Amended Administrative Complaint, Docket No. E-2020-0047 (Oct. 21, 2021). The case is still pending.

> lists of the most-traded securities on Robinhood's platform and the most popular securities traded by Robinhood customers. This is no different from a broker-dealer agent handing a list of securities to a customer, pretending to be surprised when the customer purchases securities from that list, and then proclaiming that he made no recommendations to the customer.

The Complaint reveals that in Robinhood's zeal to increase its customer base and encourage trading, it violated the option rules.

> Robinhood gave hundreds of customers with limited or no investment experience the ability to make thousands of trades in a matter of months. At least 670 Robinhood customers with limited or no investment experience averaged at least five trades per day, with two customers averaging close to 100 trades per day. As one example, Robinhood allowed a customer with no investment experience to make more than 12,700 trades in just over six months.
>
> While encouraging constant engagement with its platform, Robinhood failed to properly screen customer profiles and allowed thousands of inexperienced investors to engage in very risky trading activity. Robinhood failed to follow its own policies and procedures in place regarding the approval of options trading in customer accounts.

Conclusion

In Las Vegas casinos and used car parking lots, it is a "Buyer Beware" market. If you listen to our legislators, read the securities regulations of the feds, the states, and FINRA and if you visit the websites of those regulatory agencies, they broadcast loud and clear that the securities markets in the United States are not and should not be a "Buyer Beware" market. Yet, the major online broker-dealers, through their mantra, "We Have No Duties," have created just such a casino-gambling environment, where millions of investors are losing millions of dollars, and sadly far too often, their life savings.

WHY VARIABLE ANNUITIES ARE UNSUITABLE FOR SENIORS

Fred Rosenberg

Introduction

Far too often brokers recommend Variable Annuities (VA) for elderly[1] clients rather than more suitable Single Pay Immediate Annuities[2] (SPIAs) or Deferred Fixed Paid-Up Annuities (DFPAs) either of which offers equal security without market risk and far higher guaranteed monthly distributions. Recommending VAs exposes the elderly investor's cash value unnecessarily to market volatility, burdened by automatic withdrawals, corrosive fees and costly riders.[3] Therefore, recommending VAs to elderly investors seeking lifetime retirement income vs SPIAs or DFPAs is, in most cases, unsuitable.

I. Annuities Defined

An SPIA[4] is a contract between an individual annuitant and an insurance company that pays monthly distributions, typically commencing immediately, at a constant amount for life. The distribution amount is calculated at a rate that returns the premium based upon actuarial life expectancy. Men live shorter lives and receive higher distributions than women of the same age. As life expectancy declines, distribution rates increase. For example, a person with a 20-yr life expectancy will receive about 5%/year while a person with a 10-year life expectancy would receive approximately 10%/yr., with an SPIA. The shorter the life expectancy, the higher the distribution rate. Typically

1. "Elderly" refers specifically to men and women in their mid-70s and 80s with actuarial life expectancy of a decade or less and well short of a Variable Annuity's projected break-even point.

2. This is also sometimes referred to as an Immediate Payout Annuity. *See* Julia Kagan, Immediate Pay Annuity, (August 7, 2021), in INVESTOPEDIA, https://www.investopedia.com/terms/i/immediatepaymentannuity.asp.

3. One important selling point of VAs is deferred taxes, of no import for Seniors.

4. SPIA are also known as Immediate Annuities.

distributions terminate upon death,[5] but most policies offer guarantees for a minimum number of years at a reduced distribution.

A DFPA is an annuity that commences distributions at a deferred date taken either as a guaranteed periodic income stream or a lump sum payment. Changes to these agreed terms usually results in penalties.

Comparing an SPIA to a DFPA, for example, a 77 year old male would receive 10.11% per year for life guaranteed for 10 years,[6] but if this man were to defer his distributions five years to age 83 with a DFPA, his annual distribution rate would increase to 15.6% per year for life,[7] guaranteed for a minimum of 10 years to age 93 and breaking even in seven years.

II. How Variable Annuities function for the Elderly

Variable Annuities offered by insurance companies[8] differ from the SPIA and DFPA above in that the premiums are invested in sub-accounts of mutual funds of either equities and/or fixed income investments. The sub accounts are the cash value of the variable annuity whose value fluctuates based upon market performance adjusted for deductions for withdrawals, expenses, and costs.

VAs have two phases, *Accumulation Phase* and *Distribution Phase (Annuitization)*. The Accumulation Phase of an annuity is the period when the cash value of the annuity can increase with market risk[9] and taxes on growth of the initial principle are deferred. Ending the Accumulation Phase requires

5. *See* Kagan, *supra* note 2.

6. Nationwide Immediate Annuity Quote (Dec. 31, 2022) ("Nationwide Immediate Annuity"). Note that often SPIAs often have no guaranteed length of payout and thus size of payouts would be adjusted accordingly.

7. Guardian Longevity Paid-up Annuity Quote, Guarantee Full Payout (Feb. 7, 2023) ("Guardian Longevity Annuity").

8. There is risk associated with the solvency of the insurance company and thus the payouts offered must take into account credit worthiness. A number of private companies rate these companies as they do bonds. *E.g.,* Kim Borwick, Annuity Company Ratings, (February 7, 2023), in ANNUITY.ORG, https://www.annuity.org/annuities/providers/ratings/.

9. Investors must choose either the remaining Cash Value (Contract Base) after surrender charges or the GLIB Annuity at the end of the Accumulation period.

either annuitizing and ceding the subaccounts[10] to the insurance company, or surrendering the policy in whole or part and paying taxes on gains. Pre-annuitization withdrawals that do not exceed the permitted withdrawal percentages are allowed although withdrawals of principal will reduce benefits proportionally. Investors typically elect a Guaranteed Lifetime Income Benefit Rider[11] (GLIB) guaranteeing a lifetime distribution rate based upon the Income Base, regardless of losses associated with the subaccounts.

Under a GLIB, the Income Base is a notional account that will be increased annually by 6%-10% of the original premium, non-compounding. This is called the "Step-Up" or "Roll-Up" benefit of the GLIB, and depending on the rider selected, usually must be in effect for five years to achieve maximum guaranteed distribution rates under the rider.

Prior to annuitizing, investors may take withdrawals without penalty from the Contract Base under a policy's "Guaranteed Withdrawal Benefit" (GWB). The "Contract Base", initially the premium, is a cash account consisting of the original premium adjusted for market performance of the subaccounts, withdrawals, and costs and fees assessed prior to annuitization. Withdrawals require liquidating the subaccount mutual funds and typically are limited to 7%-10% of the contract base per year before penalties are assessed for most policies. Excess withdrawals will be subject to withdrawal penalties and may void Step-Up in that year.

Unfortunately, many seniors fail to grasp the corrosive impact of automatic withdrawals prior to annuitizing. With 3-4% in annuity fees plus portfolio management fees each year, even 6% withdrawals will burden the mutual funds by upwards of 9-10% annually, an unsustainable depletion rate, making appreciation problematic over time, particularly in volatile markets.

If the contract value falls below the premium adjusted for principal withdrawal, a common occurrence in investor claims, withdrawals will be treated as partial surrenders permanently lowering benefits and Step-Up,

10. Subaccounts provides cash value exposure to either the fixed income or equity markets whose elements may mirror traded mutual funds but slightly vary in performance. *See e.g.,* Mark P. Cussen, *Subaccounts: As Good As Their Clone Funds?*, (updated June 22, 2022), in INVESTOPEDIA, https://www.investopedia.com/articles/mutualfund/09/subaccounts-or-mutual-funds.asp.

11. GLIB is also sometimes referred to as a Guaranteed Lifetime Withdrawal Benefit (GLWB). As the name implies, this annuity guarantees the withdrawal of a set amount regardless of the performance of the sub accounts and thus market value of the annuity. *See, e.g.,* Daniel Kurt, Guaranteed Lifetime Withdrawal Benefit, (September 30, 2002), in INVESTOPEDIA, https://www.investopedia.com/terms/g/glwb.asp.

resulting in income uncertainty despite guarantees and promotional illustrations.

Furthermore, should the contract value decline below the premium either because of market action or withdrawals, automatic withdrawals must be reduced or they will exceed the permitted withdrawal percentage, generating penalties, accelerating the depletion of the contract value, and jeopardizing Step-Up benefits in the selected GLIB.

In summary, a VA's GWB permits withdrawals prior to annuitization at a stated penalty free rate, usually 8-10% of contract value while a GLIB requires annuitization for distribution rates between 6% and 8% of the Income Base.

SPIAs and DFPAs are best for Seniors

SPIA's commence payments immediately at a "constant" rate based actuarially on age and sex. In my case, age 77, I will receive $50,579.64 annually on a $500,000 policy[12], a *Constant* distribution of 10.11%/year for life guaranteed for the first 10 years, 87% excluded from income tax. My break-even year, the point when cumulative SPIA distributions first exceed my premium, is 87, just 10 years. My life expectancy is 10.1 yearsIn contrast, the Variable Annuity from the same company[13], offered three GLIBs at various costs none of which outperform the SPIA. Under the GLIBs Step-Up benefit, the Income Base will be increased between 6% and 7% of the premium per year while annual distribution rates will range between 6.3% and 8% after 5 years, age 83, a distribution rate applied both to men and women. Break-even on the VA's occurs between 15 and 18 years, well beyond my life expectancy and over 20 years, the SPIA distributes a substantial surplus of between $227K to $387K over the VA GLIB riders. See illustrations below.

12. Nationwide Immediate Annuity, *supra* note 6.

13. Nationwide Destination Navigator Prospectus (Sept. 2022).

		Nationwide SPIA-10 yr Gtee			Nationwide Dest Navigatort VA					
			Distr		Inc Base	Distr				
		Premium	Rate		Step-up/yr	Rate	Annuity		Shoebox	
			10.12%		6.00%	6.30%			7%	
Age	year		Distr	Cum Distr	$ 30,000	Distr	Cum Distr	SPIA Excess	$500,000	Cum Distr
77		$ 500,000			$ 500,000					
78	1	$ 500,000	$ 50,580	$ 50,580	$ 530,000		$ -	$ 50,580	$ 35,000	$ 35,000
79	2	$ 500,000	$ 50,580	$ 101,160	$ 560,000		$ -	$ 101,160	$ 35,000	$ 70,000
80	3	$ 500,000	$ 50,580	$ 151,740	$ 590,000		$ -	$ 151,740	$ 35,000	$ 105,000
81	4	$ 500,000	$ 50,580	$ 202,320	$ 620,000		$ -	$ 202,320	$ 35,000	$ 140,000
82	5	$ 500,000	$ 50,580	$ 252,900	$ 650,000		$ -	$ 252,900	$ 35,000	$ 175,000
83	6		$ 50,580	$ 303,480		$ 40,950	$ 40,950	$ 262,530	$ 35,000	$ 210,000
84	7		$ 50,580	$ 354,060		$ 40,950	$ 81,900	$ 272,160	$ 35,000	$ 245,000
85	8		$ 50,580	$ 404,640		$ 40,950	$ 122,850	$ 281,790	$ 35,000	$ 280,000
86	9		$ 50,580	$ 455,220		$ 40,950	$ 163,800	$ 291,420	$ 35,000	$ 315,000
87	10	*Payout*	$ 50,580	$ 505,800		$ 40,950	$ 204,750	$ 301,050	$ 35,000	$ 350,000
88	11		$ 50,580	$ 556,380		$ 40,950	$ 245,700	$ 310,680	$ 35,000	$ 385,000
89	12		$ 50,580	$ 606,960		$ 40,950	$ 286,650	$ 320,310	$ 35,000	$ 420,000
90	13		$ 50,580	$ 657,540		$ 40,950	$ 327,600	$ 329,940	$ 35,000	$ 455,000
91	14		$ 50,580	$ 708,120		$ 40,950	$ 368,550	$ 339,570	$ 35,000	$ 490,000
92	15		$ 50,580	$ 758,700		$ 40,950	$ 409,500	$ 349,200	$ 10,000	$ 500,000
93	16		$ 50,580	$ 809,280		$ 40,950	$ 450,450	$ 358,830	$ -	$ 500,000
94	17		$ 50,580	$ 859,860		$ 40,950	$ 491,400	$ 368,460	$ -	$ 500,000
95	18		$ 50,580	$ 910,440	*Payout*	$ 40,950	$ 532,350	$ 378,090	$ -	$ 500,000
96	19		$ 50,580	$ 961,020		$ 40,950	$ 573,300	$ 387,720	$ -	$ 500,000

		Nationwide SPIA-10 yr Gtee			Nationwide Dest Navigatort VA					
			Distr		Inc Base	Distr				
		Premium	Rate		Step-up/yr	Rate	Annuity		Shoebox	
			10.12%		6.00%	7.00%			7%	
Age	year		Distribution	Cum Distr	$ 30,000	Distribution	Cum Distr	SPIA Excess	$500,000	Cum Distr
77		$ 500,000			$ 500,000					
78	1	$ 500,000	$ 50,579	$ 50,579	$ 530,000		$ -	$ 50,579	$ 35,000	$ 35,000
79	2	$ 500,000	$ 50,579	$ 101,158	$ 560,000		$ -	$ 101,158	$ 35,000	$ 70,000
80	3	$ 500,000	$ 50,579	$ 151,737	$ 590,000		$ -	$ 151,737	$ 35,000	$ 105,000
81	4	$ 500,000	$ 50,579	$ 202,316	$ 620,000		$ -	$ 202,316	$ 35,000	$ 140,000
82	5	$ 500,000	$ 50,579	$ 252,895	$ 650,000		$ -	$ 252,895	$ 35,000	$ 175,000
83	6		$ 50,579	$ 303,474		$ 45,500	$ 45,500	$ 257,974	$ 35,000	$ 210,000
84	7		$ 50,579	$ 354,053		$ 45,500	$ 91,000	$ 263,053	$ 35,000	$ 245,000
85	8		$ 50,579	$ 404,632		$ 45,500	$ 136,500	$ 268,132	$ 35,000	$ 280,000
86	9		$ 50,579	$ 455,211		$ 45,500	$ 182,000	$ 273,211	$ 35,000	$ 315,000
87	10	*Payout*	$ 50,579	$ 505,790		$ 45,500	$ 227,500	$ 278,290	$ 35,000	$ 350,000
88	11		$ 50,579	$ 556,369		$ 45,500	$ 273,000	$ 283,369	$ 35,000	$ 385,000
89	12		$ 50,579	$ 606,948		$ 45,500	$ 318,500	$ 288,448	$ 35,000	$ 420,000
90	13		$ 50,579	$ 657,527		$ 45,500	$ 364,000	$ 293,527	$ 35,000	$ 455,000
91	14		$ 50,579	$ 708,106		$ 45,500	$ 409,500	$ 298,606	$ 35,000	$ 490,000
92	15		$ 50,579	$ 758,685		$ 45,500	$ 455,000	$ 303,685	$ 10,000	$ 500,000
93	16		$ 50,579	$ 809,264	*Payout*	$ 45,500	$ 500,500	$ 308,764	$ -	$ 500,000
94	17		$ 50,579	$ 859,843		$ 45,500	$ 546,000	$ 313,843	$ -	$ 500,000
95	18		$ 50,579	$ 910,422		$ 45,500	$ 591,500	$ 318,922	$ -	$ 500,000
96	19		$ 50,579	$ 961,001		$ 45,500	$ 637,000	$ 324,001	$ -	$ 500,000

		Nationwide SPIA-10 yr Gtee			Nationwide Dest Navigatort VA					
		Premium	Distribution Rate		Inc Base Step-up/yr	Distribution Rate	Annuity		Shoebox	
			10.12%		7.00%	8.00%			7%	
Age	year		Distribution	Cum Distr	$ 35,000	Distribution	Cum Distr	SPIA Excess	$500,000	Cum Distr
77		$ 500,000			$ 500,000					
78	1	$ 500,000	$ 50,579	$ 50,579	$ 535,000		$ -	$ 50,579	$ 35,000	$ 35,000
79	2	$ 500,000	$ 50,579	$ 101,158	$ 570,000		$ -	$ 101,158	$ 35,000	$ 70,000
80	3	$ 500,000	$ 50,579	$ 151,737	$ 605,000		$ -	$ 151,737	$ 35,000	$ 105,000
81	4	$ 500,000	$ 50,579	$ 202,316	$ 640,000		$ -	$ 202,316	$ 35,000	$ 140,000
82	5	$ 500,000	$ 50,579	$ 252,895	$ 675,000		$ -	$ 252,895	$ 35,000	$ 175,000
83	6		$ 50,579	$ 303,474		$ 54,000	$ 54,000	$ 249,474	$ 35,000	$ 210,000
84	7		$ 50,579	$ 354,053		$ 54,000	$ 108,000	$ 246,053	$ 35,000	$ 245,000
85	8		$ 50,579	$ 404,632		$ 54,000	$ 162,000	$ 242,632	$ 35,000	$ 280,000
86	9		$ 50,579	$ 455,211		$ 54,000	$ 216,000	$ 239,211	$ 35,000	$ 315,000
87	10	*Payout*	$ 50,579	$ 505,790		$ 54,000	$ 270,000	$ 235,790	$ 35,000	$ 350,000
88	11		$ 50,579	$ 556,369		$ 54,000	$ 324,000	$ 232,369	$ 35,000	$ 385,000
89	12		$ 50,579	$ 606,948		$ 54,000	$ 378,000	$ 228,948	$ 35,000	$ 420,000
90	13		$ 50,579	$ 657,527		$ 54,000	$ 432,000	$ 225,527	$ 35,000	$ 455,000
91	14		$ 50,579	$ 708,106		$ 54,000	$ 486,000	$ 222,106	$ 35,000	$ 490,000
92	15		$ 50,579	$ 758,685	*Payout*	$ 54,000	$ 540,000	$ 218,685	$ 10,000	$ 500,000
93	16		$ 50,579	$ 809,264		$ 54,000	$ 594,000	$ 215,264	$ -	$ 500,000
94	17		$ 50,579	$ 859,843		$ 54,000	$ 648,000	$ 211,843	$ -	$ 500,000
95	18		$ 50,579	$ 910,422		$ 54,000	$ 702,000	$ 208,422	$ -	$ 500,000
96	19		$ 50,579	$ 961,001		$ 54,000	$ 756,000	$ 205,001	$ -	$ 500,000

In addition to SPIA's many insurance companies offer a Deferred Paid-Up Fixed Annuity, an annuity similar to an SPIA, but where the investor can defer taking the income for a number of years for substantially higher distribution rates than VAs. If a 77-year-old man in New York defers his distributions by 5 years in a DFPA, a period identical to GLIB requirement of the VA, at age 83 he would receive $78,268/year[14], 15.6%/yr for life guaranteed with full payout vs. $54,000/year for the highest paying VA Rider[15], an excess of $ 24,268/year and a $315,000 surplus by age 95[16]. The

14. Guardian Longevity Annuity, *supra* note 7.

15. Ref. illustration 7% step up, 8% distribution rate above.

16. Annuity distribution rates may vary by state of residence.

Deferred Fixed Annuity distribution is 64.7% exempt from income tax based upon the proportion of gains. See Illustration below.

		Guardian Longevity Paid UP full payout guarantee			Nationwide Dest Navigator 2 VA			
		Premium	Distrib Rate 15.65%		Inc Base Step-up/yr 7.00%	Distrib Rate 8.00%	Annuity	DFPA
Age	year		Distr	Cum Distr	$ 35,000	Distr	Cum Distr	Excess
77		$ 500,000			$ 500,000			
78	1	$ 500,000		$ -	$ 535,000		$ -	$ -
79	2	$ 500,000		$ -	$ 570,000		$ -	$ -
80	3	$ 500,000		$ -	$ 605,000		$ -	$ -
81	4	$ 500,000		$ -	$ 640,000		$ -	$ -
82	5	$ 500,000		$ -	$ 675,000		$ -	$ -
83	6		$ 78,268	$ 78,268		$ 54,000	$ 54,000	$ 24,268
84	7		$ 78,268	$ 156,536		$ 54,000	$ 108,000	$ 48,536
85	8		$ 78,268	$ 234,804		$ 54,000	$ 162,000	$ 72,804
86	9		$ 78,268	$ 313,072		$ 54,000	$ 216,000	$ 97,072
87	10		$ 78,268	$ 391,340		$ 54,000	$ 270,000	$ 121,340
88	11		$ 78,268	$ 469,608		$ 54,000	$ 324,000	$ 145,608
89	12	*Payout*	$ 78,268	$ 547,876		$ 54,000	$ 378,000	$ 169,876
90	13		$ 78,268	$ 626,144		$ 54,000	$ 432,000	$ 194,144
91	14		$ 78,268	$ 704,412		$ 54,000	$ 486,000	$ 218,412
92	15		$ 78,268	$ 782,680	*Payout*	$ 54,000	$ 540,000	$ 242,680
93	16		$ 78,268	$ 860,948		$ 54,000	$ 594,000	$ 266,948
94	17		$ 78,268	$ 939,216		$ 54,000	$ 648,000	$ 291,216
95	18		$ 78,268	$ 1,017,484		$ 54,000	$ 702,000	$ 315,484
96	19		$ 78,268	$ 1,095,752		$ 54,000	$ 756,000	$ 339,752

The Shoebox Standard

When assessing VA claims for Seniors, life expectancy is a key variable. Based upon life expectancy and the 15-18 year breakeven point of VAs, most senior investors will never live long enough to see full payout of their lifetime benefits, which are guaranteed for only 10 years. In fact, a 77 year old senior could put his money in a shoebox and immediately withdraw 6.5%/year for 15.8 years to age 92, tax free, before exhausting his funds, assuming no growth whatsoever (it's a shoebox!). A 77 year old male has an actuarial life expectancy of 10.1 years, well short of breakeven in a VA. With a conservative 2% annual return, the shoebox would exhaust in 18 years, age 95, 98% tax free. The shoebox has several other advantages over the VA such as assuring full return of original investment, liquidity, and transferability at no cost.

Social Security Life Expectancy Table Extract

Exact age	Male			Female		
	Death probability [a]	Number of lives [b]	Life expectancy	Death probability [a]	Number of lives [b]	Life expectancy
65	0.016001	79,994	18.09	0.009617	87,807	20.70
66	0.017124	78,714	17.37	0.010328	86,963	19.89
67	0.018298	77,366	16.67	0.011167	86,065	19.10
68	0.019519	75,950	15.97	0.012158	85,103	18.31
69	0.020847	74,468	15.28	0.013312	84,069	17.52
70	0.022381	72,915	14.59	0.014673	82,950	16.75
71	0.024185	71,283	13.91	0.016221	81,733	16.00
72	0.026266	69,559	13.25	0.017905	80,407	15.25
73	0.028660	67,732	12.59	0.019714	78,967	14.52
74	0.031401	65,791	11.95	0.021714	77,410	13.80
75	0.034618	63,725	11.32	0.024080	75,729	13.10
76	0.038263	61,519	10.71	0.026831	73,906	12.41
77	0.042190	59,165	10.11	0.029855	71,923	11.74
78	0.046367	56,669	9.54	0.033151	69,776	11.08
79	0.050948	54,041	8.97	0.036829	67,463	10.45
80	0.056237	51,288	8.43	0.041122	64,978	9.83
81	0.062360	48,404	7.90	0.046102	62,306	9.23
82	0.069226	45,385	7.39	0.051683	59,434	8.65
83	0.076884	42,243	6.91	0.057896	56,362	8.09
84	0.085452	38,996	6.44	0.064863	53,099	7.56
85	0.095062	35,663	6.00	0.072731	49,655	7.05
86	0.105829	32,273	5.57	0.081626	46,043	6.56
87	0.117838	28,858	5.17	0.091644	42,285	6.10
88	0.131138	25,457	4.80	0.102840	38,410	5.67
89	0.145751	22,119	4.45	0.115236	34,460	5.26
90	0.161678	18,895	4.12	0.128837	30,489	4.88

Recommending a VA distributing at a lower rate than the SPIA with a breakeven of 15.8 years is clearly unsuitable due to a shorter life expectancy and the need for current income. Additionally, annuitizing the GLIB prior to 5 years will also result in a lower distribution rate than the maximum GLIB guaranteed rate. For example, by annuitizing the VA prior to 5 years, the GLIB distribution rate can be reduced by .25%-1%/year, reducing distributions and extending breakeven further beyond life expectancy.

Accumulation Phase Dilemma

The Accumulation Phase of a VA presents an income dilemma for seniors. Either they must deplete their remaining assets during the Accumulation Phase as the Income Base is increased annually or they must liquidate the subaccounts prior to annuitizing adding substantial risk to future distributions and depleting cash value. Even one negative year during the Accumulation Phase will reduce contract value by the 10% withdrawals and fees, and 10% market decline, a total of 20%.

In one case I reviewed, the impact of a two-year Accumulation Phase was profound. The investor, a 78-yr widow, in addition to her permitted 10%/yr. VA withdrawals which eliminated Step-Up, was forced to deplete her remaining mutual funds at a rate of 16%/year just to meet living expenses. Over the 2-yr accumulation period 1/3 of her income producing assets had been consumed and were inadequate to meet her future budgeted needs. It was clear from the outset that a greater proportion of the portfolio needed to be guaranteed and not subject to market risk, sequence risk,[17] excessive withdrawals, and costs.

The Death Benefit?

The standard death benefit for a deferred variable annuity is the greater of the contract value of any remaining assets at death, or the total premiums paid less distributions received by death. The annual cost of the death benefit is called "Mortality and Expense", (M & E) and ranges between 1% and 2% of the contract value annually. Additional riders may enhance the pre-annuitization death benefit.

Importantly, the death benefit is not insurance but a put option for the beneficiaries. If the contract value at the investor's death is less than the death benefit, the option will be exercised, the death benefit will be paid, and the sub

17. Sequence risk refers to the fact that the order and timing of investment returns can have a big impact on how long your retirement savings last, even holding the long-term average rate of return constant. *See* Julia Kagan, Sequence Risk, (November 20, 2020), in INVESTOPEDIA, https://www.investopedia.com/terms/s/sequence-risk.asp (last visited Feb. 16, 2023).

accounts retained by the insurance company. Conversely, if the contract value exceeds the death benefit, the option will expire worthless, and the beneficiaries will receive the cash value of the account.

A VA with a contract value of $250,000 and a 1.25% M&E charge, for example, costs $3,125 a year just for the death benefit in addition to GLIB fees and various other riders. For many people, this is a very expensive way to buy a limited amount of death benefit for the beneficiaries with a cost that continues to increase as the VA's contract value grows. Over time, it is common for a VA to end up having a death benefit that is higher than the actual contract surrender value. Once annuitized however, the death benefit terminates.

A caveat on the Cost of Rider fees

GLIBs charge 1.25%+ of the notional Income/Benefit Base. If the investor withdraws only the subaccount gains each year prior to annuitizing, in 6 years of 8% Step-up the notional Income Base will have been increased to $150,000 (rounded) while the contract value will remain at $100,000. The reported 1.25% Rider fee of $1,875 actually amounts to 1.875% of the contract value, .625% greater than reported. When calculating costs, you must divide the annual GLIB charge by the contract value to determine the actual GLIB cost percentage. In many instances where markets have declined, the GLIB fees can amount to 2%-5% of contract value accelerating its decline.

Exchanges: 26 U.S. Code § 1035 (A)(3)- Certain exchanges of insurance policies.

Many senior investors have older VAs that have matured and are no longer subject to withdrawal penalties. These investors are frequently encouraged to 1035 exchange the old annuity for a newer VA ostensibly with enhanced benefits, restarting the cycle, paying new commissions, adding new costly riders, restarting the accumulation period, and extending the withdrawal penalties for an additional 7-10 years. In most cases however, exchanging the old annuity for an SPIA with substantially higher distributions and equal security, is the preferred exchange for income seeking seniors. Caveat: Once annuitized, a VA cannot be exchanged.

Taxation of Annuities

IRA Publication 575 - Pension and Annuity Income

Under 575, "If your Variable Annuity is under a nonqualified[18] plan (including a contract you bought directly from the issuer), the amount withdrawn is allocated first to earnings (the taxable part) and then to your cost (the tax-free part)."[19] The impact of this rule is that both withdrawals and annuity distributions from VA's are fully taxed until all gains are distributed. This can be quite burdensome for seniors especially if there is a long accumulation period. Unfortunately, when VAs are 1035 exchanged for an SPIA, the VA tax treatment carries over to SPIA distributions.

Furthermore, regardless of tax treatment, in the event the investor withdraws principal prior to annuitization, the withdrawal is considered a surrender by the insurance company and the investor's cost basis will be reduced and the taxable portion will increase proportionately.

Unfortunately, it is common for senior investors to take automatic fixed withdrawals from the VAs contract value prior to annuitization only to discover years later that their guaranteed income benefits had been reduced over time, sometimes significantly due to surrenders.

Commissions

SPIA commissions range in the 1.5%-3.5% range without trailing commissions, additional costs, or fees. VA commissions on the other hand are 5%-6%, about double that of SPIAs plus trailers of .25% to .5% annually depending on VA structure. VAs also do not have breakpoints, which would be available were the subaccount's mutual funds invested outside of a VA. Recommendations of VAs are frequently and arguably commission driven, clearly not in a senior's best interests, and are unsuitable.

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18. Not in a Qualified Plan such as an IRA, 401K, or pension where pre-tax contributions are deductible.

19. I.R.S. Publication 575, Pension and Annuity Income at 5 ("Variable Annuities") (Feb. 28, 2022).

Comparisons and Illustrations

SPIAs and DFPAs are rarely if ever offered, recommended, or presented as an alternative to VAs for seniors. Instead, VA prospectuses and sales material typically incorporate pages of illustrations comparing living benefits with market performance analogs, even though the income guaranteed in a GLIB rider is actuarial and not market dependent.

Finra Rule 2210 (d)(1)(a) requires that, "All member communications must be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service. *No member may omit any material fact or qualification if the omission, in light of the context of the material presented, would cause the communications to be misleading*." (emphasis added).

Finra Rule 2210(d)(2) Comparisons: "Any comparison in retail communications between investments or services must disclose all material differences between them, including (as applicable) investment objectives, costs and expenses, liquidity, safety, guarantees or insurance, fluctuation of principal or return, and tax features."

Finra Rule 2211, "Communications with the Public About Variable Insurance and Variable Annuities," establishes the General standards for communications relating to Variable Annuities. Rule 2211(b)(2) "Product Comparisons" adopts the 2210(d) content standards: "A comparison of investment products may be used provided the comparison complies with applicable requirements set forth under Rule 2210. Particular attention must be paid to the specific standards regarding 'comparisons' set forth in Rule 2210(d)(2)."

Finra Rule 3120: "(a) Each member shall designate and specifically identify to FINRA one or more principals who shall establish, maintain, and enforce a system of supervisory control policies and procedures that:

(1) test and verify that the member's supervisory procedures are reasonably designed with respect to the activities of the member and its associated persons, to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules; and

(2) create additional or amend supervisory procedures where the need is identified by such testing and verification. The designated principal or principals must submit to the member's senior management no less than annually, a report detailing each member's system of supervisory controls, the summary of the test results and significant identified exceptions, and any additional or amended supervisory procedures created in response to the test results."

Questions: Having read through dozens of prospectuses and reams of sales materials over the years, I have never seen any illustration comparing a VA with an available SPIA or DFPA. Why? Arbitrators must decide:

a. Does omitting SPIA and DFPA comparisons when recommending a VA to a senior seeking guaranteed retirement income constitute a violation of the 2210 and 2211 requisites?
b. Is the omission of SPIA and DFPA comparisons material to understanding or misleading about variable annuities under Rule 2210 that states, "No member may omit any material fact or qualification if the omission, in light of the context of the material presented, would cause the communication to be misleading."?
c. Are seniors ever made aware that based upon their life expectancy, it is unlikely they will ever live long enough to even achieve VA breakeven when compared with SPIAs or DFPAs?
d. Are representatives properly trained and supervised under Finra Rule 3120 in insurance products, including SPIAs and DFPAs?
e. Is the recommendation commission-driven given the availability of SPIAs and DFPAs with higher distributions and equal safety but about half the commission?

Damages

If a panel finds liability, then damages must be sufficient to restore the expected and budgeted lifetime income bargained for and which was achievable with SPIAs or DFPAs.

1. **Lost Income During Accumulation Period**. Had an SPIA been recommended vs a VA., a Senior would have received SPIA distributions for 5 years before full benefits were available under the GLIB. In my case at 77-yrs-old, 5-years of lost income during the accumulation phase amounts to $252,000, far too great a cost for delaying projected annuity payments for five years especially considering my declining life expectancy.
2. **Consequential Damages**: Typically, when VA's are recommended to seniors with GLIBs conditioned upon not taking withdrawals, the investors' remaining assets must then be sold at an accelerated rate to sustain budgeted life expenses, substantially depleting those assets over the accumulation period. In many cases after 5 years, at annuitization, the remaining assets, foreseeably depleted by withdrawals are insufficient to produce the needed lifetime income.

It is often demonstrable that had the remaining assets been invested in SPIAs or DFPAs in greater proportion at the outset, the investor's goals would have been met. The depletion of the Senior's remaining income producing assets is a foreseeable consequence of the VA recommendation calling for full restoration of the depleted account, arguably in addition to the SPIA income loss.

3. **Restoration of Principal**: At the end of the accumulation period, it is common to find automatic withdrawals have reduced contract value and that remaining portfolio assets, significantly depleted, are inadequate to meet future living expenses. An amount that restores principal sufficient to allow the investor to meet their guaranteed income objectives is a measurable way to make the senior whole.
4. **Income Replacement**: Over years of accumulation, the taxes on a full VA surrender becomes too onerous. Consequently, to avoid a tax disaster, the cost of restoring the income deficiency with an SPIA that adds sufficient income to make the investor whole is appropriate. In most cases, given the increased age of the investor a supplemental SPIA to restore the income deficiency may be preferable. Damages would amount to the premium for the supplemental SPIA plus, arguably, the SPIA income lost during the accumulation phase.
5. **Market Adjusted Damages**. In most cases where the investor has opted for guaranteed income without market risk, neither Market Adjusted Damages (MAD) nor Well Managed Account Damages (WMA) are adequate or appropriate analogs. MADs and WMAs adjust for actual cash flows, fluctuating principal, and market risk in a growth comparison, not guaranteed income.

   Only if the investor has no intention of ever annuitizing will MADs or WMAs be appropriate to illustrate the impact of VA fees and costs on a similarly allocated or a well-managed portfolio. If the investor intends to annuitize however, MADs and WMAs are essentially meaningless since the insurance company retains the subaccounts regardless and damages are measured by the impairment of or loss of retirement income.
6. **Disgorgement of Commissions**: Whether a Respondent is permitted to offset an award with the commissions earned from unsuitable recommendations is a question for the panel. Nevertheless, where a recommendation is clearly commission-driven versus incidental to the transaction, allowing such an offset creates a perverse incentive. In such cases disgorgement of commissions in addition to calculated losses would be appropriate.

STROLLING THROUGH CITRUS GROVES, STRUTTING INTO COUNTRY CLUBS: A SECURITIES VENTURE OF INVESTMENT, RISK, PROFIT & RIFT

*Aryamen Andrew Omshehe**

I. INTRODUCTION

"The markets themselves must have characteristics of liquidity and sensitivity to economic reality. They must be honest and fair and orderly. The public must have confidence that those characteristics prevail."[1]

Put yourself in the shoes of a for-profit Rhode Island business venture, such as a country club that needs to raise capital to improve its club. The board of directors decided that the interest rates associated with a bank loan to fund the improvements are significant, and the owners are not excited about providing the bank with a personal guarantee. The directors are also wary of raising the needed capital by assessing the current members. So, the directors introduce the idea of issuing new memberships to finance the improvements.

To the uninitiated in the complexities of securities law, this financing scheme would seem like an easy way to raise capital for improvements. Memberships generally are for the use of the club, not for profits, and investors purchase securities to earn profits in some form for the holders of the securities.[2] Unfortunately, this simple capital-raising scheme is not as straightforward as it seems. Because of the nature of this transaction, which aims to raise profits for business improvements, the transaction may

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*Candidate for Juris Doctor, Roger Williams University School of Law, 2023. For my son, Caspian, when something is important enough, you do it even if the odds are not in your favor. I want to thank my incredible wife, Jordanna, whose love, patience, and support made law school possible. My brilliant mentor, Professor Andrew C. Spacone, viewed my bravado as a skill and matched my audacious desire to succeed in life as a tenacious visionary yet fatherly, supportive, and kind. For his insight and encouragement, Matthew Gendron of the Rhode Island Department of Business Regulation, Securities Department. Finally, the views expressed and conclusions reached are my own.

1. William J. Casey, The Public Interest in Our Securities Markets, Address Before the Institutional Trading Conference (June 17, 1971), *in* NEWS, SECURITIES AND EXCHANGE COMMISSION*,* http://www.sec.gov/news/speech/1971/061771casey.pdf.

2. *See* Donald J. Regan, *Securities Regulations: When is a Club Membership a Security*, 10 LOY. L.A. L. REV. 356, 365–75 (1977).

inadvertently become governed by federal or state securities laws. Specifically, the U.S. Securities and Exchange Commission (hereinafter the "SEC") or Rhode Island's securities commission, the Department of Business Regulation (hereinafter the "DBR"), would consider whether this transaction comprises a security governed by securities laws. Once it is determined that a security has been issued, the regulatory paradigm shifts dramatically. The presence of a security is the gateway to regulation under federal or state securities law or both.[3] Compliance with the relevant regulations can add unanticipated costs and risks to the transaction and, more importantly, lead to significant penalties for failure to comply with the law.[4] The unintentional issuance of a security commonly occurs to uncategorized financial instruments or transactions that are "investment contracts."[5]

For federal securities law purposes, it is not easy to categorize an unusual financing scheme as an investment contract.[6] In order to properly evaluate whether an uncategorized instrument falls within the definition of a security under federal securities laws, the U.S. Supreme Court provided a detailed analysis in its seminal case on securities laws, *SEC v. W.J. Howey Co*.[7] The Supreme Court's analysis is known as the *Howey* test. Regulators, including the SEC, have endorsed the *Howey* test, and it is applied to this day.[8]

Many states have adopted the *Howey* test.[9] Other states have not, instead choosing the broader Risk Capital test adopted in the seminal California

3. JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 27 (9th ed. 2019).

4. *See id.*

5. *See id.* at 28.

6. The U.S. Court of Appeals for the Fourth Circuit found it "exceedingly difficult to [determine what] characteristics [are] associated with investment contracts." *See* Robinson v. Glynn, 349 F.3d 166, 174 (4th Cir. 2003).

7. 328 U.S. 293 (1946).

8. *See* William Hinman, The Regulation of Corporation Finance – A Principles-Based Approach, Address Before the PLI Directors' Institute on Corporate Governance (Eighteenth Annual) (Nov. 18, 2020), *at* https://www.sec.gov/news/speech/hinman-regulation-corporation-finance-2020-11-18.

9. At the federal level, the SEC manages securities transactions and requires that all securities sold to the public register first with them. Securities laws at the state level will differ depending on the state where the transaction occurs. For example, in Rhode Island, the Corporations, Associations, and Partnerships Act (R.I. Gen. Laws § 7–11–301) regulates the issuance, offer, sale, and purchase of securities. This

Supreme Court decision, *Silver Hills Country Club v. Sobieski*.[10] Under the Risk Capital test, depending on certain conditions, the financing scheme discussed above is a security and thus regulated by state securities law and Section 10(b) and Rule 10b-5 of the Securities and Exchange Act of 1934 (hereinafter, the "Exchange Act").[11] This federal omnibus anti-fraud provision applies to any purchase or sale of a security.[12]

At the federal level, if the transaction involves a public offering of the security, it is subject to the rigorous registration requirements of Section 5 of the Securities Act.[13] Suppose the offering is exempt from Section 5 registration. In that case, it is not subject to SEC prior review; however, rest assured that it does not live free of SEC scrutiny because the offering must meet all relevant conditions and requirements, including Section 5 exemptions.[14] If not exempt, the SEC can bring an enforcement action for penalties against issuers of the securities, and investors can sue the issuers for the return of their investment.[15]

The states have similar regulatory requirements. In Rhode Island, for example, R.I. Gen. Laws § 7–11–301 requires registration to offer and sell a security unless it is exempt under Chapter 11 of the Rhode Island Uniform Securities Act or is a covered federal security.[16] The critical distinction between federal and state securities regulation is that in many states, the securities commissions review the merits of the offering, which adds a further

largely covers the same rules and regulations of the federal securities laws; however, it is specifically tailored to business in Rhode Island.

10. 55 Cal. 2d 811 (Cal. 1961).

11. *See generally* Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq*.

12. Additionally, the Exchange Act regulates the operation of stock exchanges and trading. Whereas the Securities Act of 1933 (hereinafter, the "Securities Act") is the federal law that requires that securities sold to the public be registered with the SEC and that material information about the seller and the stock offering is made available to investors. *See* 15 U.S.C. § 77a *et seq*.

13. Under Section 5 of the Securities Act, all issuers must register non-exempt securities with the SEC. *See* 15 U.S.C. § 77e.

14. *See generally id.*

15. *See Investor Bulletin: SEC Investigations*, U.S. SEC. & EXCHANGE COMMISSION (Oct. 22, 2014), https://www.sec.gov/oiea/investor-alerts bulletins/ib_investigations .html.

16. *See* 7 R.I. GEN. LAWS ANN. § 7–11–301 (2022).

risk component.[17] The intent is to prohibit imbalance between the proverbial *inexperienced* public and the *greedy* promoter, but clearly, not every investor wants or needs government protection or intervention. However, "merit review is just that: state government steps in between the investor and promoter and requires [contract reformation] because the relationship between the parties is inequitable."[18] Rhode Island is not one of the states that conduct so-called merit reviews.[19] Similarly, the SEC does not consider the merits of any securities offering.[20] Its central focus, like Rhode Island, is whether the offering meets the relevant statutory and SEC requirements.

In addition to "direct" regulation[21] of securities offerings, federal securities law anti-fraud provisions, most importantly Section 10(b) and Rule 10b-5, regulate communications related to the purchase or sale of a security.[22] False

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17. Rhode Island applies a disclosure review of securities. The DBR reviews disclosures and determines whether it appropriately addressed the risks but would not materially review the offering itself in a registration. Congress considered three different models of securities regulation that states used in their Blue Sky laws: (1) the merit model: a review by a state official of a proposed offering of securities to determine whether the deal included provisions that were "'unfair, unjust, inequitable or oppressive' and whether it offered 'a fair return;'" (2) the fraud model: prohibits fraud in the sale of securities, with civil or criminal penalties for committing fraud; (3) the disclosure model: allows issuers to sell very risky or unsound securities, providing buyers with enough information to make an informed investment decision. *See* STEPHEN M. BAINBRIDGE, THE COMPLETE GUIDE TO SARBANES-OXLEY: UNDERSTANDING HOW SARBANES-OXLEY AFFECTS YOUR BUSINESS (Adams Media Corporation 2007).

18. Kim M. Robak, Comment, *What to Do with Merit Review*, 65 NEB. L. REV. 413, 416–17 (1986) (emphasis added).

19. *Id.*

20. *See Filing Review Process*, U.S. SEC. & EXCHANGE COMMISSION (Sept. 27, 2019), https://www.sec.gov/divisions/corpfin/cffilingreview.htm.

21. The securities laws create behavioral change directly or indirectly. Direct or entity regulation involves regulatory measures focusing immediately on the regulation of the target industry as a "discrete activity or as part of the broader, regulated investment services universe." *See* Hossein Nabilou & Alessio M. Pacces, *The Hedge Fund Regulation Dilemma: Direct vs. Indirect Regulation*, 6 WM. & MARY BUS. L. REV. 183, 190 (2015). In contrast, indirect regulation utilizes an intermediary to transmit the imperatives or commands to the (primarily intended) regulated entity or activity that is ultimately the target. *Id.*

22. *See Section 10(b) Litigation: The Current Landscape*, AM. BAR ASS'N (Oct. 20, 2014), https://www.americanbar.org/groups/business_law/publications/blt

or misleading statements of material fact expose the issuer of the securities and others to several penalties in a government enforcement action, investor private fraud action, or both.[23] At the state level, common law fraud does the work of 10(b) and 10b-5.[24] In sum, for-profit businesses in Rhode Island that offer securities regulated under the state's securities statute must ensure compliance with the regulatory requirements and avoid fraud in connection with the offering.

Neither the DBR nor the Rhode Island courts have addressed whether financing schemes like the abovementioned example involve a security. Both the *Howey* and Risk Capital tests remain viable approaches to the issue. Still, several states, including California, have given the subject considerable attention, and most importantly, the lingering questions surrounding the Risk Capital test have left lower courts to address many unanswered questions. In particular, when a transaction fits under one test but not the other, the question for the courts is to apply one or both tests, and if one test does not get the result the court intends, may the court apply the other test? Furthermore, the question remains whether the federal test, *i.e., Howey*, trumps the state test, Risk Capital, in states that employ both, or is it separate, and can challengers, whether in a Risk Capital adopted or unadopted state, persuade courts to use that test as opposed to the federal test.

This Comment suggests that Rhode Island, and other states, should adopt the *Howey* test rather than the Risk Capital test because the latter test exposes issuers of securities to unnecessary costs and legal risks by broadening the scope of what is considered a security. *Howey* focuses on profits and whether the investor was "led to solely expect profits."[25] The Risk Capital test, unlike *Howey*, focuses on whether the investors' capital is at substantial risk. However, this analysis makes the test unnecessarily broad. The Risk Capital test is also unpredictable because the factual inquiry turns on the extent of the business development at the time the interest is purchased;[26] thus, a showing

/2014/10/03_kasner/.

23. *Id.*

24. *See* McNulty v. Chip, 116 A.3d 173, 182–83 (R.I. 2015) (quoting Parker v. Byrne, 996 A.2d 627, 634 (R.I. 2010)).

25. Cox et al., *supra* note 3.

26. As Harvard economists put it, the formulated legal definition of Risk Capital merely accounts for *operational risk*, "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events," yet excludes strategic and reputational risk. *See* Peter Sands et al., *Rethinking Operational Risk Capital Requirements*, Project on Behavioral Finance and Financial Stability,

of minimal risk based on the issuer's strong balance sheet or adequate collateralization lessens the likelihood an investment contract escapes security regulation protections. Moreover, given that the Risk Capital test emphasizes form over substance, the Risk Capital test unreasonably complicates and impedes common, everyday business ventures, which could inadvertently render many business projects and undertakings as the offer and sale of securities.

Part II of this Comment provides a brief overview of the landscape, creation, and development of securities laws. In Part III, this Comment addresses the Risk Capital test's needless extension of public policy protections for fraud to underlying securities law and compares the *Howey* test's more tailored protections. Part IV considers the inherent touchstones of the rule of law, emphasizing reliability, which multiple tests undermine, especially considering the interstate nature of many securities transactions. Finally, Part V considers the financial economy and how the *Howey* and Risk Capital tests influence the productivity and efficiency in everyday transactions for businesses and consumers.

II. BACKGROUND

The primary federal securities statutes were put into place through the enactment of the Securities Act and the Exchange Act.[27] The overriding objective of federal securities law is to protect investors in securities.[28] One of the ways federal securities laws accomplish this goal is by ensuring investors receive from security issuers accurate and complete information (full and fair) from securities issuers necessary to make an informed investment decision.[29] A myriad of SEC rules and regulations further flesh out the provisions detailed in the Securities Act and Exchange Act.

HARVARD BUSINESS SCHOOL p. 9, (June 2016), https://www.hbs.edu/behavioral-finance-and-financial-stability/Documents/2016-06%20Rethinking%20Operational%20Risk%20Capital%20Requirements.pdf.

27. *See* 15 U.S.C. § 77a *et seq*; *see also* 15 U.S.C. § 78a *et seq*.

28. *See*, *e.g.*, H.R. REP. NO. 73-1383, pt. 2, at 5 (1934) (discussing the need to protect individual investors in enacting the Exchange Act); H.R. REP. NO. 73-85, pt. 1, at 2 (1933) (highlighting protecting reasonable investors as the purpose of the Securities Act).

29. *See generally* Susan B. Heyman, *Rethinking Regulation Fair Disclosure and Corporate Free Speech*, 36 CARDOZO L. REV. 1099, 1107 (2015).

The states also have their own securities laws and securities commissions. The overriding objective of state securities laws (also known as "Blue Sky" laws) is essentially the same objective as federal securities laws, including the requirement to provide full and fair disclosures to the investing public.[30] For example, Rhode Island has its Blue Sky laws, its own state securities commission, and its own rules and regulations that govern, *inter alia*, securities and securities transactions.[31] As such, there exists a dual securities regulatory regime of securities transactions which take place in a particular state.

The gateway to the application of federal or state securities law regulation is whether a security is present.[32] In the context of this Comment, a critical issue for the states and for-profit businesses seeking to raise capital in unconventional or untraditional ways, such as in the example provided above, is whether the transaction involves a security.

A. *WHAT IS A SECURITY?*

A general starting point is the understanding that a financial instrument is a monetary contract between parties,[33] and under federal law purposes, the Securities Act and Exchange Act identifies several financial instruments that are securities.[34] However, in rare situations, the inquiry into whether something is a security is fact-dependent because the instrument is "unusual." In other words, Congress did not include the challenged instrument in the Securities Act and Exchange Act.[35] Unusual financial instruments are nonrecurring or one-time transactions; in other words, they are not part of normal business operations.[36]

30. *See generally* Rutheford B. Campbell, Jr., *The Role of Blue Sky Laws After NSMIA and the JOBS Act*, 66 DUKE L.J. 605, 607–09 (2016).

31. *See generally* 7 R.I. GEN. LAWS ANN. § 7–11–101 (2022).

32. Cox et al., *supra*, note 3.

33. *See* James Girling, *Unusual Financial Instruments*, SHORELINE (Apr. 14, 2021), https://shorelineawc.com/unusual-financial-instruments/[https://perma.cc/5YHN-ZJHC].

34. *See* 15 U.S.C. § 77b ("The term 'security' means any note, stock, treasury stock, security future, security-based swap, bond . . . investment contract . . . .").

35. *See generally* King v. Pope, 91 S.W.3d 314, 319–20 (Tenn. 2002).

36. *See* Girling, *supra* note 33 (listing a number of unusual financial instruments, including Bespoke Tranche Opportunities, Weather Derivatives, Catastrophe Bonds,

Courts commonly analyze unusual financial instruments to determine whether they have the characteristics of any product that meets the definition of "security" under the federal securities laws. One of the defined securities under both acts is the "investment contract," which provides the most interpretive issues of whether a financial instrument or interest is a security and is the focus of this Comment.[37] The seminal Supreme Court case of *SEC v. W.J. Howey Co.* provides the framework for determining whether an unusual financial instrument is an *investment contract*.[38] Therefore, by analogy, an unusual financial instrument may be considered a fish, and federal securities laws as nets. The fish, floating down the river, hopes to make it to the big ocean. The first net is the Securities Act and Exchange Act; if these do not catch the fish, the next and only net should be the *Howey* framework.

i. *Howey—SEC v. W.J. Howey Co.*

The Supreme Court in *Howey* crafted an investment contract analysis, which includes a test to determine if an unusual financial instrument is an investment contract and, therefore, a security subject to the Securities Act and Exchange Act.[39] The Supreme Court held that a transaction involves an investment contract if: (1) there is an investment of money, (2) in a common enterprise, with (3) a reasonable expectation of profits, which was (4) solely derived from the efforts of a third party.[40] *Howey* involves an owner of a citrus grove proposing to sell a land interest to investors.[41] The investors would then each contract with the current owner of the citrus grove so that the current

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Movie Futures, Peer-to-Peer Lending, and Bowie Bonds). Bowie Bonds were "named after David Bowie as he was the first artist to have this type of security issued after him, these types of securities are essentially [bonds backed] by the royalties from an artist's [sic] catalog. These bonds are not unique to Bowie. In the summer of 2012, Goldman Sachs announced it was issuing a bond backed by the royalties of Bob Dylan's [sic] catalog." *Id.*

37. *See* 15 U.S.C. § 77b.

38. *Howey*, 328 U.S. at 293 (emphasis added).

39. *See id.* at 293–95.

40. *Id.* at 298–99.

41. *Id.*

owner would tend to the trees and harvest the resulting produce.[42] The investor and citrus grove tender share any profit from the fruit.[43]

The *Howey* test categorizes transactions in which investors rely on others to manage the enterprise to produce profits[44] on their investments.[45] These investors need the disclosure from registration under the federal securities laws to make informed decisions.[46] Moreover, the Supreme Court has further elaborated on *Howey's* third prong—the concept of a "for-profit venture." This element requires investing money into a common enterprise with the expectation of profits.[47] The expected return on the investment must come from the profits of the enterprise, "not merely additional contributions."[48] Furthermore, this return must be the principal motivation for the investment.[49]

After *Howey*, the Supreme Court modified the test; *solely* "derived from the efforts of a third party" became *substantially*.[50] Thus, it was no longer as easy to escape security regulation merely by involving the investor in the profit-making scheme. Furthermore, the Supreme Court modified the *Howey* test's focus to the substance and economic reality of the transaction, rather than the form, to determine the nature of the financial instrument.[51] The

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42. *Id.*

43. *See id.* at 296.

44. The profit element of *Howey* is capital appreciation resulting from the development of the initial investment or a participation in earnings from using investors' funds. *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 (1975).

45. *See generally id.*

46. Cox et al., *supra*, note 3.

47. *See Howey*, 328 U.S. at 301.

48. *See* Miriam R. Albert, *The Howey Test Turns 64: Are the Courts Grading this Test on a Curve?*, 2 WM. & MARY BUS. L. REV. 1, 19 (2011). "Many courts combine the third and fourth components, and thus refer to the test as a three-part test. This combination makes sense, as the full idea is that the investor has an expectation of profit and that expectation must come, to a large measure, from the efforts of someone other than the investor." *Id.* at 19 n.90 (internal citations omitted).

49. *See id.* at 19.

50. *See generally* Int'l Brotherhood of Teamsters v. Daniel, 439 U.S. 551, 561–62 (1979) (emphasis added).

51. *See* SEC v. Edwards, 540 U.S. 389, 393 (2004) ("Congress's purpose in enacting the securities laws was to regulate investments, in whatever form they are made and

Supreme Court found that focusing on economic realities means examining whether omitted instruments in the Securities Act and Exchange Act were regulated securities.[52]

In *Howey*, the risk of the investment was not a factor. The SEC assumed that the citrus grove scheme was an investment contract.[53] The Supreme Court focused on the economic realities of the underlying contract; in other words, the defendants were "offering an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by [W. J. Howey Company and Howey-in-the-Hills Service]."[54] However, the defendants' position was that they were offering fee simple interests in land and nothing "different from a farm or orchard coupled with management services."[55] The Supreme Court in *Howey* provided that if all four elements are not present, a security does not exist.[56] The Court applied this rationale to the facts and determined that all four elements existed concerning the citrus grove scheme, and the defendants were engaged in dealing securities.[57] Thus, the transaction was subject to several requirements under federal securities laws, including proper registration, the necessity of an investment prospectus, and that the transaction was subject to the anti-fraud provisions of federal securities laws because it involved an investment contract.[58]

To further elaborate on the concept that the test for a security should focus on the economic realities of a particular transaction, the Supreme Court granted *certiorari* in *United Housing Foundation, Inc. v. Forman*[59] to clarify the idea that instruments labeled as "stock" do not face immediate regulation

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by whatever name they are called" (quoting Reves v. Ernst & Young, 494 U.S. 56, 61 (1990))); *see also Daniel,* 439 U.S. at 558 (evaluating the economic reality of the underlying transactions to determine if an unusual financial instrument is an investment contract; therefore, a security under the Securities Act and Exchange Act).

52. *See Howey*, 328 U.S. at 298–99.

53. *Id.*

54. *Id.* at 295–99.

55. *Id.* at 299.

56. *Id.*

57. *Id.* at 300–01.

58. *See generally* Securities Act, 15 U.S.C. § 77a.

59. 421 U.S. 837 (1974).

under the Securities Acts, absent other qualifying factors.[60] In *United Housing Foundation, Inc.*, the plaintiff, United Housing Foundation, issued what it labeled as stock to investors, which entitled purchasers to lease a state-subsidized apartment as a co-op member, not for profit, but for use.[61] The Supreme Court held that the Housing Foundation was not dealing in securities and explicitly rejected a literal reading of the Securities Act and Exchange Act.[62] The Court reasoned that the instrument was not an investment contract under the *Howey* test and thus not a security because the investors expected to use the facility and not profit from the managerial efforts of the United Housing Foundation's stocks, and the payments of interest and resulting tax deduction could not satisfy the "expectation of profit" element under *Howey*.[63] Therefore, under the *Howey* test, any financial instrument or interest that "involves an investment of money in a common enterprise with profits to come [substantially] from the efforts of others" is an investment contract, thereby included within the definition of "security" and subject to the rules and regulations of the federal securities laws.[64]

ii. Risk Capital—Silver Hills Country Club v. Sobieski

The states that do not adopt the *Howey* test adopt some variation of the Risk Capital test expressed in the seminal case of *Silver Hills Country Club v. Sobieski*.[65] In *Silver Hills*, the promoters solicited investment capital with which to develop a country club business for profit.[66] The country club entered into a land-sale contract to purchase a 22-acre parcel of land for $75,000.[67] The contract required a $400 down payment, $50,000 eighteen months from the date of the contract, and $1,000 monthly starting three years from the date of

60. *Id.* at 859–60.

61. *Id.* at 848.

62. *Id.* at 851.

63. *Id.* at 855.

64. *See* Albert, *supra* note 48, at 4–5.

65. 55 Cal. 2d 811 (1961).

66. *Id.* at 815.

67. *Id.* at 813.

the contract.[68] After the country club received the initial $400 payment, it planted grass, installed a swimming pool, and remodeled the main house.[69] The club also planned for future improvements.[70] However, only part of the capital for these improvements came from selling memberships in the prospective club.[71]

The court developed the Risk Capital test, which protects those who "risk their capital . . . whether or not they expect a return on their capital in one form or another."[72] The key components are (1) an investment of capital, (2) in a for-profit business, in (3) substantial risk.[73] In this context, the concept of a substantial risk is limited to mean investments or solicitation of "high risk" capital.[74] The California Supreme Court reasoned that the investors' only chance of materializing any benefits from club membership was due to risked capital of the investors and the other purchasers.[75] Moreover, it did not matter whether the interest was labeled a membership or that the investors were on notice of this membership purchase because its label or, more importantly, its truth to the investor did not reduce risk.[76] Nothing from the *Silver Hills* decision provides that the investor is seeking a profit.

Due to the "financial structure of the club and the potential risk of loss to the investor-members, California's Commissioner of Corporations concluded that membership in the proposed club constituted a 'beneficial interest in the title to property'"[77] and was, hence, "'a security as then defined by section 25008 of the California Corporations Code."[78] Therefore, the primary distinction between the *Howey* test and the Risk Capital test is that "risk" is

68. *Id.* at 812.

69. *Id.* at 812–13.

70. *Id.*

71. *Id.*

72. *See id.* at 815.

73. *See generally id.* at 815–16.

74. *See generally id.*

75. *See id.*

76. *Id.*

77. David M. Roberts, *The Definition of a Security under the California Corporate Securities Law of 1968: The Risk Capital Test*, 6 PAC. L. J. 683, 689–90 (1975) (quoting Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 813–15 (1961)).

78. *Id.*

not a factor in the *Howey* test analysis. Under the *Howey* test, the central inquiry is profit; under the Risk Capital test, the central inquiry is the presence of risk. Furthermore, the major problem with the risk capital theory of *Silver Hills* is that the court never defined what it meant by "risk capital."[79] It could mean capital used to promote a previously nonexistent project, capital invested in a risky chance or venture, or capital with a very risky chance of return.[80]

The court in *Silver Hills* was well-intentioned. It provided a rationale to support the statutory and jurisprudential policy of flexibility in the context of determining the coverage of the federal securities laws, believing that the advantage in their decision permitted the SEC and the courts sufficient flexibility to ensure that those who market investments are not able to escape the coverage of the Securities Act and Exchange Act by creating new instruments that a more determinate definition would not cover.[81] This policy approach to permit flexibility in law is an admirable goal and powerful tool at times; however, the reality is that multiple tests undercut the purposes of the Securities Act and Exchange Act, which serve to ensure that issuers of securities disclose material information to the public.[82] The appropriate test to define what is or is not a security should be universally applicable, considering the interstate nature of many securities transactions; thus, flexibility in determining whether an unusual financial instrument is an investment contract by permitting courts to focus on risks, as opposed to profits, stands in the juxtaposition of the most inherent touchstone in law—reliability.[83] In sum, courts that maneuver exponentially using the Risk Capital test can potentially undermine the purpose of the law at issue. In the case of the definition of an investment contract, the cost of the Risk Capital test is the protection of at least one group of investors who seek judicial relief in a court bound to follow the California Supreme Court precedent in *Silver Hills*. However, the *Howey* test's more tailored protections catch transactions inducing investments with reasonable promises of profit without the need to extend public policy protections for fraud to underlying securities laws. Furthermore, *Howey* is

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79. *See* Michael E. Stevenson & John J. O'Leary III, *Definition of A Security: Risk Capital And Investment Contracts In Washington*, 3 U. PUGET SOUND L. REV. 83, 84 n.7 (1991).

80. *See generally id.*

81. Albert, *supra* note 48, at 37 (quoting *Reves*, 494 U.S. at 63 n.2).

82. *See generally* Campbell, *supra* note 30.

83. Daniel J. McCauley, Jr., *Intrastate Securities Transactions Under the Federal Securities Act*, 107 U. PA. L. REV. 937, 941 (1959).

predictable, applied uniformly, with certainty, and foreseeable because its focus is on profit, which is not a perfect measure but one that is systematic, historically surveyed, and calculated.[84] However, *substantial risk* is a palpable factor more easily subject to undue influence, not to mention subjective and ambiguous.[85] If Rhode Island, or other states, adopted the Risk Capital test, the consequences would impact the productivity and efficiency in conducting common everyday transactions for the financial economy, businesses, and consumers.

The underlying idea of the Securities Act and Exchange Act was "not to eliminate the risk that the investor will lose his money [because of] an unsound economic decision."[86] Rather, the "risk the Securities Act [and Exchange Act] seek to avoid is investor losses based on incomplete or fraudulent disclosure that induces investors into purchasing the instrument."[87] Going back to our scenario of the country club seeking to raise capital to expand and improve the club, it would not be an investment contract under *Howey*. Under the *Silver Hills* framework, absent mitigating circumstances, it might be an investment contract even though the members have only invested a minimal amount of capital. Thus, there are two different results with two different tests. As further discussed below, states that reject the *Silver Hills* framework show support for the *Howey* test.

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84. *See* Steven Toms, *Calculating profit: A historical perspective on the development of capitalism*, ACCOUNTING ORGANIZATIONS AND SOCIETY, at 205-06, https://doi.org/10.1016/j.aos.2009.06.002.

85. The term "profit" is generally unequivocal and universally unambiguous; however, Merriam's Dictionary definition may provide some relief for the irritated pedant. *See* Profit, Merriam-Webster, https://www.merriam-webster.com/dictionary/profit (last visited July 13, 2022) (defining profit as a valuable return; the excess of returns over expenditure in a transaction or series of transactions; the excess of the selling price of goods over their cost; the ratio of profit for a given year to the amount of capital invested or to the value of sales; and the compensation accruing to entrepreneurs for the assumption of risk in business enterprise as distinguished from wages or rent).

86. Scott D. Museles, *To Be or Not to Be a Security: Reves v. Ernst & Young*, 40 CATH. U. L. REV. 711, 743 n.253 (1991).

87. *Id.*

B. *INVESTMENT CONTRACTS IN RHODE ISLAND*

Neither the Rhode Island courts nor the DBR have addressed whether the *Howey* test or the Risk Capital test would apply to investment contracts (or any other uncategorized financial instrument or interests). One reason is that investors have never challenged the issue; thus, the question has not been considered.[88] Perhaps for-profit businesses and their lawyers have not given the subject much thought or relied on the courts and the DBR to adopt *Howey* when a challenger brings the matter to court.[89] However, sixteen other jurisdictions have adopted versions of the Risk Capital test[90] by implementing the rationale under a risk-reducing regime, which is to lessen the utilization of risky instruments, thereby providing sufficient investor protection, rendering notions of instrument protection futile.[91]

III. NEEDLESSLY BLENDING PUBLIC POLICY PROTECTIONS INTO SECURITIES LAWS

The Risk Capital test examines the degree of risk accompanying the transaction to the party purchasing the financial instrument. This species of risk is primarily concerned with "the risk that results from the relationship of the parties rather than any extrinsic risk-reducing factor."[92] The *Howey* test requires evidence of strong investment representations, such as a significant, realistic expectation of profit or income that will motivate investors to risk

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88. *See* 15 U.S.C. § 77(b)(1).

89. *See generally* Bainbridge, *supra* note 17.

90. Sixteen jurisdictions have adopted a version of the Risk Capital analysis: Supreme Court of California (1961); Supreme Court of Hawaii (1971); Supreme Court of Arkansas (1987); District Court of Guam (Appellate Division, 1981); Court of Appeals of Ohio (10th District, 1975); Supreme Court of Oregon (1976); by statute in Alaska, Georgia, Michigan, North Dakota, Oklahoma, and Washington; through regulatory rule in Illinois, New Mexico, North Carolina, Wisconsin, and Wyoming. *See The Risk Capital Test - List of States*, SUSTAINABLE ECONS. L. CTR., https://www.theselc.org/which_states_apply_the_risk_capital_test_when_deciding_what_is_a_security.

91. *See generally* Museles, *supra* note 86, at 743–44.

92. *Id.* at 744 n.254.

their capital.[93] Federal law prohibits fraud by any person concerning the purchase or sale of securities.[94] Securities lawsuits, primarily under 10b-5 for securities fraud, are primarily concerned with victim compensation and fraud deterrence.[95] However, the Risk Capital test instead attempts "to effect a circular transfer of wealth between two groups of innocent shareholders" without accounting for the experienced investor, who "does not suffer losses from corporate securities fraud in aggregate because they will benefit from fraud in some investments and lose in others."[96] Moreover, not only are general fraud suits better left to the common law but incorporating these suits in securities laws opens a wide floodgate of "strike suits,"[97] which deter "companies and their executives from providing socially valuable but speculative information to the public[] for fear that the information will later be attacked as fraudulent."[98]

An eruption of securities fraud filings is a cause for concern, especially for jurisdictions with burdened judicial economies. In *State ex rel. Owens v. Colby*, the Kansas Supreme Court not only adopted the *Howey* test but rejected the Risk Capital test analysis discussed in *Silver Hills*, thus refusing to extend the policy of public protection underlying securities laws to transactions susceptible to fraud.[99] The corporate defendant agreed to sell and purchase mini-warehouses and automobile repair and tune-up parts to its customers, who in turn sold them wholesale to garages and service stations.[100] The court considered the plaintiff's claims for fraud and misrepresentation; however, it

93. *See Forman*, 421 U.S. at 837 (holding persons who purchased interests with the intent of personal consumption do not expect Howey-type profit; thus, generally excluding schemes that attract consumers rather than investors). The added requirement that a significant, realistic expectation of profit or income will motivate investors to risk their capital excludes schemes that attract consumers rather than investors. *See generally id.*

94. *See*, *e.g.,* 17 C.F.R. § 240.10b-5 (2022).

95. *See generally* Note, *Congress, the Supreme Court, and the Rise of Securities-Fraud Class Actions*, 132 HARV. L. REV. 1067, 1071 (2019).

96. *See generally id.*

97. *See* BLACK'S LAW DICTIONARY (11th ed. 2019) (defining a strike suit as a suit (esp. a derivative action), often based on no valid claim, brought either for nuisance value or as leverage to obtain a favorable or inflated settlement).

98. *See generally* Note, *supra* note 95.

99. 231 Kan. 498, 504 (Kan. 1982).

100. *Id.* at 499.

found that the defendant was not dealing in securities because fraud and misrepresentation are not dispositive for applying securities laws.[101] Further, there was no common enterprise upon which the defendant's customers relied because the defendant merely made efforts to eliminate several layers of intermediaries by buying directly from manufacturers or its major distributors and selling parts to its customers.[102] Accordingly, the defendant was not subject to securities laws because the common enterprise and reasonable expectation of profits prongs were unmet under *Howey*.

The Risk Capital test is not an acceptable test to determine whether an unusual instrument is an investment contract; *Howey*, on the other hand, was reaffirmed by the SEC when the Division of Corporate Finance of the SEC issued a no-action letter[103] in *In re Coral Beach & Tennis Club*.[104] The country club sought a no-action letter whereby the SEC would evaluate the country club's capital raising scheme to sell memberships without registration under the Risk Capital and *Howey* tests and recommend no enforcement action.[105] The SEC paid no deference to the holding in *Silver Hills,* did as the country club requested, and considered the Risk Capital test but did not find the existence of an investment contract, even though the facts at hand were virtually identical to those in *Silver Hills*.[106] The SEC did not apply the Risk Capital test to the facts; however, it did differentiate the cases.[107] Here, the club built its facilities before the promoters solicited memberships for capital; the funds were designated into an escrow account and not used to build the facility.[108] In *Silver Hills*, the promoters bought land to develop the country

101. *Id.* at 503–06.

102. *Id.* at 505.

103. *See* BLACK'S LAW DICTIONARY (11th ed. 2019) ("A ["no-action letter" is a] letter from the staff of a governmental agency stating that if the facts are as represented in a person's request for an agency ruling, the staff will advise the agency not to take action against the person.").

104. Letter from Glenn A. Gerena, Counsel for the Coral Beach & Tennis Club to SEC, Office of Chief Counsel (Dec. 22, 2011), https://www.sec.gov/divisions /corpfin/cf-noaction/2012/coralbeachtennisclub012512-2a1-incoming.pdf.

105. *See id.*

106. *See generally id. See also* Coral Beach & Tennis Club, 2012 WL 249847, at *11 (S.E.C. No-Action Letter Jan. 25, 2012).

107. *See* Gerena, *supra* note 104, at 10.

108. *See id.*

club and then solicited the capital to pay for the cost of building the club.[109] The outcome in *Coral Beach* was insightful because, one, the SEC was provided an opportunity to accept the Risk Capital test but did not, and two, its issuance of a no-action letter undermines, if not puts into question, the holding of *Silver Hills*, which had virtually identical facts yet had a drastically different outcome.

In sum, the Securities Act and Exchange Act account for a myriad of mechanisms that mandate the disclosure of material risks to investors, and the unilateral attempts by courts to further bake public protections from risky investments into common law are needless. Indeed, even where well-intentioned, securities law can sweep broadly to ensnare even those who engage in legitimate practices.[110] Therefore, Rhode Island and other states should adopt the *Howey* test to better protect its investors from low-risk investment contracts with reasonable promises of profit without the need to extend public policy protections for fraud to underlying securities laws.[111] Moreover, the Securities Act and Exchange Act are not simply general proscriptions against fraud; the test used must define those transactions whose characteristics are such that applying the protections of the Securities Act and Exchange Act is appropriate.[112]

IV. THE DISSOLUTION OF UNIFORMITY AND PREDICTABILITY

The *Howey* test, unlike the Risk Capital test, provides predictable requirements for Rhode Island businesses and businesses in other states. The U.S. Supreme Court in *Forman*[113] found "[t]he touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of

109. *Silver Hills Country Club*, 55 Cal. 2d at 811–12.

110. *See* Andrew C. Spacone, *The Second Circuit's Curious Journey Through the Law of Tippee Liability for Insider Trading: Newman to Martoma*, 24 ROGER WILLIAMS U. L. REV. 1 (2019).

111. *See*, *e.g.*, Reves v. Ernst & Young, 494 U.S. 56, 61 (1990) (holding that "Congress did not . . . intend to provide a broad federal remedy for all fraud" in the Securities Act and Exchange Act).

112. *See id.*

113. *Forman*, 421 U.S. at 852.

others,"[114] thus, simplifying the profit analysis requiring (1) the expectation of substantial economic gain, (2) primarily for investment as opposed to personal occupancy or consumption.[115] This is considerably unlike the states that adopt the Risk Capital test, including Oregon, Idaho, and Alaska.[116] None, however, have provided uniform applications.

The Oregon Court of Appeals selected the Risk Capital test as an alternative to the *Howey* test for interpreting investment contracts in *State v. Consumer Business Systems, Inc.*[117] In *Consumer Business Systems*, the defendant sold franchise agreements that did not meet the requirements of the *Howey* test because the investors' profits did not result solely from the efforts of others.[118] First, the court applied the *Howey* test factors and, when it did not find that the investment was a security, applied the Risk Capital test to find the underlying transaction was a security.[119] The court thus established that Oregon transactions not met under the *Howey* test must then be analyzed under the Risk Capital test when warranted.[120]

The Oregon Court of Appeals limited the application of the Risk Capital test only to unproven enterprises. In *Jet Set Travel Club v. Corporation Commissioner*,[121] the court held that memberships sold in Oregon were not "investment contracts" and thus were not subject to registration under securities law.[122] The defendant sold memberships for the use of an airplane and placed the funds in escrow; however, the substantial portion of the initial capital that aided the defendant's operational start-up was not from memberships sold in Oregon.[123] The court reasoned that limiting the Risk Capital test was proper to allow for instances such as that experienced by the defendant here, where benefits of memberships had materialized due to prior

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114. *Id.*

115. *See generally id.*

116. *See* Sustainable Econs. L. Ctr., *supra* note 90.

117. 5 Or. App. 19 (Or. Ct. App. 1971).

118. *See id.* at 25–26.

119. *See id.* at 25–30.

120. *See generally id.* at 30–32.

121. 21 Or. App. 362 (Or. Ct. App. 1975).

122. *Id.* at 367.

123. *Id.* at 366.

raised capital from their established operation before they sold memberships to Oregon residents.[124]

Idaho also adopted the Risk Capital test but disagreed with Oregon in its application. In *State v. Gertsch*, the court applied the Risk Capital test but disagreed with the version enunciated in *Consumer Business Systems* because it limited its substantial risk analysis to "initial capital."[125] In *Gertsch*, the court held that the Risk Capital test could apply to schemes to raise capital for any existing but unproven business, including capital invested in newly formed enterprises.[126] Alaska also adheres to the Risk Capital theory; however, it did not limit the application to the initial capital.[127] It is thus important to connect the drawbacks of implementing the Risk Capital test due to its several variations and intangible definition. The uncertainties triggered by a lack of uniformity can be disastrous. It is not just a lack of predictability that causes theoretical or academic problems; if adopted, the Risk Capital test complications materialize systemically for current and future businesses, and the consequences antithetically pass to the jurisdiction's capital markets, impacting consumers and investors.[128]

The courts could have advanced the outcomes had it applied the *Howey* test in the cases discussed above because the *Howey* test requires evaluating financial instruments' facts, circumstances, and economic realities. The Risk Capital test diminishes the efficacy of transactions formed for realities, party autonomy, and expectations with its focus on substantially risked capital. Moreover, the *Howey* framework accounts for investor protections and party autonomy without departing from a uniform application of the investment contract analysis. As such, the *Howey* test is predictable, and the Risk Capital test is not, which results in a lack of uniformity and makes the Risk Capital test's application unforeseeable and uncertain.

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124. *See generally id.* at 366–67.

125. 137 Idaho 387, 393 (Idaho 2002).

126. *See generally id.* at 387.

127. Am. Gold & Diamond Corp. v. Kirkpatrick, 678 P.2d 1343, 1347 (Alaska 1984) (finding that an already established "territorial distributorship[] constituted an investment contract, and hence were securities subject to registration").

128. In 2016, Harvard economist found that an average common equity ratio was 11.7%, meaning USD$411 billion of equity capital went to protect banks, their investors, and society from the consequences of risks. *See* Peter Sands et al., *supra* note 26, at 3.

V. THE RESULTING CONSEQUENCES ON THE CAPITAL MARKET ECONOMY OF RHODE ISLAND AND OTHER STATES

The strengths of the *Howey* test include its ease of application and the meaningful limits it sets on the types of enterprises that qualify as securities. The test establishes an easily determinable formula that is not difficult for judges to apply. For example, investors who have undertaken some degree of economic risk are susceptible to the investment of money prong.[129] Furthermore, interest in partnerships and corporation stock are generally freely transferable for services or property.[130] Thus, plaintiffs who make the necessary investment of capital and undertake the consequent risk of loss will not face elimination under *Howey's* investment of money prong, unlike Risk Capital which "focuses retrospectively on what the investor stands to lose rather than prospectively on what he expects to gain."[131]

The U.S. Supreme Court addressed "the expectation of profits" requirement from *Howey* in *Forman*.[132] The Court held the shares in question did not meet the expectation of profits requirement because the purchasers' incentive to enter the transaction was to obtain affordable housing and not earn a return.[133] The Court looked at shares of stock in a low-income housing cooperative to see if the shares qualified as investment contracts under the Securities Act and Exchange Act.[134] Furthermore, the Court reasoned that the financial instrument was not an investment contract because it focused its analysis on the motivation of the investors rather than the form in which they received returns.[135] There is substantial deference to an instrument's form under the Risk Capital test because the focus is on whether capital is at

129. *See Reves*, 494 U.S. at 67 (1990) (discussing the relationship between risk and the necessity of application of the Securities Acts).

130. Under section 6.21(b) of the Revised Model Business Corporation Act, consideration may consist of "any tangible or intangible property . . . including cash, promissory notes, services performed, contracts for services to be performed, or other securities of the corporation." *See* REVISED MODEL BUS. CORP. ACT § 621(b) (1985).

131. *What is a security and why does it matter?*, CUTTING EDGE CAP., https://www.cuttingedgecapital.com/what-is-a-security-and-why-does-it-matter/.

132. *Forman*, 421 U.S. at 840–45.

133. *Id.* at 856–57.

134. *Id.* at 848.

135. *Id.* at 855.

substantial risk rather than the realities. As such, if applied in Rhode Island and other states, the Risk Capital test's investment contract analysis reduces or impedes business transactions where the parties did not intend to deal in securities.

This risk requirement is not part of the *Howey* test's rationale; the *Howey* Court specifically rejected it as necessary to satisfy that test.[136] In Rhode Island and other states, the *Howey* test is preferable because it identifies transactions in which investors rely on others to manage the enterprise to produce financial returns on their investments.[137] The *Howey* test isolates transactions that do not combine ownership and control, suggesting the importance of mandatory disclosure and higher liability standards to ensure that investors allocate capital to its highest-valued uses.[138] Moreover, the test is entirely consistent with the investor protection goals of federal securities law.[139]

Accordingly, Rhode Island and other states should adopt the *Howey* test because it will help facilitate the productivity and efficiency of the common everyday business by not overly complicating transactions. The theory here is that investors need disclosure to make investment decisions "that would come from registration and, through anti-fraud liability under the federal securities laws;" however, the principal policy under the Risk Capital test focuses on the capital's substantial risk, not the misinformed investor.[140] As such, what originally intended "to put some teeth" behind the mandatory disclosure requirements for violations to protect investors and securities markets arguably cannot have the information needed to move the capital to its optimal uses.[141] Adding the Risk Capital test definition to Rhode Island's securities law and the laws of other states will expand regulation to many transactions previously unhindered by regulation. Moreover, the very existence of multiple tests undermines the purposes of the Securities Act and Exchange Act. The appropriate test should be universally applicable because in drafting the Securities Act and Exchange Act, Congress recognized that the existing structure of state regulation was inadequate considering the interstate nature of many securities transactions.

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136. Roberts, *supra* note 77, at 683.

137. *See generally Forman*, 421 U.S. at 852.

138. Albert, *supra* note 48, at 15.

139. *Id.*

140. *Id.* at 6.

141. *See generally id.* at 7.

VI. CONCLUSION

The Risk Capital test exposes issuers of securities to unnecessary costs and legal risks by broadening the scope of securities laws and focusing on whether the investors' capital in a for-profit business or enterprise is at substantial risk. The *Howey* test focuses on profit and enforces materially informing the investor on the transaction's profitability.[142] The Risk Capital test's emphasis on form, rather than the *Howey* test's emphasis on profit, not only disregards the intentions and motivations of the investor or underlying transaction but can regulate unsuspecting for-profit businesses merely seeking to raise capital in unconventional or untraditional ways.

Furthermore, securities regulation has remained relatively unimportant from a compensatory perspective.[143] Lawsuits can never compensate for losses suffered in improvident investments.[144] Moreover, the Risk Capital test's central focus on substantial risk puts issuers who can show that they are offering financial instruments with minimal risk based on strong balance sheets or adequate collateralization at an advantage of avoiding securities regulations. This advantage is a disadvantage to investors because issuers would focus on preventing an appearance of substantial risk. For more than 100 years, the purpose of securities regulation has been to prevent not restore fraudulent investments because "man's habit of sleeping on his legal rights is notorious."[145] However, for most prudent investors, avoiding litigation is not always due to ignorance but to "judgment of the futility of spending a thousand dollars to get a thousand dollars."[146] The truth of this generalization is apparent from a regime employing the *Howey* test or the Risk Capital test; however, the *Howey* test's intentional breadth and adaptability of the definition of investment contract necessarily results in the fittest outcomes.[147]

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142. *See Forman*, 421 U.S. at 852.

143. William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 216 (1933).

144. *Id.*

145. *Id.*

146. *Id.* at 216–217.

147. *See* SEC v. Ripple Labs, Inc., No. 20CIV10832ATSN, 2022 WL 762966, at *15 (S.D.N.Y. Mar. 11, 2022) (denying the defendant's motion to dismiss; therefore, unless the case settles, a federal court can address whether issuing XRP (a cryptocurrency) was an investment contract under federal securities law).

Notes & Observations

INVESTORS CORNERED: "YOU DON'T FIND OUT WHO'S BEEN SWIMMING NAKED UNTIL THE TIDE GOES OUT"[1]

Jason W. Burge[2] *and Bradley R. Stark*

The next wave of FINRA arbitrations is finally approaching the shore. Years of historically low interest rates from 2009 through 2021[3] (in some instances negative real interest rates[4]) saw the broader market indices increase *six-fold* over thirteen years. 2022 saw the first sustained pullback in a generation, with over $30 trillion of stock and bond losses in a single year.[5] After years of 'yield hunting'[6] and asset bubbles[7] created by these low-interest rate market conditions, valuations across asset classes are reverting towards their means.[8] Some "alternative" investments, such as cryptocurrencies, have

1. This famous comment was made by Warren Buffett at the Berkshire Hathaway 1994 Annual Meeting in the context of overspeculation in the reinsurance business.

2. Partner, Fishman Haygood LLP. I would like to thank my co-author, and to thank Jeffrey A. Koncius for his help revising this article.

3. Indeed, it is hard to overstate the historically anomalous market conditions of the past decade. Following the 2008 financial crash, the Federal Reserve's headline Fed Funds rate remained essentially at zero for seven years, did not rise above 1% until June 2017, and did not exceed 2.5% until September 2022. Every single day of the 2010s, the Fed Funds rate was lower than any single day of the 1970s, 80s, or 90s.

4. Talmon Joseph Smith, *Inflation and Deficits Don't Dim the Appeal of U.S. Bonds*, N.Y. TIMES (Jan. 30, 2022), https://www.nytimes.com/2022/01/30/business/economy/inflation-bonds-treasury-yields.html.

5. Tommy Stubbington, Adam Samson & Kate Deguid, *Stock and bond markets shed more than $30tn in 'brutal' 2022*, FIN. TIMES (Dec. 30, 2022), https://www.ft.com/content/87ed8ea6-4913-4452-9135-498040ad338f.

6. *E.g.*, Colby Smith, *Desperate hunt for yield forces investors to take 'extreme risk'*, FIN. TIMES (July 26, 2020), https://www.ft.com/content/b44281c0-2ddb-46ae-83e2-150461faed65.

7. *E.g.*, Amy Fontinelle, *What Causes Bubbles?*, INVESTOPEDIA (Updated July 19, 2022), https://www.investopedia.com/financial-edge/0911/what-causes-bubbles.aspx.

8. *E.g.,* James Chen, *What Is Mean Reversion, and How Do Investors Use It?*, INVESTOPEDIA (Updated Aug. 18, 2021), https://www.investopedia.com/terms/m/meanreversion.asp.

collapsed or been exposed as outright frauds.[9] The tide has gone out on excess liquidity in asset markets and plenty of people were skinny dipping. Given the financialization of the American economy,[10] the process of unwinding bubbles and frauds is just beginning and will become more dramatic as higher interest rates slow the economy.

Brokers who were giving bad advice and selling inappropriate products—whether unsuitable, over-concentrated, fraudulent, or misaligned with the client's objective or risk tolerances—will soon run out of excuses for why their predicted "imminent rebound stay the course" has not occurred. Soon their clients will seek legal advice and want to file FINRA cases.

This phenomenon is just part of the historic rhythms, the ebbs and flows of financial markets. The history of the stock market is one of bubbles that beget frauds that beget regulations and litigation that make markets more efficient and safer for investors.[11] Indeed, research shows that securities litigation increases market efficiency, the purpose of markets.[12] The securities market is in need of a deep cleanse, and claimants and their counsel are going to spend several years cleaning up the mess created by brokers who spent the past thirteen years engaged in irrational exuberance.

A 'Rule of Thumb' for Modern Portfolio Theory is to subtract the investor's age from 100 to determine the amount to have in equities and the

9. David Gura, *FTX made a cryptocurrency that brought in millions. Then it brought down the company*, NAT'L PUB. RADIO (Nov. 15, 2022), https://www.npr.org/2022/11/15/1136641651/ftx-bankruptcy-sam-bankman-fried-ftt-crypto-cryptocurrency-binance.

10. *E.g., Financialization*, INVESTOPEDIA, http://www.investopedia.com/terms/f/financialization.asp.

11. For a historical review of prior bubbles, frauds and subsequent reforms in markets, *See* Michael S. Edmiston & Bradley Stark, *The Financial Services Industry's Historic Pattern of Opposition to Reform: "Wolf" is the Only Cry*, 22 PIABA B.J. 165, 171-72 (2015).

12. Rafael La Porta et al., *What Works in Securities Laws?*, J. Fin. (Jan. 2006), https://onlinelibrary.wiley.com/doi/full/10.1111/j.1540-6261.2006.00828.x ("We examine the effect of securities laws on stock market development in 49 countries. We find little evidence that public enforcement benefits stock markets, but strong evidence that laws mandating disclosure and facilitating private enforcement through liability rules benefit stock markets.").

remainder in bonds and cash.[13] Given the almost non-existent yield in Treasuries and other highly rated bonds in this asset class over recent years, we expect to see over concentrations of high-yield junk bonds, stocks, and the many other risky asset classes that rose in valuation due to this vast increase in liquidity. In particular, one can anticipate that brokers sold to investors bonds of companies (or other alternative investments) that were very high risk, and that in more 'normal' times these companies would be unable to raise money by selling bonds at any yield.[14]

Historically low interest rates created bubbles in many asset classes. Real estate is one such asset class and thus REITS may be found to be over weighted or not of investment grade in many portfolios. Other defective products will emerge amongst the skinny dippers because, as one scholar observed, "(i)f the most profitable line of business is to dupe investors with complex financial products, competitive pressure will induce financial firms to innovate along that dimension, with a double loss to society: talents are wasted in search for better duping opportunities and the mistrust towards the financial sector increases."[15]

The stock market bubble created 'Meme' stocks that had no basis in the fundamentals of finance but rather were popular amongst day traders, some newly minted while stuck at home during the pandemic.[16] Meme stocks were sometimes manipulated by retail day traders themselves and offered enticing returns due to their volatility. Meme stocks such as GameStop Corp. (GME), AMC Entertainment Holdings Inc. (AMC), Blackberry Limited (BB), Bed Bath & Beyond Inc. (BBBY), Koss Corp. (KOSS), Vinco Ventures (BBIG), Support.com, and even the meme stock enabler Robinhood Markets Inc.

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13. Daniel Kurt, *Stock Allocation Rules*, INVESTOPEDIA (Updated July 11, 2022), https://www.investopedia.com/articles/investing/062714/100-minus-your-age-outdated.asp.

14. Sebastian Pellejero, *Falling 'Real' Yields Drive Investors to Junk Bonds*, WALL ST. J. (Updated Nov. 17, 2020), https://www.wsj.com/articles/falling-real-yields-drive-investors-to-junk-bonds-11605643777.

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

16. Adam Hayes, *What Are Meme Stocks, and Are They Real Investments*, INVESTOPEDIA (Updated Sept. 12, 2022), https://www.investopedia.com/meme-stock-5206762.

(HOOD) briefly rocketed upwards, and should be viewed suspiciously if they appear in any portfolio.[17]

Other alternative investments were likely unsuitable for any investor. No one should ever have received advice to invest in a cryptocurrency, ever. Besides the fraud sometimes discovered in cryptocurrencies like FTT with its parent issuer, the bankrupt and indicted FTX, the historical volatility of cryptocurrencies is excessive. In addition, there is no substance to cryptocurrencies. A currency issued by a government, no matter how rogue, small, corrupt or inflated, at least has some value because the government of the country accepts it as legal tender. Cryptocurrencies have underlying value, if at all, merely for their 'greater fool' pyramid valuation and as an aid to money laundering.

Another defective product that became popular during this period of 'yield hunting' was Variable Annuities, often sold in IRA or tax deferred accounts to Seniors. In this issue, Fred Rosenberg's "Why Variable Annuities are Unsuitable for Seniors" explains why a Variable Annuity found in a retirement account should be carefully scrutinized.

The pandemic created unusual times for investment, but 'once in a lifetime' market conditions are not an excuse to suspend the fundamentals of Modern Portfolio Theory (MPT), which is premised on the fact that markets are by definition unpredictable and cannot be timed. This is the basis for diversification in Modern Portfolio Theory. The efficacy of MPT and passive investing is well summarized by Burton Malkiel in "The Random Walk Guide to Investing: Ten Rules for Financial Success".[18] Malkiel writes, "(i)t's true that when you buy an index fund, you give up the chance to boast at the golf course that you picked the best performing stock or mutual fund. That's why some critics claim that indexing relegates your results to mediocrity. In fact, you are virtually guaranteed to do better than average. It's like going out on the golf course and shooting every round at par. How many golfers can do better than that? Index funds provide a simple low-cost solution to your investing problems."[19]

But passive investment in index funds produces very few fees or commissions, and the financial services industry is not built on the sale of products that yield little return for brokers and advisors. We expect there are much more risky, and expensive, products in many investors' accounts. Now

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17. *Id.*

18. BURTON G. MALKIEL, THE RANDOM WALK GUIDE TO INVESTING: TEN RULES FOR FINANCIAL SUCCESS (2003).

19. *Id.* at 137.

that the tide is receding, those investors are only now beginning to discover they were unwittingly skinny-dipping. Having been left cold and exposed by their brokers, many of them will turn to securities arbitration attorneys to provide them a cover up and escort them back to shore.

Notes & Observations

RECENT ARBITRATION AWARDS

Melanie Cherdack[1]

This issue's featured arbitration awards include two large awards handed down by unanimous panels in Atlanta, Georgia and Tampa, Florida. The largest award in excess of $36 million, which is one of the biggest FINRA awards in recent history, was based on a selling away scenario involving what turned out to be a Ponzi scheme. That case involved multiple Claimants who fell victim to the same Ponzi scheme. The "smaller" large award, coming in at just over $11.5 million, was based upon a failed covered call strategy. The final award included is an employment case which ended in a favorable Respondent's award for a directed verdict. These tremendous awards, and a procedural loss on a directed verdict, illustrate the great glory and the agony of defeat when the fates are placed in the hands of three disparate FINRA arbitrators.

Robinson et al v. Oppenheimer & Co., Inc.
Case No. 21-02234
Hearing Dates: August 8, 2022 – August 26, 2022
Atlanta, GA
Award Date: September 5, 2022
Counsel:
Counsel for Claimants:
John S. Chapman, Esq., and Philip L. Vujanov, Esq., ChapmanAlbin LLC, Cleveland, OH; Craig H. Kuglar, Esq., The Law Office of Craig Kuglar, LLC, Atlanta, GA.
Counsel for Respondent:
William E. Mahoney, Jr., Esq., and Samuel E. Paul, Esq., Stradley Ronon Stevens & Young, LLP, Philadelphia, PA; Jason J. Carter, Esq., Bondurant Mixson & Elmore LLP, Atlanta, GA
Arbitration Panel:
George Pinckney Shingler, Public Arbitrator, Presiding Chairperson, John D. Mattingly, Public Arbitrator, Jennifer Chandler Garvin, Non-Public Arbitrator

1. The author would like to thank the Hillary Gabriele, Law Student Fellow at the University of Miami Investor Rights Clinic, for her significant contributions to this article.

Investments at Issue:

The causes of action relate to Claimant's investments in Horizon Private Equity III.

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Violations of FINRA Rules;
(2) Negligence;
(3) Breach of Fiduciary Duty;
(4) Violation of the Georgia RICO Statute; and
(5) Breach of Contract.

Relief Requested:

(1) Compensatory damages in an amount to exceed $6,000,000.00;
(2) Punitive damages;
(3) RICO damages in an amount three times the actual damages sustained, punitive damages, attorney's fees, and costs of investigation and litigation;
(4) Pre-judgment interest from the date of investment and post-judgment interest to the date the award is paid by Respondent at the highest legal rate;
(5) Costs;
(6) Attorneys' fees; and
(7) Any other and further relief as the Panel deemed just and proper.

Award

(1) Respondent is liable for and shall pay to Claimant Robinson the sum of $700,000.00 in compensatory damages;
(2) Respondent is liable for and shall pay to Claimant T. Padden the sum of $202,750.00 in compensatory damages;
(3) Respondent is liable for and shall pay to Claimant S. Padden the sum of $500,000.00 in compensatory damages;
(4) Respondent is liable for and shall pay to Claimants Rainey, Rainey Trust, and Toucan Holdings the sum of $800,000.00 in compensatory damages;
(5) Respondent is liable for and shall pay to Claimant Goodman the sum of $1,000,000.00 in compensatory damages;
(6) Respondent is liable for and shall pay to Claimant Burgner the sum of $188,250.00 in compensatory damages;
(7) Respondent is liable for and shall pay to Claimant Burgner Trust the sum of $955,000.00 in compensatory damages;
(8) Respondent is liable for and shall pay to Claimant Kasemeier the sum of $450,000 in compensatory damages;
(9) Respondent is liable for and shall pay to Claimant Callaway the sum

of $603,166.00 in compensatory damages;

(10) Respondent is liable for and shall pay to Claimant Loveless the sum of $300,000.00 in compensatory damages;

(11) Respondent is liable for and shall pay to Claimants the sum of $11,398, 332.00 in punitive damages pursuant to O.C.G.A. § 16-14-6(c);[2]

(12) Respondent is liable for and shall pay to Claimant Robinson the sum of $2,100,000.00 in RICO damages pursuant to O.C.G.A. § 16-14-6(c);

(13) Respondent is liable for and shall pay to Claimant T. Padden the sum of $608,250.00 in RICO damages pursuant to O.C.G.A. § 16-14-6(c);

(14) Respondent is liable for and shall pay to Claimant S. Padden the sum of $1,500,000.00 in RICO damages pursuant to O.C.G.A. § 16-14-6(c);

(15) Respondent is liable for and shall pay to Claimants Rainey, Rainey Trust, and Toucan Holdings the sum of $2,400,000.00 in RICO damages pursuant to O.C.G.A. § 16-14-6(c);

(16) Respondent is liable for and shall pay to Claimant Goodman the sum of $3,000,000.00 in RICO damages pursuant to O.C.G.A. § 16-14-6(c);

(17) Respondent is liable for and shall pay to Claimant Burgner the sum of $564,750.00 in RICO damages pursuant to O.C.G.A. § 16-14-6(c);

(18) Respondent is liable for and shall pay to Claimant Kasemeier the sum of $1,350,000.00 in RICO damages pursuant to O.C.G.A. § 16-14-6(c);

(19) Respondent is liable for and shall pay to Claimant Callaway the sum of $1,809,498.00 in RICO damages pursuant to O.C.G.A. § 16-14-6(c);

(20) Respondent is liable for and shall pay to Claimant Loveless the sum of $900,000.00 in RICO damages pursuant to O.C.G.A. § 16-14-6(c);

(21) Respondent is liable for and shall pay to Claimants the sum of $98,655.96 in costs;

(22) Respondent is liable for and shall pay to Claimants the sum of $5,315,624.30 in attorneys' fees pursuant to O.C.G.A. § 16-14-6(c) and O.C.G.A. § 13-6-11;

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2. The Official Code of Georgia provides that, "Any person who is injured by reason of any violation of Code Section 16-14-4 shall have a cause of action for three times the actual damages sustained and, where appropriate, punitive damages. Such person shall also recover attorneys' fees in the trial and appellate courts and costs of investigation and litigation reasonably incurred." *See* GA. CODE ANN. § 16-14-6(c).

(23) Respondent shall pay Claimants the sum of $800.00, representing the reimbursement of the non-refundable portion of the initial claim filing fee previously paid by Claimants to FINRA Dispute Resolution Services;
(24) Claimant Burgner Trust's request for RICO damages is denied; and
(25) Any and all claims for relief not specifically addressed herein are denied.

Other Issues Considered and Decided

Respondent filed a Motion to Dismiss pursuant to Rule 12206 of the Code of Arbitration Procedure. Claimants filed a response opposing the Motion to Dismiss, and Respondent filed a reply in support of the Motion to Dismiss. The Panel heard oral arguments on the Motion to Dismiss and issued an order denying the Motion with prejudice on July 14, 2022.

Analysis:

This Atlanta-based arbitration panel awarded Claimants more than $36 million for their claims that Oppenheimer & Co. failed to prevent its brokers from executing a $110 million Ponzi scheme which victimized over 400 investors in more than 20 states, many of whom were elderly retirees. The Claimants—twelve former Oppenheimer clients—alleged that, due to its improper supervision, the firm was liable for the harm caused by their brokers' ten-year long private equity fund Ponzi scheme involving the Horizon Private Equity, III, LLC investment ("Horizon Ponzi scheme"). This case was the first arbitration related to the Horizon Ponzi scheme to proceed to hearing; there are currently more than twenty-five additional arbitrations pending.

This arbitration award is notable because (1) the panel awarded RICO damages, which included treble compensatory damages and mandatory attorneys' fees and costs of investigation, (2) Oppenheimer's chief executive officer, Albert "Bud" Lowenthal, testified at the FINRA hearing, and (3) Oppenheimer refused to produce documents and filed a motion to postpone, which the panel denied because the case was expedited under FINRA rules.

The Horizon Ponzi scheme involved multiple registered representatives from Oppenheimer, as well as the former Atlanta branch broker, John Woods. Oppenheimer representatives sold the fund to Oppenheimer customers, telling customers that Horizon was sponsored and approved by Oppenheimer. However, the Horizon investment was never registered with the SEC; Horizon claimed the securities were exempt from registration under state securities law. Woods promised investors that they would receive steady returns of 6-7% interest. In reality, a large percentage of these returns were paid out of new investor money, in typical Ponzi fashion, rather than legitimate investment returns.

Claimants allege that in 2016, Oppenheimer discovered that Woods was selling Horizon to customers, but rather than reporting the misconduct to regulators and the investing public, the firm allowed Woods to voluntarily resign and told customers that they had to custody the Horizon investments outside of Oppenheimer. Ultimately, Claimants succeeded on their RICO claim by showing that Oppenheimer's CEO became aware of the Horizon Ponzi scheme in 2016 and decided to cover it up. The arbitration panel found that Oppenheimer was involved in a common enterprise, violating securities statutes.

Oppenheimer has filed a motion to vacate the award in a Georgia state court. In a statement to *Financial Advisor*, Oppenheimer claims that the other defendants in the case, rather than Woods, are responsible for any losses, and the FINRA panel erred by allowing the hearing to proceed without them. The other defendants are currently covered by a judicial stay. Oppenheimer also questioned the impartiality of a FINRA arbitrator. Claimants opposed Oppenheimer's motion to vacate and filed a motion to confirm the award. The motions will be fully briefed in December and decided in early 2023.

Arbo v. ProEquities, Inc.
Case No. 20-02471
Hearing Dates: August 15, 2022 – August 17, 2022
Augusta, ME
Award Date: August 23, 2022
Counsel:
    Counsel for Claimant:
        Robert G. Heim, Jr., Esq., Tarter Krinsky & Drogin LLP, New York, NY
    Counsel for Respondent:
        Kathryn Roe Eldridge, Esq., Maynard, Cooper & Gale, P.C., Birmingham, AL
Arbitration Panel:
    William Norton, Public Arbitrator, Presiding Chairperson, Richard W. Dissen, Public Arbitrator, Dallas Whitney Coffman, Non-Public Arbitrator
Investments at Issue:
    Employment case
Claimants' Claims:
    Causes of Action in Statement of Claim:
        (1) Defamation;
        (2) Tortious interference with economic relationships;
        (3) Wrongful termination;

(4) Breach of contract;
(5) Violations of FINRA Rule 2010;
(6) Unjust enrichment;
(7) Intentional infliction of emotional distress; and
(8) Negligent infliction of emotional distress.

Relief Requested:

(1) Unspecified compensatory damages;
(2) Punitive damages;
(3) Expungement of the termination explanation on Claimant's Form U5;
(4) Revision of the reason for termination on Claimant's Form U5;
(5) Interest on losses sustained from the date of the loss;
(6) Attorneys' fees and costs, including expert witness fees; and
(7) Such other and further relief as deemed just and appropriate.

Award

(1) Claimant's claims are denied in their entirety.
(2) Any and all claims for relief not specifically address herein, including any requests for expungement, punitive damages, and attorneys' fees, are denied.

Analysis:

This arbitration action between an associated person and his employer member firm is notable in that it ended with a directed verdict in favor of the Respondent. The facts are as follows. In 2018, ProEquities, Inc. terminated its broker, Matthew Arbo, for violating firm policy. Specifically, the firm reported that Arbo admitted to authorizing employees to sign his names on documents that he had previously told state regulators and firm personnel contained his own signature. Arbo maintained that the firm mischaracterized the situation, arguing that he knowingly authorized an agent to sign his name while he was out of the office in order to avoid delays for his clients. ProEquities also reported that some of Arbo's client files contained forms with white-out and cut and pasted signatures. Arbo challenged the Firm's allegation as misleading, claiming it omits material information that the problems were limited to a small group of documents and resulted from actions taken by either a former employee or the client. At the conclusion of Claimant's case-in-chief, Respondent made a Motion for Directed Verdict seeking dismissal of all Claimant's claims, which this Maine-based arbitration panel unanimously granted. This sudden end to the arbitration signals that the panel did not agree that the testimony and documents in the case-in-chief supported a valid claim.

Dr. Anthony E. Nowak, Individually and as Trustee of the Anthony E. Nowak Revocable Trust v. Morgan Stanley

Case No. 21-02127

Hearing Dates: May 16-20, 2022 – October 11-15, 2022

Tampa, Florida

Award Date: December 1, 2022

Counsel:

Counsel for Claimant:

Robert Savage, Esq., Alfred Villoch, Esq. and Brenda Combs, Esq., Savage Villoch Law, PLLC, Tampa, Florida.

Counsel for Respondent:

Jeremy S. Winer, Esq. and Thomas Roberts, Esq., Morgan Stanley, New York, New York.

Arbitration Panel:

Gayle B. Carlson, Public Arbitrator, Presiding Chairperson, John G. Sciandra, Public Arbitrator, Mark Joseph Mugnaini, Public Arbitrator

Investments at Issue:

The causes of action relate to Respondent's alleged covered call writing strategy resulting in large positions of technology stocks in Claimants' accounts, including but not limited to, Nvidia Corporation ("NVDA"), Tesla Motors ("TSLA"), Apple Computers ("AAPL"), Salesforce ("CRM"), Microsoft Corporation ("MSFT"), and other stocks being called away from Claimants' Trust Account.

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Respondeat superior;
(2) Negligence;
(3) Breach of fiduciary duty;
(4) Failure to supervise;
(5) Breach of FINRA rules (including 2010, 2020 and 3620); and
(6) Violation of the Florida Securities and Investor Protection Act.

Relief Requested:

(1) Rescission of all trades;
(2) Return of all shares in Claimants' accounts;
(3) Return of fees and commissions;
(4) Interest;
(5) Compensation for lost investment opportunity;
(6) Attorneys' fees
(7) Costs;
(8) Expenses
(9) Such other and further relief as deemed just and appropriate.

Relief Requested at Hearing:

(1) Lost opportunity damages due to the unauthorized sale of NVDA shares after December 14, 2018 in the amount of $14,334,224.39;
(2) Lost opportunity damages due to the unauthorized sale of NVDA shares after December 14, 2018 in the amount of $16,344,936.28;
(3) The sale and buy-back of 40,000 NVDA shares in the amount of $2,010,088.53; damages for the unauthorized transactions of opening NVDA option contracts in the amount of $5,623,610.55;
(4) Damages for the unauthorized transactions of opening AAPL option contracts in the amount of $201,982.44;
(5) Damages for the unauthorized transactions of opening CRM option contracts in the amount of $228,492.60;
(6) Damages for the unauthorized transactions of opening MSFT option contracts in the amount of $46,934.49;
(7) Lost opportunity damages due to the unauthorized sale of securities in the amount of $275,815.52;
(8) Lost opportunity damages due to the sale of 20,000 shares of NVDA on August 17, 2021, in the amount of $15,227,967.68; and
(9) Florida Statutes section 517.211 Statutory Interest at the rate of 4.25%.

Other Motions Heard and Decided

On March 17, 2022, Claimants filed a Motion for Sanctions and/or an Adverse Inference ("Motion for Sanctions") against Morgan Stanley for its Spoliation of Evidence, in which they asserted, among other things, that Respondent failed to both retain and maintain text messages between Unnamed Party Thistlethwaite and Claimant. In its March 28, 2022, Opposition to Claimants' Motion for Sanctions, Respondent argued, among other things, that the text messages were not exchanged on Morgan Stanley-issued devices, that Claimant and Unnamed Party Thistlethwaite were close friends and, at times, discussed investments, and that upon learning that Unnamed Party Thistlethwaite had utilized his personal cell phone to text with Claimant on investment-related matters, it took reasonable steps to ensure the retention of potentially relevant messages. Claimants did not file a reply. On April 18, 2022, the Panel conducted a pre-hearing conference so the parties could present oral argument on Claimants' Motion for Sanctions, and subsequently filed an Order in which it denied the motion.

Award:

(1) Respondent is liable for and shall pay to Claimants the sum of $11,500,000.00 in compensatory damages.
(2) Respondent is liable for and shall pay to Claimants the sum of $157,656.81 in costs.

(3) Respondent is liable and shall pay to Claimants the sum of $400.00, which represents reimbursement of the non-refundable portion of the filing fee previously paid by Claimants to FINRA Dispute Resolution Services.
(4) Having proved a violation of Section 517.301, Florida Statutes, Claimant is the prevailing party. The Panel leaves it to a court of competent jurisdiction to determine whether to award attorneys' fees.
(5) The Panel finds that the evidence presented did not support an affirmative finding under FINRA Rule 2080. Accordingly, Respondent's request for expungement on behalf of Unnamed Party Craig Sherman Thistlethwaite (CRD Number 2507050) from registration records maintained by the CRD in the above-captioned arbitration (Occurrence Number 2150194) is denied.
(6) Any and all claims for relief not specifically addressed herein, including any requests for punitive damages, are denied.

Analysis:

This whopping $11.5 million arbitration award centered around a covered call strategy gone wrong. The panel found that the Respondent firm violated the Florida Securities and Investor Protection Act, awarding both compensatory damages and an *entitlement* to attorney's fees under that statute. Under Florida law, the Claimant may request, and the panel may order, that a court determine the amount of attorney's fees to be awarded on a claim allowing for attorney's fees. Some Claimant attorneys choose to go this route under the theory that a judge might order a larger and/or more appropriate attorney's fee than that of an arbitration panel who sometimes are not themselves attorneys.

CASES & MATERIALS

Tad Bartlett

The Tenth Circuit affirms the denial of a motion to compel arbitration of putative class action alleging that the administration of corporation's employee stock ownership plan amounted to financial misconduct in violation of ERISA.

Harrison v. Envision Management Holding, Inc. Board of Directors, -- F.4th ---, 2023 WL 1830446 (10th Cir. February 9, 2023):

The plaintiff, a former employee of Envision Management, LLC ("Envision"), a diagnostic imaging company that employs approximately 1,000 people, filed suit alleging six causes of action under ERISA against Envision and its affiliated shell corporation, Envision Management Holding, Inc. ("Envision Holding"). Envision created an employment stock ownership plan ("ESOP"), and an ERISA-protected, defined contribution plan under which Envision made contributions to employee-participants into the plan to be invested in Envision's stock. As an "eligible employee" under the plan, Harrison was automatically a plan participant. Under the management of Envision Holding, the ESOP purchased $163.7 million in Envision's stock, depending on $103 million in direct loans from members of the ESOP committee, at 12% interest, and another $50 million in debt to Envision itself. Harrison alleges that the sale was at a stock price far in excess of the stock's market value. "In sum, Harrison alleges that the Seller Defendants … were able to financially benefit by selling Envision to the ESOP for significantly more than it was worth, while at the same time leaving the ESOP with a $154.4 million debt," and brought claims under ERISA for declaratory, injunctive, and compensatory relief.

The Defendants moved to compel arbitration under the Plan Document's ERISA arbitration and class action waiver. Harrison argued that the Plan Document's class waiver and arbitration provision conflicted with ERISA's provision to seek multiple remedies on behalf of the Plan as a whole under 29 U.S.C. § 1132(a)(2). The district court denied the Defendants' motion to compel arbitration.

The Tenth Circuit affirmed under the "effective vindication" exception. "This exception, which rests on public policy grounds, 'finds its origin in the desire to prevent prospective waiver of a party's *right to pursue* statutory remedies.' The key question is whether 'the prospective litigant effectively may vindicate its statutory cause of action in the arbitral forum.'" 2023 WL 1830446, at *4 (quoting *Am. Express Co. v. Italian Colors Restaurant*, 570 U.S. 228, 235 (2013)). The Court identified that four of the six causes of action brought by Harrison specifically sought relief under ERISA §§ 502(a)(2) and (a)(3). The Court then held that the Plan Document's arbitration provision prevents Harrison from obtaining those statutory remedies:

> The second sentence of Section 21(b) states that "[e]ach arbitration shall be limited solely to one Claimant's Covered Claims, *and that Claimant may not seek or receive any remedy which has the purpose or effect of providing additional benefits or monetary or other relief to any Eligible employee, Participant or Beneficiary other than the Claimant*." The emphasized portion of this sentence would clearly prevent Harrison from obtaining at least some of the forms of relief that he seeks in his complaint pursuant to § 1132(a)(2)[.] … That is because all of these forms of relief would clearly "ha[ve] the purpose or effect of providing additional benefits or monetary or other relief to" all of the Plan participants and beneficiaries and would thus be barred by the second sentence of Section 21(b) of the Plan Document.

Id. at *11 (emphasis in original). The Court went on to hold that the arbitration provision in the Plan Documents "is not problematic because it requires Harrison to arbitrate his claims, but rather because it purports to foreclose a number of remedies that were specifically authorized by Congress in the ERISA provisions cited by Harrison." *Id.* at *12.

The Court rejected the defendants' argument that this result would make it so that an individual claim could never be arbitrated because the participant would not be able to waive the ERISA provision for plan-wide remedies. "[B]oth the nature of the claims and the specific relief sought by the complainant matter. Thus, an ERISA complainant who is asserting a claim unique to himself or herself could not, simply by citing to the same ERISA provisions cited by Harrison, avoid arbitration in reliance on the effective vindication exception." *Id.* at *14.

The Fifth Circuit reversed the dismissal of plaintiff institutional investor's claim against amusement park company for securities fraud, examining the utility of confidential-informant-based allegations, the parameters of the PSLRA's safe harbor provision for forward-looking statements, the line between actionable misrepresentations and inactionable puffery, and the particularity requirement with regard to scienter.

Oklahoma Firefighters Pension & Retirement System v. Six Flags Entertainment Corporation, 58 F.4th 195 (5th Cir. January 18, 2023):

The plaintiff labor union retirement system brought suit against an amusement park company, alleging that the company and two of its executives had made material misrepresentations about the company's development of amusement parks in China. The district court had granted the company's motion to dismiss the plaintiff's Securities Exchange Act claims.

Because the plaintiff's complaint was based in large part on facts divulged from a confidential source, the district court had "generally" discounted those allegations, and "significantly" discounted allegations about the financial health of the amusement park company's Chinese partner. The Court of Appeals recognized that, under the PSLRA heightened pleading standard, the process of weighing the strength of the plaintiff's favored inference against other possible inferences "is obstructed when the witness is anonymous, so courts must apply a discount to confidential witness allegations"; but the Court then held, "Discount does not mean unfettered discretion to disregard." 58 F.4th at 209. Because the complaint provided particular detail about the person who was the confidential source and about their position relative to the facts being alleged, there was "reason to credit the informant's reliability." *Id.* The Court also held that the allegations based on the confidential informant's knowledge were sufficiently particular, and that the company's particularity arguments were actually disagreements about the merits of those allegations. *Id.* at 213-14.

The Court then examined the district court's finding that the company's statements about the progress of the development of the Chinese parks were "forward-looking" and had the appropriate cautionary language to fit within the PSLRA's safe harbor provision. The Court held that the statement that, "right now, barring some other decisions that's made, all our parks are progressing nicely towards their anticipated opening dates," was a mixed present/future statement outside the scope of safe-harbor protection. The Court did hold, however, that other statements that just stated an anticipated park opening date without any commentary on present construction progress were purely prospective. But the Court held that there was not appropriate cautionary language, rejecting as such language both the general cautionary statements at the beginning of each earnings call and Form 10-Ks, as well as company-specific language that nevertheless failed to identify specific factors that could cause actual results to differ materially from the prospective statement. *Id.* at 211-12.

The Court held that forward-looking statements are subject to a higher pleading standard for scienter, requiring particular allegations of actual knowledge of the falsity of the forward-looking statements. *Id.* at 214. The Court held that the "collective weight" of the complaint's allegations of the company's financial motives for making the statements in question, the internal corporate reports of the reality of the construction progress, and the allegations of specific presentations for the benefit of the company's executives who made the representations was sufficient to particularly allege scienter. *Id.* at 215-16.

The Court then turned to whether certain statements were mere puffery or were actionable misrepresentations:

> Some of the general, abstract statements about the prospect of future parks, such as, "[w]e will not be stopping at 10 parks," and "we're already at 11, I think 20 parks is possible," are vague, optimistic generalizations that would not convey to a reasonable investor such aspirations are guaranteed or even likely. … On the other hand, other identified statements were made in the context of announcing projected park opening dates and are therefore too specific to categorize as general corporate optimism. Statements such as, "[t]he timing of the parks remains exactly the same as previously discussed" or that the "parks are progressing nicely" are not "vague" or "generalized, positive statements," because they confirmed the projections previously provided by Defendants.

Id. at 220. The Court held, therefore, that the district court had applied "too broad a definition of that concept" regarding inactionable puffery. *Id.*

The Ninth Circuit affirmed the denial of a motion to compel arbitration of a putative class action brought by the buyer of a lifetime tire balancing and rotation service agreement, holding that the service agreement was not an interrelated agreement with transaction to buy the tires themselves, which transaction had included an arbitration agreement.

Johnson v. Walmart Inc., 57 F.4th 677 (9th Cir. January 10, 2023):

The plaintiff had purchased a set of tires from Walmart's website, which transaction subjected him to the Terms of Use that included an arbitration provision. Subsequently, while the plaintiff was having the tires installed at a Walmart Auto Care Center, he separately purchased a lifetime tire balancing and rotation service agreement, which did not contain an arbitration provision. After he was denied the tire balancing and rotation service on multiple occasions, he commenced this putative class action. The district court denied Walmart's motion to compel arbitration.

Because the plaintiff contested the existence, rather than the scope, of an arbitration agreement encompassing his dispute as to the service agreement, the Court held that the district court appropriately ruled on the arbitrability question. 57 F.4th at 681. The Court then held that the tire purchase Terms of Use and the service agreement were not so interrelated that the arbitration provision in one applied to the other. *Id.* at 682. The Court noted that the Walmart Auto Care Center did not fall under the definition of a "Walmart Site" under the website Terms of Use, and that "[n]o provision of the Terms of Use addresses any form of in-store engagement with Walmart. … As the Terms of Use cover a defined subset of consumer interaction with Walmart—access to and use of Walmart Sites—the nested arbitration provision of the Terms of Use cannot apply to the controversy over the in-store purchase of the Service Agreement." *Id.*

The Court also rejected the interrelated-agreements argument because the purchase of the tires and the purchase of the service agreement were separately negotiated and entered into, involved separate consideration, and were not mutually dependent (*i.e.*, the service agreement did not depend on the tires subject to the agreement being tires purchased from Walmart).

The Ninth Circuit affirmed the denial of a motion to compel arbitration of a putative class action brought by users of an online cryptocurrency exchange who had opted into the exchange's sweepstakes, on basis that the sweepstakes rules superseded the user agreement and its arbitration clause under California law.

Suski v. Coinbase, Inc., 55 F.4th 1227 (9th Cir. December 16, 2022):

Plaintiffs created Coinbase accounts under a User Agreement that included an arbitration provision. Subsequently, they opted into a sweepstakes that included Official Rules that included a forum selection clause mandating exclusive jurisdiction by California courts. The plaintiffs brought consumer claims arising from the marketing and administration of the sweepstakes, and the district court denied Coinbase's motion to arbitrate.

The Court held that the delegation clause in the User Agreement, which delegated questions of the existence, scope, and validity of the arbitration provision to the arbitrator, did not apply to strip the district court of jurisdiction to determine if the plaintiffs' sweepstakes-related claims were subject to arbitration. 55 F.4th at 1230. The Court held that the question was as to the existence of an arbitration provision applicable to the sweepstakes, and not the scope of the arbitration provision in the User Agreement. *Id.*

The Court then held that the Official Rules of the sweepstakes superseded the User Agreement's arbitration clause. *Id.* Under California law, the Court held that a forum selection clause in a subsequent agreement will be held to supersede an arbitration provision in an earlier agreement where the forum selection clause sufficiently manifests the parties' intent to do so. *Id.* The Court held that the integration clause in the User Agreement did "not preclude a superseding contract from being formed in the future." *Id.* at 1231. "By including the forum selection clause, … the Official Rules evince the parties' intent not to be governed by the User Agreement's arbitration clause when addressing controversies concerning the sweepstakes." *Id.*

WHERE WE STAND

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

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

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

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

1. To review all PIABA Comment letters, visit www.PIABA.org. For more information, contact Hugh D. Berkson at hdb@mccarthylebit.com or Jennifer Shaw at jshaw@piaba.org for assistance.

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The following Comment Letter regarding *OFR Bill Reforming Chapter 517 - Recommendation to Support Florida's Office of Financial Regulation Ch. 517 Reform Legislation* was submitted to the Insurance & Banking Subcommittee by Hugh Berkson on March 2, 2023. (prepared with the assistance of Jorge Riera)

The Honorable Wyman Duggan, Chair
Insurance & Banking Subcommittee
303 House Office Building
402 South Monroe Street
Tallahassee, FL 32399-1300

The Honorable Christine Hunschofsky, Ranking Member
Insurance & Banking Subcommittee
329 The Capitol
402 South Monroe Street
Tallahassee, FL 32399-1300

Re: OFR Bill Reforming Chapter 517 - Recommendation to Support Florida's Office of Financial Regulation Ch. 517 Reform Legislation

Dear Chair Duggan and Ranking Member Hunschofsky:

I write on behalf of the Public Investors Advocate Bar Association ("PIABA"), an international, not-for profit, voluntary bar association that consists of attorneys who represent investors in disputes with the securities industry. Since its formation in 1990, PIABA's mission has been to promote the interests of the public investor by, among other things, seeking to protect such investors from falling prey to investment fraud, and advocating for public education related to investment fraud and industry misconduct. Our members and their clients have a fundamental interest in the rules promulgated by the Florida Office of Financial Regulations (the "OFR") relating to exempt offerings, the practices of brokers and broker-dealers, and investor protection.

I. Introduction

PIABA is concerned with the current effort to pass deregulatory legislation that would dramatically expand the ability of unlicensed individuals, so-called "finders," to solicit and engage in securities activities **on behalf of private**

issuers and receive transaction-based compensation without being subject to appropriate regulatory oversight. We are especially concerned that efforts to expand crowdfunding offerings to retail investors in an exempt offering could result in harm to accredited elderly investors, who are unsophisticated and may face challenges in analyzing and valuing such securities or who may be confused by the descriptions of such securities on the funding portals. The OFR's proposed expansion of crowdfunding offerings under the auspices of facilitating capital formation is an abrogation of the OFR's core mission to protect Florida investors, and maintain safe, fair, orderly, and efficient markets."[1]

As you may know, PIABA opposed deregulatory proposals Fla. H.R. 779 and Fla. S. 1536 ("2021-2022 Proposed Legislation")[2] that are the same or similar to the ones set forth under Fla. H.R. 253 and Fla. S. 180 ("2023 Proposed Legislation"). Much like the 2021-2022 Proposed Legislation that died in House of Representative's Insurance & Banking Subcommittee in March 2022, we believe the 2023 Proposed Legislation demonstrates a radical, negative policy change in light of its proposed expansion of private issuer's ability to market their securities to financially unsophisticated retail investors. These investors, many of whom are elderly and vulnerable, are ill-prepared to protect themselves from unscrupulous individuals who engage in deceptive and abusive solicitation activities. In short, the OFR is sacrificing investor protection by failing to give any serious consideration to how these investors would be affected by its radical deregulatory proposal in favor of capital formation and special interest hand-outs.

The 2023 Proposed Legislation should be narrowly tailored to address the capital formation needs of entrepreneurs and certain smaller issuers while preserving investor protections. Expanding exempt offerings in the manner proposed will do nothing to promote capital formation in the public markets and will ultimately have negative consequences for investors. Additionally, the 2023 Proposed Legislation expands the pool of investors who may be eligible to invest in exempt offerings. The 2023 Proposed Legislation is solely focused on expanding the private markets that would unquestionably cause

1. See The Florida Office of Financial Regulation, Our Mission, available at https://flofr.gov/sitePages/AboutOFR.htm.

2. See Letter from PIABA President Michael Edmiston to Michelle Suarez and Ton Tsvetanova, Re: OFR Bill Reforming Chapter 517 (Jan. 3, 2022), available at https://piaba.org/piaba-newsroom/comment-letter-ofr-bill-reforming-chapter-517-recommendation-support-floridas-0.

retail investors harm. The OFR does not even acknowledge that finders are often associated with fraudulent activity and the Proposed Legislation does not ensure that finders are subject to appropriate regulatory oversight. The most likely outcome of the 2023 Proposed Legislation will be to increase private issuers, which will have the harmful effect of depriving investors in those companies of the benefits of registration.

II. Expansion of Exempt Offerings Will Undermine Investor Protection

Expansion of exempt offerings to Florida retail investors will almost certainly increase the risks to which retail investors are exposed to while decreasing the information available to investors attempting to perform due diligence. It will also substantially increase the number of instances in which Florida investors fall prey to fraudulent investment schemes. These implications are significant and must be addressed if the OFR is to honor its mission of protecting the investing public. If the OFR is to expand the pool of investors who may be eligible to invest in exempt offerings, it must simultaneously improve investor protections for those who are eligible to invest.

The evidence is clear that fraud and other harms occur frequently where unregistered persons promote unregistered products to retail investors. In August 2020, the SEC's Division of Economic and Risk Analysis ("DERA") published a study of fraud in the private markets based on SEC enforcement actions brought over a single year.[3] Results from the DERA' study showed the majority of offerings were fraudulent offerings that did not qualify for an exemption from registration.[4] DERA's study further found that "offerings linked to SEC enforcement actions more likely involved an unregistered intermediary or a recidivist, or solicited from unsophisticated investors."[5] Importantly, the DERA study found that while Florida had the sixth largest number of Regulation D issuers compared to other states, it had the highest number of issuers with unregistered offerings.[6] Florida also has the highest

3. Rachita Gullapalli, *Misconduct and Fraud in Unregistered Offerings: An Empirical Analysis of Select SEC Enforcement Actions*, SEC Division of Economic and Risk Analysis (Aug. 2020) ("DERA Study"), available at https://www.sec.gov/files/Misconduct%20And%20Fraud%20In%20Unregistered%20Offerings.pdf.

4. *Id*. at 33.

5. *Id*. at 11.

6. *Id*. at 19.

proportion of seniors in its population and accounts for the second largest number of seniors amongst all states.[7] With more than half of financial assets in the U.S. estimated to be owned by seniors,[8] elderly investors are considered to be the most targeted and vulnerable to financial exploitation.[9]

III. Finder's Exemption

PIABA opposes the proposed registration of finders ("Finder's Exemption") for many of the same reasons PIABA opposed the U.S. Securities and Exchange Commission (the "SEC") Release Number 34-90112, Notice of Proposed Exemptive Order Granting Conditional Exemption from the Broker Registration Requirements of Section 15(a) of the Securities Exchange Act of 1934 for Certain Activities of Finders (the "Proposed Finders Exemption").[10] We strongly believe that if a finder acts as a broker with respect to the securities activities of non-reporting issuers, they should be subject to all of the requirements that would apply to a broker-dealer when acting in that same capacity.

In December 2021, after receiving numerous comments expressing significant concerns that the exemption could undermine investor protection, the SEC announced that it would not move forward with the proposed exemption.[11] While the exemption was intended to help small businesses and startups raise capital, the SEC determined that the Proposed Finders Exemption was not in the best interests of investors or the integrity of the securities markets. Since then, the SEC has not taken further action on the proposal, and the provision of regulatory clarity for finders is not in the Commission's current regulatory agenda.[12]

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7. *Id*.

8. *Id*.

9. *Id*.

10. See Letter from PIABA President David P. Meyer to Vanessa Countryman, Re: File No. S7-13-20 (Nov. 12, 2020): available at https://www.sec.gov/comments/s7-13-20/s71320-8011738-225383.pdf.

11. See Annual Report for Fiscal Year 2021, Office of the Advocate for Small Business Capital Formation ("OASB") at 64, available at https://www.sec.gov/files/2021-OASB-Annual-Report.pdf.

12. See Office of Information and Regulatory Affairs, Office of Management and Budget, U.S. Securities and Exchange Commission Agency Rule List (Fall 2022) available at https://www.reginfo.gov/public/do/eAgendaMain?operation=

In the 2023 Proposed Legislation, similar to the Proposed Finders Exemption, finders would not have to possess any minimum knowledge or competency with respect to securities to qualify for the exemption, nor would they have to pass any examinations or undergo any training or continuing education to serve as a finder. Because the exemption would allow virtually any individual to promote sales of unregistered securities so long as the individual was not statutorily disqualified, there would be no assurance to the investor, the issuer, or the securities market at large that such individuals have the knowledge, skills, integrity, or competency to serve investors or issuers in capital raising activities.

Under the federal securities laws, finders would not need to notify regulatory authorities of their activities, or to keep any records of their activities, communications, or finances, making it extremely difficult for the Commission or any other regulator with jurisdiction over finders to determine whether they were complying with the exemptive order or other applicable laws and standards. There would be no database, such as BrokerCheck, for investors to learn more about a finder's background, including any customer complaints or past crimes or disciplinary actions that do not trigger disqualification.

The 2023 Proposed Legislation would not allow finders to participate in the preparation of issuer sales materials, but in our experience, persons involved in securities sales are typically involved in the preparation of the sales materials used to promote an offering. Moreover, it is not clear from the 2023 Proposed Legislation whether a finder may provide investors with projections of the price performance of a privately offered security, which generally is not permissible for broker dealers.

Because there would be no regular oversight of the use of these materials or standards applicable to such sales materials other than general anti-fraud laws, there remains a risk that Finders may be involved in preparing sales materials that are designed to maximize sales at the cost of compliance with standards requiring such communications to be fair and balanced.

Further, because finders would not need to have any background in the securities industry or pass minimum knowledge or competency examinations, it is possible they would not even recognize when they are providing misleading content to investors. The North American Securities Administrators Association ("NASAA") issues enforcement reports every

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OPERATION_GET_AGENCY_RULE_LIST&currentPub=true&agencyCode=&showStage=active&agencyCd=3235&csrf_token=7CE97CC2D49C9B6B70868F7B2752E582C86F1945A4A46F34426C18AF1ABE101E611318F64B67159C3A36E7556BD0FB872C8F.

year that summarize enforcement actions filed by state regulators. NASAA's recent Enforcement Report show that during 2019, state securities regulators brought 738 enforcement actions against unregistered persons, including 57 unregistered finders or solicitors.[13]

In addition, finders should be required to do their own due diligence before making a recommendation. Prohibiting finders from investigating or performing reasonable diligence on an issuer or its securities could provide a shield from liability for a finder in an investor's claim that he/she suffered losses from the finder's solicitation activities. For example, a finder would likely assert that the restriction from performing due diligence on the issuer, and thus any claims by an investor that the finder should have known about any fraud or investment risk related to the investment, would run counter to the finder's obligations.

Additionally, if the OFR does move forward with the finder exemption, it should be limited only to natural persons because permitting entities to come into this space opens the door to boiler room operations and other fraudulent enterprises acting under the approval of an OFR exemption, which increases the potential harm to investors significantly.

IV. Crowdfunding

The Task Force's reasoning to expand crowdfunding offerings is deeply flawed. As support for the proposed reform measures, the OFR states that "to date there has not been a single securities offering under Florida's crowdfunding statute."[14]As further support, the OFR states that "there have been numerous offerings in Georgia under their crowdfunding provisions that are substantially similar to the OFR's reform proposals."[15] Despite the Task Force's assertions, not only has Florida had numerous crowdfunding offerings under its existing regulatory framework but in 2022 Florida had 115 offerings; ranking it among the top three states, after California and New York.[16] Moreover, in 2022 Georgia had 42 offerings or 64% less crowdfunding

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13. See NASAA 2020 Enforcement Report at 5, available at https://www.nasaa.org/wp-content/uploads/2020/09/2020-Enforcement-Report-Based-on-2019-Data-FINAL.pdf.

14. See Ch. 517 Task Force Report at p. 3.

15. *Id*.

16. See Annual Report for Fiscal Year 2022, OASB at 16, available at https://www.sec.gov/files/2022-oasb-annual-report.pdf.

offerings than Florida.[17] Thus, mirroring Georgia's crowdfunding provisions will not likely increase capital raising opportunities for smaller companies.

PIABA is adamantly opposed to the growth of unregulated crowdfunded offerings. Our members have found that unsophisticated retail investors are the ones most likely to fall victims to fraudulent unregulated crowdfunding offerings. In 2020, crowdfunding offerings in the U.S. raised $239 million.[18] Two years later, crowdfunding offerings soared to $494 million, raising more than twice the amount raised in 2020.[19] The OFR should not increase or waive the current annual cap on investors, accredited or not. More control and review will protect investor. Increasing offering document disclosure and auditing, as well as regulating or limiting promotion and advertising are all worthwhile provisions which should be adopted.

Additionally, the Task Force proposes to create a new exemption for micro-offerings under $50,000. While a micro-offering could allow small business access to investors' capital, businesses seeking relatively small amounts of capital should use traditional forms of financing, like commercial loans. The risk inherent in micro-offerings is not the type of risk that should be passed on to investors. Further, the ability of a business to issue a new micro-offering every thirty days would create a loophole for fraudsters to exploit, allowing them to raise larger amounts of capital than should be allowed under a micro-offering exemption by utilizing serial micro-offerings across a short period of time.

Finally, please note that PIABA members commonly see cases where the investor is unaware of the liquidity or illiquidity of an investment which they are holding. In 2019, the SEC published the results of a study conducted by its staff on the capital formation and investor protection impacts of Regulation Crowdfunding (the "SEC Crowdfunding Report").[14] According the SEC Crowdfunding Report, the average issuer had "no revenues (just over half of the offerings were by issuers with no revenues)."[15]

17. *Id.*

18. See Alois, JD, *$239 Million was Raised using Reg CF During 2020, this Amount Could Double in 2021,* Crowdfund Insider (Jan. 6, 2021), available at https://www.crowdfundinsider.com/2021/01/170982-239-million-was-raised-using-reg-cf-during-2020-amount-could-double-in-2021/ (citing a report by Crowdfund Capital Advisors ("CCA")).

19. See Brian, 2022 Equity Crowdfunding Stats and Top Platforms (Jan. 16, 2023), available at https://crowdwise.org/funding-portals/2022-equity-crowdfunding-stats-and-top-platforms/.

V. Conclusion

Once again, PIABA appreciates the opportunity to comment on the OFR's 2023 Proposed Legislation. We urge the OFR to remember its mission to protect investors while it tackles the legitimate goal of simplifying the exempt offering framework. Although increasing the efficiency of the capital markets and ability of companies to raise money is a laudable goal, it cannot be done to the detriment of Florida investors.

PIABA would be happy to engage with the OFR further on this issue.

Respectfully submitted,

Hugh D. Berkson, President
Public Investors Advocate Bar Association

The following Comment Letter regarding *SR-FINRA-2023-00425 Self-Regulatory Organizations* was submitted to the SEC by Hugh Berkson on February 1, 2023. (prepared with the assistance of Jason Kane and Daren Luma)

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

Re: File Number SR–FINRA–2023–00425– Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change To Amend the Codes of Arbitration Procedure To Make Various Clarifying and Technical Changes to the Codes, Including in Response to Recommendations in the Report of Independent Counsel Lowenstein Sandler

Dear Ms. Countryman:

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

Pursuant to Rule of Practice 192(a) of the Securities and Exchange Commission, PIABA submits this comment to the SEC concerning FINRA's recent proposed rule changes set forth in Release No. 34-96607. The proposed rule changes include substantive changes to the arbitrator list selection process in response to recommendation made by Independent Counsel Lowenstein Sandler, such as requiring the Director to provide a written explanation whenever a challenge to remove an arbitrator is granted or denied, if a written explanation is requested by either party. In addition, the proposed rule changes include several procedural amendments, such as additional virtual hearing options, clarifying changes to amended and third-party claims and redaction requirements for simplified arbitrations.

While PIABA generally supports the rule proposals, we urge FINRA to consider additional steps in the arbitration selection process to promote our shared goal of improving transparency and fairness in the Dispute Resolution forum.

List Selection Process Amendments

The appointment of arbitrators is the most important procedural part of the arbitration process and investors who are forced into arbitration must have confidence in the integrity of the selection process. Unfortunately, the arbitration selection process is still an imperfect one several decades since its introduction, as illustrated by last years' Fulton County, Georgia Superior Court decision vacating an arbitration award in favor of respondent Wells Fargo Clearing Services, LLC, which necessitated the appointment of Lowenstein Sandler as Independent Counsel. While PIABA remains concerned about the lack of transparency in the process and the appearance of impropriety in that case, PIABA welcomes FINRA's rule amendments to the arbitrator appointment process recommended by the Lowenstein Sandler report, as such efforts will operate to prevent abuses, provide consistent results, and give greater transparency.

Amending the Codes of Arbitration Procedure ("Codes") to explicitly reference conflict of interest checks during arbitrator selection, as well as the procedures related to challenging an arbitrator for cause are welcome additions to the arbitration process that give much greater transparency to internal FINRA processes. Requiring the Director to issue a written decision when deciding a party-initiated challenge to an arbitrator is another improvement to the Codes that improves the transparency of the arbitration process.

Nevertheless, PIABA believes additional steps can be taken to promote transparency and fairness. For example, PIABA believes that Director's decisions regarding party-initiated challenges should be placed in a publicly available database, such as the one currently maintained for FINRA awards. Such release would provide helpful precedents for future parties to consider in evaluating potential arbitrators. Moreover, such a database would give parties insight that would help them in understanding what FINRA considers to be a legitimate ground for a challenge to a potential arbitrator and provide greater transparency, consistency and fairness to the process. PIABA understands FINRA's likely reluctance to have such a database contain the name(s) of the arbitrator(s) at issue, and would support the redaction of those names from the database records.

Procedural Amendments to the Codes

PIABA generally supports FINRA's proposed procedural amendments in the rules proposals, many of which are simply to clarify and codify existing policies into the FINRA Code provisions. PIABA submits the following additional comments with respect to the specific procedural amendments detailed below.

Virtual Hearings Default Option for Special Proceedings

FINRA's proposed rule change making video conferencing as the default for "special proceedings" aligns with PIABA's belief that investors must be provided with a full and fair opportunity to present their cases. Considering the time restrictions (*e.g.* hearings completed in one day) and the restriction of questioning opposing party witnesses, Claimants will benefit from having video conferencing as the default method of presenting their cases to the single arbitrator in this abbreviated proceeding, rather than a telephonic hearing. PIABA supports this proposal.

Redaction Requirements for Simplified Arbitration

PIABA agrees that the safeguarding of personal confidential information is of paramount importance. At the same time, in contrast to the sophisticated and well-resourced FINRA Members, many unsophisticated Claimants in simplified arbitrations may have serious difficulty complying with the PCI redaction requirements in simplified arbitrations. PIABA proposes that the suggested guidance for protecting PSI posted on FINRA's website is likewise posted by the Director on each case's docket/portal so that Claimants are aware and can take action to protect their information. PIABA supports this proposal.

Amended Claims and Third-party Claims

Several of the procedural amendments concern amending claims and the filing of third-party claims. PIABA supports these proposals to specifically codify existing FINRA policy and/or provide additional procedural details and requirements for these types of claims. PIABA believes that parties to FINRA arbitration should be able to rely on the Code for the procedural rules and requirements to the greatest extent possible, and the proposed additions to the Code help to provide necessary procedural details about these claims that are currently lacking.

In sum, PIABA generally supports FINRA's proposed rule amendments set forth in Release No. 34-96607. PIABA thanks the Commission and FINRA for the opportunity to comment on these proposals.

Very Truly Yours,

Hugh Berkson
President, Public Investors Advocate Bar Association

The following Comment Letter regarding *Proposed Rule Change to Prohibit Registered Investment Advisers From Outsourcing Certain Services or Functions Without First Meeting Minimum Requirements* was submitted to the SEC by Hugh Berkson on December 21, 2022. (prepared with the assistance of Ryan Cook)

Via Email Only @ rule-comments@sec.gov

Ms. Vanessa Countryman
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Release No. IA-6176 – Proposed Rule Change to prohibit registered investment advisers ("advisers") from outsourcing certain services or functions without first meeting minimum requirements

Dear Ms. Countryman:

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

Pursuant to Rule of Practice 192(a) of the Securities and Exchange Commission, PIABA submits this comment to the SEC concerning the SEC's recent rule proposal to create rule 206(4)-11, amend rule 204-2, and amend the Form ADV. The proposed rule changes would affect the ability and duties around a registered investment adviser ("RIA") contracting with a third party for various issues.

PIABA generally supports the rule proposal.

Background

Generally, these proposed rule changes would establish regulatory standards against which RIAs who wanted to hire a third party to perform various functions could be measured. To begin, the idea that financial services firms should have to meet regulatory standards related to hiring third party vendors, but that the firm is still ultimately responsible for compliance, is not new or novel. Brokerage firms have long been regulated in their use of third party vendors, and FINRA has even recently reminded its members of those obligations.

> FINRA Rule 3110 (Supervision) requires member firms to establish and maintain a system to supervise the activities of their associated persons that is reasonably designed to achieve compliance with federal securities laws and regulations, as well as FINRA rules, including maintaining written procedures to supervise the types of business in which it engages and the activities of its associated persons.
>
> This supervisory obligation extends to member firms' outsourcing of certain "covered activities"—activities or functions that, if performed directly by a member firm, would be required to be the subject of a supervisory system and WSPs pursuant to FINRA Rule 3110.2
>
> Notice 05-48 reminds member firms that "outsourcing an activity or function to … [a Vendor] does not relieve members of their ultimate responsibility for compliance with all applicable federal securities laws and regulations and [FINRA] and MSRB rules regarding the outsourced activity or function." Further, Notice 05-48 states that if a member outsources certain activities, "the member's supervisory system and [WSPs] must include procedures regarding its outsourcing practices to ensure compliance with applicable securities laws and regulations and [FINRA] rules."

FINRA, Regulatory Notice 21-29. As a result, this type of rulemaking is neither new nor novel in the financial services industry, nor has it resulted in some onerous burden which pushed firms out of the business as some RIAs claim.

Scope of the Rule

The scope of the proposed rule for a "covered function" is broad and flexible; including any "function or service that is necessary for the investment adviser to provide its investment advisory services in compliance with the Federal securities laws, and that, if not performed or performed negligently, would be reasonably likely to cause a material negative impact on the adviser's clients or on the adviser's ability to provide investment advisory services." A covered function does not include clerical, ministerial, utility, or general office functions or services. A definition like this is helpful in making the rule flexible as the industry continues to develop. The list of functions that a third party vendor might offer to an RIA today is different from what may be offered ten years from now. By leaving this definition flexible, it protects from potential future holes in the rule which could develop in services which the SEC did not predict would be potential concerns.

PIABA is, however, concerned that the proposed definition of a covered function that excludes "clerical, ministerial, utility, or general office functions or services" might create inconsistencies with SEC record keeping rules. RIAs already have a variety of record keeping rules.[1] Ultimately, the obligation to maintain those records is and must be borne by the RIA. This should not be changed or affected by a situation where an RIA engages a third-party vendor to fulfill some or any of the functions, such as maintaining copies of written communications with customers. A vendor hired to, for instance, maintain the records for the RIA of all written agreements with clients, communications with clients, and grants of discretionary authority for clients, could arguably be excluded from the covered function definition as merely "ministerial, utility, or general office function."

A RIA should be required to vet any vendor fulfilling any function necessary to comply with its regulatory obligations. Moreover, ensuring that the covered function definition includes all required record-keeping would simply mirror the requirement already in place for broker-dealers on the issue. FINRA has disciplined firms for failing "to perform adequate due diligence to verify Vendors' ability to maintain books and records on behalf of member firms" as well as for "violations of Books and Records rules and related supervisory obligations involving Vendors, including, but not limited to, failing to preserve and produce business-related electronic communications (including emails, social media, texts, instant messages, app-based messages and video content) due to: Vendors' system malfunctions; Vendors' data purges after termination of their relationship with firms; Vendors failing to correctly configure default retention periods resulting in inadvertent deletions of firm electronic communication for certain time periods; Vendors' system configurations making deleted emails unrecoverable after 30 days; Vendors failing to provide non-rewriteable, non-erasable storage; and Firms failing to establish an audit system to account for Vendors' preservation of emails."[2] There is no reason why RIAs shouldn't be held to the same standard that brokerage firms already are.

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1. *See* 17 CFR § 275.204-2.

2. FINRA, Regulatory Notice 21-29.

to prosecute claims for wrongdoing and regulators would be affected in their ability to conduct investigations of potential misconduct. It makes no difference whether the regulations were ignored by a third-party vendor or the RIA itself.

Beyond the potentially conflicting obligations discussed above, PIABA supports the rule proposal for its stated purpose of ensuring that RIAs do not attempt to outsource responsibilities without appropriate due diligence concerning, and supervision of, the vendor. Ultimately, clients entrust their monies with a RIA and trust it will fulfill its obligations to give appropriate investment advice and management of those funds. To the extent any functions are being outsourced, whether that includes complex calculations and modeling, due diligence on products for sale, or doing background checks on staff being hired, the clients are ultimately the one who bear the risk of failure. Clients have no ability to conduct the due diligence and oversight of a vendor; they expect the RIA with whom they chose to invest will ensure that all aspects of the services will be provided in an appropriate fashion. By setting minimum standards and explicitly holding RIA's liable for any vendor failures, this rule simply formalizes what clients already expects to be done.

PIABA thanks the Commission and FINRA for the opportunity to comment on this proposal.

Very Truly Yours,

Hugh Berkson
President, Public Investors Advocate Bar Association

The following letter regarding *Investor Choice and Digital Commodities Legislation* was submitted to the US Senate Committee on Agriculture by Various Investor Protection Groups on December 9, 2022.

The Honorable Debbie Stabenow
Chairwoman
U.S. Senate Committee on Agriculture
328-A Russell Senate Office Building Washington, D.C.
20510

The Honorable John Boozman
Ranking Member
U.S. Senate Committee on Agriculture
328-A Russell Senate Office Building
Washington, D.C. 20510

Re: Investor Choice and Digital Commodities Legislation

Dear Chairwoman Stabenow and Ranking Member Boozman:

As organizations that share a commitment to investor choice, we write to express strong concern that the Digital Commodities Consumer Protection Act (S. 4760), as currently drafted, does not contemplate any safeguards with respect to injured investors' ability to hold digital commodity issuers, brokers, and affiliated entities, accountable for misconduct.[1] Decades of experience with the investment adviser and brokerage industry demonstrate that any legislation lacking such explicit safeguards will, inevitably, open the door to the use of forced arbitration contracts, class action waivers, and forum selection clauses – all of which are demonstrably harmful to consumers.

Such protection is critical as we've continued to witness devastating crypto collapses this past year, from lender Celsius Network, to coin project Terraform Labs, to hedge fund 3AC, and most recently, FTX's bankruptcy filing. Unsecured creditors, including institutional investors managing

1. The signatories to this letter include organizations that have taken public positions on this legislation, and organizations that have not. This letter should not be construed as addressing any aspects of the bill other than those that could potentially limit investors' access to the court system, or limit investors' ability to recover for the harms that they might suffer as a result of misconduct by digital issuers and other related market participants.

retirement savings, have been forced to write down hundreds of millions of dollars on losses, while individual retail investors also find themselves losing tens of thousands of dollars in investments. Investors must be able to access the court system and retain the ability to hold these corporations legally accountable when such wrongdoing occurs.

Any federal legislation addressing digital commodities (or other digital assets) must guarantee investors' ability to access the state and federal court system to resolve cases. Without such protections, digital commodity issuers and other related market participants will undoubtedly seek to block investors' access to the court system, restricting investors' ability to recover for the harms that they suffered as a result of digital commodities issuers' and other related market participants' misconduct and undermining a critical accountability mechanism in the digital commodities market. An important component of investors' confidence is the independence and transparency that has historically accompanied the rights and protections afforded them in state and federal courts. This kind of accountability is critical in all investments, and especially with untested and novel products, such as digital commodities.

Effective and comprehensive government regulation alone is an insufficient remedy to ensure corporate accountability. The government is not equipped to hold every company accountable and return ill-gotten gains to investors. Private actions on the other hand, have proven a better mechanism to hold companies accountable for wrong-doing and recoup investor money. For example, in five large securities fraud scandals, SEC enforcement action recovered a total of 1.75 billion dollars, while private actions recovered a total of 19.4 billion dollars.[2] In fact, federal securities class actions have returned over $100 billion to defrauded investors in the past 20 years alone.[3]

2. Tyco SEC Settlement Fair Fund: http://www.tycosecsettlement.com/ ($55.8 million settlement); Enron SEC Settlement Fair Fund: http://enronvictimtrust.com/ ($570 million); WorldCom SEC Settlement Press Release: http://www.sec.gov/news/press/2003-81.htm ($750 million); Bank of America SEC Fair Fund: http://bankofamericafairfund.com/ ($375 million); Global Crossing SEC Settlement Press Release: http://www.sec.gov/litigation/litreleases/lr19179.htm ($300,000).

3. In re: Tyco International, Ltd., Securities Litigation, U.S. District Court, District of New Hampshire, 02-266 ($3.2 billion settlement); In re: Enron Corporation Securities Litigation, U.S. District Court, Southern District of Texas, 01-3624($7.2 billion settlement); In re: WorldCom, Inc. Securities Litigation, U.S. District Court, Southern District of New York, 02-3288 ($6.1 billion); In re: Bank of America Corp. Securities, Derivative, and Employee Retirement Income Security Act (ERISA)

We strongly urge this committee to ensure investors are protected and their choice in how to pursue their rights is upheld in any federal legislation on digital currencies.

Sincerely,

American Association for Justice (AAJ)
Americans for Financial Reform (AFR)
Consumer Action
Consumer Federation of America (CFA)
Consumer Reports
Institute for Agriculture and Trade Policy (IATP)
National Association of Consumer Advocates (NACA)
Public Citizen
Public Investors Advocate Bar Association (PIABA)
U.S. Public Interest Research Group (US-PIRG)
20/20 Vision

CC: Members of the Senate Committee on Agriculture, Nutrition and Forestry
Member of the Senate Committee on Banking, Housing and Urban Affairs

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Litigation, U.S. District Court, Southern District of New York, 09-2058 ($2.4 billion settlement); In re: Global Crossing Ltd. Securities Litigation, U.S. District Court, Southern District of New York, 02-910 ($447.8 million settlement).The Top 100 U.S. Settlements of All Time, ISS: Securities Class Action Services, (2017), available at: https://www.issgovernance.com/file/publications/SCAS-Top-100-US-Settlements-31Dec2016.pdf.

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The following Comment Letter regarding *FINRA Proposed Rule Change to Amend the Codes of Arbitration Procedure to Modify the Current Process Relating to the Expungement of Customer Dispute Information* was submitted to the SEC by Hugh Berkson on December 7, 2022. (prepared with the assistance of Daren Luma)

Via Electronic Mail
Rule-comments@sec.gov

Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F St. NE
Washington, DC 200549-1090

RE: FINRA Proposed Rule Change to Amend the Codes of Arbitration Procedure to Modify the Current Process Relating to the Expungement of Customer Dispute Information, As Modified by Amendment No. 1 – File No. SR-FINRA-2022-024

Dear Ms. Countryman:

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

Thank you for the opportunity to comment on FINRA's proposed amendment to its rule change proposal regarding the expungement of customer dispute information from an associated person's registration records maintained in the Central Registration Depository ("CRD"). In practice, expungement has not been the "extraordinary remedy" that it is supposed to be, but something that is routinely granted, with troubling consequences for investor protection.

PIABA appreciates FINRA's continued efforts to examine the expungement problem and attempt to find solutions to the issues PIABA members have previously identified. On September 7, 2022, in response to FINRA's initial submission of the proposed expungement rules changes, PIABA filed a comment letter largely in support of FINRA's efforts noting that "SR-2022-024 is a significant improvement over current FINRA rules and FINRA's prior rule proposal concerning expungement, SR-2020-030."[1] FINRA has now refiled the proposed expungement rules changes, modified by Amendment No. 1, in response to comments made during the review period. As detailed below, PIABA reiterates its support for SR-2022-024 as a significant improvement to existing FINRA rules and further supports the revisions contained in Amendment No. 1 as additional improvements to the existing expungement process.

FINRA's proposal in Amendment No. 1 to specifically state that customers have the right to participate "in all aspects" of the expungement pre-hearing conference and the expungement hearing is a positive clarification of the proposed rule revision as it removes any doubt a panel could have concerning a customer's ability to attend and take part in the expungement proceedings. PIABA believes that codifying the right of customers to participate in the expungement process and hearing is a worthwhile and necessary effort that will enable arbitration panels to have a more detailed and balanced view of the relevant facts and events underlying the expungement request. The codification will also remedy the persistent problem of arbitration panels refusing to allow aggrieved customers to testify, only to then grant the requested expungement for a lack of evidence that the registered representative did anything wrong.

PIABA also endorses the proposal that arbitration panels "should not give any evidentiary weight" to the fact that customers may choose not to attend or participate in the expungement hearing. While customer participation should be encouraged, a customer's absence must not be considered, seen to benefit, or deemed to support, the expungement request in any way. Public customers who choose to participate in the expungement process are doing so for a public, not a personal, benefit. And they do so at their own expense without bearing any personal stake in the outcome. As such, an arbitration panel should not view a public customer's election to not put themselves through that process as any sort of tacit agreement or approval of an expungement. Associated persons seeking expungement must be held to the high evidentiary standard intended by the FINRA's rules, without regard to the customer's decision not to participate.

FINRA's final proposal in Amendment No. 1 is to prohibit associated persons from seeking expungement where "a panel or court of competent jurisdiction previously found the associated person liable in a customer

1. *See* PIABA Comment Letter to Vanessa Countryman, File No. SR-FINRA-2022-024 (September 7, 2022), p. 2.

arbitration or civil litigation associated with the same customer dispute information." PIABA believes this proposed restriction on expungement is a logical and necessary one. Given that the existing FINRA Rule 2080 only allows expungement when the claim at issue is "factually impossible or clearly erroneous" (Rule 2080(b)(1)(A)); the registered person was not involved (Rule 2080(b)(1)(B)); or the claim, allegation, or information is false (Rule 2080(b)(1)(C)), it defies credulity to believe it appropriate that an associated person who fought a customer claim and lost would then attempt to have the matter expunged from their record. The arbitral finding is one in which the underlying claim was found to be meritorious and that the associated person is liable therefor. While the application of common sense would result in such instances being immune from expungement proceedings, PIABA endorses the proposed clarification that an associated person found liable by an arbitration panel or court of competent jurisdiction is not eligible to seek expungement of that claim.

In summation, PIABA supports the three proposed amendments insofar as they are all common sense clarifications to the existing rule proposal, and would help ensure the appropriate and fair application of the expungement process. PIABA appreciates the opportunity to submit these comments and urges the Commission to approve the proposed rules with the revisions suggested above.

Very Truly Yours,

Hugh D. Berkson
President, Public Investors Advocate Bar Association

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The following Comment Letter regarding FINRA *Proposed Rule Change to Determine Whether to Approve or Disapprove a Proposed Rule Change to Adopt Supplementary Material* was submitted to the SEC by Hugh Berkson on December 7, 2022. (prepared with the assistance of Ryan Cook and David Neuman)

Via Email Only @ rule-comments@sec.gov

Ms. Vanessa Countryman
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: SR-FINRA-2022-021 – Proposed Rule Change to Determine Whether To Approve or Disapprove a Proposed Rule Change To Adopt Supplementary Material .18 (Remote Inspections Pilot Program) Under FINRA Rule 3110

Dear Ms. Countryman:

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

Pursuant to Rule of Practice 192(a) of the Securities and Exchange Commission, PIABA submits this comment to the SEC concerning FINRA's recent filing, with the Securities and Exchange Commission ("SEC" or "Commission"), of a proposed rule change to amend FINRA Rule 3110 (Supervision). Specifically, FINRA has filed with the Commission a proposed rule change to adopt supplementary material .18 (Remote Inspections Pilot Program) under FINRA Rule 3110 (Supervision). The proposal would adopt a voluntary, three-year remote inspection pilot program to allow member firms to elect to fulfill their obligation under Rule 3110(c) (Internal Inspections) by conducting inspections of some or all branch offices and locations remotely without an on-site visit to such office or location, subject to specified terms.

The proposed rule was initially published for comment on August 15, 2022. PIABA submitted its comment on September 6, 2022, urging the

Commission to reject the rule proposal. FINRA then consented to an extension of time through November 11, 2022, for the Commission to approve the rule, disapprove it, or institute proceedings to determine whether to approve or disapprove the proposal. As such, the rule was published again on November 16, 2022, and PIABA once again asks the SEC to reject the proposal.

Background

FINRA's rule 3110(c)(1) was amended, effective in 2005, to codify the schedule by which member firms were to conduct on-site inspections of branch offices and unregistered offices (i.e., non-branch locations). *See* NTM 04-71. FINRA now states that widespread advancements in technology and communications in the financial industry have significantly changed the way in which members and their associated persons conduct their business and communicate, including the practices that formed the original bases for an on-site inspection requirement.

FINRA's present amendment filing contends that:

> the COVID-19 pandemic has accelerated the use of a wide variety of compliance and workplace technology as many government and private employers, including member firms, were driven to adopt a broad remote work environment by quickly moving their employees out of their usual office setting to an alternative worksite such as a private residence. Insights obtained from member firms and other industry representatives, through various pandemic-related initiatives and other industry outreach, have led FINRA to carefully consider whether some processes and rules, including the manner in which a firm may satisfy its Rule 3110(c) obligations, should be modernized . . . [and] technological improvements and developments in regulatory compliance have provided more tools than before to create more effective and efficient compliance programs. To that end, FINRA believes that regulatory models should evolve to benefit from the availability and use of effective technology tools.

Therefore, and ostensibly to address the operational challenges in conducting on-site inspections during the pandemic, FINRA adopted temporary Rule 3110.17, effective since November 2020, to provide member firms the option to conduct inspections of their branch offices and non-branch locations remotely, subject to specified terms therein. As such, FINRA believes now is the time to assess possible longer-term rule changes and is, therefore, proposing this voluntary, three-year remote inspections pilot program.

The Proposed Rule Would Almost Certainly Increase Investor Harm

PIABA submits this comment because the bar association believes this amendment, much like the recently proposed amendment SR-FINRA-2022-019, to allow a home office to be considered residential supervisory location and impose rules and procedures for the supervision of same, runs counter to FINRA's stated objective of investor protection. While it is understood that FINRA is attempting to change with the increased use of virtual technology, it leaves considerable opportunity for associated persons to skirt the rules.

There are some things that technology cannot detect, but would be found with little difficulty through an in-person audit. For example, when an auditor visits the advisor's office, the auditor can see their car and personal belongings, the signage on their building, the physical files in their office, whether they share office space with other professionals or businesses, etc. Many firms' compliance procedures ask supervisors to gauge whether the advisor is living within their means (or at least, their legitimate commissions or compensation), and this cannot be done effectively remotely or through in-person visits taking place every three years. Moreover, a remote inspection will not find evidence of files or other documents related to unapproved investments being recommended to customers (i.e., "selling away"). Our members have had cases where brokers sold unapproved investments with brochures and other offering documents left in plain sight of their office. Obviously, a remote inspection would not uncover such problems.

Enforcement actions by both FINRA and SEC call into question the propriety of the rule proposal. One such case is *In the Matter of Royal Alliance Associates, Inc*., Release No. 38174, 63 S.E.C. Docket No. 1606 (Jan. 15, 1997). In this case, the SEC took issue with Royal Alliance's practice of performing announced audits on "small dispersed offices" beyond the "direct aegis of the firm:"

> Royal Alliance operates 1,500 offices with 2,700 registered representatives. Some 49 of these are one-person offices. Here, Royal Alliance's failure to scrutinize adequately the securities-related business of its registered representatives, which were conducted beyond the direct aegis of the firm, was a certain recipe for trouble. Further, Royal Alliance's practice of conducting a pre-announced compliance examination only once a year was inadequate to satisfy its supervisory obligations.
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> * * *
>
> Nevertheless, such arrangements necessarily entail greater supervisory challenges and the Commission requires firms organized in such a fashion, and individual supervisors at those firms, to meet

the same high standards of supervision as at more traditionally organized firms.

The SEC continued to recognize this problem in another matter: *In the Matter of 1st Discount Brokerage, Inc.,* Release No. 66212A, Admin. Proc. File No. 3-14710 (Jan. 23, 2012). The SEC opined that firms using an independent broker model require greater supervision than that of a traditional wire house brokerage firm. The lack of unannounced audits of a far-away broker with no one looking over his shoulder was wholly deficient. The failure to adequately supervise the subject broker's conduct resulted in a nearly $9 million Ponzi scheme.

Other regulatory actions involving brokers running "selling away" or Ponzi schemes from residential or remote (often one-broker) offices are too plentiful to count but include *In re Lawrence John Fawcett, Jr.*, FINRA No. 2017056329801 (operating from home); *see also Hailey v. Westpark Capital, Inc*., FINRA Arb No. 20-00320 (detailing the lack of sufficient supervision of Fawcett's home office); *In re Jerry Irvin Chancy*, FINRA No. 2014043629801 (operating from home), *In re Mark Lewton Hopkins*, FINRA No. 2018060968101 (operating from an office on a golf course owned by the broker); *In re Malcolm Segal*, FINRA No. 2014041990901 (home office); *In re Robert Van Zandt*, FINRA No. 2011027577001; *In re Nevin Gillette*, FINRA No. 2006007067401; *In re Charles Caleb Fackrell*, FINRA No. 2014043705201; *In re Thomas H. Laws*, FINRA No. 2019061095601; *In re Brian Royster*, FINRA No. 2017052882601; *In re Michael James Blake*, FINRA No. 2010021710501; *In re Murray Todd Petersen*, FINRA No. 2019064432901; *In the Matter of Rebecca Engle*, SEC Admin. Release 34-75127 (June 9, 2015); *In the Matter of Brian Schuster*, SEC Admin. Release 34-75128 (June 9, 2015); *In the Matter of Larry Dearman Sr.*, SEC Release No. 75292 (June 24, 2015); *In the Matter of Levi D. Lindemann*, SEC Release No. 77696 (Apr. 22, 2016); and *In the Matter of Securities America Advisors, Inc*., SEC Release No. 94995 (May 26, 2022) (regarding a failure to supervise Hector May, who ran a $8 million Ponzi scheme).

The proposal suggests that certain locations would be ineligible for the proposed pilot program, such as brokers with marks on Questions 14A, B, C, D, and E of their Form U4s. Given that the referenced sections of Question 14 all have to do with whether a court or regulatory issued a finding of a violation of law or regulation, associated persons who have simply been subject to customer complaints and settled them, were terminated for cause, have had judgments or liens issued against them, or are merely under a regulatory investigation would be eligible for the pilot program since none of that wrongdoing would be reportable under the referenced sections of Question 14. While one questions why problematic brokers should be subjected to substantially weakened supervision, one cannot question the likely outcome: meaningful investor harm.

The efficacy of remote electronic supervision is called into question given the existing scheme for surveillance of electronic communications. At present, firms commonly review a sampling of emails or electronic messages, leaving opportunities for bad actors to make improper sales presentations or commitments to clients via email or text so long as those messages do not trigger the key words used to flag potentially problematic communications. Our members have seen numerous cases where the broker engaged in selling away and openly discussed such through their firm-approved email address, but the firm did not detect it for years (or ever) because the firm simply did not see or review the emails.

Not surprisingly, most of the comments in support of this rule came from brokerage firms. However, FINRA and the SEC must look at how things have changed in the last year, or even within the last three months. More and more brokerage firms are asking their advisors and staff to return to the office. Numerous news articles have covered brokerage firms' return to work policies:

a) https://www.investmentnews.com/big-brokerages-gearing-up-for-return-to-the-office-208856 (July 2021) - discussing Morgan Stanley's and Raymond James' brokers' return to the office;

b) https://www.financialadvisoriq.com/c/3255614/411324/edward_jones_others_address_flexibility_needs_amid_return_offices (July 2021) - discussing Edward Jones' expectation that most employees will return to the office, while LPL sought a hybrid approach;

c) https://www.advisorhub.com/exclusive-morgan-stanley-calls-brokers-back-to-offices-sets-90-day-cap-on-wfh/ (Mar 2022) – discussing Morgan Stanley's policy that workers cannot work more than 90 days remotely per year, beginning July 1, 2022;

d) https://www.businessinsider.com/return-to-office-wall-street-covid19-goldman-jefferies-jpmorgan-2022-9 (Sep 2022) - discussing Jeffries', Goldman Sachs', Credit Suisse's, and Morgan Stanley's desire to have employees back in the office on a regular basis – "the underlying message is clear: Come back to your desks;"

e) https://www.reuters.com/business/finance/banks-ready-leave-pandemic-behind-staff-return-desks-2022-09-02/ (Sep 2022):

1) discussing Goldman Sachs ending its Covid protocols on September 6, 2022;
2) Morgan Stanley discontinuing Covid testing and monitoring effective September 5, 2022;
3) Citigroup, Wells Fargo, and BlackRock all expected its employees to work at least three days per week in the office;

4) Royal Bank of Canada was updating its policies and asking colleagues to come together more in-person.

In short, the argument that the Pandemic-related need to allow increased use of remote inspections, and the resulting need to use technological tools to remotely supervise those activities, is no longer compelling as the number of remote employees dwindles.

Certainly many industries have moved increasingly towards work from home or hybrid approaches. PIABA does not claim that such an arrangement would cause major problems for many brokers in the industry. However, FINRA's purpose to "protect investors and ensure the market's integrity"[1] cannot be brushed aside for the sake of convenience. FINRA's rules exist to protect investors from bad actors. Even with the current rules, Ponzi schemes and similar scams are increasingly prevalent. In 2019 alone, "State and federal authorities uncovered 60 alleged Ponzi schemes last year with a total of $3.25 billion in investor funds — the largest amount of money unearthed in these scams since 2010 and more than double the amount from 2018."[2] The SEC published a notice that during the COVID pandemic it "experienced a significant uptick in tips, complaints, and referrals involving investment scams. The SEC's Office of Investor Education and Advocacy urges investors to be on high alert in order to protect themselves and others from becoming victims of investment fraud."[3] Yet, despite an increase in the problem that only frequent in-person surprise visits would catch, FINRA proposes a rule that will serve to reduce the oversight of remote brokers and would thereby exacerbate the growing problem.

Any provision that weakens the rules as they relate to inspections of home or remote offices is flawed and would likely lead to more harmed investors. These proposed rules (SR-FINRA-2022-019 and SR-FINRA-2022-021) would provide even more ample opportunity for a broker to engage in fraudulent conduct without a supervisor or auditor adequately supervising the broker's conduct. If anything, FINRA should require firms to develop and

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1. FINRA, *About FINRA*, https://www.finra.org/about#:~:text=To%20protect%20investors%20and%20ensure,in%20the%20market%20with%20confidence. (last visited November 18, 2022).

2. CNBC.com, *Ponzi schemes hit highest level in a decade, hinting next 'investor massacre' may be near*, https://www.cnbc.com/2020/02/11/ponzi-schemes-hit-the-highest-level-in-10-years.html (Feb 11, 2020).

3. SEC, Investment Scam Complaints on the Rise – Investor Alert, https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-alerts/investment-0 (December 14, 2020).

implement *more* unannounced inspections as residential and remote offices and virtual technology becomes more prevalent. Additionally, rules that require firms to review more than just a sampling of electronic correspondence would be needed to combat potential problem brokers.

The instant rule proposal states that the Commission will consider any request for an oral presentation pursuant to Rule 19b-4. If the Commission decides to hold a hearing and allow interested parties to present oral argument on the rule proposal, PIABA requests the opportunity to participate in that hearing and present its oral argument.

PIABA thanks the Commission and FINRA for the opportunity to comment on this proposal.

Very Truly Yours,

Hugh D. Berkson
President, Public Investors Advocate Bar Association

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The following Comment Letter regarding FINRA *Proposed Rule Change to Adopt New Supplementary Material under FINRA Rule 3110* was submitted to the SEC by Hugh Berkson on November 22, 2022. (prepared with the assistance of Ryan Cook)

Via Email Only @ rule-comments@sec.gov

Ms. Vanessa Countryman
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: SR-FINRA-2022-019 – Proposed Rule Change to Adopt New Supplementary Material .19 (Residential Supervisory Location) under FINRA Rule 3110

Dear Ms. Countryman:

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

Pursuant to Rule of Practice 192(a) of the Securities and Exchange Commission ("SEC" or "Commission"), PIABA submits this comment to the SEC concerning FINRA's recent filing with the Commission a proposed rule change to amend FINRA Rule 3110 (Supervision). FINRA has filed proposed changes to FINRA Rule 3110 to add new Supplementary Material as section .19 (3110.19 - Residential Supervisory Location). The proposed amendment would allow a home office to be considered residential supervisory location and then create rules and procedures for the supervision of same.

The proposed rule was initially published for comment on August 2, 2022. PIABA submitted its comment on August 23, 2022, urging the Commission to reject the rule proposal. FINRA then consented to an extension of time through October 31, 2022, for the Commission to approve the rule, disapprove it, or institute proceedings to determine whether to approve or disapprove the proposal. As such, the rule was published again on November 4, 2022, and PIABA again submits this comment, asking the SEC to reject this proposal.

Background

As a result of the Covid pandemic, regulators eased regulatory requirements to accommodate brokerage firm employees working from home. This effort included the introduction of new technologies to permit remote supervision. By way of this proposal, FINRA appears to be adapting to a new, post-pandemic "blended workforce" model, one in which employees work on-site in traditional offices as well as in their homes. FINRA has noted that "technological advances in surveillance and monitoring capabilities" have enabled greater "workplace flexibility." This rule change proposal, therefore, is considered a reassessment of "the manner in which firms may effectively and efficiently carry out their supervisory responsibilities considering evolving business models and practices, advances in technology, and regulatory benefits."

FINRA's stated intent is to classify some private residences as "non-branch" locations and thereby "align" with procedures already in place (with certain exclusions) for non-traditional methods of supervision. FINRA contends that the elevation of private residences to non-branch status "will not result in a loss of the important regulatory information that the rules were designed, in part, to provide regarding the locations or associated persons."

Under the FINRA proposal, the private residential (non-branch) locations would be subject to limitations including, but not limited to: 1) that only one associated person can conduct business at the location; 2) that the location is not held out to the public as an office (and that the associated person cannot meet with clients or prospects there); 3) that no customer funds or securities are handled there; 4) that the associated person is assigned to a specific branch office; 5) that all electronic communications are made through the member firm's electronic data systems; and, 6) that typical books and records must be maintained as is customary for the brokerage industry. It should be noted, FINRA has pointed out that once a home office has been designated a "residential supervisory location," inspections would be required on a regular periodic schedule (likely once every three years, as opposed to annually), as is required of other more traditional supervisory branch offices.

PIABA submits this comment because the Association believes the amendment is a fundamentally flawed idea and runs counter to FINRA's stated objective of investor protection. While it is understood that FINRA is attempting to change with the increased use of virtual technology, it leaves considerable opportunity for advisors working from home to skirt the rules.

There are some things that technology cannot detect, but would be found with little difficulty through an in-person audit. For example, when an auditor visits the advisor's home office, the auditor can see their home, car, and other assets. Many firms' compliance procedures ask supervisors to gauge whether the advisor is leaving within their means (or at least, their legitimate commissions or compensation), and this cannot be done effectively remotely or through in-person visits taking place every three years. Moreover, a remote inspection will not find evidence of files or other documents related to unapproved investments being recommended to customers (i.e., "selling away"). Our members have had cases where brokers sold unapproved investments with brochures and other offering documents left in plain sight of their office. Obviously, a remote inspection would not uncover such problems.

Enforcement actions by both FINRA and SEC call into question the propriety of the rule proposal. One such case is *In the Matter of Royal Alliance Associates, Inc*., Release No. 38174, 63 S.E.C. Docket No. 1606 (Jan. 15, 1997). In this case, the SEC took issue with Royal Alliance's practice of performing announced audits on "small dispersed offices" beyond the "direct aegis of the firm":

> Royal Alliance operates 1,500 offices with 2,700 registered representatives. Some 49 of these are one-person offices. Here, Royal Alliance's failure to scrutinize adequately the securities-related business of its registered representatives, which were conducted beyond the direct aegis of the firm, was a certain recipe for trouble. Further, Royal Alliance's practice of conducting a pre-announced compliance examination only once a year was inadequate to satisfy its supervisory obligations.
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> Nevertheless, such arrangements necessarily entail greater supervisory challenges and the Commission requires firms organized in such a fashion, and individual supervisors at those firms, to meet the same high standards of supervision as at more traditionally organized firms.

The SEC continued to recognize this problem in another matter: *In the Matter of 1st Discount Brokerage, Inc.,* Release No. 66212A, Admin. Proc. File No. 3-14710 (Jan. 23, 2012). The SEC opined that firms using an independent broker model require greater supervision than that of a traditional wire house brokerage firm. The lack of unannounced audits of a far-away broker with no one looking over his shoulder was wholly deficient. The failure to adequately supervise the subject broker's conduct resulted in a nearly $9 million Ponzi scheme.

Other regulatory actions involving brokers running "selling away" or Ponzi schemes from residential or remote (often one-broker) offices are too plentiful to count but include *In re Lawrence John Fawcett, Jr.*, FINRA No. 2017056329801 (operating from home); *see also Hailey v. Westpark Capital, Inc.*, FINRA Arb No. 20-00320 (detailing the lack of sufficient supervision of Fawcett's home office); *In re Jerry Irvin Chancy*, FINRA No. 2014043629801 (operating from home), *In re Mark Lewton Hopkins*, FINRA No. 2018060968101 (operating from an office on a golf course owned by the broker); *In re Malcolm Segal*, FINRA No. 2014041990901 (home office); *In re Robert Van Zandt*, FINRA No. 2011027577001; *In re Nevin Gillette*, FINRA No. 2006007067401; *In re Charles Caleb Fackrell*, FINRA No. 2014043705201; *In re Thomas H. Laws*, FINRA No. 2019061095601; *In re Brian Royster*, FINRA No. 2017052882601; *In re Michael James Blake*, FINRA No. 2010021710501; *In re Murray Todd Petersen*, FINRA No. 2019064432901; *In the Matter of Rebecca Engle*, SEC Admin. Release 34-75127 (June 9, 2015); *In the Matter of Brian Schuster*, SEC Admin. Release 34-75128 (June 9, 2015); *In the Matter of Larry Dearman Sr.*, SEC Release No. 75292 (June 24, 2015); *In the Matter of Levi D. Lindemann*, SEC Release No. 77696 (Apr. 22, 2016); and *In the Matter of Securities America Advisors, Inc.*, SEC Release No. 94995 (May 26, 2022) (regarding a failure to supervise Hector May, who ran a $8 million Ponzi scheme).

Section (a)(3) of the rule proposal provides that a remote location cannot qualify as a "non-branch location" if the broker meets with clients at their remote or home office. However, common sense tells us that the securities industry simply cannot rely on a fraudulent broker to follow the rules in the absence of real oversight. *See NASD v. Robert Joseph Kernweis*, NASD No. C02980024 (Feb. 16, 2000) (finding that supervisors cannot rely on unverified representations of a broker). Likewise, a review of all electronic communications that are made through the member firm's electronic data systems would only be sufficient if firms are required to adequately review these emails; yet firms commonly review only a small sampling of electronic correspondence. Our members have seen numerous cases where the broker engaged in selling away and openly discussed such through their firm-approved email address, but the firm did not detect it for years (or ever) because the firm simply did not see or review the emails.

Not surprisingly, most of the comments in support of this rule came from brokerage firms. However, FINRA and the SEC must look at how things have changed in the last year, or even within the last three months. More and more brokerage firms are asking their advisors and staff to return to the office. Numerous news articles have covered brokerage firms' return to work policies:

a) https://www.investmentnews.com/big-brokerages-gearing-up-for-return-to-the-office-208856 (July 2021) - discussing Morgan Stanley's and Raymond James' return to office;
b) https://www.financialadvisoriq.com/c/3255614/411324/edward_jones_others_address_flexibility_needs_amid_return_offices (July 2021) - discussing Edward Jones' expectation for most employees to return to the office, while LPL sought a hybrid approach;
c) https://www.advisorhub.com/exclusive-morgan-stanley-calls-brokers-back-to-offices-sets-90-day-cap-on-wfh/ (Mar 2022) – discussing Morgan Stanley's policy that workers cannot work more than 90 days remotely per year, beginning July 1, 2022;
d) https://www.businessinsider.com/return-to-office-wall-street-covid19-goldman-jefferies-jpmorgan-2022-9 (Sep 2022) - discussing Jeffries', Goldman Sachs', Credit Suisse's, and Morgan Stanley's desire to have employees back in the office on a regular basis – "the underlying message is clear: Come back to your desks;"
e) https://www.reuters.com/business/finance/banks-ready-leave-pandemic-behind-staff-return-desks-2022-09-02/ (Sep 2022):
    1) discussing Goldman Sachs ending its Covid protocols on September 6, 2022;
    2) Morgan Stanley discontinuing Covid testing and monitoring effective September 5, 2022;
    3) Citigroup, Wells Fargo, and BlackRock all expected its employees to work at least three days per week in the office;
    4) Royal Bank of Canada was updating its policies and asking colleagues to come together more in-person.

Moreover, it is noteworthy that some of the firms who supported the rule proposal have actually made statements in support of their advisors and staff returning for work. For example, Virtu Financial submitted a letter in support of the proposal on August 23, 2022. A quick review of Virtu Financial's website states that "We are developing plans to bring people back to the office, but this will be a cautious and methodical process."[1] Charles Schwab also submitted a comment supporting the proposal but planned a "sequenced" return to the office, beginning in April 2022.[2] In short, the argument that the

1. *See* Virtu Financial's website at https://www.virtu.com/about/virtutogether/ (last visited November 16, 2022).

2. See Financial Advisor IQ, "Schwab Sets Return for April; Vaccination is Optional", Feb. 28, 2022, at https://www.financialadvisoriq.com/c/3515434/437874/

Pandemic-related need to allow associated persons to work from home, and the resulting need to use technological tools to remotely supervise those activities, is no longer compelling as the number of people working remotely dwindles.

Certainly many industries have moved increasingly towards work from home or hybrid approaches. PIABA does not claim that such an arrangement would cause major problems for many brokers in the industry. However, FINRA's purpose to "protect investors and ensure the market's integrity"[3] cannot be brushed aside for the sake of convenience. FINRA's rules exist to protect investors from bad actors. Even with the current rules, Ponzi schemes and similar scams are increasingly prevalent. In 2019 alone, "State and federal authorities uncovered 60 alleged Ponzi schemes last year with a total of $3.25 billion in investor funds — the largest amount of money unearthed in these scams since 2010 and more than double the amount from 2018."[4] The SEC published a notice that during the COVID pandemic it "experienced a significant uptick in tips, complaints, and referrals involving investment scams. The SEC's Office of Investor Education and Advocacy urges investors to be on high alert in order to protect themselves and others from becoming victims of investment fraud."[5] Yet, in light of an increase in the problem that only frequent in-person surprise visits would catch, FINRA proposes a rule that will serve to reduce the oversight of remote brokers, and would thereby exacerbate the growing problem.

Any provision that weakens the rules as they relate to inspections of home or remote offices is flawed and would likely lead to more harmed investors. These proposed rules (SR-FINRA-2022-019 and SR-FINRA-2022-021) would provide even more ample opportunity for a broker to engage in fraudulent conduct without a supervisor or auditor adequately supervising the broker's conduct. If anything, FINRA should require firms to develop and

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schwab_sets_office_return_april_vaccination_optional (last visited November 16, 2022).

3. FINRA, *About FINRA*, https://www.finra.org/about#:~:text=To%20protect%20 investors%20and%20ensure,in%20the%20market%20with%20confidence. (last visited November 18, 2022).

4. CNBC.com, *Ponzi schemes hit highest level in a decade, hinting next 'investor massacre' may be near*, https://www.cnbc.com/2020/02/11/ponzi-schemes-hit-the-highest-level-in-10-years.html (Feb 11, 2020).

5. SEC, Investment Scam Complaints on the Rise – Investor Alert, https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-alerts/investment-0 (December 14, 2020).

implement *more* unannounced inspections as residential and remote offices and virtual technology becomes more prevalent. Additionally, rules that require firms to review more than just a sampling of electronic correspondence would be needed to combat potential problem brokers.

The instant rule proposal states that the Commission will consider any request for an oral presentation pursuant to Rule 19b-4. If the Commission decides to hold a hearing and allow interested parties to present oral argument on the rule proposal, PIABA requests the opportunity to participate in that hearing and present its oral argument.

PIABA thanks the Commission and FINRA for the opportunity to comment on this proposal.

Very Truly Yours,

Hugh D. Berkson
President, Public Investors Advocate Bar Association

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The following Comment Letter regarding *Proposed Rule Change to Prohibit Registered Investment Advisers From Outsourcing Certain Services or Functions Without First Meeting Minimum Requirements* was submitted to the SEC by Michael Edmiston on September 29, 2022. (prepared with the assistance of Robert Girard and Amber Heinze)

Via Electronic Mail @ Rule-comments@sec.gov
Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F St. NE
Washington, DC 20549-1090

RE: SEC's Draft Strategic Plan 2022-2026

Dear Ms. Countryman:

I write on behalf of the Public Investors Advocate Bar Association ("PIABA"), an international, not-for-profit bar association comprised of attorneys who represent public investors in disputes with the securities industry. Since its formation in 1990, PIABA's mission has been to promote the interests of the investor by, among other things, protecting investors from securities industry misconduct and abuses in all securities and commodities arbitration forums, as well as advocating for public education related to investment fraud and industry misconduct. Our members and their clients have a fundamental interest in the SEC's oversight of the financial industry and the rules promulgated by the SEC that relate to investor protection and the practices of Registered Investment Advisers.

We appreciate the opportunity to comment on the SEC's Strategic Plan for Fiscal Years 2022-2026. In reviewing the Strategic Plan, we noted the SEC did not address the issue of dispute resolution for investors, particularly those involving Registered Investment Advisers ("RIAs"). Our members are seeing RIAs take advantage of the lack of oversight and impose oppressive pre-dispute arbitration clauses that prevent their clients from seeking redress. Since the SEC is tasked with protecting the investing public and overseeing more than 14,000 SEC-registered RIAs, the Strategic Plan should call for the SEC to make efforts to control RIAs' use of pre-dispute clauses and require, among other things, standardized pre-dispute clauses, shifting of the majority of arbitration fees to the RIAs using such clauses, increased transparency of the scope and implications of the dispute process, as well as the mandatory disclosure of information regarding a RIA's dispute history so the SEC and investing public may be better informed.

Over the past five years, there has been a mass migration of firms, investment professionals, customers, and assets from FINRA-registered broker-dealers to SEC- and state-registered RIAs. Following the lead of the brokerage industry, RIAs now regularly include forced pre-dispute arbitration clauses in their account agreements. Unlike brokerage firms that, pursuant to FINRA rules, must include FINRA Dispute

Resolution Services as an available forum, RIAs are not subject to any similar requirements. Often, RIAs designate private commercial dispute resolution forums in their arbitration clauses, such as the American Arbitration Association (AAA) or JAMS. These forums allow arbitrators to set their own billing rates and as a result, they charge investors massive arbitration forum fees, effectively prohibiting many investors from seeking redress due to cost. For small claims, the forum fees often exceed the amount at issue in the dispute. For example, it is not uncommon for a single arbitrator in JAMS[1] to charge $8,000 or more for a single day's work. The arbitrator's fees alone can exceed $64,000 for five days of hearings and three days of pre-hearing and post-hearing work, with a requirement all the fees be paid in advance of the hearing taking place. These exorbitant expenses, generally assessed equally between the disputants, are often far too much for investors who have already lost much of their savings. Moreover, and most troubling, the forum can refuse to proceed with the arbitration if the RIA fails to pay its share of the fees, and there is no regulatory mechanism to force the RIA to pay the fees or force the arbitration to go forward. By intentionally designating an expensive private dispute resolution provider in an arbitration agreement, RIAs shield themselves from many customer disputes and put their interests ahead of their customers: a clear breach of their fiduciary duty. Worse, there is no disclosure in the arbitration clauses about how much an arbitration claim may cost to pursue. A harsh economic reality is concealed behind the bland boilerplate used by RIAs. At a minimum, a true fiduciary would disclose the economic consequence of bringing an arbitration claim through an arbitration provider of the RIA's choice. Of course, a true fiduciary would not impose any forced arbitration obligation and would instead let its customer make their own choice of forum, whether court or arbitration.

Along with using expensive arbitration providers, our members are seeing RIAs use venue selection clauses to designate a hearing location that is far

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1. JAMS arbitrators set their own fees, and these fees are in addition to what the forum charges for its administrative fees. AAA arbitrators also set their own fees under the AAA Commercial Arbitration and Mediation Rules in addition to the AAA's administrative fees charged to disputants.

from an investor's residence to make arbitration inconvenient; use forbidden hedge clauses to make investors believe they do not have viable claims;[2] and use choice-of-law provisions to select the law most favorable to the RIA without regard to the customer's state of residence to make arbitration as one-sided as possible. In totality, RIAs are using these oppressive clauses to discourage claims from being filed.

Additionally, the forced arbitration agreements conceal fundamental information about the arbitration process for an investor to make an informed decision to pursue an arbitration claim. In order to assess the impact of an arbitration clause on an investor's ability to pursue a claim, one must know 1) the likely fees to prosecute the claim, 2) whether the arbitration provider will set the hearing location near the customer's place of residence despite a venue selection clause, 3) the SEC's express prohibition against using a hedge clause to limit a disputant's ability to assert claims or seek damages, and 4) state law prohibitions against the use of choice-of-law clauses denying investors the ability to seek redress under state securities laws. Further, based on the forum and rules selected, investors need to know up front about any limitations on the dispute resolution process such as limits to discovery and the length of a hearing. Despite being fiduciaries with a duty to disclose such information, RIAs are not disclosing *any* of this information in their arbitration clauses. Of course, the underlying issue remains that a true fiduciary should never use such one-sided terms in a customer agreement.

As a result of this misconduct, many RIAs have created an access to justice issue. They are denying clients with viable and compensable claims for RIA misconduct from seeking, much less obtaining redress. These ongoing abuses require regulatory intervention to protect the rights of investors.

There is a black hole of information about RIA arbitration claims which harms an investor's ability to learn about a RIA's history. No one, not even the SEC, knows the number of investor complaints and arbitration claims filed, the RIAs named in the claims, the outcome of each claim, and whether arbitration awards are being paid by RIAs. In fact, there is no securities regulator in the United States that knows how many arbitration claims have been filed in a given time period against RIAs in general, or individual RIAs in particular. This lack of public information makes it virtually impossible to

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2. The inclusion of hedge clauses in customer-RIA advisory agreements still continues despite *In re: Comprehensive Capital Management, Inc.*, Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Findings and Imposing Remedial Sanctions, and a Cease-and-Desist Order in Release No. 5943, Administrative Proceeding File No. 3-20700 (Jan. 11, 2022).

know how many investor complaints have been made against an RIA, whether the complaint resulted in an arbitration, and the outcome of the arbitration including whether any arbitration award has been paid. As a result, prospective investors looking for a trustworthy RIA are left in the dark as to whether an RIA is a repeat offender with a history of misconduct. The SEC is also left in the dark as to how its regulated entities are handling customer disputes and the types of issues the investing public is facing in this burgeoning area. The informational black hole will continue to exist as long as the SEC gives RIA's the discretion whether to disclose the existence of an arbitration claim on its Form ADV. Mandatory disclosure is a solution to this problem.

Currently, FINRA's Dispute Resolution arbitration program is the only securities industry-sponsored forum. FINRA rules mandate that FINRA-registered firms use the forum if requested by the investor, regardless of other forum selection language in an investor account agreement. FINRA rules also provide certain protections and prohibitions regarding dispute resolution, including the mandate that member firms must provide clear, prominent disclosures about the presence and terms of the arbitration clause.[3] FINRA, through the CRD, also tracks the number of investor complaints, whether the complaint was brought to arbitration and whether the arbitration resulted in an award, vital information for an investor who is considering engaging a member firm to manage their hard-earned savings. Further, FINRA member firms subsidize the bulk of FINRA arbitration forum fees, and while additional forum fees may be assessed against the investor at the end of a FINRA hearing, investors can proceed with their FINRA arbitration claim by paying only the initial filing fee, ranging between \$50 to \$2,300: sums that are significantly less than the fees charged by private forums. The Director of FINRA Dispute Resolution may also waive the initial filing fee for investors. Even if the FINRA member firm or associated person does not timely pay their share of forum fees, FINRA allows the case to proceed. This is a significant difference from private arbitration forums. By comparison to what RIAs are imposing through forced arbitration clauses, FINRA's rules and regulations relating to the arbitration of customer disputes with broker-dealers provide a more accessible forum with superior investor protections. While PIABA does not believe forcing customers into arbitration for securities disputes is ever appropriate, at a minimum, there needs to be sufficient protections at the levels FINRA provides in its arbitration forum so investors with RIAs are not doubly abused.

3. FINRA reminded its members about its prohibitions related to hedge clauses, choice-of-law clauses and hearing location clauses in FINRA RN 21-16 (Apr. 21, 2021).

The SEC can and should increase its oversight of RIAs to include standardization of transparent pre-dispute clauses to ensure all investors have access to justice, shift the majority of costs of arbitration to the RIAs using forced arbitration clauses, and commence gathering information related to a RIA's dispute resolution practices and disclosures so securities regulators and the investing public may be better informed.

PIABA appreciates the opportunity to submit these comments and urges the SEC to consider addressing RIAs' pre-dispute resolution usage as detailed above as part of its Strategic Plan for Fiscal Years 2022-2026.

Respectfully submitted,

Michael S. Edmiston
PIABA President

Notes & Observations