PIABA BAR JOURNAL

VOLUME 30, NO. 2 • 2023

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a publication of

Public Investors Advocate Bar Association

// PIABA Bar Journal

Volume 30 | 2023 | No. 2

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THE NEW EXPUNGEMENT RULES

David E. Robbins[1]

On April 12, 2023, the Securities and Exchange Commission ("SEC") approved FINRA's major "modification" to "the current process relating to the expungement of customer dispute information."[2] This article explains what the SEC approved, the implications for financial advisers seeking such "extraordinary relief"[3] and recommendations for participation by customers and their attorneys in the process. The new rules will have an impact on brokers' publicly available Central Registration Depository (CRD) records. Throughout this article, references will be made to specific statements in FINRA's rule filings with the SEC, its training of arbitrators for these cases and the SEC's approval Release. FINRA has not yet established an effective date for the new rules, but it is anticipated that they will soon become effective in a Regulatory Notice.

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1. © 2023 David E. Robbins. of Kaufmann Gildin & Robbins LLP, is a founding member of PIABA and is the recipient of PIABA's James Beckley Golden Bowtie Award. This is his 15th Law Journal article. He represents investors, brokers and firms. He is on the Board of Editors of the *PIABA Bar Journal* and of *Securities Arbitration Alert* and is the author of the Securities Arbitration Procedure Manual (5th ed. 2022) and The New York Practitioners Guide to Securities Arbitration and Mediation, Supp. Prac. Comm., N.Y. Gen. Bus. Law Ch. 20, Art. 23-A (McKinney 2023). Mr. Robbins thanks his friend and fellow *Bar Journal* board member John Sutherland for editing this work, especially his suggestion of adding a table of contents.

2. FINRA's April 3, 2023 Rule Filing With the SEC, *available at* https://www.finra.org/sites/default/files/2023-04/sr-finra-2022-024-partial-amendment-2.pdf; FINRA's April 3, 2023 Comment Letter to the SEC ["April 3, 2023 Letter"], *available at* https://www.sec.gov/comments/sr-finra-2022-024/srfinra2022024-20163319-333785.pdf; and SEC's April 12, 2023 Approval of Rule Changes ["SEC Approval"], *available at* https://www.sec.gov/rules/sro/finra/2023/34-97294.pdf. *See also* FINRA's 2022 Discussion Paper on Expungement [Discussion Paper], *available at* https://www.finra.org/sites/default/files/2022-04/Expungement_Discussion_Paper.pdf.

3. *See* April 3, 2023 Letter at 3, *supra* note 2 ("FINRA is concerned that the current expungement process is not working as intended as a remedy that is appropriate only in extraordinary circumstances in accordance with the narrow standards in FINRA rules.").

What is in this Article?

Since many subjects are covered in this article, a table of contents of sorts is called for:

I. Overview – The five major distinctions between the process for the new expungement arbitration rules and other customer-related FINRA arbitrations.

II. The Applicable FINRA Rules – The Customer Code and the Industry Code.

III. The Three Expungement Grounds

- A. The claim, allegation or information is factually impossible or clearly erroneous.
- B. The registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation or conversion of funds.
- C. The claim, allegation or information is false.

IV. Balancing Competing Interests – Securities regulators, investors, broker-dealers and the brokerage community.

V. How Expungement Requests Began

VI. Who Decides Expungement Cases?

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I. Overview – Major Distinctions

There are at least five major distinctions between the process for the new expungement arbitration rules and other customer-related FINRA arbitrations:

1. *Rules of Repose* – The inapplicability of the six-year arbitrability rule to expungement requests.
2. *Agency Selection* – The elimination of party selection of arbitrators for "straight-in" expungement requests.
3. *Unanimous Vote* – The requirement of a unanimous decision to grant such relief, instead of awards by majority vote.
4. *Forfeiture* – The distinct possibility of the forfeiture of an adviser's right to expungement.
5. *State Regulators* – The participation by an authorized state securities regulator in "straight-in" expungement arbitrations.

II. The Applicable FINRA Rules: The Customer Code and the Industry Code

In its April 2023 approval of the new expungement rules, the SEC made this distinction between the two arbitration codes:

- "The Customer Code, which comprises the series of rules governing customer arbitrations, governs expungement requests filed by firms or associated persons during customer arbitrations."
- "In contrast, the Industry Code comprises the series of rules governing arbitrations for disputes between or among industry parties, such as between a broker-dealer and an associated person, including straight-in [expungement] requests."

- "As a result, whether an expungement request is governed by the Customer Code or Industry Code will generally depend on whether the request is filed during a customer arbitration or is a straight-in request filed by the individual broker against the firm separately from a customer arbitration."[4]

III. The Three Expungement Grounds

Shifting Burden of Proof - While the burden of a customer is to prove to a *majority* of the arbitration panel that actionable misconduct directly gave rise to quantifiable financial damages (based on a preponderance of the evidence), for an expungement to be granted, the burden is on the financial adviser to prove a negative to a *unanimous* panel – that one of three grounds exists (and is supported by the preponderance of the evidence).

In FINRA's website *Frequently Asked Questions About FINRA Rule 2080 (Expungement)*[5] and in the training of its arbitrators, the following examples are given for the three grounds:

A. The claim, allegation or information is factually impossible or clearly erroneous.

   1. The training material states: "The 'factually impossible or clearly erroneous' standard has clear meaning to regulators and public investors. For example, if the evidence shows that the broker was not even employed by the securities firm during the relevant time period, the arbitrators could find that they were erroneously named in the arbitration claim, dismiss the claim against the individual and

---

4. *See* SEC Approval at 3-4, *supra* note 2. *See also* FINRA, Rule 12805 (setting forth in the Customer Code the requirements arbitrators must meet to issue an expungement Award containing expungement of customer dispute information); FINRA, Rule 13805 (providing "Straight-In Request" requirements in the Industry Code); FINRA, Rule 12800(d) (handling of expungement requests in "simplified customer arbitrations"); FINRA, Rule 2080 ("Obtaining an Order of Expungement of Customer Dispute Information from the Central Registration Depository (CRD) System").

5. *See Frequently Asked Questions About FINRA Rule 2080 (Expungement), available at* https://www.finra.org/registration-exams-ce/classic-crd/faq/finra-rule-2080-frequently-asked-questions.

recommend expungement of any mention of the claim from the CRD record under this standard."

2. The online training module adds: "An example would be if a broker was not employed at the time of issue and was therefore erroneously named."

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

1. The training material provides: "The above standard would require an affirmative arbitral or judicial finding that the broker was not involved in any of the activities listed above. This list of activities is taken from Question 14 of Form U-4, which specifies the types of customer complaints that registered persons must report. Therefore, if arbitrators make the required finding, no logical basis would exist for keeping the reported claim on an individual's CRD record."
2. The online module states: "These are Form U-4 Reportable Complaints – investment related sales practice violation, forgery, theft, misappropriate or conversion of funds."[6]

C. The claim, allegation or information is false.

1. Here, arbitrators will: (a) assess the evidence in the case, (b) make an affirmative finding that the claim. allegation or information is false and (c) if warranted, order expungement relief. This is the ground customer attorneys should have the greatest trouble with since it contradicts the allegations in most Statements of Claim.
2. The training material states: "This basis for expungement is premised on a finding that the claim, allegation or information given was false. Arbitrators should make such a finding only after considering the merits of the allegations against the broker or securities firm. For example, if the customer alleged that the broker made unauthorized trades and the broker provided evidence contrary to this claim, such as a document signed by the

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6. *See* FINRA, Form U-4, *available at* https://www.finra.org/sites/default/files/form-u4.pdf.

customer directing the trades, arbitrators could find that the claim or allegation was false."

3. The online module adds: "Consider the merits of the allegations and evidence contracting the claim."

IV. Balancing Competing Interests

In its SEC filing and in the Federal Register Notice,[7] FINRA stated that the expungement rules seek to balance the interests of:

1. *Securities regulators* in having accurate and relevant information to fulfill their regulatory responsibilities, what FINRA refers to throughout its filing as "maintaining the integrity of information in the CRD system;"
2. The interests of *investors* in having access to accurate and meaningful information about associated persons with whom they may entrust their money;
3. The interests of *broker-dealers* in having accurate information for use in making informed employment decisions; and,
4. The interests of the *brokerage community* in having a fair process to address inaccurate customer dispute information.

V. How Expungement Requests Began

The process of seeking expungement through FINRA began when brokers who were not found liable in a customer arbitration asked arbitration panels to expunge the underlying customer dispute from the CRD system.

Separate and apart from customer arbitrations, so-called "straight-in requests" were found by FINRA, as stated in its Initial SEC Filing, to "present inherent difficulties and panels deciding straight-in requests issue awards containing expungement relief more often than panels deciding expungement requests made in customer arbitrations."

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7. *See supra*, n.2.

VI. Who Decides Expungement Cases?

A. What is the composition of the panels?

1. *Special Arbitrator Roster* – For all straight-in expungement requests, FINRA will select three arbitrators from the Special Arbitrator Roster, but the parties will not be able to strike and rank a longer list, as they do for all other FINRA arbitrations.
2. *Regular Panels* – For pending customer arbitrations, the typical customer arbitration panel will decide the expungement request unless the case settles or is withdrawn prior to the issuance of an award. If the case settles, three arbitrators from the Special Arbitrator Roster will decide the expungement request in a new, straight-in arbitration (except for Simplified Arbitrations).

B. Why can't parties select arbitrators for Straight-in Expungement cases?

"To minimize the potential for influence in the arbitrator selection process by the associated person and member firm, whose interests may be aligned, and to help ensure the development of a more complete factual record," wrote FINRA in its Initial SEC Filing, "the … rule change …. requires a NLSS to select randomly the three public chairpersons from the Special Arbitrator Roster."

"FINRA believes that the higher standards that the arbitrators must meet to serve on the Special Arbitrator Roster should mitigate the impact of the absence of party input on the selection of arbitrators. In addition. associated persons and member firms would still be permitted to challenge any arbitrator for cause."

C. Who will be on the Special Arbitrator Roster?

Public arbitrators (a) who are eligible for the chairperson roster, (b) who have successfully completed enhanced expungement training and (c) who have served as an arbitrator through award on at least four customer arbitrations in which a hearing was held.

D. What does Training Consist of?

"The public chairpersons must have evidenced successful completion of, and agreement with enhanced expungement training provided by FINRA, which will be expanded for arbitrators seeking to qualify for the Special Arbitrator Roster," wrote FINRA in its Initial SEC Filing.

FINRA added: "This would allow FINRA to further emphasize with the arbitrators on the Special Arbitrator Roster the unique, distinct role they play in determining whether to issue an award containing expungement relief and that expungement should be issued in limited circumstances and only if the arbitrators unanimously find that the information to be expunged is factually impossible, clearly erroneous or false, or that the associated person was not involved in the alleged misconduct."

VII. New Procedural Hoops

A. Request or Forfeit

In a customer arbitration in which the financial adviser is a named Respondent, the request to expunge must be contained either in the Answer (filed on the Portal within 45 days upon receiving the Statement of Claim) or by separate pleading (to be submitted on the Portal no later than 60 days before the first scheduled hearing).

Warning: Failing to do this *will* result in an adviser's forfeiture of an expungement request.

B. On-Behalf of Requests

If the person is not a named Respondent in the customer arbitration and if a party (e.g., brokerage firm) wishes to have that panel decide the expungement request, the so-called "unnamed person" (the financial adviser) must sign a FINRA Dispute Resolution Services submission form agreeing to be part of the arbitration, along with the requesting party. This "on-behalf of" request must be filed no later than 60 days before the first scheduled hearing.

C. Caveat

An "unnamed person" (the financial adviser who is not a Respondent) is not required to take part in the customer arbitration for expungement purposes and may, instead. file a separate, straight-in case before a Special Arbitrator Roster. In this instance, the "unnamed person" – unlike a "named person" – would not forfeit his/her right to seek expungement.

D. Six Things That Must Be Contained In All Expungement Requests

1. The applicable filing fee under the Codes.
2. The CRD number of the party requesting expungement.
3. Each CRD "Occurrence" number that is the subject of the request (and which appears on the adviser's FINRA Financial Professional Gateway (FinPro) report,[8] not found on the Broker Check Report.)[9]
4. The case name and docket number associated with the customer dispute information.
5. An explanation whether expungement of the same customer dispute information was previously requested and, if so, how it was decided.
6. Which of the three grounds for expungement apply and why.

E. The Seven Situations that will bar filing Straight-In Expungement Requests

1. Prior Arbitration*:* A panel held a hearing to consider the merits of the associated person's request for expungement of the same customer dispute information.
2. Res Judicata: A court of competent jurisdiction previously denied the associated person's request to expunge the same customer dispute information.
3. Pending Action*:* The customer arbitration, civil litigation or customer complaint associated with the customer dispute

8. *See* Financial Professional Gateway (FinPro), *available at* https://www.finra.org/registration-exams-ce/finpro.

9. *See* FINRA, BrokerCheck, *available at* https://brokercheck.finra.org/.

information is not closed.

4. 2 Year Rule of Repose for Actions*:* More than two years have elapsed since the customer arbitration or civil litigation associated with the customer dispute information has closed.
5. 3 Year Rule of Repose for Complaints*:* There was no customer arbitration or civil litigation associated with the customer dispute information and more than three years have elapsed since the date the customer complaint was initially reported to the CRD system.
6. Forfeiture*:* A named person is prohibited from seeking expungement because he/she did not request expungement in the customer arbitration pursuant to Rule 12805(a)(l)(A).
7. Regulatory Action – In its April 2023 amendment to the Initial Filing with the SEC, FINRA added this seventh restriction: "An associated person shall not file a claim requesting expungement of customer dispute information from the CRD system against a member firm at which the person was associated at the time the customer dispute arose if the customer dispute information involves the same conduct that is the basis of a final regulatory action taken by a securities regulator or self-regulatory organization." [10]

F. An Ironic Twist to a Time Restriction

Claimants can bring a FINRA arbitration as long as the arbitrators find that the six-year rule of arbitration eligibility has been complied with – as provided in Rules 12206 and 13206.

But not straight-in expungement Claimants; they are bound by either the two-year or three-year rules of repose.

What happens if the financial adviser brings a successful straight-in expungement case and prevails? Does that prevent the customer from thereafter bringing a case?

No, according to FINRA's Initial SEC Filing: "As a result of this six-year eligibility rule, a customer arbitration may be filed after an associated person

10. However, if the person is successful at appealing a final regulatory action, he/she may file a claim requesting expungement involving the same conduct that is the basis of the final regulatory action, provided that the request is not otherwise ineligible for arbitration, including time barred. *See* April 3, 2023 Letter at 23, *supra* note 2.

has filed and received an award in connection with a customer complaint associated with the customer arbitration."

"To avoid unfairly impacting a customer arbitration filed after a panel has issued an award on a request to expunge a customer complaint associated with the customer arbitration, the … rule change provides that a prior expungement award shall not be admissible in the customer arbitration."

VIII. Making Sure Financial Advisers Know of Arbitrations and Complaints

In FINRA's April 3, 2023 follow-up letter to the SEC ("Letter"), it recognized the possibility that financial advisers may not be aware of: (a) customer complaints and/or (b) that a customer arbitration closed in which they were not a named Respondent. This is important because under the new rules, advisers have only two years to file an expungement request from the closure of an arbitration and three years from the brokerage firm's receipt of a customer's complaint. FINRA deals with these possibilities as follows:

A. Notifying Financial Advisers About the Arbitration's Close

- "There could be instances when associated persons may not be aware that a customer arbitration has closed, and that the two-year time limit for requesting expungement of customer dispute information has begun to run."
- "Accordingly, … FINRA will update the cover letter that is provided by Dispute Resolution Services (DRS) to Respondents once a Statement of Claim has been filed ("cover letter") to explain that:
  - (a) an associated person is prohibited from filing a straight-in request while a customer arbitration or civil litigation associated with the customer dispute information that is the subject of the straight-in request is pending; an associated person is permitted to file a straight-in request within two years of the close of a customer arbitration or a civil litigation associated with the customer dispute information, unless such request is barred under the Industry Code; and,
  - (b) associated persons may remain apprised of the status of the customer arbitration, including case closure, by contacting the parties to the arbitration or DRS."

- "FINRA will publish guidance on its website about the changes to the Codes that will include information about how associated persons can remain apprised of the status of a customer arbitration, including through contacting DRS."[11]

B. Customer Complaints – No Notification Required

- "As a result of the three-year time limitation, an associated person may be prevented from filing a request for expungement of customer dispute information because the member firm's investigation of the customer complaint has not concluded and, therefore, the customer complaint associated with the customer dispute information has not closed."
- "FINRA believes that the three-year time limitation would generally provide sufficient time for firms to complete their investigation of the complaint, and for associated persons to develop a sense of whether the complaint may evolve into an arbitration or civil litigation and to gather the necessary resources and determine whether to request expungement."
- "In the event that an associated person is prevented from filing a request for expungement of customer dispute information in the DRS arbitration forum because of the three-year time limitation, the associated person could seek a court order directing expungement of the customer dispute information."[12]

IX. Third-Party Participants – Customers and Regulators (Since Customers Rarely Appear)

Customers have always been encouraged to participate in expungement hearings, but few do – especially after they settle. The new rules: (a) make it easier for customers to play an important role in the expungement process and (b) provide for a new person to attend, whether customers appear or not. For the first time in FINRA's arbitration history. a non-party (an "authorized representative of state securities regulators") may take an active role at straight-in hearings.

A. Customer Participation

11. *See* April 3, 2023 Letter at 9-10, *supra* note 2.

12. *Id.* at 10-11.

- *Notification to Customers:* The new rule requires the financial adviser and the Director to notify all customers whose customer arbitrations, civil litigations or customer complaints are a subject of the expungement request, of: (a) the time, (b) date and (c) place of any prehearing conferences and the expungement hearing. (It is hoped that the Director will also notify their counsel-of-record.)
- *No Compulsion* – "FINRA does not believe customers should be compelled to attend or participate in a separate proceeding to decide an expungement request after the customer has resolved [his/her] arbitration claim or civil litigation."[13]
- *The Breadth of Customer Participation* – In its Initial Filing with the SEC, FINRA stated that, at the hearing, arbitrators should allow customers and their representatives to appear, customers to testify (telephonically, in person, or other method), to introduce documents and evidence, to cross-examine the associated person or other witnesses called by the party seeking expungement and to make opening and closing statements.
- *No Intervening in Customer Arbitrations to Request Expungement*

Neither FINRA nor the SEC favor the ability of a financial adviser to intervene in a pending customer arbitration in which that adviser is not a Respondent and expungement is not sought:

- *FINRA*– "If the associated person is neither a party to the arbitration nor the subject of an on-behalf-of request by another party to the arbitration, FINRA continues to believe that the associated person should not be able to intervene in the customer's arbitration to request expungement."[14]
- *SEC* – "The rule change provides 'that if an associated person is not a party to a customer arbitration (i.e., they are an unnamed person), and no party to the customer arbitration requests expungement on their behalf, the unnamed person would be prohibited from intervening in the customer arbitration to request expungement.' Instead, the unnamed person would be able to file the request as a new claim against the member firm at which the person was associated at the time the customer dispute arose under … Rule 13805 [of] the Industry Code, and a panel from the

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13. *See* April 3, 2023 Letter at 6, *supra* note 2.

14. *Id.* at 8.

Special Arbitrator Roster would decide the request."[15]

B. Securities Regulator Participation

1. *The Extent of the Regulators' Participation*

According to FINRA's Initial SEC Filing, "The authorized representative will be permitted to:

a. Introduce documentary, testimonial or other evidence;
b. Cross-examine witnesses; and,
c. Present opening and closing arguments if the panel allows any party to present such arguments.

The other persons appearing at the expungement hearing can state objections to the authorized representative's evidence and cross-examine the authorized representative's witnesses."

Here is what the SEC has to say about the involvement of state regulators in expungement proceedings:

a. *Certain Cases* – "The rule change would limit attendance and participation by an authorized representative to straight-in requests."[16]
b. *Time Limit* – "If the Director receives notification from an authorized representative no later than 30 days after the last answer is due that the authorized representative intends to attend and participate in the expungement hearing, the … rule change … requires the Director to notify the authorized representative of the time, date and place of any prehearing conferences and the expungement hearing."[17]
c. *Low-Cost Options* – "FINRA acknowledged that in-person attendance and participation by an authorized state representative may be limited given state resource constraints. FINRA pointed out that the … rule change provides low-cost options to help facilitate state participation; specifically, that it would permit the authorized representative to attend and participate via video conference or submit a state's position in writing."[18 -]
d. *Why the SEC Endorsed Regulator Participation*

15. *See* SEC Approval at 19, *supra* note 2.

16. *See* SEC Approval at 46, *supra* note 2.

17. *Id.*

18. *Id.* at 91.

1. "The Commission believes that permitting attendance and participation by state securities regulators in straight-in expungement proceedings, which have a higher likelihood of proceeding unopposed, and providing state regulators low-cost options to do so, will enhance the straight-in expungement process."[19]
2. "[I]ncluding state securities regulators and providing them with access to documents relevant to the expungement request provides them the opportunity to fulfill their own regulatory obligations, while at the same time increasing the likelihood that the panel in an expungement proceeding will hear evidence from multiple viewpoints, thus allowing the panel to make more informed decisions."[20]

e. *Why FINRA is Permitting Regulator Participation*

1. While FINRA and the SEC expanded on this issue in subsequent filings, in its Initial Filing, FINRA gave these reasons: "[A]llowing an authorized representative to attend and participate in straight-in requests may provide meaningful opposition to the expungement request, which might otherwise be unopposed, and thus help create a more complete factual record for the panel to rely upon to decide the expungement request."[21]
2. Further, stated FINRA: "NASAA and state securities regulators have a shared interest with FINRA in protecting the integrity of the information contained in the CRD system, as it is a crucial tool in their registration and oversight responsibilities."[22]

Regulator participation will also have a chilling effect on financial advisers who are considering seeking expungement relief.

Notifications to State Securities Regulators: According to the SEC's approval Release, FINRA will be required "to notify state securities regulators, in the manner determined by the Director in collaboration with state securities regulators, of an expungement request within 15 days of receiving an expungement request. FINRA stated that the notification requirement would help ensure that state securities regulators are timely notified of expungement

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19. *Id.* at 92.

20. *Id.*

21. *Id.* at 47.

22. *Id.* at 47 n.197.

requests."[23] Notification to state regulators by the Director would help – in FINRA's opinion – to ensure that they are timely notified of expungement requests.

X. The Critical Role of Customers in Expungements

In 2016, the *PIABA Bar Journal* published my article, "Challenging Expungements After Settlements."[24] It expressed the importance for customers and their counsel to participate in the expungement process. The cornerstone of that 2016 article is as relevant now as it was then: customers and their counsel can and should play a critical role in expungement proceedings.

A. Overview

Once a case has been settled on financial terms, should a broker secure expungement relief of that case without any input from the individual who had, according to the Statement of Claim, been the victim of the broker's misconduct? Should customers challenge brokers' efforts to expunge settled arbitrations? These are questions central to the integrity of FINRA's securities arbitration process.

At the October 2016 PIABA annual conference in San Diego, a panel dealt with the question of whether customer attorneys should challenge requests by brokers to expunge a settled arbitration. A number of PIABA members expressed reluctance to participate in expungement hearings to challenge expungement requests once a case was settled because, they said, their contingency retention compensation arrangements did not encompass such services after settlement. In other words, they would not receive any additional compensation for preparation or participation in an expungement hearing.

In the 2016 *PIABA Bar Journal* article, four situations were presented where a customer's attorney should consider participating in an expungement hearing after reaching a settlement, despite the fact that the customer's attendance is not mandatory under the Customer Code of Arbitration. The article suggested that the purpose of such participation is twofold:

1. To recover losses suffered by the clients.

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23. *Id.* at 45.

24. David E. Robbins, *Challenging Expungements After Settlements*, 23 PIABA B.J. 387 (2016).

2. To discourage the recurrence of the misconduct.

Deterrence is often achieved with a significant arbitration award. Should customers settle (and most do), rendering a prospective award moot, FINRA provides customers with an opportunity to discourage similar alleged misconduct against other customers. Instead of "taking the money and running," more customers should, in appropriate circumstances, show up and be heard at expungement hearings. FINRA encourages them to do so and if customers participate in such hearings, fewer expungement requests will be granted.

B. Recommendations

Premise – Your client settled the arbitration prior to the hearing and executed a settlement agreement. You deposited the settlement check into your firm's Special Account, paid the client, took your fee and moved on to the next case. Then your client receives notice from the broker and his/her brokerage firm that the broker has filed a straight-in arbitration seeking expungement relief.

Question – Should your client testify at the hearing, with or without you as counsel, recognizing that the settlement agreement will be entered into evidence and the client will be subject to questions from the broker's attorney and from the arbitrators?

Answers -

1. Broker as Respondent – Intentional Misconduct

If you named the broker as a Respondent and believe you could have met the burden of proof that intentional sales practice abuses directly resulted in your client's losses (even though now satisfied through settlement), the client should testify if the client believes the case should remain on the broker's Broker Check Report, so that other customers and potential customers will have proper warning.

2. Broker as Respondent – Unintentional Misconduct

If you named the broker as a Respondent but believe the broker's misconduct was based on negligence and the brokerage firm's failure to properly train and supervise him/her, there may be a question whether your

client would have met his/her burden of proof at the arbitration hearing. If your client wants other customers and potential customers of the broker to make similar complaints and/or move their accounts away from the broker – even if the broker's conduct was based on negligence – the client should testify because the allegations were not, in his/her opinion, false.

3. Product Cases

If you named the broker as a Respondent in a "product case" (which may have been a tactical and procedural mistake on your part) and believe the broker's misrepresentations were based on the firm's misconduct (e.g., failing to disclose to its brokers the inherent risks of the product or strategy and encouraging its brokers to nevertheless solicit the product/strategy to as many clients as possible), serious thought should be given to participating in the hearing *but* joining the broker in the expungement request. This was done as a matter of routine – with clients' authorization – in auction rate securities cases, even when the broker was not named as a Respondent (because the case was on the broker's Broker Check Report).

4. Broker Not Named as a Respondent

If you did not name the broker as a Respondent but the firm still (as is required) amended the broker's U-4 and therefore the Broker Check Report, you may want to take a pass at participating in the hearing. If you did not believe the conduct justified naming the broker as a Respondent, it may be considered hypocritical of you to now insist on the case remaining on the broker's record after your client agreed to settle the arbitration with the brokerage firm and possibly other brokers who were named as Respondents.

XI. The Unanimous Award and What Happens Next

The granting of an expungement request must now be by the unanimous vote of the arbitrators, although that is not the case for other FINRA arbitrations or FINRA disciplinary proceedings. Why is that so?

- *Other Cases* – FINRA awards are decided by majority vote in accordance with Customer Code Rule 12904 and Industry Code Rule 13904, as are all FINRA disciplinary decisions pursuant to Rule 9268. Until the new FINRA rules, that was the rule for all expungement

requests.

- *Outlier* – Now, however, arbitrators may not grant expungement requests by majority vote; the award must be unanimous. Nor can the granting of expungement request just cite one or more of the grounds for expungement; more is required.
- *How Come?* According to its Initial SEC Filing, "FINRA believes that this change would help protect the integrity of the information in the CRD system and help ensure that the expungement process operates as intended-as a remedy that is appropriate only in limited circumstances in accordance with the narrow standards in FINRA rules."

In addition, said FINRA: "The panel's explanation must be complete and not solely a recitation of one of the FINRA Rule 2080(b)(1) grounds or language provided in the expungement request. The panel's explanation should identify any specific documentary, testimonial or other evidence on which the panel relied in awarding expungement relief."

The SEC Speaks on Expungement Awards – The SEC added this justification for approving the unanimous vote rule: "Requiring a unanimous decision will help enhance the integrity of the information in the CRD system by helping ensure expungement will only be awarded when there is no disagreement among the arbitrators that the factual record supports it. The importance of the CRD system extends to all aspects of regulation of broker-dealers and registered representatives. … For these reasons, the importance of the integrity of information in the CRD system militates against awarding expungement in circumstances where there may be disagreement about the merits of a claim."[25]

The Ironic Expungement Award – While the goal of the broker is to get the arbitration and/or complaint removed permanently from the broker's public record, even if the broker is successful, the award itself remains publicly accessible on FINRA's online website.

After the Request is Granted –

1. In its April 2022 *Discussion Paper on Expungement,* FINRA dealt with the expungement process *after* a favorable award is rendered. "FINRA will not expunge customer dispute information from the CRD system based on an arbitration award unless that award is confirmed by a court of competent jurisdiction."[26]
2. Before seeking the award's confirmation in a court of law as a judgement, FINRA should be requested by the financial adviser to

25. *See* SEC Approval at 126-127, *supra* note 2.

26. *See* Discussion Paper at 4, *supra* note 2.

waive participation in the court proceeding.

3. Effective March 16, 2023, FINRA no longer accepts Rule 2080 waiver requests via email. All waiver requests and supporting documentation must be submitted via an online form that can be accessed through the Rule 2080 FAQ page.[27] Refer to the FAQs, specifically Question 7, for more information and tips on submission and for logging into the new system.

XII. Expungement Requests During Simplified Customer Arbitration

Customer arbitrations involving $50,000 or less – called simplified arbitrations – are governed by FINRA Rule 12800. The first thing one needs to know is that such customer-Claimants can request that a single arbitrator decide the case one of three ways:

1. Without a hearing (referred to as "on the papers"), where the arbitrator decides the case on the pleadings or other materials;
2. In an "Option One" full hearing. in which prehearings and hearings on the merits take place in accordance with the regular provisions of the Code; or,
3. In an "Option Two" special proceeding, where the parties present their case in a hearing to the arbitrator in a compressed timeframe, so that hearings last no longer than one day.

An associated person named as a Respondent in a simplified arbitration could, during the arbitration, make a request for the right to bring a separate straight-in arbitration before an arbitration panel from the Special Arbitrator Roster.

If named associated persons in a simplified case request expungement, they will be required to file the request in an answer or in a separate pleading requesting expungement (within 30 days after FINRA notifies the parties of the arbitrator's appointment). The request must include the same information as a request filed in a non-simplified arbitration.

As with "on-behalf-of requests" filed in customer arbitrations under Rule 12805(a)(2), the unnamed person who would benefit from the expungement request must consent to such filing by signing the same FINRA form. And to limit arbitrator shopping, the arbitrator would be required to decide an on-behalf-of request once it is filed by the requesting party.

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27. *See Frequently Asked Questions About FINRA Rule 2080 (Expungement), available at* https://www.finra.org/registration-exams-ce/classic-crd/faq/finra-rule-2080-frequently-asked-questions.

If expungement is not requested during the simplified arbitration under Rule 12800(d), the associated person would still be able to file a straight-in request under Rule 13805 and have the request decided by a three-person panel randomly selected from the Special Arbitrator Roster.

If a named associated person or party on-behalf-of an unnamed person requests expungement during a simplified arbitration, the arbitrator would be required to decide the expungement request regardless of how the simplified arbitration closes (e.g., even if the arbitration settles). If the customer chooses not to have a hearing (a paper case) or chooses an Option Two special proceeding, the arbitrator would decide the customer's dispute first and issue an award. After the customer's dispute is decided, the arbitrator must hold a separate expungement-only hearing to consider and decide the expungement request and issue a separate, subsequent award.

If the customer in a simplified case chooses to have a full "Option One" hearing on his/her claim and the hearing closes by award. the arbitrator is required to consider and decide the expungement request during the customer arbitration and include the decision on the expungement request in the same award as the decision on the customer arbitration. If, however, the customer arbitration closes other than by award or by award without a hearing (e.g., settles or is withdrawn). the arbitrator would be required to hold a separate expungement-only hearing to consider and decide the expungement request and issue a separate award containing the decision on the expungement request. This is a distinction from Special Arbitrator Roster straight-in cases.

Who are the arbitrators for simplified arbitrations in which expungements are requested? FINRA stated in its Initial Filing with the SEC that it "does not believe that it is necessary for a panel from the Special Arbitrator Roster to decide an expungement request if a simplified customer arbitration is decided on the papers, in an Option Two special proceeding or if the simplified customer arbitration closes other than by award or by award without a hearing."

XIII. An Intriguing Coda – Things to Come?

The SEC's approval of these new rules will not end FINRA's desire to continue to adapt the process to what it may see as problematic developments. In the conclusion of FINRA's April 3, 2023 letter to the SEC, it made this intriguing statement:

> "FINRA will continue to evaluate whether there are other ways to further strengthen the current expungement process, including:
>
> a) Whether a panel from the Special Arbitrator Roster should be

required to decide an expungement request in simplified arbitrations;

b) Whether to allow state securities regulators to attend and participate in separate expungement-only hearings in simplified arbitrations; and,

c) Whether to require that a panel find that the evidence presented in support of an expungement request meets a clear and convincing standard of proof in order to issue an award containing expungement relief."[28]

XIV. Conclusion - Why the SEC Approved the New Rules

In FINRA's April 3, 2023 follow-up letter to the SEC proposing minor amendments to the expungement rules, it wrote that "PIABA and PIABA Foundation stated their support for the Proposal and recommended that the SEC approve the Proposal. NASAA generally supported the Proposal, but also suggested one modification [that was thereafter contained in the amended filing]."[29]

And in its approval of these important procedural changes to the expungement process, the SEC stated it best:

- "After careful review of the proposed rule change, the comment letters, and FINRA's responses to the comments, the Commission finds that the proposed rule change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder that are applicable to a national securities association."[30]
- "The Commission finds good cause to approve the proposed rule change."[31]

While it has been said that FINRA Dispute Resolution Services would prefer not to be involved in "the expungement business," with these new rules it has nevertheless done so in a carefully considered, clearly articulated and balanced manner.

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28. *See* April 3, 2023 Letter at 18-19, *supra* note 2.

29. *Id*.

30. *See* SEC Approval at 55, *supra* note 2.

31. *Id.* at 156.

DOCUMENT DISCOVERY IN RIA CASES

Michael S. Edmiston,[1] *Timothy J. O'Connor,*[2] *and Jeffery Schaff*[3]

I. INTRODUCTION

Where have all the arbitrations gone? From 2018 through 2022, the number of FINRA Dispute Resolution arbitration cases trended downward for customer claims.

FINRA Dispute Resolution Arbitration Case Filings by Year 2017-2022

Year	Total Cases Filed	Customer Cases Filed
2022[4]	2,671	1,693
2021[5]	2,893	1,895
2020[6]	3,902	2,081
2019[7]	3,757	2,363
2018[8]	4,325	2,713
2017[9]	3,456	2,260

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2. Timothy J. O'Connor is an attorney in private practice in Albany, NY and is also licensed to practice in Florida.

3. Jeffery Schaff is a principal of Ardor Fiduciary Services and expert witness.

4. *2022 Dispute Resolution Statistics*, FINRA, https://www.finra.org/arbitration-mediation/dispute-resolution-statistics/2022 (last visited June 13, 2023).

5. *2021 Dispute Resolution Statistics*, FINRA, https://www.finra.org/arbitration-mediation/dispute-resolution-statistics/2021 (last visited June 13, 2023).

6. *2020 Dispute Resolution Statistics*, FINRA, https://www.finra.org/arbitration-mediation/dispute-resolution-statistics/2020 (last visited June 13, 2023).

7. *2019 Dispute Resolution Statistics*, FINRA, https://www.finra.org/arbitration-mediation/dispute-resolution-statistics/2019 (last visited June 13, 2023).

8. *2018 Dispute Resolution Statistics*, FINRA, https://www.finra.org/arbitration-mediation/2018-dispute-resolution-statistics (last visited June 13, 2023).

9. *2017 Dispute Resolution Statistics*, FINRA, https://www.finra.org/arbitration-mediation/2017-dispute-resolution-statistics (last visited June 13, 2023).

The decline in cases can be attributed, in part and imprecisely, to the lengthy bull market, the COVD-19 pandemic, stronger regulation, and improved supervision and compliance functions. Data, however, points out another reason for the falling number of FINRA arbitration case filings, the shift of retail investment advisery services from the broker-dealer model to the Registered Investment Advisor ("RIA").

Delivery of investment advice is changing from the broker-dealer channel to the RIA channel. Today, there are almost 10 times as many RIAs as there are broker-dealers. As of 2022, FINRA reported there were 3,394 FINRA-registered broker-dealers.[10] As of December 31, 2021, there were 14,806 SEC-registered RIAs[11] and 17,371 state-registered RIAs.[12] FINRA's registration numbers have been declining for the past five years.[13] The number of RIAs and related investment adviser representatives have grown year-over-year for the last five years.[14] With 10 times the number of RIAs to broker-dealers, the arbitrations have not gone away, they have gone RIA. At this point a typical law review article would cite statistics from reputable and trusted sources to support such a statement. However, no regulator, government agency, or private organization is tracking the number of RIA arbitration claims filed each year. Only hard-earned anecdotal evidence from practitioners supports the fact the securities arbitration world is changing.

The use of arbitration to resolve customer disputes remains similar as between customers and broker-dealers. However, the RIA business models, the regulatory schemes governing the industry, and what documents and information exist in this ever-expanding universe are markedly different than those of the broker-dealers. Obtaining documents through discovery to be successful in a case against an RIA and its Investment Advisor Representative(s) ("IARs") requires a meaningful understanding of the types of documents available, understanding each document's relationship to the

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10. *2021 Industry Snapshot*, FINRA, https://www.finra.org/rules-guidance/guidance/reports-studies/2021-industry-snapshot (last visited June 13, 2023).

11. Investment Adviser Association, *Investment Adviser Industry Snapshot 2022*, https://investmentadviser.org/wp-content/uploads/2022/06/Snapshot2022.pdf at 19 (last visited June 13, 2023).

12. NASAA, *NASAA 2022 Investment Adviser Section Annual Report*, https://www.nasaa.org/wp-content/uploads/2022/06/2022-IA-Section-Report-FINAL-updated-05192022.pdf at 3 (last visited June 13, 2023).

13. *2021 Industry Snapshot*, *supra* note 10.

14. *Investment Adviser Industry Snapshot 2022*, *supra* note 11 at 15.

RIA, client, and/or case, and how each document may lead to a second or third tranche of discoverable documents.

The purpose of this article is to highlight the different discovery rules of arbitration providers may influence how and when discovery is available, create an RIA Discovery Guide for claimant's counsel to use for all claims, discuss how to recognize some of the unique relationships a given RIA may have with its regulator(s), broker-dealers, and other financial services providers, and focus on some of the key documents available in every RIA case.

II. DOCUMENT DISCOVERY IN FINRA, AAA, AND JAMS

The procedure for asking for the production of documents and information in an arbitration varies by the arbitration rules selected by the parties or mandated by a pre-dispute arbitration agreement.

In an arbitration proceeding with an RIA, it is possible to see FINRA, JAMS, or AAA arbitration rules selected regardless of the arbitration provider being used by the parties.

FINRA's discovery rules are the closest to self-executing, requiring the production of documents and information pursuant to the FINRA Discovery Guide, and permitting additional discovery requests for production without the need to seek the arbitrator or panel's permission to do so.

With AAA and JAMS arbitration rules, the document discovery process is dependent on the consent or voluntary participation of the parties or by order of the arbitrator. With these rules it is important to design a plan for discovery of the desired documents and information to maximize the probability of receiving it.

A. THE FINRA CODE OF ARBITRATION PROCEDURE

FINRA's Code of Arbitration Procedure allows for discovery of documents and information in two layers. The first layer is the Discovery Guide documents which are considered presumptively discoverable[15] and governed by Rule 12506. The second layer is case-specific requests for

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15. "While the parties and arbitrators should consider the documents described in the Lists presumptively discoverable, the parties and arbitrators retain their flexibility in the discovery process." Discovery Guide, FINRA (Dec. 2, 2013), https://www.finra.org/sites/default/files/ArbMed/p394527.pdf at 1.

production of documents and information propounded by a party. The FINRA Discovery Guide should be considered as only the start of document discovery.

Rule 12506 Document Production Lists

Within 60 days of the date the answer to the statement of claim is due, the parties must "Produce to all other parties all documents in their possession or control that are described in Document Production Lists 1 and 2…"[16] and/or "[o]bject as provided in Rule 12508 and serve this response on all parties and file this response with the Director."[17]

In the context of a FINRA arbitration case involving an RIA, there may be documents responsive to List 1 of the FINRA Discovery Guide in the possession, custody, and/or control of the RIA. However, List 1 of the FINRA Discovery Guide was designed for disputes between a customer and FINRA Broker-Dealers and their Associated Persons. As a result, some documents may bear different titles or otherwise not exist in the possession of the RIA. Likewise, the RIA may have documents that are relevant to the case and claims, but are not contemplated by the Discovery Guide. As a result, a claimant needs to formulate RIA-specific discovery requests.

Rule 12507 Other Discovery Requests

"Parties may also request additional documents or information from any party by serving a written request on the party. Requests for information are generally limited to identification of individuals, entities, and time periods related to the dispute… [s]tandard interrogatories are generally not permitted in arbitration."[18]

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16. FINRA, Code of Arbitration Procedure for Customer Disputes, R. 12506(b)(1)(A) (2017), https://www.finra.org/rules-guidance/rulebooks/finra-rules/12506.

17. *Id.* R. 12506(b)(1)(C).

18. FINRA, Code of Arbitration Procedure for Customer Disputes, R. 12507(a) (2017), https://www.finra.org/rules-guidance/rulebooks/finra-rules/12507.

"[D]iscovery requests may be served… 45 days or more after the Director serves the statement of claim…."[19] Responses to discovery requests are due 60 days after the date of the Request(s).[20]

Under the FINRA Rules, a party can propound requests for production of documents without obtaining either the consent of the opposing party or permission from the arbitrator or panel. The RIA Discovery Guide provided herein may form the basis of many Rule 12507 requests for production.

B. AAA COMMERCIAL RULES[21]

AAA Commercial Rules R-23

The AAA Commercial Rules leave document discovery in the hands of the arbitrator and parties. There is no set standard for the making or responding to document discovery requests. Instead, under R-23(b), the arbitrator may on "application of a party or on the arbitrator's own initiative…" "(iii) require the parties, in response to reasonable document requests, to make available to the other party documents, in the responding party's possession or custody, not otherwise readily available to the party seeking the documents, and reasonably believed by the party seeking the documents to exist and to be relevant and material to the outcome of disputed issues…"

Key to this Rule is the phrase "relevant and material to the outcome of disputed issues." The Commercial Rules appear to set a higher threshold than the "reasonably calculated to lead to admissible evidence" standard in federal courts and many state courts. The AAA Commercial Rules address issues of electronic discovery,[22] the obligation to update discovery productions,[23] and leaves the resolution of discovery disputes and enforcement of orders to the arbitrator.[24]

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19. *Id.* R. 12507(a)(2).

20. *Id.*, R. 12507(b).

21. American Arbitration Association, Commercial Arbitration Rules and Mediation Procedures (Sept. 1, 2022), https://www.adr.org/sites/default/files/CommercialRules_Web_0.pdf (last visited June 13, 2023).

22. *Id.* R-23(b)(iv) at 22-23.

23. *Id.* R-23(b)(ii) at 22.

24. *Id.* R-23 & R-24 at 22-23.

C. AAA CONSUMER RULES[25]

AAA Consumer Rules R-22

The AAA Consumer Arbitration R-22 provides a much skinnier arbitrator-controlled discovery process. R-22(a) provides, "[i]f any party asks or if the arbitrator decides on his or her own, keeping in mind that arbitration must remain a fast and economical process, the arbitrator may direct (1) specific documents and other information to be shared between the consumer and business."[26] On its face, the AAA Consumer Rule R-22 excludes third-party documents (e.g., the agreement between the RIA and broker-dealer) that may be relevant to how and why the RIA and/or IAR served the client as they did.

R-22(c) limits discovery to just R-22(a) unless the "arbitrator determines further information exchange is needed to provide for a fundamentally fair process."[27]

The scope of document requests under the AAA Consumer rules is left to either the parties' agreement or the arbitrator's control.

D. JAMS COMPREHENSIVE ARBITRATION RULES & PROCEDURES

JAMS Comprehensive Rules Rule 17

The JAMS Comprehensive Arbitration Rules and Procedures split the difference between FINRA and AAA by directing an "initial exchange of all relevant, non-privileged documents, including, without limitation, copies of all documents in their possession or control on which they rely in support of their positions.[28] The time frame for the initial exchange is short, just 21

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25. American Arbitration Association, Consumer Arbitration Rules (Sept. 1, 2014), https://www.adr.org/sites/default/files/Consumer-Rules-Web_0.pdf (last visited June 13, 2023).

26. *Id.* R-22(a) at 20.

27. *Id.* R-22(c) at 20.

28. JAMS, JAMS Comprehensive Arbitration Rules & Procedures (June 1, 2021), https://www.jamsadr.com/files/Uploads/Documents/JAMS-Rules/JAMS_Comprehensive_Arbitration_Rules-2021.pdf (last visited June 13, 2023), R. 17(a) at 11.=.

calendar days after all pleadings have been received.[29] The arbitrator is given the discretion to "modify these obligations at the Preliminary Conference."[30]

JAMS Rule 17 imposes an on-going production obligation on the parties. "As they become aware of new documents or information… all Parties continue to be obligated to provide relevant, non-privileged documents to supplement their identification of witnesses and experts and to honor any informal agreements or understandings between the Parties regarding documents or information to be exchanged" Beyond the Rule 17 exchange of documents, all other discovery processes and tools are left to counsel stipulation or arbitrator order.

E. JAMS STREAMLINED ARBITRATION RULES & PROCEDURES (CLAIMS LESS THAN $250,000)

JAMS Streamlined Rules Rule 13

For claims less than $250,000, the JAMS Streamlined Arbitration Rules & Procedures apply. Under the Streamlined Rules, "[t]he Parties shall cooperate in good faith in the voluntary and informal exchange of all non-privileged documents and information (including electronically stored information ("ESI")) relevant to the dispute or claim..."[31] The time frame for the initial exchange is even shorter, just 14 calendar days after all pleadings have been received.[32]

Any discovery sought beyond the initial voluntary exchange is left to the arbitrator. "The necessity of additional information exchange shall be determined by the Arbitrator based upon the reasonable need for the requested information, the availability of other discovery options and the burdensomeness of the request on the opposing Parties and the witness."[33]

The Streamlined Rules also impose an on-going duty of production. "As they become aware of new documents or information, including experts who

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29. *Id.*

30. *Id.*

31. JAMS Streamlined Arbitration Rules & Procedures, Rule 13(a), available at https://www.jamsadr.com/rules-streamlined-arbitration/#Rule-13 (last visited Apr. 13, 2023).

32. Id.

33. Id.

may be called upon to testify, all Parties continue to be obligated to provide relevant, non-privileged documents."[34] With all other discovery left to the arbitrator's discretion, understanding the universe of possible documents that may exist in an RIA case becomes critical to making cogent arguments requesting additional document discovery.

F. CONCLUSIONS ABOUT ARBITRATION RULES AND RIA DISCOVERY

Understanding the applicable rules is paramount in knowing how to approach discovery in an RIA case. The FINRA Code of Arbitration Procedure contemplates and allows written requests for production of documents. AAA leaves all the control to the arbitrator and/or party agreement. JAMS splits the difference with a voluntary production of documents, and leaves the rest to the arbitrator. Ultimately at a non-FINRA arbitration provider, developing a discovery plan prior to or at the initial scheduling conference with the arbitrator is a necessary precursor before requesting the documents necessary for trying an arbitration case involving an RIA. Without a discovery plan, a claimant can be left to whatever documents the RIA and opposing counsel believe are relevant.

III. THE RIA DISCOVERY GUIDE

RIAs are different than broker-dealers. Just as a Statement of Claim against a broker-dealer cannot be repurposed for an RIA case, the usual suite of discovery propounded on a broker-dealer cannot be reused with any expectation of success. Initial discovery on an RIA targets documents that are common to all RIA firms. For most RIA cases, these common documents will form the core of discovery about the RIA.

There are eight separate categories of documents which are relevant to every customer-RIA dispute. They are:

1. Client-Specific Documents;
2. Regulatory Disclosure Documents
3. Compliance Documents
4. Supervisory Documents

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34. JAMS, JAMS Streamlined Arbitration Rules & Procedures (June 1, 2021), https://www.jamsadr.com/files/Uploads/Documents/JAMS-Rules/JAMS_streamlined_arbitration_rules-2021.pdf (last visited June 13, 2023), R. 13(b) at 8-9.

5. Marketing Documents
6. Business-Related Documents
7. Advice-Related Documents
8. Agreements with Third-Parties

Beyond the eight core discovery categories, there can be other documents that are particular and relevant to the relationship pattern involved with the RIA. The two relationship patterns where additional discovery is needed are:

1. The investment adviser representative ("IAR") is dually registered with a FINRA-registered Broker-Dealer and an RIA; and
2. The Respondent is a FINRA-registered Broker-Dealer that provided brokerage services to the RIA that caused the losses.

The following eight sections and bullet points are an "RIA Discovery Guide."[35]

A. CLIENT-SPECIFIC DOCUMENTS

Client-specific documents capture the entire relationship between the claimant and the RIA from each side's perspective. These documents will answer one or more of four questions: What did the client expect from the RIA? What did the client receive? What did the RIA expect of the client? What did the RIA receive from the client? Somewhere in these documents is the heart of the dispute.

- Investment Advisory Agreement and updates.
- Investor (Client) Questionnaires.
- Investment Policy Statement.
- Account record information for the client including name, tax identification number, address, telephone number, date of birth, employment status, annual income, net worth, investment objectives, and risk tolerance.
- Account Application(s) with Custodial Broker-Dealer.
- Supporting documents (e.g., trusts, family partnerships, etc.).
- Updates to client documents.

35. In cases involving RIAs before FINRA arbitration or where the parties selected the FINRA Code of Arbitration to govern their case, the FINRA Discovery Guide remains available and applicable. Further, the FINRA Discovery Guide should be considered in creating a discovery plan for a non-FINRA arbitration involving an RIA party.

- All written correspondence between RIA and the assigned Investment Advisor Representative(s) ("IAR") and customer.
- All electronic correspondence between RIA and IAR(s) and customer including, but not limited to, email, text messages, and electronic messaging app communications.
- All written communication between the RIA and any third-parties regarding the client and/or client's account(s).
- Account Statements.
- Client-specific performance reports.
- Client-specific annual reports.
- Fee calculations, amounts invoiced, and amounts collected.
- Written financial analysis and advice provided to client, including financial plans.
- Investment due diligence files, research reports, sales materials, performance or risk data, prospectuses, other offering documents and copies of news articles or outside research, including documents intended or identified as being "for internal use only" for the securities and products purchased and/or sold on behalf of the client.
- All notes the RIA and/or IAR made about the client, client's accounts, claims, and/or transactions including, but not limited to, entries in any diary or calendar, relating to the claims or products at issue.
- All notes or memoranda evidencing supervisory, compliance, or managerial review of the client's account(s) or transactions therein or of the IAR assigned to the client's account(s) for the period at issue.
- All correspondence between the client and the RIA and/or IAR relating to the client's claims, accounts, transactions, or products or types of products at issue bearing indications of managerial, compliance, or supervisory review of such correspondence.
- Phone records (recordings, phone logs, and audio files).
- All writings reflecting communications between the IAR assigned to the client during the time period at issue and members of the RIA compliance department relating to the securities/products at issue and/or the client's claims, accounts or transactions.

B. REGULATORY DISCLOSURE DOCUMENTS

Regulatory disclosure documents are those documents the RIA is obligated to provide to its regulator(s) and sometimes its clients. Not all of these disclosure documents are publicly available.

- Form ADV, in its entirety, for the RIA.
- Annual filings with the SEC and/or state regulators.
- Responses to SEC and/or state audits, correspondence with auditors, and results of audits.
- Responses to SEC and/or state regulatory inquiries, investigations, and/or charges, and responses thereto.
- SEC filings not available on EDGAR.[36]
- Records of disciplinary action taken against the RIA and/or IAR by any regulator (state, federal or self-regulatory organization) or employer for all sales practice violations or conduct similar to the conduct alleged.

C. COMPLIANCE DOCUMENTS

Compliance documents are those created and retained by the RIA to evidence compliance with securities laws and regulations. Many of these documents are not available to the public and are created by the RIA in the course of its day-to-day business based on its business model and the activities of its IAR(s).

- Compliance manual (sometimes termed Policies and Procedures manual).
- Ethics manual
- Internal compliance procedures and periodic compliance reviews and reports.
- Records of securities held by RIA firms when acting as principal.
- Continuing education seminars, training seminars for Investment Advisor Representative(s).
- Publications, bulletins, memoranda and notices regarding regulatory notices and requirements.

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36. "EDGAR, the Electronic Data Gathering, Analysis, and Retrieval system, is the primary system for companies and others submitting documents under the Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939, and the Investment Company Act of 1940." *About Edgar*, SEC (Apr. 6, 2023), https: //www.sec.gov/edgar/about (last visited June 13, 2023).

D. SUPERVISORY DOCUMENTS

Supervisory documents are those created and retained by the RIA to evidence supervision of its IARs' activities with its clients and clients' accounts. Many of these documents are not available to the public and are created by the RIA in the course of its day-to-day business based on its business model and the activities of its IAR(s).

- Supervisory manual.
- Documents evidencing supervision of IAR (including reviews of branch, e-mails, advice, trading, custody, outside business activities, etc.).
- Customer complaints and responses thereto.
- Resumes/CVs of investment advisor representatives.
- Cross-reference holding pages of all client holdings.
- Internal communications with IARs pertaining to the client or related practices.
- Documents identifying supervisor of IAR.
- All exception reports, supervisory activity reviews, concentration reports, active account runs and similar documents produced to review for activity in the client's accounts or in which the claims, transactions, products or types of products at issue are referenced or listed.
- Organizational chart of RIA.
- Branch office audits.
- Logs evidencing that the client was provided requisite disclosure documents (e.g., Form ADV parts 2a and 2b, and form CRS).
- A record of all agreements pertaining to the relationship between the IAR and the RIA, summarizing each IAR's compensation arrangement or plan with the firm.
- Identifications of each IAR's social media and message board handles (e.g., Twitter, Reddit, and Seeking Alpha).

E. MARKETING DOCUMENTS

Marketing documents are the documents the RIA uses to sell its services to potential and existing clients. These are business model-specific documents with some RIAs having far more documents than others. Marketing documents containing representations about the services of the RIA or the skills and abilities of the IAR(s) can be compared to the Client-Specific documents and

regulatory documents disclosing the actual services the RIA will provide and the skills and abilities of its IARs.

- Promotional brochures and investment style marketing materials.
- Sales brochures.
- Archived RIA website (current and historic).
- Archived social media (e.g., LinkedIn, Facebook, and Instagram).
- Newsletters and blogs.

F. BUSINESS-RELATED DOCUMENTS

An RIA receives documents related to the operations of its business from a variety of vendors and service providers. These documents can be valuable in determining the extent of client-facing services the RIA could have provided based on systems and software available to it. The documents also reflect day-to-day operations expenses and services used by the RIA to operate its business.

- Advisory fee billing software manuals.
- Compliance and supervision software manuals.
- Customer Relationship Management software manuals
- Account management software manuals.
- Errors and omissions liability insurance policies.
- Directors and officers' liability insurance policies.
- RIA entity formational documents, including bylaws, articles of organization, and meeting minutes.

G. ADVICE-RELATED MATERIALS

Advice-related documents are materials generated or received in connection with providing financial services to the RIA's clients. These documents tend to be more specific to the investment or investment type and related to the decision(s) by the RIA to use certain investments in connection with providing financial advice and services.

- Evidence that private placements have been notice-filed with SEC as exempted securities.
- Due diligence on advice generally including, but not limited to, investments and strategies.
- Due diligence on advice to the client including, but not limited to, the use of electronic analysis (financial plans, Monte Carlo

projections, hypotheticals, etc.) prepared for the client, whether provided to the client or not.

- Minutes of the RIA's Due Diligence committee meeting(s) discussing and approving the investment(s) at issue for offering to clients.
- Minutes of any and all RIA committee meetings discussing the investment(s) at issues.

H. AGREEMENTS WITH THIRD-PARTIES

Agreements with Third-Parties are agreements between the RIA and entities related to providing either financial services or products. These agreements may contain embedded fees or other incentives which may create a conflict of interest for the RIA and its client.

- Agreements with delegated RIAs (e.g., money managers).
- Mutual fund selling agreements.
- Broker-dealer account agreements.
- Buy-in agreements with mutual funds.
- Buy-in agreements with money managers.
- Variable annuity marketing agreements.
- All other third-party agreements, directly or indirectly pertaining to advisor's services to client.

IV. SPECIAL SITUATION DISCOVERY LISTS

There are two special situations where a broker-dealer may be involved with an IAR. The first situation is where the IAR is registered with an unrelated broker-dealer. This is seen in situations where the registered representative is registered with an independent firm without an RIA subsidiary or related company and the broker-dealer has approved the registered representative's outside business activity to act as an RIA. The second situation is where the IAR is registered with a related broker-dealer.

In both instances, the broker-dealer may be a party or potential third-party source of documents. In either situation, List 1 of the FINRA Discovery Guide should be a consideration to obtain discovery from the broker-dealer (whether as an adverse party or through third-party discovery orders to produce or subpoenas).

A. SPECIAL LIST 1: THE INVESTMENT ADVISER REPRESENTATIVE ("IAR") IS DUALLY REGISTERED WITH A FINRA-REGISTERED BROKER-DEALER AND AN RIA

In some cases, broker-dealers will allow their registered representatives to work for unaffiliated RIAs. Whether affiliated or not, the broker-dealer should maintain all of the following documentation relevant to its registered representative's investment advisory activities:

- Outside Business Activities approval.
- Basis for determining that the fee program was appropriate (NASD Notice to Members 03-68).
- Client file (new account form, IRA application, options, margins, etc.).
- Client statements.
- Agreements
  - Between RIA and Broker-Dealer and
  - Between RIA and Client.
- Payments/compensation between RIA and Broker-Dealer.
- Compensation from client account (including trailers, etc.).
- Supervision by Broker-Dealer supervisors of IAR.
- Supervision of account (risk management, options, trading, AML, etc.).
- Exception reports
  - List of all reports that can be generated;
  - The reports that were generated and who reviewed them;
  - All exception reports generated specifically for client's account(s);
  - Communications with the client;
  - Letters;
  - Calls (recordings, call logs and audio files); and
  - E-mails.
- FINRA correspondence, including responses to audits, 8210 letters, responses to requests regarding customer complaints and AWC matters.
- IAR's other Outside Business Activities, disclosure documents given to the RIA, and all approvals, denials, or other RIA generated documents related to the IAR'S Outside Business Activities.

B. SPECIAL LIST 2: THE RESPONDENT IS A FINRA REGISTERED BROKER-DEALER THAT PROVIDED BROKERAGE SERVICES TO THE RIA THAT CAUSED THE LOSSES

Broker-dealers like Schwab, Fidelity and Interactive Brokers offer brokerage services for RIAs, and are sometimes named as respondents/defendants for their roles in the alleged bad acts. A broker-dealer's relationship with an RIA may be a bare bones custodial arrangement for client accounts, it may provide software and analytical tools to the RIA, or it could be much cozier with the broker-dealer providing research and other services (even referrals) in exchange for the RIA bringing certain types of business to the brokerage firm. The relationship may be the genesis of a client's dispute with the RIA if the RIA intentionally steered its advice to what the broker-dealer wanted rather than what the client needed.

- Initial due diligence on RIA when onboarding.
- Client file (new account form, IRA application, options, margins, etc.).
- Client statements.
- Agreements
  - Between RIA and Broker-Dealer and
  - Between RIA and Client.
- Payments/compensation between RIA and Broker-Dealer.
- Supervision of RIA (institutional services).
- Supervision of account (risk management, options, trading, AML, etc.).
- Exception reports
  - List of all reports that can be generated;
  - The reports that were generated and the persons in the RIA responsible for reviewing them; and
  - All exception reports generated specifically for client's account(s).
- Communications with the brokerage firm custodying the client's assets, pertaining to the client or related practices of the RIA.
- Communications with the client
  - Letters;
  - Calls (recordings, call logs and audio files); and
  - E-mails.
- FINRA correspondence, including responses to audits, 8210 letters, responses to requests regarding customer complaints and AWC matters.

V. NON-DISCOVERY DOCUMENT AVAILABILITY

RIAs are businesses that depend on building their reputations in public to attract clients. Similarly, simply doing business as an RIA and will create a fingerprint of publicly available regulatory documents. These troves of documents are free for the taking and often reveal substantial amounts of information about the RIA and its operations.

- Filings found on the SEC's EDGAR database (e.g., Reg. D, 13f and 13g filings).
- Bulletin board postings (e.g., SeekingAlpha and Reddit).
- Review notes from regulators, including FINRA's Brokercheck, and states' corporate filings, plus securities and insurance regulators.
- The IAR's published books and writings.
- The IAR's other professional credentials to review (including ones that may have been withdrawn or revoked).
- If the IAR is insurance licensed, research the various states in which the IAR was licensed.
- The RIA and/or IAR court records.
- The RIA and/or IAR may own other business entities (related and otherwise).
- Published works (magazine articles, books).
- Quotes and interviews.

VI. DISCUSSION OF KEY DOCUMENTS

This section discusses some of the RIA-specific documents which appear in the eight lists and are important to every customer case. Owning a more than passing understanding of these documents will help to create the discovery plan, form the document requests, and aid in meet and confer and motion practice.

A. FORM ADV

The registered part of a "registered" investment adviser is the filing and maintenance of standardized disclosure documents that are common to every RIA, collectively known as "Form ADV". Those documents can be found publicly at the Investment Adviser Public Disclosure ("IAPD") website, https://adviserinfo.sec.gov/. ADV disclosures are required to be updated

annually, along with periodic updates to reflect material changes. RIAs are required to provide the current disclosures directly to the client at the outset of the relationship, and then to provide (or at least offer) the updates. The publicly available sources for the Form ADV do not provide public access for prior (archived) versions. It is therefore necessary to request that the RIA produce each complete Form ADV for the time period at issue, as well as any evidence that the documents were provided to the client.

Form ADV consists of three "Parts," each with additional schedules and supplements where necessary.[37]

Part 1A consists of disclosures about the RIA's business practices, ownership, control persons, and the Investment Adviser Representatives ("IARs"). Supplementing Part 1A, where necessary, are Disclosure Reporting Pages ("DRPs") which disclose disciplinary events about the firm's personnel.[38] For larger RIA firms with multiple employees and locations, the form ADV is often an "Umbrella Registration."[39]

Part 1B contains questions asked by state securities regulators, and is only applicable if the RIA is registered with a state securities regulator.[40]

Part 2A is a Plain English brochure of Part II of the adviser's Form ADV, describing the RIA's services and disclosures.

Part 2B is a Plain English brochure that describes the IAR in the same way that the 2A brochure describes the RIA. Small RIAs do not have to produce 2B brochures for their IARs if the 2A and 2B forms would be materially identical.

Part 3 is the Form CRS ("Relationship Summary"). [41] Since June 30, 2020, SEC-registered RIAs are required to give their retail investor customers Form CRS. Form CRS is meant to provide a brief summary of the RIA-customer relationship in plain English. "The relationship summary is intended to inform retail investors about: the types of client and customer relationships and services the firm offers; the fees, costs, conflicts of interest, and required standard of conduct associated with those relationships and services; whether the firm and its financial professionals currently have reportable legal or disciplinary history; and how to obtain additional information about the

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37. SEC, Form ADV: General Instructions, https://www.sec.gov/about/forms/formadv-instructions.pdf (last visited June 13, 2023), at 2-3.

38. *Id.* at 2.

39. *Id.* at 5.

40. *Id.* at 2.

41. *Id.* at 2-3.

firm."[42] For dual-registrants, their Form CRS will include both their brokerage and investment adviser practice information. The summary can be compared to the rest of the Form ADV, marketing materials, Investment Advisory Agreement, and the IAR's conduct with the client.

RIAs must update their Form ADV each year, within 90 days of the end of the firm's fiscal year.[43] For a multi-year advisory relationship, this means there are multiple Form ADVs.

Out-of-cycle updates of Form ADV are required when an IAR is added or removed, there are disclosable disciplinary events, changes in investment strategies or philosophies, or if the disclosures in Part 2B brochure become *materially* inaccurate.[44]

B. DOCUMENTS AND INFORMATION IDENTIFYING RIA CONTROL PERSONS

SEC Form ADV identifies the control persons of an RIA firm. This information can be useful in identifying individual respondents in RIA claims and claims involving officer, executive, and control person liability. However, the designated roster of control persons specified on a Form ADV lists only those officers, executives, and control persons as of the date of the Form ADV. There may be other individuals who may have acted as officers, executives, and/or control persons during the time period at issue, but whose names no longer appear in the current Form ADV, thus seeking the firm's prior Form ADV filings is necessary to identify key witnesses and parties.

In addition, corporate filings, articles of incorporation, and organizational charts of the RIA may exist throughout the contested time period and provide relevant information to identify witnesses and possibly other responsible parties.

42. SEC, Form CRS Relationship Summary; Amendments to Form ADV, Release Nos. 34-86032; IA-5247; File No. S7-08-18, https://www.sec.gov/rules/final/2019/34-86032.pdf at 1 (last visited June 13, 2023).

43. 17 C.F.R. § 275.204-1(a).

44. Form ADV: General Instructions, *supra* note 37, at 4.

C. THE INVESTMENT ADVISORY AGREEMENT (CLIENT AGREEMENT)

RIAs managing client monies are required to enter into a written contractual relationship with their customers. The client agreement is an important source for assessing contractual representations of investment and management style, client investment objectives and standards of care presumably associated with the RIA/client relationship.

D. CUSTOMER COMPLAINTS

RIAs are subject to public disclosure requirements for customer complaints which are available on the Investment Adviser Public Disclosure (IAPD) website, available at https://adviserinfo.sec.gov. These complaints, if disclosed, can reveal supervisory issues with the firm, IAR, products, due diligence and/or strategies used by the RIA.

E. RIA FINTECH AND REG TECH

The emergence of Fintech and Regtech software has made the transition from the traditional retail securities brokerage relationship to that of a Registered Investment Advisor relationship easier, simpler, and more efficient. Individual RIAs now manage books of business well in the hundreds of millions of dollars out of the privacy of their home offices, given the incredible functionality and ease of operation of this emergent software in this arena.

Wholesale categories of documents and information formerly kept on paper records, such as cross-reference holding pages, position pages, account reviews, account rebalancing, sector concentration, individual position concentration, due diligence files, account notes, and client contact notes and correspondence are now routinely formatted in these software programs and require specific demands that the RIA firm generate printouts of these various categories of documents and information from their software programs.

F. CONTRACTUAL RELATIONSHIPS WITH BROKER-DEALERS AND OTHER THIRD-PARTIES

Registered Investment Advisory firms enter into contractual relationships with FINRA registered broker-dealers, clearing firms and other third-parties.

These documents can include custodial agreements, clearing broker agreements, soft-money agreements, indemnification/hold-harmless agreements, independent contractor-type agreements, agreements to maintain books and records, 12b-1 fee splitting, insurance policies, coverages, and contractual relationships with other third-party money managers, analysts, and support-type services.

These relationships should be disclosed on Part 2A of the Form ADV if they may or affect the advice the Investment Advisor provides the client.

G. BROKER-DEALER DUE DILIGENCE AND APPROVALS RECORDS

Many RIAs enter into contractual and promotional relationships with brokerage firms whereby they become approved money managers for customers of FINRA member firms. This process generates documents and information relating to the relationships and can include all categories of documents associated with the vetting process which broker-dealers maintain with these continuing relationships.

H. PROFESSIONAL LIABILITY INSURANCE AND ERRORS AND OMISSIONS POLICIES

There is no requirement that RIAs maintain liability insurance coverage. Nonetheless, many RIAs maintain liability insurance coverage for various categories of civil claims. State and federal court discovery procedures almost uniformly mandate the disclosure of insurance coverages in liability cases and reluctance on the part of an RIA firm to disclose insurance coverages may be addressed the relevant discovery rules requiring the production of this information.

I. INVESTMENT ADVISORY AFFILIATES OF BROKER-DEALERS

Virtually all of the top 30 broker-dealer wire houses have formed their own separate investment advisory subsidiaries or affiliates created in large part to stem the flow of customer accounts to independent RIAs offering fee-based account management services. Some of these affiliate entities are structured in a franchise format whereby franchise owners actually own an individual office

in either the broker-dealer format, the investment advisory format or both. Discovery of these franchise and correspondent agreements can identify additional parties, the types of services exchanged between the entities, and the respective obligations which may exist in these relationships.

J. CORRESPONDENT BROKER-DEALER ACCOUNT PLATFORM AGREEMENTS IN CONTRACTUAL RELATIONSHIPS

RIA firms, including independent RIA firms and RIA firms affiliated with broker-dealers, maintain contractual agreements with broker-dealers evidencing the contractual terms of their platforming agreement for client accounts and churning activity. These agreements and all ongoing updates, as well as the internal compliance and supervisory procedures associated with RIA platform relationships, are essential discovery items as they will reveal the division of supervision and compliance responsibilities, the existence of key reports and documents, and the use of software to manage the compliance, supervision, and client account responsibilities.

K. INVESTMENT ADVISORY FEE CALCULATIONS AND RELATED SOFTWARE FUNCTIONALITY

Investment advisory fees are typically taken through quarterly automatic withdrawals of monies from customer accounts. Few firms opt for quarterly billing anymore. It is important to assess the accuracy and legitimacy of periodic cash deductions from client accounts and how they are calculated. Some firms' fee arrangements afford them the ability to charge an investment advisory fee on the basis of total assets under management. The "total assets" calculation may tend to incentivize an investment adviser to leverage customer accounts with excess margin borrowing to enhance the fees which can be charged based upon *total* assets under management, as opposed to net assets under management less the margin debit balance in the customer account.

L. PAYMENTS MADE BY RIAS TO BROKER-DEALERS AND OTHER THIRD-PARTIES NOT REFLECTED ON RIA CUSTOMER ACCOUNT STATEMENTS

There are often money flows between RIAs, the broker-dealers through whom they platform customer accounts and/or third-party vendors (e.g., mutual funds, private placement vendors, market makers and other financial institutions) with cash payments for any number of cloaked or described services they might contend or otherwise package. These payments may influence the provision of financial advice or service to the client. Exploring the existence of these money flows is necessary to determine if the RIA breached its fiduciary obligations to its clients by putting its own interests first.

M. DUE DILIGENCE FILES

Given that RIA firms are acting in a fiduciary capacity, there is a profound obligation to engage in thorough due diligence and continued monitoring of securities selected for customer accounts. Some RIA firms consider themselves special situation experts versed in finding and selecting investment opportunities for customer accounts, with the same positions being purchased across the board in the accounts of many customers. Issuers of alternative investments design and market products to be sold through the RIA channel. As a fiduciary, an RIA selling an alternative investment is obligated to perform its own due diligence on the investment.

Similarly, in circumstances where concentrated positions in customer accounts have sustained devastating and disproportionate losses, the discovery of these due diligence files may go towards ascertaining the extent to which an RIA performed its fiduciary obligations for the client. This is all the more essential in circumstances where positions in thinly traded companies are involved. The area of inquiry includes the extent to which the investment advisor was involved with any Schedule 13D filings with the SEC[45] and other filings related to concentrated positions in individual securities.

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45. Schedule 13D, the "Beneficial Ownership Report," must be filed with the SEC when a person or entity acquires more than 5% of a voting class of a company's shares. 17 CFR § 240.13d-101.

N. CRM SYSTEMS[46] AND DOCUMENTS AND INFORMATION EVIDENCING PERIODIC REVIEW OF HOLDINGS IN CUSTOMER ACCOUNTS

One of the most important areas of discovery is ascertaining the extent to which an RIA firm engaged in prudent, periodic assessment of client holdings and asset allocations to assure that they are in line with the stated investment objectives or investment policy statement of a customer account. Recent years have seen the emergence of a number of very effective client relationship management software programs. Additionally, documents and information memorializing client in-person meetings and teleconferences relative to the status of an account and its holdings can likewise provide essential information when assessing RIA account management.

O. RESULTS OF PERIODIC SEC AND STATE REGULATOR RIA OFFICE AUDITS

The SEC and state regulators conduct periodic audits of RIA firms, as well as audits conducted pursuant to specific events of alleged customer victimization. In this regard, all such audits, reviews, recommendations, and related correspondence exchanged between the RIA and regulator(s) are essential items to seek in the discovery phase of claims against RIA firms.

46. Client Relationship Management ("CRM") systems are programs used to help a business track, manage, and interact with its clients. According to RIA in a Box, an RIA compliance vendor, 52% of all RIAs used a CRM system in 2021. The study also found that the larger the Assets Under Management of the RIA, the more likely it was to use a CRM system. https://www.riainabox.com/resources/2022-ria-technology-survey-redtail-and-other-top-crm-providers (last visited June 25, 2023).

P. DOL FIDUCIARY RULE (PROHIBITED TRANSACTION EXEMPTION 2020-02)

With the US Department of Labor's ("DOL") new Fiduciary Rule,[47] RIAs must also comply with DOL regulations pertaining to investment advice given to ERISA plan assets and IRAs, including:

- Acknowledge fiduciary status in writing;
- Disclose services and material conflicts of interest;
- Adhere to Impartial Conduct Standards;
- Adopt policies and procedures prudently designed to ensure compliance with Impartial Conduct Standards and to mitigate conflicts of interest;
- Document and disclose specific reasons that any rollover recommendations are in the retirement investor's best interest; and
- Conduct an annual retrospective compliance review.

These documents are necessary to define the scope of the relationship and services and compare them to the services provided by an RIA to its client where a retirement account is at issue.

VII. THIRD-PARTY SUBPOENAS TO PRODUCE DOCUMENTS

Subpoenas in aid of arbitration if properly fashioned can be an effective tool to access essential witnesses, documents and information.

The procedural mechanisms to compel the appearance of witnesses and production of documents and information in arbitration proceedings can require considerable patience. Unlike FINRA arbitration proceedings where member firms and associated persons are subject to discipline for failing to cooperate in the discovery process, there is no similarly effective internal mechanism induce RIA firms and their advisers to cooperate with the discovery process in the arbitration context. The only remedy to enforce an arbitrator-ordered subpoena is pursuit of state (where available) or federal court-venued proceedings to compel compliance.[48] The turnaround time on such discovery-related filings with the whole submission, deliberation and decision process may easily take up to a year's time or more.

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47. Prohibited Transaction Exemption 2020-02, *Improving Investment Advice for Workers & Retirees*, 85 Fed. Reg. 82798 (Dec. 18, 2020).

48. See 9 U.S.C. § 7.

VIII. CONCLUSION

The change in how investment advice is provided to retail customers and the disputes which arise between customers and RIAs appear outwardly similar to those involving broker-dealers. Underneath the veneer of similarity, the disputes, rules and documents are two different worlds. With the variety of arbitration providers and rules used by RIAs, making a discovery plan, knowing the scope of documents available, and understanding some of the most important documents are necessary ingredients to successfully position a case for settlement or prove liability for a customer claim against an RIA.

DIVERSIFYING A CONCENTRATED STOCK POSITION IN 2023[1]

Susan Song, CFA, Regina Meng, CFA,
Mike Yan, PhD and Craig McCann, PhD

Introduction

Twenty years ago, we evaluated brokerage firms' recommendation that investors should diversify a concentrated stock position by buying additional stocks on margin [McCann and Luo, 2003].[2]

We found:

1. Borrowing against a concentrated stock position and buying additional stocks increases the investor's risk unless the returns to the securities bought are significantly negatively correlated with the returns to the concentrated position. The necessary condition for reducing risk will not be met if both the concentrated investment and the additional securities purchased are common stocks.
2. The more similar the securities bought are to the concentrated position, the riskier the resulting leveraged portfolio. In practice, the securities purchased to "diversify" are often quite similar to the concentrated position and the strategy amounts to little more than making additional investments in the concentrated position on margin.
3. The more an investor followed this bad advice, the worse the resulting portfolio.
4. In rare cases where the "leveraged diversification" strategy reduces risk, the leveraged portfolio's expected return is much less than the concentrated position's expected return. The recommended strategy either increases risk or dramatically lowers the expected return of the concentrated portfolio - or it does both.

Twenty years later, some brokers and advisors continue to recklessly recommend that their clients borrow against concentrated stock positions and

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1. © 2023 SLCG Economic Consulting, LLC, 8401 Greensboro Drive, Suite 1050, McLean, VA 22102. www.slcg.com. The authors can be reached at SusanSong@SLCG.com, ReginaMeng@SLCG.com and MikeYan@SLCG.com respectively. We received helpful comments from Craig McCann.

2. Throughout we will talk about this position as if it were a single stock but it could be any number of stocks so long as it is not well diversified.

purchase additional stocks to diversify. In this note, we use recent stock market returns to update our previous work which used data from the 1990s. We also extend the analysis to cover a larger universe of stocks and employ more sophisticated simulations. Our updates and enhancements show that this "hold, borrow, and buy some more" strategy remains inconsistent with basic principles of prudent investment management; leveraged diversification perversely increases risk and or lowers expected returns.

Our analysis of the leveraged diversification strategy applies to many other situations where investors are encouraged to borrow against their concentrated stock positions rather than sell some of the stock to fund purchases of real estate or other big ticket items.

Based on our forthcoming analysis of Form Ds and Form ADVs, registered investment advisors are placing their clients in illiquid private placements the advisors create and promote. For example, ICONIQ has sponsored 399 Reg D offerings and places 79.6% of its clients' assets in illiquid investments.[3] ICONIQ grew into a Silicon Valley powerhouse as a result of its management of the Zuckerburg wealth tied to Facebook (now Meta). The leveraged diversification strategy is even more risky if conflicted RIAs like ICONIQ are leveraging concentrated Silicon Valley stock positions using their sponsored illiquid private placements.

Intuition

The fundamental error in leveraged diversification is the misuse of rates of return and ignoring debit balances when dealing with long portfolios of different size. Consider an investor with $1,000,000 invested entirely in a single stock with a 70% chance that the stock's returns over the next month will be between +20% and -20%. Suppose this investor invests another $1,000,000 using margin in a portfolio of other stocks and the range over which the enlarged portfolio's monthly percentage returns will vary narrows to between +15% and -15%. The risk may appear to be reduced but the range of likely $-value losses has actually gone up. After buying the additional securities, the reduced variation in percentage returns are being applied to the much larger $2,000,000 portfolio in which the investor still only has $1,000,000 in equity. Before buying the additional securities, there was a 70% chance that the investor's portfolio would be worth between $800,000 and

3. ICONIQ's Form ADV can be found here: https://reports.adviserinfo.sec.gov/reports/ADV/159198/PDF/159198.pdf.

$1,200,000 at the end of the month. After buying the additional securities, the range of likely outcomes widens to $700,000 to $1,300,000, which translates to a 50% increase in the range of returns on the investor's equity from ±20% to ±30% as a result of implementing the flawed strategy.

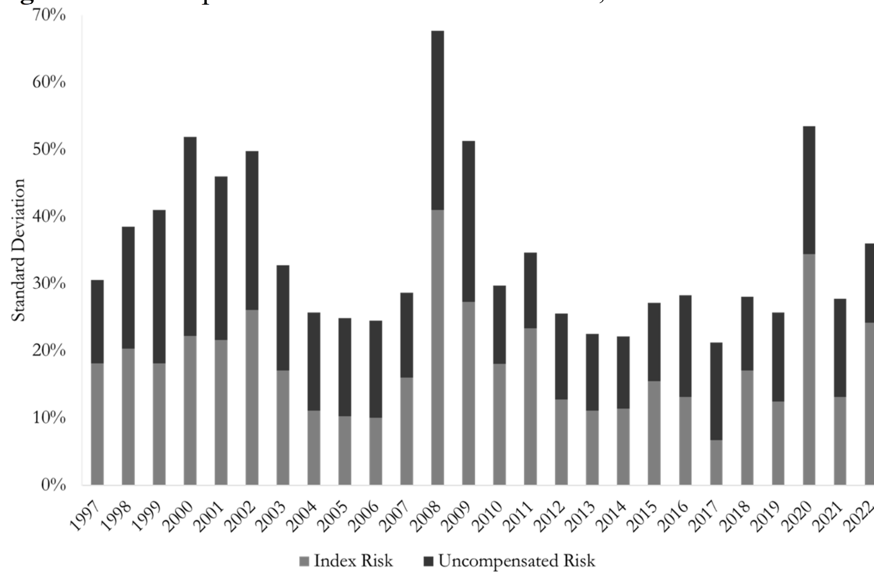
In our simple example, leveraged diversification increased risk because the 2:1 leverage increased the $-amounts that could be lost even though the variation in the percentage returns to the more diversified $2,000,000 securities portfolio was 25% smaller (±15% compared to ±20%) than the variation in the percentage returns to the $1,000,000 concentrated stock position.

The riskiness of the investor’s portfolio after leveraged diversification increases with 1) the amount of additional stocks bought on margin, 2) the volatility of the returns to the concentrated stock position, 3) the volatility of the returns to the additional stocks and 4) the correlation between the returns to concentrated stock position and the returns to the additional stocks purchased.

Unless the correlation between the returns to the concentrated stock position and the returns to the additional stocks purchased is significantly negative, the leveraged portfolio will be substantially riskier than the concentrated stock position. Correlation coefficients can range from -1 to +1 but the correlation coefficients between individual stocks and candidate additional stock portfolios will always be positive, and so the leveraged portfolio will always be riskier - typically much riskier - than the concentrated stock portfolio.

Less obvious, in many scenarios where leveraged diversification increases risk, it also lowers expected returns. That is, the strategy harms investors by both increasing risk and lowering expected returns. Leveraged diversification performs so much worse than simple diversification strategies because there is a lot of diversifiable and therefore uncompensated risk in single-stock portfolios as illustrated in Figure 1.

Figure 1: Uncompensated Risk of S&P 500 Stocks, 1997-2022



The grey bars reflect the standard deviation of daily returns to investing in the S&P 500 each year. The red bars reflect the average additional risk from investing in a single S&P 500 stock over and above the risk of investing in the S&P 500. Consistently each year, holding a single stock from within the S&P 500 is twice as risky as holding a portfolio of all 500 S&P 500 stocks. This additional risk is called "uncompensated" risk because it can be eliminated by holding the individual stock as part of the overall stock market portfolio. Investors do not earn any additional returns for bearing this diversifiable risk.

Simulations

We next report on extensive simulations we performed to demonstrate that a strategy of holding a concentrated position and borrowing to buy additional securities will virtually always increase risk.

Each year from 1997 through 2022, we generate 1,000,000 sample portfolios from the stocks in the S&P 500 at the beginning of the year.[4] For each sample portfolio, we first randomly select a stock to serve as the concentrated position and then randomly draw 15 additional stocks from the

4. We get the same qualitative results if we use complementary portfolios of 10, 25 or 50 stocks.

remaining 499 stocks to create returns to equally-weighted, 15-stock portfolios. We calculate the returns and annualized volatilities each year for:

1) the S&P 500 ("100% Diversified S&P 500"),
2) a single stock ("Concentrated Single Stock"),
3) a portfolio that is 50% S&P 500 and 50% concentrated single stock position ("50% Diversified"),
4) the concentrated single-stock position plus 50% invested in a companion 15-stock portfolio bought on margin ("50% Leveraged Diversification"), and
5) the concentrated single-stock position plus 100% invested in a companion 15-stock portfolio bought on margin ("100% Leveraged Diversification").

If a sampled concentrated stock stops trading before the end of the year, we end that simulation path and annualize the risk for all portfolios in the simulation path.[5] If any of the 15 additional stocks purchased stops trading before the end of the holding period, the value of the dropped stock on the last trading date is invested in another randomly selected member not previously selected as the concentrated stock position or one of the 15 additional stocks purchased for this sample path.

We apply the WSJ Prime Rate + 3.0% as the margin interest rate to the leveraged portfolios for the days with margin debt. A margin call is applied whenever a simulated portfolio's net value falls below 25% of its total asset value. On the margin call date, sufficient holdings are liquidated to pay down the margin debt and restore the portfolio to the original (100% or 50%) leverage.

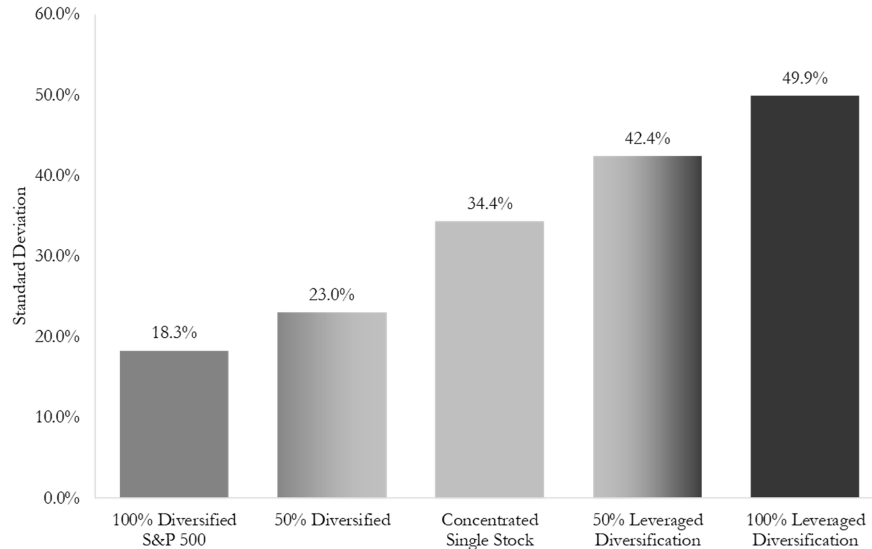
These simulated portfolios - over 100 million portfolios in all – allow us to compare the results to holding concentrated stock positions, diversified stock portfolios, partially diversified portfolios and "hold, borrow and buy some more" portfolios. Only 1.3% of the 26 million fully leveraged portfolios had less risk than the concentrated positions. Thus, the strategy if implemented would have increased risk 98.7% of the time between 1997 and 2022. On average, the fully leveraged portfolios were 45% more risky than concentrated stock positions. On average, the 50% leveraged portfolios were 24% more risky than concentrated stock positions.

Figure 2 illustrates the disastrous results of the leverage diversification strategy. Over the 26-year period from 1997 through 2022, the average risk of the concentrated positions was 34.4%. Borrowing 50% of the value of the

5. We get the same qualitative results if we drop from the simulations any concentrated stock which ceases trading during the year.

concentrated positions to buy 15 additional stocks increased the investor's risk to 42.4% and borrowing 100% increased the risk to 49.9%. Our empirical results show that following the "leveraged diversification" advice increased risk and the more investors followed the advice the worse the results. Leveraged diversification leads to portfolios that are nearly three times as risky, on average, as well diversified stock portfolios.

Figure 2: The Average S&P 500 Stock Had a 34.4% Standard Deviation of Daily Returns Compared to an 18.3% Standard Deviation for the S&P 500's Daily Returns, 1997-2022



Instead of following this obviously flawed strategy, investors could have significantly lowered their risk without sacrificing much return by following traditional diversification strategies. Selling only half the concentrated stock position and buying a diversified portfolio of stocks would have reduced the risk of the concentrated positions by 33.1%, from 34.4% down to 23%. Fully diversifying concentrated stock positions would have lowered the investor's risk, on average by 46.8%, from 34.4% all the way down to 18.3%.

This dramatic result is not a function of the date we chose to start the analysis or of any particular year. Table 1 reports the results of our simulations for each year from 1997 to 2022. The leveraged portfolios were much more risky than concentrated stock positions in every year. The leveraged diversification strategy also has a high likelihood of receiving margin calls.

Table 1: Risk and Return by Strategy and Year, S&P 500, 1997-2022

	100% Diversified S&P 500		50% Diversified		Concentrated Single Stock		50% Leveraged Diversification		100% Leveraged Diversification		Margin Call for Leveraged Diversification	
Year	**Return**	**Risk**	**Return**	**Risk**	**Return**	**Risk**	**Return**	**Risk**	**Return**	**Risk**	**50%**	**100%**
1997	32.9%	19.8%	30.6%	21.7%	28.2%	30.5%	36.4%	33.8%	44.5%	38.2%	0.0%	0.2%
1998	27.6%	22.1%	20.8%	25.7%	14.0%	38.6%	15.0%	45.4%	15.1%	53.6%	0.7%	8.6%
1999	19.6%	18.2%	16.7%	24.6%	13.7%	41.2%	14.9%	44.6%	16.0%	50.0%	0.7%	3.9%
2000	-9.3%	24.4%	0.7%	31.2%	10.7%	51.8%	9.8%	58.8%	8.5%	67.5%	3.2%	13.2%
2001	-11.6%	22.2%	-5.6%	28.7%	0.4%	45.7%	-5.0%	53.8%	-11.6%	62.7%	6.0%	23.0%
2002	-21.4%	26.4%	-19.7%	31.7%	-18.0%	49.5%	-31.4%	63.3%	-44.5%	74.2%	14.2%	50.7%
2003	28.0%	16.6%	34.6%	22.1%	41.3%	32.6%	57.8%	38.0%	74.4%	45.1%	0.5%	1.2%
2004	10.5%	11.1%	13.6%	16.1%	16.7%	25.6%	21.3%	29.4%	25.8%	34.2%	0.0%	0.9%
2005	4.8%	10.3%	6.6%	15.3%	8.5%	24.9%	8.1%	28.7%	7.6%	33.6%	0.6%	1.5%
2006	15.5%	10.0%	15.7%	15.0%	16.0%	24.4%	18.4%	27.5%	20.8%	31.7%	0.2%	0.2%
2007	5.2%	15.7%	4.3%	19.4%	3.4%	28.2%	-0.6%	34.4%	-4.5%	41.6%	0.6%	4.8%
2008	-36.4%	40.9%	-37.5%	46.8%	-38.6%	67.4%	-62.7%	102.4%	-75.8%	115.69%	48.6%	95.6%
2009	26.1%	26.7%	35.1%	35.6%	44.2%	51.6%	60.0%	65.9%	64.7%	79.5%	4.1%	22.9%
2010	14.7%	17.9%	17.9%	22.0%	21.0%	29.6%	28.3%	37.3%	35.7%	46.2%	0.0%	0.0%
2011	1.9%	22.8%	1.4%	26.5%	0.8%	34.4%	-1.9%	47.1%	-5.2%	61.3%	0.1%	6.5%
2012	15.9%	12.7%	16.3%	16.9%	16.8%	25.4%	22.0%	29.5%	27.1%	34.4%	0.0%	0.6%
2013	32.1%	11.1%	34.5%	15.0%	36.8%	22.5%	52.0%	25.0%	67.2%	28.1%	0.0%	0.0%
2014	13.4%	11.3%	13.7%	14.8%	14.1%	22.1%	17.9%	25.8%	21.8%	30.3%	0.0%	0.3%
2015	1.2%	15.4%	-0.3%	18.7%	-1.9%	26.8%	-6.0%	33.4%	-10.1%	41.0%	0.6%	4.4%
2016	11.6%	13.3%	12.7%	18.4%	13.8%	28.1%	17.4%	33.3%	20.8%	40.0%	0.0%	0.5%
2017	21.4%	6.7%	20.1%	11.8%	18.8%	21.2%	24.6%	22.4%	30.4%	24.3%	0.1%	0.2%
2018	-4.3%	17.0%	-5.6%	19.9%	-6.9%	27.9%	-14.5%	34.1%	-22.2%	42.2%	0.0%	6.8%
2019	31.0%	12.5%	29.9%	16.7%	28.8%	25.7%	38.9%	28.2%	49.0%	31.6%	0.0%	0.2%
2020	18.2%	33.4%	13.9%	38.8%	9.6%	53.5%	7.7%	80.2%	-18.6%	93.6%	8.3%	72.7%
2021	28.5%	13.0%	28.8%	17.9%	29.0%	27.7%	40.3%	30.5%	51.6%	34.4%	0.0%	0.0%
2022	-18.1%	24.2%	-14.3%	27.2%	-10.5%	36.2%	-19.8%	49.7%	-29.5%	63.6%	0.9%	23.6%
Average	**10.0%**	**18.3%**	**11.0%**	**23.0%**	**12.0%**	**34.4%**	**13.4%**	**42.4%**	**13.8%**	**49.9%**	**3.4%**	**13.2%**

Table 1's average returns and standard deviations may not be intuitive to everybody and don't fully convey the significant increase in likelihood of large losses resulting from the leveraged diversification strategy.

Table 2 reports the probability of losing more than 5% to 95% of equity in one year for the same five strategies presented in Table 1

We have highlighted three rows reflecting the probability of losing more than 5%, 25% and 50% of equity in a single year to illustrate how to read the table. The probability of losing more than 25% in a year holding a diversified S&P 500 portfolio is only 3.8%. The probability of losing more than 25% nearly doubles to 6.7% if the portfolio is half invested in a diversified S&P 500 portfolio and half invested in a single S&P 500 stock and further increases to 12.7% if the portfolio is fully invested in a single S&P 500 stock. Borrowing 100% of the value of a single S&P 500 stock to buy an equal value spread across 15 additional S&P 500 stocks increases the probability of losing more than 25% of equity to 20.4%.

Table 2 also reports the 95% Value-at-Risk ("VaR") for each strategy. 95% VaR is the maximum amount you are likely to lose 95% of the time. Equivalently, you are likely to lose more than the 95% VaR amount only 5% of the time. This standard risk measurement ranges from 22.2% for a diversified stock portfolio to 44.2% for a concentrated stock position and to 66.8% for a concentrated single stock position subject to the 100% leveraged diversification overlay.

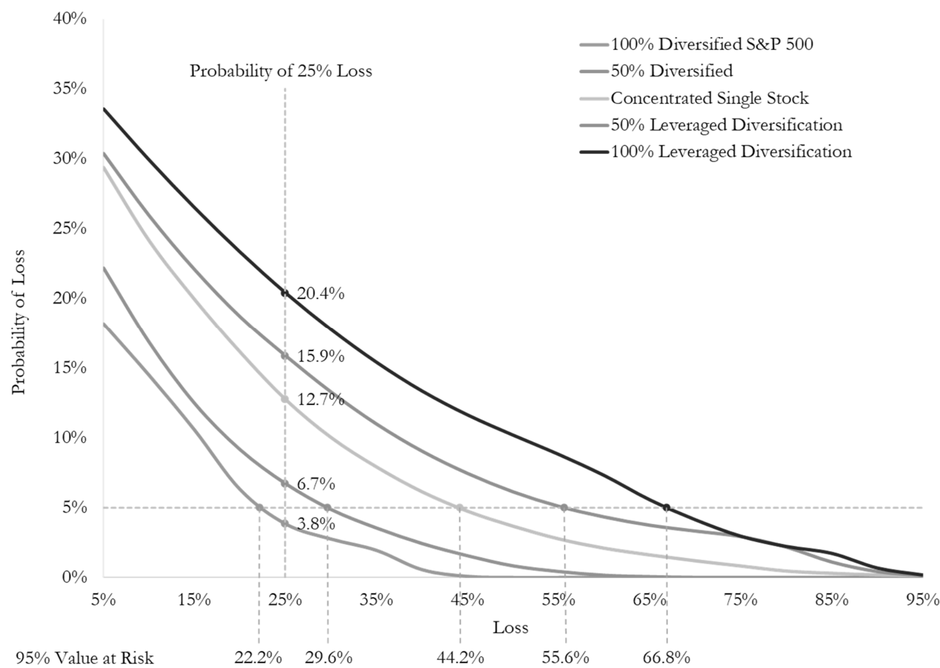
Table 2: Leveraged Diversification Increases Probability of Large Losses, S&P 500

	Probability				
Loss	**100% Diversified S&P 500**	**50% Diversified**	**Concentrated Single Stock**	**50% Leveraged Diversification**	**100% Leveraged Diversification**
5%	18.2%	22.2%	29.4%	30.4%	33.6%
10%	14.5%	16.9%	24.1%	25.9%	29.9%
15%	10.6%	12.5%	19.9%	22.1%	26.5%
20%	6.3%	9.2%	16.1%	18.7%	23.3%
25%	3.8%	6.7%	12.7%	15.9%	20.4%
30%	2.7%	4.9%	10.0%	13.3%	17.8%
35%	1.9%	3.5%	7.9%	11.0%	15.4%
40%	0.6%	2.4%	6.1%	9.0%	13.4%
45%	0.1%	1.6%	4.7%	7.4%	11.6%
50%	0.0%	0.8%	3.7%	6.1%	10.2%
55%	0.0%	0.4%	2.8%	5.1%	8.8%
60%	0.0%	0.2%	2.1%	4.3%	7.3%
65%	0.0%	0.1%	1.6%	3.7%	5.6%
70%	0.0%	0.0%	1.2%	3.3%	4.1%
75%	0.0%	0.0%	0.8%	2.9%	3.0%
80%	0.0%	0.0%	0.5%	2.2%	2.2%
85%	0.0%	0.0%	0.3%	1.1%	1.7%
90%	0.0%	0.0%	0.2%	0.4%	0.7%
95%	0.0%	0.0%	0.1%	0.1%	0.2%
95% VaR	**-22.2%**	**-29.6%**	**-44.2%**	**-55.6%**	**-66.8%**

Table 1 and Table 2 suggest a straightforward disclosure that could be made by any advisor recommending leveraged diversification: "If you follow my advice to hold your concentrated position, borrow an equal value and buy additional stocks to diversify, I can increase the expected return on your concentrated portfolio from 12.0% to 13.8% but the chance you will lose 25% in a year will increase from 12.7% to 20.4%. On the other hand, if you sell your concentrated single stock position and invest in a diversified stock portfolio, the expected return on your portfolio will drop from 12.0% to 10.0% but the chance you will lose 25% in a year will fall from 12.7% to 3.8%."

The probability of losing more than 5% to 95% of equity in one year and the 95% VaR of the five strategies are also plotted in Figure 3 for a visualized illustration of how traditional diversification cuts the risk of the average S&P 500 stock, while leverage diversification increases the risk.

Figure 3: Traditional Diversification Cuts the Risk of the Average S&P 500 Stock in Half; Leveraged Diversification Increases the Risk 50%, S&P 500, 1997-2022



The More Similar Additional Stocks Purchased, the Worse Leveraged Diversification

In the previous section, we selected the single concentrated stock and also the additional 15 stocks bought on margin from the S&P 500. In our experience, the concentrated stock positions subject to the flawed leveraged diversification strategy continue to typically be technology stocks or other stocks which have recently gone public. To more closely track the situations we observe, we re-ran our simulations using stocks from the S&P 500's technology sector and found, as we posited 20 years ago, that when the leveraged diversification strategy selects from stocks that are similar to the concentrated single stock, the results are even worse. Using 15 stocks drawn from the S&P 500 to diversify an S&P 500 stock increased risk by 45% on average. As shown in Table 3, using 15 stocks from S&P's technology sector to diversify a technology stock increased risk by more than 50% on average – from 42.1% to 64.7%.

Table 3 Risk and Return by Strategy and Year, S&P 500 Technology Stocks, 1997-2022

Year	100% Diversified S&P 500		50% Diversified		Concentrated Single Tech Stock		50% Leveraged Diversification		100% Leveraged Diversification		Margin Call for Leveraged Diversification	
	Return	Risk	Return	Risk	Return	Risk	Return	Risk	Return	Risk	50%	100%
1997	33.2%	19.8%	27.4%	29.6%	21.6%	48.4%	26.4%	54.6%	31.0%	62.3%	0.0%	2.3%
1998	27.5%	22.0%	38.0%	33.6%	48.5%	55.6%	66.7%	64.5%	79.8%	74.3%	1.8%	15.2%
1999	19.5%	18.2%	52.2%	33.8%	84.9%	57.0%	121.8%	60.9%	158.7%	67.4%	0.0%	0.1%
2000	-9.5%	24.5%	-15.0%	47.8%	-20.6%	82.8%	-36.0%	105.6%	-46.9%	122.1%	23.7%	59.1%
2001	-11.8%	22.2%	-14.3%	44.8%	-16.9%	81.7%	-33.1%	113.9%	-48.5%	129.8%	37.6%	79.6%
2002	-21.4%	26.3%	-33.4%	40.8%	-45.5%	76.9%	-73.7%	116.5%	-83.9%	130.2%	75.4%	98.3%
2003	27.8%	16.6%	52.6%	29.9%	77.4%	46.1%	112.4%	53.6%	147.4%	62.7%	0.0%	0.0%
2004	10.6%	11.1%	9.1%	21.6%	7.6%	37.7%	7.4%	48.0%	4.9%	59.6%	1.0%	14.2%
2005	4.7%	10.3%	3.5%	17.7%	2.3%	31.5%	-1.3%	38.3%	-5.6%	46.6%	0.0%	7.5%
2006	15.4%	10.0%	12.5%	18.6%	9.6%	32.0%	8.7%	38.1%	7.7%	46.2%	0.0%	1.1%
2007	5.1%	15.7%	3.4%	20.0%	1.7%	30.1%	-3.2%	36.3%	-8.0%	44.1%	0.0%	3.3%
2008	-36.4%	41.0%	-40.1%	44.8%	-43.7%	59.3%	-69.9%	100.8%	-80.9%	114.4%	58.7%	98.6%
2009	26.4%	26.6%	48.4%	34.2%	70.5%	46.0%	102.6%	57.0%	132.4%	69.8%	0.0%	1.9%
2010	14.6%	17.9%	16.1%	22.9%	17.5%	32.1%	23.2%	41.5%	28.8%	52.5%	0.0%	0.2%
2011	1.9%	22.7%	-2.0%	28.1%	-6.0%	38.9%	-12.1%	54.3%	-18.8%	70.3%	1.7%	14.2%
2012	15.7%	12.7%	13.9%	18.6%	12.1%	29.1%	15.0%	35.1%	17.5%	41.9%	0.0%	2.0%
2013	32.0%	11.1%	36.2%	16.5%	40.4%	26.1%	57.4%	28.7%	74.4%	32.2%	0.0%	0.0%
2014	13.3%	11.3%	16.0%	15.7%	18.8%	23.3%	25.0%	28.1%	31.2%	33.8%	0.0%	0.0%
2015	1.3%	15.4%	3.4%	19.3%	5.5%	27.6%	5.0%	34.7%	4.4%	43.2%	0.0%	2.1%
2016	11.6%	13.3%	15.5%	18.6%	19.4%	27.9%	25.8%	34.9%	32.3%	43.4%	0.0%	0.0%
2017	21.3%	6.7%	28.3%	12.8%	35.2%	21.3%	49.3%	23.2%	63.3%	25.8%	0.0%	0.0%
2018	-4.4%	17.1%	-2.2%	22.6%	0.0%	31.6%	-4.1%	39.7%	-8.2%	49.2%	0.0%	1.5%
2019	30.9%	12.5%	36.7%	18.7%	42.4%	28.0%	59.3%	32.6%	76.3%	37.9%	0.0%	0.0%
2020	18.4%	33.4%	23.8%	39.0%	29.2%	50.3%	39.1%	72.7%	34.9%	96.8%	2.8%	30.4%
2021	28.4%	13.0%	29.1%	19.4%	29.8%	30.2%	41.5%	35.2%	53.3%	41.2%	0.0%	0.0%
2022	-18.1%	24.2%	-21.1%	30.5%	-24.0%	42.1%	-40.2%	66.7%	-55.8%	85.7%	1.4%	63.9%
Average	**9.9%**	**18.3%**	**13.0%**	**26.9%**	**16.1%**	**42.1%**	**19.7%**	**54.4%**	**23.9%**	**64.7%**	**7.9%**	**19.1%**

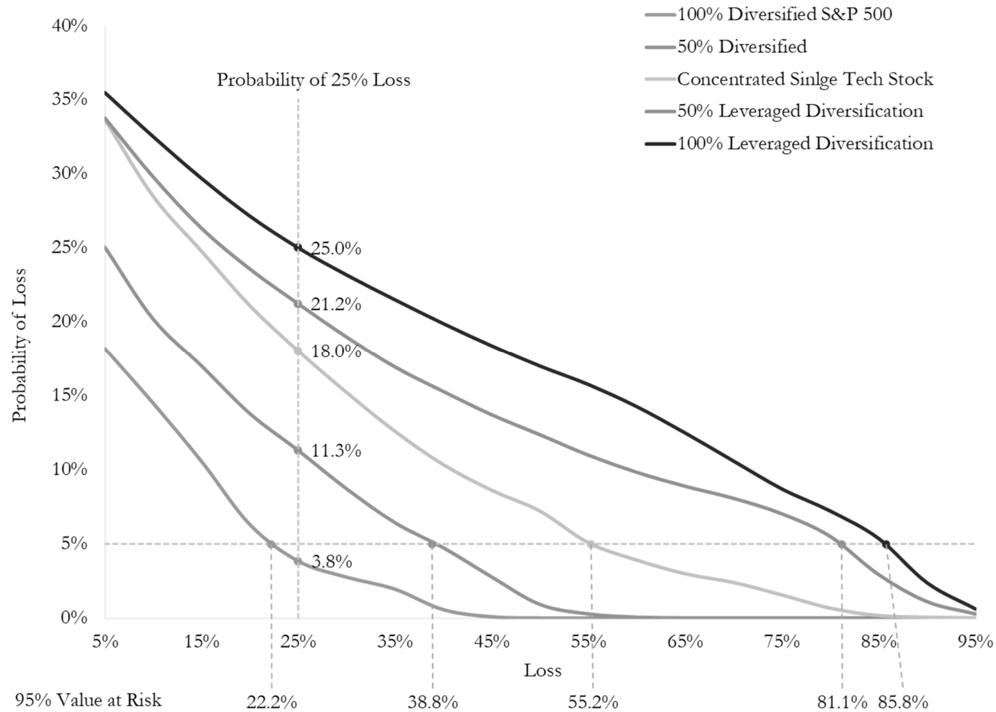
Table 4 and Figure 4 report the probability of losing more than 5% to more than 95% in one year for the same five strategies selecting stocks and from the S&P 500 Technology sector. The probability of losing more than 25% in a year holding a diversified S&P 500 portfolio is only 3.8%. The probability of losing more than 25% increases to 18.0% if the portfolio is fully invested in a single S&P 500 technology stock. Borrowing 100% of the value of a single S&P 500 technology stock to buy an equal value spread across 15 additional S&P 500 technology stocks increases the probability of losing 25% of equity to 25.0%. The 95% VaR for portfolios drawn from S&P 500 technology stocks are significantly higher than for portfolios drawn from all sectors of the S&P 500, further highlighting the importance of diversifying risky individual stocks.

Comparing the results in Table 4 to the results in Table 2 we can see that the leveraged diversification strategy performs even worse when applied to technology stocks than when applied across all S&P 500 sectors.

Table 4: Leveraged Diversification Increases Probability of Large Losses, S&P 500 Technology Stocks

	Probability				
Loss	**100% Diversified S&P 500**	**50% Diversified**	**Concentrated Sinlge Tech Stock**	**50% Leveraged Diversification**	**100% Leveraged Diversification**
5%	18.2%	25.1%	33.7%	33.8%	35.5%
10%	14.5%	20.2%	28.5%	29.8%	32.5%
15%	10.6%	17.0%	24.8%	26.3%	29.7%
20%	6.3%	13.8%	21.1%	23.6%	27.1%
25%	3.8%	11.3%	18.0%	21.2%	25.0%
30%	2.7%	8.7%	15.2%	19.0%	23.2%
35%	1.9%	6.4%	12.6%	16.9%	21.5%
40%	0.6%	4.7%	10.3%	15.3%	19.9%
45%	0.1%	2.8%	8.6%	13.7%	18.4%
50%	0.0%	0.9%	7.2%	12.3%	17.0%
55%	0.0%	0.3%	5.1%	11.0%	15.7%
60%	0.0%	0.1%	3.9%	9.8%	14.2%
65%	0.0%	0.0%	3.0%	8.9%	12.5%
70%	0.0%	0.0%	2.4%	8.1%	10.6%
75%	0.0%	0.0%	1.6%	7.0%	8.7%
80%	0.0%	0.0%	0.7%	5.5%	7.2%
85%	0.0%	0.0%	0.2%	2.9%	5.4%
90%	0.0%	0.0%	0.1%	1.1%	2.4%
95%	0.0%	0.0%	0.0%	0.3%	0.6%
95% VaR	**-22.2%**	**-38.8%**	**-55.2%**	**-81.1%**	**-85.8%**

Figure 4: Traditional Diversification Cuts the Risk of the Average S&P 500 Technology Stock Even More; Leveraged Diversification Increases the Risk Even More, S&P 500 Technology Stocks, 1997-2022



Finally, we ran simulations using stocks from the NASDAQ 100 and found that when the leveraged diversification strategy selects from NASDAQ stocks to diversify a single NASDAQ stock on margin the results worse than selecting additional stocks from the S&P 500. Using 15 stocks drawn from the NASDAQ 100 to diversify a NASDAQ 100 stock generated portfolios that were 50% more risky than the single NASDAQ 100 stock average. See Table 5.

Table 5: Risk and Return by Strategy and Year, NASDAQ 100, 1997-2022

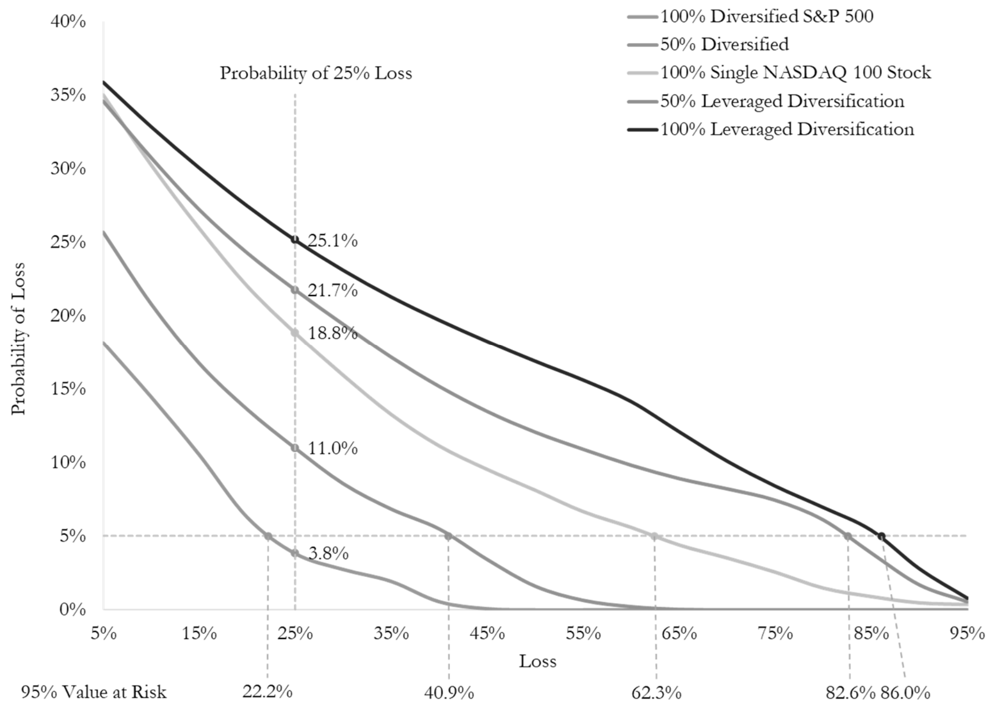
	100% Diversified S&P 500		50% Diversified		Concentrated Single NASDAQ 100		50% Leveraged Diversification		100% Leveraged Diversification		Margin Call for Leveraged Diversification	
Year	**Return**	**Risk**	**Return**	**Risk**	**Return**	**Risk**	**Return**	**Risk**	**Return**	**Risk**	**50%**	**100%**
1997	33.2%	20.0%	22.5%	29.6%	11.9%	52.6%	11.9%	59.9%	11.1%	67.3%	1.7%	14.0%
1998	28.0%	22.2%	31.6%	34.4%	35.1%	60.5%	45.7%	69.5%	52.4%	79.5%	6.7%	22.5%
1999	19.2%	18.3%	54.8%	35.0%	90.4%	60.4%	130.2%	65.7%	169.3%	73.8%	0.6%	2.7%
2000	-9.6%	24.3%	-12.1%	51.2%	-14.7%	91.6%	-27.0%	115.9%	-37.1%	135.2%	23.7%	52.5%
2001	-11.7%	22.2%	-18.4%	45.9%	-25.2%	93.2%	-45.1%	122.6%	-59.2%	137.8%	51.2%	82.9%
2002	-21.6%	26.4%	-31.4%	39.8%	-41.3%	77.2%	-64.7%	108.3%	-77.2%	121.9%	56.7%	94.3%
2003	28.1%	16.5%	41.8%	27.2%	55.6%	41.4%	79.7%	48.2%	103.8%	56.5%	0.0%	0.0%
2004	10.6%	11.1%	11.3%	20.5%	12.1%	35.2%	14.4%	42.8%	15.1%	52.1%	0.0%	7.1%
2005	4.7%	10.3%	4.2%	17.3%	3.7%	29.8%	0.8%	35.5%	-2.4%	42.9%	0.0%	2.8%
2006	15.3%	10.0%	13.2%	18.3%	11.1%	31.9%	11.1%	37.3%	10.9%	44.6%	0.0%	1.5%
2007	5.3%	15.7%	8.8%	21.4%	12.3%	32.6%	12.7%	37.9%	13.1%	44.5%	0.0%	0.6%
2008	-36.5%	41.1%	-39.2%	46.3%	-41.9%	64.1%	-66.0%	102.2%	-78.3%	117.9%	53.4%	96.0%
2009	26.4%	26.6%	43.8%	33.6%	61.3%	45.7%	88.7%	55.9%	114.7%	68.2%	0.0%	1.6%
2010	15.1%	17.9%	18.7%	22.2%	22.3%	30.6%	30.2%	38.2%	38.2%	47.3%	0.0%	0.0%
2011	1.9%	22.9%	0.3%	26.9%	-1.3%	36.3%	-5.1%	48.0%	-9.1%	61.2%	1.0%	6.7%
2012	16.0%	12.7%	15.3%	19.4%	14.6%	31.0%	18.7%	35.1%	22.6%	40.2%	0.0%	0.9%
2013	32.0%	11.1%	36.6%	16.1%	41.2%	25.2%	58.6%	27.4%	76.1%	30.3%	0.0%	0.0%
2014	13.5%	11.2%	16.7%	16.6%	20.0%	25.9%	26.8%	30.2%	33.6%	35.5%	0.0%	0.5%
2015	1.3%	15.3%	3.0%	19.8%	4.6%	29.4%	3.8%	35.5%	2.6%	42.7%	0.0%	2.8%
2016	11.7%	13.2%	9.3%	19.1%	6.8%	30.2%	6.9%	37.3%	7.1%	46.2%	0.5%	0.9%
2017	21.6%	6.7%	23.5%	13.8%	25.3%	24.4%	34.4%	25.2%	43.4%	26.9%	0.0%	0.0%
2018	-4.4%	17.0%	-4.6%	22.1%	-4.7%	31.9%	-11.1%	39.8%	-17.7%	49.6%	0.0%	5.6%
2019	30.8%	12.5%	33.0%	18.6%	35.1%	28.8%	48.4%	32.2%	61.8%	36.5%	0.0%	0.0%
2020	18.4%	33.4%	29.0%	38.1%	39.6%	49.0%	55.7%	67.4%	59.9%	87.6%	1.0%	20.7%
2021	28.5%	13.0%	24.2%	19.8%	19.9%	32.3%	26.6%	36.7%	33.3%	42.6%	0.0%	0.8%
2022	-18.1%	24.2%	-21.1%	31.1%	-24.1%	46.1%	-40.2%	69.6%	-54.5%	84.1%	11.3%	62.6%
Average	**10.0%**	**18.3%**	**12.1%**	**27.1%**	**14.2%**	**43.7%**	**17.2%**	**54.8%**	**20.5%**	**64.3%**	**8.0%**	**18.5%**

The probabilities of losing more than 5% to 95% of equity in one year selecting single stocks and 15-stock complementary portfolios from the NASDAQ 100 reported in Table 6 and plotted in Figure 5 are similar but slightly higher than the probabilities of various loss thresholds and the VaR results for the S&P 500 Technology sector reported in Table 4.

Table 6: Leveraged Diversification Increases Probability of Large Losses, NASDAQ 100

	Probability				
Loss	**100% Diversified S&P 500**	**50% Diversifed**	**100% Single NASDAQ 100 Stock**	**50% Leveraged Diversification**	**100% Leveraged Diversification**
5%	18.2%	25.7%	35.0%	34.6%	35.9%
10%	14.5%	20.8%	30.2%	30.7%	32.8%
15%	10.6%	16.7%	25.9%	27.2%	30.1%
20%	6.3%	13.6%	22.0%	24.3%	27.5%
25%	3.8%	11.0%	18.8%	21.7%	25.1%
30%	2.7%	8.6%	15.9%	19.4%	23.1%
35%	1.9%	6.8%	13.3%	17.2%	21.3%
40%	0.6%	5.5%	11.1%	15.2%	19.7%
45%	0.1%	3.4%	9.5%	13.5%	18.2%
50%	0.0%	1.6%	8.1%	12.0%	16.9%
55%	0.0%	0.7%	6.7%	10.9%	15.6%
60%	0.0%	0.2%	5.6%	9.8%	14.1%
65%	0.0%	0.0%	4.4%	8.9%	12.1%
70%	0.0%	0.0%	3.5%	8.2%	10.1%
75%	0.0%	0.0%	2.5%	7.4%	8.4%
80%	0.0%	0.0%	1.5%	6.1%	6.9%
85%	0.0%	0.0%	0.9%	3.8%	5.4%
90%	0.0%	0.0%	0.5%	1.7%	2.8%
95%	0.0%	0.0%	0.3%	0.5%	0.8%
95% VaR	**-22.2%**	**-40.9%**	**-62.3%**	**-82.6%**	**-86.0%**

Figure 5: Traditional Diversification Cuts the Risk of the Average NASDAQ100 Stock; Leveraged Diversification Increases the Risk, NASDAQ100, 1997-2022



Conclusion

The leveraged diversification strategy is still being recommended to reduce risk today, twenty years after we first demonstrated that it *predictably* did exactly the *opposite*. In this update to our earlier work, we extended our analysis to cover the broader stock market using 26 years of daily returns. We also present more sophisticated risk measures and demonstrate the "hold, borrow, and buy some more" advice is always wrong.

How could such a flawed strategy continue to be recommended and followed in 2023? An investor might wish to defer paying capital gains taxes if the concentrated stock position has large, embedded capital gains even though the true benefit of deferring capital gains taxes is actually quite small in most cases. Perhaps, the stock has recently gone public and the investor/employee feels loyalty and confidence in the issuer. The investor may be a risk-taker. Neither taxes nor sentiment nor an appetite for risk-taking is

likely to be a good reason to hold the concentrated position in light of the empirical evidence we have marshalled. An advisor facing an investor reluctant to diversify a concentrated position should at a minimum present the type of probability of loss analysis we present above so the investor can appreciate how likely it is she will lose 25% or even 50% of her wealth following the leveraged diversification strategy.

Of course, advisors and brokers who make more money if they advise more of their clients' gross assets have an incentive to recommend a variety of borrowing strategies, including the leveraged diversification strategy. Rather than strenuously advocate for traditional diversification which will lower the risk and increase the risk-adjusted returns for most investors with a concentrated stock position, these conflicted advisors and brokers may present leveraged diversification and other borrowing strategies, understating the extraordinary risks attendant with following such bad advice. The conflicts are greater, and the advice worse, if the additional investments purchased to "diversify" are illiquid private placements.

Notes & Observations

INVESTORS CORNERED: THE RISKS OF SECURITIES-BACKED LOANS

Jason Burge[1]

Non-purpose loans,[2] or more colloquially, "securities-backed loans," are a way for investors to borrow against the securities held in an investment account, thereby obtaining liquidity without immediately liquidating the assets. Securities-backed loans became increasingly common through the 2010s, with the SEC reporting that "between 2012 and 2014, one large brokerage firm that offered these programs reported a 70 percent increase in its securities-based lending business, while another reported an over 50 percent increase."[3]

Not surprisingly, the increase in securities-backed lending led to an increase in customer complaints and arbitrations resulting from investors with securities-backed loans. A search through FINRA's Arbitration Award database for awards discussing a "credit line" shows 48 total awards, of which twenty were from 1991 through 2014 (i.e., less than one per year), but eight such awards were from the last two years alone. Likewise, FINRA's Arbitration Award database contains no awards discussing a "securities-backed loan" prior to 2019, but there have been five since then. Investor claims involving credit lines and securities-backed loans are becoming more common as these products become more popular.

As Susan Song, Regina Meng, Mike Yan, and Craig McCann note in their article in this issue "Diversifying a Concentrated Stock Position in 2023," investing on margin is generally not a suitable strategy for investors looking for long-term returns on a diversified basis. Long-term investing on margin "either increases risk or dramatically lowers the expected return of the concentrated portfolio – *or it does both*."[4] For this reason alone, investing with borrowed funds is not a suitable strategy for most investors.

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1. Partner, Fishman Haygood LLP. I would like to thank Lance McCardle and Phil Vujanov for helpful comments on this article, and Jeffrey Koncius for help editing.

2. The Federal Reserve defines a "nonpurpose loan" as "a loan made for any purpose other than purchasing or carrying margin stock." *See* https://www.federalreserve.gov/supervisionreg/regucg.htm.

3. *See* SEC "Investor Alert: Securities-Backed Lines of Credit" (Dec. 21, 2015).

4. *See id*. (emphasis added).

An unfortunate characteristic of securities-backed lending, however, is that it is easy for an investor to fall into the trap of investing on a leveraged basis for a lengthy period of time. Securities-backed loans are generally non-amortizing, thus there is little inherent pressure to pay them back promptly. I have personally represented several investors who had securities-backed loans outstanding for years (in one case, over a decade), without any effort or even a plan to pay down the balance. That investment strategy exposes an investor to many risks of which they may not have been aware.

The Many Risks of Securities-Backed Loans

As an initial matter, although it's largely governed by Regulation U rather than the more familiar Regulation T, securities-backed loans pose most of the same risks as a traditional margin account. Brokerage firms are required to disclose the general risks of margin trading pursuant to FINRA Rule 2264. These risks include: the possibility of losing more than you invest; the firm's ability to liquidate the account; the inability to direct which securities will be sold in a forced liquidation; the firm's ability to adjust the margin requirements at any time; and that an investor is not entitled to an extension of time to respond to a margin call.[5] These risks have led some market observers to describe margin agreements as "contracts of adhesion,"[6] and make the margin loan relationship almost entirely one-sided. Given that securities-backed loans are often utilized in RIA accounts—where investors rightfully expect that their advisor owes them a fiduciary duty—the whiplash between the fiduciary obligations of an RIA and the contractual rights of a securities-backed lender will often surprise an unsuspecting investor.

But in addition to those risks that are required to be disclosed, securities-backed loans also create other risks and disadvantages that are not as well understood or publicized.

High Expense Ratios

One significant disadvantage of a securities-backed loan is that it can lead to a shockingly high expense ratio for an investment account. It is not difficult

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5. *See* FINRA, Rule 2264 (2011).

6. *See* Douglas J. Schulz, *Online/Internet Trading Gambling, BD's No Duties, Third-Party Accounts*, 30 PIABA Bar Journal 36 (2023).

to achieve an annual expense burden of upwards of 10-15% of the net asset value of an account when a significant securities-backed loan is involved.[7] There is no other product an investment bank could sell to a customer that would generate that level of expense, which in turn likely dooms the investors' account to a decline in value over any lengthy period.

Managing Investments to Maximize Collateral rather than Investment Returns

Investors also may not realize that in managed accounts, the need to maintain adequate collateral to support a securities-backed loan may affect the allocation of different types of securities in their account. Many brokerage firms maintain a collateral schedule, sometimes called a "release rate" schedule, which provides different collateral values for different types of securities. An investor may be entitled to take out a loan equal to 95% of the current market value of a municipal bond, but only 75% of the current market value of a common stock. Thus, an RIA seeking to ensure that an investors' account maintains adequate collateral to support a securities-backed loan may overweight the account in higher "release rate" securities, like municipal bonds or even cash equivalents. This lowers the expected return of the account, which when combined with the higher expense burden noted above, makes a long-term decline in account value even more likely.

Trapping Investors into a Relationship with a Broker or Investment Advisor

Another disadvantage of a securities-backed loan is that it can lock an investor into a relationship with their current brokerage firm, regardless of the performance of that firm or whether their current advisor remains employed with the firm. Unlike unencumbered investment assets, which generally can be freely transferred when a customer leaves a brokerage firm either due to dissatisfaction or the relocation of their advisor, a securities-backed loan and the assets it encumbers are not freely transferable. An investor will either have

7. Assume an investor had $1,000,000 of investments in a managed account, paying a 1% management fee and a 55 basis point sub-account charge, as well as a $700,000 securities-backed loan with 6% interest. On an annual basis, that would be $57,500 in interest and management fees on an account with a net asset value of only $300,000, or an expense ratio of 19.2%!.

to find a new firm willing to pay for the loan, or to pay off the loan by liquidating the assets. It's not surprising, then, that one brokerage firm reported that clients with credit lines were less likely to switch firms. Securities-backed loans greatly increase the difficulty of transferring an investor's account to a new brokerage firm.

The Timing of a Margin Call

Finally, although many investors may be aware of the possibility of a margin call, the reality is that a margin deficiency on a securities-backed account is most likely to occur at a time of a market disruption or other market nadir. Because a securities-backed loan is often secured not by a single or a few margin stocks—which may not be correlated with larger market trends—but rather by a more traditional investment account which may be relatively more diversified across the market, the likeliest time for a margin call is a market disruption or market downturn when the broader markets decline. Many investors saw margin calls on their securities-backed loans in March 2020, for example, when the markets initially dipped due to concerns about the COVID-19 pandemic. A margin call at a market disruption or downturn means that an investor's securities will be liquidated to pay off the loan at the moment of their lowest value, thus locking in losses that might never be realized if the investor could hold onto the securities through the market disruption or downturn.

Long-term Securities-Backed Loans are a Terrible Strategy for Investors

This combination of risks illustrates why long-term securities-backed loans are a terrible strategy for investors: these loans generate an extremely high expense burden, incentivize more conservative investments with lower investment returns, prevent an investor from moving their funds to a different firm, and are likely to be liquidated at the worst possible time for the investor. Sometimes an investor's immediate need for short-term liquidity might outweigh these disadvantages. But when an investor has a long-term securities-backed loan encumbering an investment account, it is reasonable to ask if their advisor's interest in generating fee and interest income has overcome that advisor's fiduciary duty to ensure that their client's funds are suitably managed. In almost any scenario, an investor would be far better served by liquidating the assets, paying off the loan, and investing the net asset value on an unencumbered basis.

RECENT ARBITRATION AWARDS

Melanie Cherdack[1]

This issue's featured arbitration awards include five awards which found firms liable for damages based upon various operational issues. Two of the awards were based upon UCC or Electronic Funds Transfer Act claims involving the unauthorized transfer of funds. Another panel assessed almost $4 million in damages against a firm in a self-directed margin blowout case where the firm failed to acknowledge the customers' promise to cover a margin call. Two other awards tagged firms for improperly allowing estate assets to be retitled or withdrawn. Finally, we include an award that grants rescission in a GWG Bond case and directs the Claimant to execute documents to assign its rights in bankruptcy upon full payment of the award to effectuate this recessionary relief.

Rotem Perelmuter v. Fidelity Brokerage Services LLC and National Financial Services LLC
Case No. 21-00819
Hearing Dates: March 6, 2023 – April 7, 2023
San Francisco, CA
Award Date: May 12, 2023
Counsel:
Counsel for Claimant:
Geoffrey T. Macbride, Esq., Patrick J. Wingfield, Esq., and Michael P. Bradley, Esq., Murphy, Pearson, Bradley & Feeney, P.C., San Francisco, California.
Counsel for Respondents:
Timothy P. Burke, Esq., Jeff Goldman, Esq., and Robert H. O'Leary, Esq., Morgan, Lewis & Bockius LLP, Boston, Massachusetts.
Arbitration Panel:
Jeffrey M. Allen, Public Arbitrator, Presiding Chairperson, Dorian Antoine Peters, Public Arbitrator, Nancy Lynne Williamson, Public Arbitrator

1. Melanie Cherdack is the Associate Director of the Investor Rights Clinic at the University of Miami School of Law. She would like to thank her wonderful research assistant, Annie Pompa Morejon, for her contributions to this article.

Investments at Issue:

The causes of action relate to Claimant's securities including Alphabet Inc. (GOOGL), Applied Materials (AMAT), Bank of America Corp. (BAC), Caterpillar Inc, (CAT), Dropbox Inc. (DBX), Facebook Inc. (FB), FitBit Inc. (FIT), Goldman Sachs Group (GS), Microsoft Corp. (MFST), Morgan Stanley (MS), Netflix (NFLX), Peloton (PTON), Oracle (ORCL), Pinterest Inc. (PINS), Starbucks (SBUX), Tesla Inc. (TSLA) Texas Instruments (TSN), 3M Company (MMM), Uber Technologies (UBER) and Yeti Holdings Inc. (YETTI).

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Fraud- Intentional Misrepresentation;
(2) Fraud - Negligent Misrepresentation;
(3) Fraud – Concealment;
(4) Fraud - False Promise;
(5) Breach of Written Contract (Improper Notice);
(6) Breach of Written Contract (Improper Margin);
(7) Breach of Implied Covenant of Good Faith and Fair Dealing;
(8) Negligence; and
(9) Violation of Business and Professions Code Section 17200 et seq.

Relief Requested:

(1) Compensatory damages in an amount to be proven with particularity at the time of the final hearing, but in no event less than $8.5 million;
(2) Damages caused by the loss of use of funds due to Respondents' actions in an amount to be proven with particularity at the time of the final hearing;
(3) General damages in an amount to be proven with particularity at the time of final hearing;
(4) Specific damages in an amount to be proven with particularity at the time of the final hearing;
(5) Interest, including prejudgment interest, at the maximum legal rate provided by law;
(6) Restitution;
(7) Attorneys' fees pursuant to 1021.5 of the California Business & Professions Code and as otherwise provided by law;
(8) Exemplary and punitive damages as to the first claim for relief against Respondents in an amount this Panel deems just and proper (California Civil Code, Section 3294(a); *Duff v. Engelberg (*1965) 237 Cal.App.2d 505, 509);

(9) Reimbursement of filing fees pursuant to Section12900(d) of the FINRA Code of Arbitration Procedure or as otherwise permitted by the FINRA Code of Arbitration Procedure; and

(10) Such other and additional relief as the Panel may deem just and proper.

Award:

(1) Respondents are jointly liable for and shall pay to Claimant the sum of $3,976,048.00 in compensatory damages;

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

Analysis:

This San Francisco-based panel awarded the Claimant almost $4 million for the Respondents' improper liquidation of a self-directed account. During the Covid-19 market volatility, a margin call was made, and the Claimant pledged to provide a cash infusion of about $9 million to cover the margin. However, according to public statements by the Claimant, before Fidelity recognized his agreement to provide more money, Fidelity's margin department liquidated many of his positions. The panel rejected the Respondent's defenses, based upon the margin agreement, that the Respondents had the legal right to take this action.

This case is a good example of the actions of a Claimant in attempting to cover a margin call outweighing the firm's legal defenses based upon the margin agreement.

Robert Jordan v. Primex, American Trust Investment Services, Inc. and Austin Richard Dutton

Case No. 22-01509

Hearing Dates: April 3, 2023

Philadelphia, PA (via videoconference)

Award Date: May 24, 2023

Counsel:

Counsel for Claimant:

Kalju Nekvasil, Esq., Goodman & Nekvasil, P.A., St Petersburg, Florida.

Counsel for Respondent:

Primex and American Trust did not enter an appearance on the matter. Dutton appeared pro se.

Arbitration Panel:

Elliot B. Platt, Public Arbitrator, Presiding Chairperson, Gail Marie Noel, Public Arbitrator, Namsoo Marcus Dunbar, Public Arbitrator

Investments at Issue:

The causes of action relate to GWG Holdings, Inc. L Bonds

Claimant's Claims:

Causes of Action in Statement of Claim:

(1) Violation of Federal securities laws;
(2) Violation of Pennsylvania securities laws;
(3) Violation of the Pennsylvania Unfair Trade Practices and Consumer Protection law;
(4) Breach of contract;
(5) Common Law fraud;
(6) Breach of fiduciary duty;
(7) Negligence; and
(8) Gross negligence.

Relief Requested in the Statement of Claim:

(1) Compensatory damages of at least $100,001.00;
(2) Benefit of the bargain damages;
(3) Recessionary damages;
(4) Loss opportunity costs;
(5) Model portfolio damages;
(6) Prejudgment interest;
(7) Costs;
(8) Attorneys' fees;
(9) Non-economic damages;
(10) Punitive damages of $ 25,000.00; and
(11) Such other and further relief as deemed just and appropriate.

Relief Requested at hearing:

(1) Compensatory damages of $43,644.69;
(2) Punitive damages of $25,000.00; and
(3) Attorneys' fees of $10,000.00

Award:

(1) Respondent Dutton is liable for and shall pay to Claimant the sum of $43,644.69 in compensatory damages.
(2) Respondent Dutton is liable for and shall pay to Claimant interest on the above-stated sum at the rate of 6% per annum from the date of the award until paid in full.
(3) Award subject to further provisions, as indicated below, which shall only apply upon full payment of $43,644.69 to Claimant.
(4) Within thirty days of payment in full of the compensatory damages in

(1), Respondent Dutton may send Claimant's attorney documentation, assigning Dutton all Claimant's rights as a creditor in the GWG bankruptcy and all Claimant's rights to ownership of the bonds at issue.

(5) Claimant has twenty days to execute the assignment and send the executed assignment to Respondent Dutton.

(6) Because the Panel did not find evidence that Primex received notice of the claim, Claimant's claim against Respondent Primex is dismissed without prejudice.

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

Other Issues Considered and Decided

The initial Statement of Claim named American Trust as a Respondent. Later, Claimant amended the Claim removing American Trust as a Respondent.

Analysis:

This GWG Bond arbitration award is unique in that the Panel granted the equitable remedy of rescission *and set forth the process for accomplishing this*. Because the investment at issue is mired in a bankruptcy action, the panel ruled that upon payment of the award in full by the Respondent, the Claimant must, within a specified time of 20 days, assign his ownership rights as a creditor in the GWG bankruptcy to the Respondent. Presumably this is the result of the claims of recessionary damages sought by the Claimant in the arbitration.

David L. Smith, Individually and as Executor of the Estate of Clara M. Bell v. Provident Private Capital Partners, Inc. and Donald L. Smith

Case No. 20-01072

Hearing Dates: February 22, 2021 – December 7, 2022

Cleveland, OH

Award Date: January 19, 2023

Counsel:

Counsel for Claimants:

Scott A. Lane, Esq., Law Office of Scott Lane, LLC, Ingomar, Pennsylvania and Eric J. Purchase, Esq., Purchase, George & Murphey, P.C., Erie Pennsylvania.

Counsel for Respondent:

G. Clinton Kelley, Esq., Pittsburgh, Pennsylvania.

Arbitration Panel:

Jeffrey M. Bain, Public Arbitrator, Presiding Chairperson, Gary Lee Ainley, Public Arbitrator, Karl Strohbehn, Public Arbitrator

Investments/Conduct at Issue:

The causes of action relate to Claimants allegations that Claimant David Smith's mother provided his brother, Respondent Donald L. Smith, with funds to invest prudently and conservatively and, upon her death, to divide the principal and interest equally among her three sons. However, Donald Smith, the president and sole owner of the Respondent firm Provident, instead used the funds to purchase a home in his own name, which he subsequently lost in foreclosure.

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Violation of the Pennsylvania Unfair Trade Practices and Consumer Protection Law;
(2) Negligence
(3) Unsuitability;
(4) Fraud;
(5) Violation of FINRA Rules 2010 and 2020;
(6) Violation of the Pennsylvania Securities Act;
(7) Fraudulent Concealment; and
(8) Breach of Contract.

Relief Requested:

In the Amended Statement of Claim:

(1) $31,666.00 plus statutory interest at a rate of six (6) percent per year from 2005;
(2) Attorneys' fees;
(3) FINRA filing fees;
(4) Hearing session fees; and
(5) All other costs and expenses of the proceedings and such other and further relief as deemed just and appropriate.

Respondents' Counterclaim:

(1) $110, 173.95
(2) Legal Fees;
(3) Costs;
(4) Expenses of $379, 757.73;
(5) Future legal fees; and
(6) Allowable interest.

In the Amended Statement of Answer to Counterclaim:

(1) Statutory interest at the rate of six (6) percent from 2005 to the present;

(2) Attorneys' Fees;
(3) FINRA filing fees;
(4) Hearing session fees; and
(5) All other costs and expenses of the proceedings and such other and further relief as deemed just and appropriate.

Relief Requested at the Hearing:

By Claimants:

(1) Compensatory damages of $31,666.00
(2) Interest;
(3) Costs;
(4) Attorneys' fees of $15,400.00 to Scott Lane, Esq., and $181,460.00 to Eric J. Purchase, Esq.; and
(5) Other costs.

By Respondents:

(1) Compensatory damages on the Counterclaim in the amount of $441, 493.81;
(2) Attorneys' Fees for $46,000.00;
(3) Expert witness fees of $4,750.00;
(4) Costs;
(5) Punitive Damages for $2,953,346.80 or alternatively, $5,414,681.90; and
(6) Forum fees against Claimant.

Award:

(1) Respondents are jointly and severally liable for and shall pay to Claimant the sum of $31,666.00 in compensatory damages.
(2) Respondents are jointly and severally liable for and shall pay to Claimant interest on the above-stated sum at the rate of 6% simple interest per annum from January 1, 2021, through and including the date the Award is paid in full.
(3) Respondents are jointly and severally liable for and shall pay to Claimant the sum of $12,000.00 in attorneys' fees for legal services performed by Scott A. Lane, Esq. and the sum of $50,000.00 in attorneys' fees for legal services performed by Eric J. Purchase, Esq., pursuant to 42 PA. CONS. STAT. § 2503(7) and the request of both sides for attorneys' fees.
(4) Respondents' Counterclaim is denied.
(5) Any and all claims for relief not specifically addressed herein, including any requests for punitive damages and treble damages, are denied.

Analysis:

This Cleveland-based panel entertained a procedurally complex case with over 50 total hearing sessions. The case centered around Respondents' alleged misappropriation of an account inherited from the mother the Claimant, David L. Smith and the Respondent broker, Donald L. Smith. The account was to be managed by Donald L. Smith during her life and, upon the death of his mother, it was to be divided among her three sons. The Claimants, one brother and the estate of the decedent, brought this claim to recover the misappropriated funds.

The compensatory damages awarded to Claimants were small (only $31,666) and no prejudgment interest was awarded despite that the claims dated back to 2005. However, the dollar amounts assessed by the arbitration panel for attorneys' fees as well as the forum fee assessment were each substantially higher. The panel awarded attorney's fees totaling $62,000 pursuant to 42 PA. CONS. STAT. § 2503(7) which allows for the assessment of fees "as a sanction against another participant for dilatory, obdurate or vexatious conduct during the pendency of a matter." Moreover, $51,187.50 of the forum fees were assessed against the Respondents, as compared to just $7,132.50 apportioned to the Claimants. In all, the attorneys' fees and costs for which Respondents were responsible totaled $113,187.50.

This award shows that while an aggressive Respondent (and attorney) might be successful in reducing a compensatory damage number, such tactics may backfire resulting in a significant assessment of attorneys' fees and forum fees for this vexatious conduct.

Lei Wang v. Fidelity Brokerage Services LLC

Case No. 22-00309

Hearing Dates: January 12, 2023 – February 8, 2023

Los Angeles, California. (Partially via videoconference)

Award Date: February 15, 2023

Counsel:

Counsel for Claimant:

Lei Wang appeared pro se.

Counsel for Respondent:

Elizabeth H. Lindh, Esq., Keesal, Young & Logan, Long Beach, California and Chan Nam, Esq., FMR LLC Legal Department, Jersey City, New Jersey.

Arbitration Panel:

Andrew M. Mintzer, Public Arbitrator, Presiding Chairperson, Barry D. Kaye, Public

Investments at Issue:

The causes of action relate to an allegedly fraudulent and unauthorized electronic funds transfer from Claimant's brokerage account with Respondent to a third-party bank account.

Claimant's Claims:

Causes of Action in Statement of Claim:

(1) Breach of contract;
(2) Negligence;
(3) Fraud;
(4) Violations of the Consumers Legal Remedies Act;
(5) Breach of Fiduciary Duty; and
(6) Violations of the U.C.C. Article 4-A Funds Transfer

Relief Requested:

In the Statement of Claim:

(1) Damages in the amount of $156,349.00; and
(2) Arbitration Fees.

Relief Requested at hearing:

(1) Compensatory damages in the amount of $80,749.00.

Award:

(1) Respondent is liable for and shall pay to Claimant the sum of $40,374.50 in compensatory damages;
(2) Any and all claims for relief not specifically addressed herein are denied.

Analysis:

While *pro se* FINRA arbitrations, particularly those involving operational claims, rarely result in a favorable award for the Claimant, this one did. The Claimant successfully argued the claim in four hearing sessions against experienced outside counsel, resulting in an award of approximately 50% of the claimed compensatory damages. It is notable that one arbitrator did dissent. The other two arbitrators, both the Chairperson and the Non-Public Arbitrator, ruled in Claimant's favor. While the award does not specify the claims that that were successful, one of the legal claims asserted was under the U.C.C. § 4A-101 *et seq.* the Funds Transfer Act, thus illustrating that operational claims against firms for wrongful transfers are viable in FINRA arbitration.

Deborah (a/k/a Debbie) Broadway v. Morgan Stanley Barney, LLC and John Malcom McLarty
Case No. 22-01003
Hearing Dates: March 27, 2023 – March 31, 2023
Jackson, Mississippi
Award Date: April 10, 2023
Counsel:
Counsel for Claimant:
Grafton E. Bragg, Esq., Bragglaw, PLLC, Ridgeland, Mississippi.
Counsel for Respondents:
Gina Shlaferman, Esq., and Trae D. Meyr, Esq., Morgan Stanley, St. Petersburg, Florida.
Arbitration Panel:
Matthew Reid, Public Arbitrator, Presiding Chairperson, Kenneth R. Starr, Public Arbitrator, James Randal (Randy) Wallace, Jr., Public Arbitrator
Investments at Issue:
The causes of action relate to Respondents allegedly wrongfully and unduly influencing their customer, who for all practical purposes was the adoptive mother of Claimant, into making written changes to the customer's investment-account beneficiaries, while allegedly knowing or strongly suspecting the customer's lack of mental capacity.
Claimant's Claims:
Causes of Action in Statement of Claim:
(1) Breach of contract- third party beneficiary;
(2) Violations of FINRA rules;
(3) Violations of industry standards;
(4) Violations of Federal law;
(5) Violations of state law;
(6) Negligence; and
(7) Breach of fiduciary duty.
Relief Requested in the Statement of Claim:
(1) The full value of the assets that were distributed from her two accounts, at least $385,000.00;
(2) Punitive Damages;
(3) Pre-award and Post-award interest;
(4) Attorneys' fees;
(5) Costs;
(6) Forum fees; and
(7) And all other relief for which Claimant may be entitled.
Relief Requested at Hearing:
(1) Damages in the amount of $999,933.07.

Award:

(1) Respondent Morgan Stanley Barney is liable for and shall pay to Claimant the sum of $153,489.04 in compensatory damages;
(2) Respondent Morgan Stanley Barney is liable for and shall pay to Claimant interest on the above sum at the rate of 8% rate per annum from December 2021 through and including the date the balance is paid in full;
(3) Respondent Morgan Stanley Barney is liable for and shall pay to Claimant $400.00 to reimburse Claimant for the non-refundable portion of the filing fee previously paid to FINRA Dispute Resolution Services;
(4) Claimant's claims against McLarty are denied entirely; and
(5) Any and all claims for relief not specifically addressed herein, including any requests for punitive damages, treble damages, and attorneys' fees, are denied.

Other Issues Considered and Decided:

Respondent filed a Motion to Dismiss on the grounds that Claimant had failed to demonstrate undue influence, and there was no evidence of any duty breached. Claimant opposed the Motion arguing that undue influence could be imputed to Respondents through their determination of the rightful beneficiary instead of the interpleader. The Panel denied the Motion to Dismiss.

Analysis:

This arbitration award is notable because Morgan Stanley, and not the individual broker, was the party held liable for the allegations of undue influence over a customer who allegedly lacked mental capacity to change account beneficiaries. While this is not specifically detailed in the award, Claimant did argue that Morgan Stanley's act of approving the change of beneficiary rather than interpleading the account so that the parties claiming ownership could resolve their dispute caused the account to be wrongfully distributed. Claimant recovered approximately $150,000 in compensatory damages which constituted less than 50% of the $385,000 sought in the Statement of Claim. This is an example of an operational decision by a brokerage firm, allowing an account to be distributed where there are competing claims, subjecting it to liability.

Michele Vitarelli v. E*Trade Securities LLC
Case No. 22-00243
Hearing Dates: January 24, 2023
San Francisco, California (via videoconference)
Award Date: February 17, 2023
Counsel:
Counsel for Claimant:
Andrei Armas, Esq., Armas & Joseph, APC, Montebello, California.
Counsel for Respondent:
Meredith Hoffman, Esq., E*Trade Securities LLC, Jersey City, New Jersey.
Arbitration Panel:
Helen Marinak Blohm, Sole Public Arbitrator
Investments at Issue:
The causes of action relate to Claimant's account with Respondent and an alleged transfer to an account in Claimant's name at Robinhood Investments.
Claimant's Claims:
Causes of Action in Statement of Claim:
(1) Violation of California Consumers Legal Remedies Act Cal. Civ. Code §§ 1750;
(2) Negligent misrepresentation;
(3) Intentional misrepresentation;
(4) Breach of contract; and
(5) Violation of the Electronic Funds Transfer Act ("EFTA") US Code§§ 1693.
Relief Requested:
In the Statement of Claim:
(1) Actual damages in the amount of $9,630.48 pursuant to the applicable laws, including, but not limited to, Cal. Civ. Code §§ 1780(a)(1) and 15 U.S.C. § 1693m(a)(1);
(2) Statutory damages in the amount of $1,000.00 pursuant to the applicable laws, including, but not limited to, 15 U.S.C. § 1693m(a)(2)(A);
(3) Punitive damages to be determined at the arbitration hearing for any intentional conduct pursuant to the applicable laws, including, but not limited to, Cal. Civ. Code §§ 1780(a)(4) and the intentional misrepresentation claim;
(4) Costs of litigation;
(5) Attorneys' fees pursuant to Cal. Civ. Code §§1780(e) and 15 U.S.C. §1693m(a)(3);

(6) Pre- and post-judgment interest for all sums awarded; and
(7) Any and all other relief that the Arbitrator deems just and proper.

In the Statement of Answer:

(1) Costs and expenses of this proceeding against Claimant;
(2) All such other and further relief as the Arbitrator deems just and necessary.

Relief Requested at Hearing by Claimant:

(1) $9,630.48 in actual damages;
(2) Attorneys' fees (the amount to be provided at a later date); and
(3) $28,891.44 for treble damages.

Award

(1) Respondent is liable and shall pay to Claimant the sum of $9,630.48 in compensatory damages;
(2) Respondent is liable for and shall pay to Claimant the sum of $20,000.00 in attorneys' fees pursuant to Section 15 U.S.C. § 1693m(a)(3) of the EFTA;
(3) Respondent is liable for and shall pay to Claimant $125.00 to reimburse Claimant for the non-refundable portion of the initial claim filing fee;
(4) Any and all claims for relief not specifically addressed herein, including any requests for punitive damages and treble damages, are denied.

Analysis:

In potential cases dealing with trading apps, many times customers complain about improper withdrawals or transfers of funds. This arbitration award is important because the panel awarded damages under the Electronic Funds Transfer Act. Since this claim was successful, the sole arbitrator awarded Claimant $20,000 in attorney's fees—more than twice the compensatory damages—pursuant to 15 U.S.C. § 1693m(a)(3) of the EFTA.

CASES AND MATERIALS

Jason Burge[1]

The Supreme Court holds that to bring a claim under the Securities Act for a false or misleading statement, a plaintiff must have shares traceable to the statement.

Slack Technologies, LLC v. Pirani, 143 S.Ct. 1433 (2023):

Plaintiffs alleging that they were harmed by material misstatements by securities issuers have two federal statutes under which to bring suit. Under the 1934 Securities Exchange Act, 15 U.S.C. § 78a *et seq.*, plaintiffs can sue for any misstatements that induced them to purchase a security, but their claims must satisfy a number of elements, including establishing the defendant's "scienter," or "intent to deceive, manipulate, or defraud." *See, e.g.*, *Herman & MacLean*, 459 U.S. 375, 382 (1983). Alternatively, plaintiffs may be able to bring a claim under the 1933 Securities Act, 15 U.S.C. § 77a *et seq*., without showing scienter, but they must show that the misstatement was contained in a registration statement for their security. In *Slack Technologies, LLC v. Pirani*, 143 S.Ct. 1433 (2023), the United States Supreme Court addressed the question of how closely the security about which a plaintiff brings suit must relate to the challenged registration statement.

Multiple courts of appeals had held that a claim under the Securities Act would only lie when the plaintiff's securities were "traceable to the particular registration statement." 143 S.Ct. 1441, n.2 (collecting cases). This requirement was tied back to the text of the Securities Act, which provides:

> In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security ... may, either at law or in equity, in any court of competent jurisdiction, sue—(1) every person who signed the registration statement ....[2]

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1. Partner, Fishman Haygood LLP. I would like to thank my lovely wife, Rebekka Veith, for helpfully editing this article.

2. 15 U.S.C. § 77k(a).

The most common situation where securities are traceable is an initial public offering, when a company offers new registered shares to the market and any preexisting unregistered shares are subject to a lockup period after the offering, during which the preexisting unregistered shares cannot be sold on the public market. *Id.* at 1438. In this scenario, an investor who acquires shares during the lock-up period could only acquire registered shares that would be traceable to the offering document.

In *Pirani*, however, the transaction at issue was not an initial public offering for new securities, but a direct listing. There was no lockup period, and preexisting unregistered shares could be sold the same day as the new registered shares. *Id.* at 1438. Pirani acquired 30,000 shares of Slack on the day the company went public, but he had no way of knowing whether his shares were registered or unregistered.

The United States Court of Appeal for the Ninth Circuit held that this was irrelevant, and Pirani could still state a claim under the Securities Act. *Pirani v. Slack Techs., Inc.*, 13 F.4th 940 (9th Cir. 2021). The Ninth Circuit noted that there was only one registration statement for Slack at the time of the direct listing, and whether the shares were registered or unregistered, they could only be sold publicly because of the registration statement. *Id.* at 947. Therefore, Pirani's securities, whether registered or unregistered, were "such securities" within the meaning of the Securities Act.

The Supreme Court reversed. It held that "such security" must be "a security issued pursuant to the allegedly misleading registration statement." *Id*. at 1439. It reached this conclusion based first on a close reading of the text of the statute, focusing on the dictionary meaning of "such" and the definitive article in "*the* registration statement." *Id*. at 1440 (emphasis in original). The Court also looked at contextual clues, such as use of "such security" in other parts of the Act and the fact that an underwriter's liability under Section 11 of the Act is limited to the total price of the securities offered in the transaction, suggesting the action must be limited to the registered shares. *Id.* The Supreme Court thus embraced the traceability requirement that most Courts of Appeals had adopted. *Id.* at 1440-41.

The effect of this decision is to insulate certain types of public offerings where trading is not limited to registered securities, including direct listings, from liability under the Securities Act. It remains to be litigated whether other exotic offerings, such as de-SPAC transactions, will have similar practical immunity from liability under the Securities Act. And of course, all of these transactions will remain subject to potential liability under the Securities Exchange Act, with its higher burdens. But the ultimate effect of this decision will be to further insulate issuers from liability even when they issue securities to the market accompanied by material misstatements and omissions.

The Supreme Court holds that proceedings in a district court must be stayed when a defendant appeals a denial of a motion to compel arbitration.

Coinbase, Inc. v. Bielski, 599 U.S. ----, --- S.Ct. ---- (2023):

Many federal cases now start with a motion to compel arbitration, where a defendant argues that an arbitration clause, perhaps only tangentially related to the dispute, requires that the plaintiff pursue their claim in arbitration. When the defendant's motion is granted, that motion stops the federal court action in its tracks, because the district court is obligated under Section 3 of the Federal Arbitration Act ("FAA") to refer the matter to arbitration and stay the federal suit. 9 U.S.C. § 3. But even if the defendant's motion is denied, the FAA grants the defendant an immediate right to appeal that decision. 9 U.S.C. § 16(a). The question in *Coinbase, Inc. v. Bielski*, 599 U.S. ----, --- S.Ct. ---- (2023) was whether that appeal should also stay the federal suit until the appeal is resolved, thereby stopping the suit in its tracks regardless whether the motion to compel arbitration is granted or denied. The United States Supreme Court concluded that it should.

Bielski brought a class action in federal court in California alleging that Coinbase failed to return funds fraudulently removed from users' accounts pursuant to the Electronic Funds Transfer Act. Coinbase moved for arbitration, which was denied. Coinbase the sought an interlocutory appeal and moved to stay the action pending appeal. The United States Court of Appeals for the Ninth Circuit was one of a minority of circuits that had not held that a suit should be automatically stayed upon an appeal of an order denying a motion to compel arbitration, and it refused to stay Bielski's action pending Coinbase's appeal. The Supreme Court reversed.

The Court noted that the FA's text does not mandate a stay pending appeal the way that it mandates a stay once a motion compelling arbitration is granted. *Coinbase*, 599 U.S. ---, at *3. But the Court relied on the background principle from *Griggs v. Provident Consumer Discount Co.*, 459 U.S. 56, 58 (1982) that an appeal "divests the district court of its control over those aspects of the case involved in the appeal." *Coinbase*, 599 U.S. ---, at *3. Because a motion to compel arbitration determines whether an action should be brought in arbitration or in court, "the entire case is essentially 'involved in the appeal.'" *Id.* Accordingly, upon appeal of the motion to compel, the district court is divested of jurisdiction over the entire case and "must stay its proceedings while the interlocutory appeal on arbitrability is ongoing." *Id.*

The Court concluded that this result "reflects common sense," because if a district court action could move forward while the interlocutory appeal of

arbitrability was pending, "many of the asserted benefits of arbitration (efficiency, less expense, less intrusive discovery, and the like) would be irretrievably lost." *Id.* at *4. The Court found that it also served the judiciary's institutional interests by ensuring that resources are not wasted on an action that could eventually proceed to arbitration. *Id.* at *5. The Court rejected Bielski's argument that this rule would encourage frivolous appeals to delay lawsuits, stating that courts of appeals have "robust tools" to prevent frivolous appeals, including summary affirmance, expediting interlocutory appeals, dismissing interlocutory appeals, district court certification of an appeal as frivolous, or sanctions. *Id*.

In dissent, Justice Jackson, joined by Justices Sotomayor, Kagan, and Thomas, noted that the Court's opinion creates a stay rule "perpetually favoring one class of litigants—defendants seeking arbitration." *Id.* at *7 (Jackson, J., dissenting). Justice Jackson noted that this issue only arises in that "subset of cases … in which a stay is not warranted under the usual discretionary standard." *Id.* at *12. The Court, Justice Jackson explained, has thus wrested control of the district court's docket away from that court, even in a situation where a stay would "harm the opposing party and the public interest much more than it would protect the moving defendant," such as where injunctive relief is warranted or immediate discovery is needed to preserve crucial evidence. *Id.* And Justice Jackson noted that, "[n]ow, any defendant that devises a non-frivolous argument for arbitration can not only appeal, but also press pause on the case—leaving plaintiffs to suffer harm, lose evidence, and bleed dry their patience and funding in the meantime." *Id.* at *14.

The Third Circuit holds that if a court finds that portions of a securities complaint did not comply with Rule 11, it must award sanctions against the plaintiff.

Scott v. Vantage Corp., 64 F. 4th 462 (3rd Cir. 2023):

Pursuant to the Private Securities Litigation Reform Act (the "PSLRA"), upon "final adjudication of an action," the district court must "include in the record specific findings" regarding compliance with Federal Rule of Civil Procedure 11(b) "as to any complaint, responsive pleading, or dispositive motion." 15 U.S.C. § 78u-4(c)(1). The PSLRA further provides that if the court finds violations of Federal Rule of Civil Procedure 11, the court "shall impose sanctions," and creates a presumption that "the appropriate sanction … is an award to the opposing party of reasonable attorneys' fees." *Id.* §§ 78u-4(c)(2) & (3)(A)(ii). Although Rule 11 applies to all federal court actions, these twin

requirements of mandatory court review and presumptive sanctions do not generally exist for other types of federal claims.

In *Scott v. Vantage Corp.*, 64 F. 4th 462 (3rd Cir. 2023), Tara Scott, a widow, was one of several investors who alleged that she was induced by misrepresentations to invest in a private placement of securities in Vantage Corp. The plaintiffs brought suit against the company, as well as a promoter who participated in the sale of the securities and a control person of the company. There was some evidence that the initial complaint was filed, in part, to "force a settlement" whereby the defendants would rescind the investments. 64 F.4th at 468, n.4. The plaintiffs brought three causes of action: sale of unregistered securities; misrepresentations in connection with the sale of a security under the Securities Act, 15 U.S.C. § 77l(a)(2); and a claim under § 10b-5 of the Securities Exchange Act for fraud in connection with the sale of a security.

Following filing of the complaint, Vantage Corp. filed for protection under the Bankruptcy Code, and thus claims against the company were stayed. *Id.* at 469. Following discovery, the district court then granted summary judgment in favor of the remaining defendants. As to the unregistered securities claim, the district court found the plaintiffs failed to show that the promoter did not reasonably believe that the investors were accredited, or that the company engaged in a broad solicitation campaign that would invalidate the private offering. *Id.* at 470. For the misrepresentation claim, the district court found that this claim was legally unavailable for private sale of securities. *Id.* And as to the 10b-5 claim, the district court found that despite no rebuttal of the alleged misrepresentations, the Plaintiffs could not establish loss causation. *Id.* at 470-71.

After the summary judgment ruling was affirmed by the United States Court of Appeals for the Third Circuit, the district court engaged in the Rule 11 analysis mandated by the PSLRA. As to the control person, the district court found a Rule 11 violation and awarded him his attorney's fees, because he was included based on his "mere status" as a control person, and was not alleged to have taken any relevant action in the complaint. *Id.* at 470, n. 9. As to the promoter, the district court found that plaintiffs violated Rule 11 because the complaint was filed for an improper purpose (to "force a settlement"), and the unregistered securities and misrepresentation claims lacked evidentiary support because plaintiffs lacked evidence of sales to unaccredited investors at the time of filing. *Id.* at 471. The district court did not find that the allegations of a 10b-5 claim against the promoter were subject to Rule 11 sanctions, because Plaintiffs had alleged viable misrepresentations and had consulted with an accountant to establish a reasonable basis for the pleading before filing. *Id.* The district court concluded that the 10b-5 allegations were the

"heart of the complaint," and thus declined to impose any sanctions on the plaintiffs relating to the claims against the promoter, despite its holding that some claims against him violated Rule 11. *Id.*

Both the plaintiffs and the promoter appealed. The Third Circuit noted that its review of a Rule 11 determination was subject to an abuse of discretion standard, and found no abuse of discretion in the district court's analysis of whether the plaintiffs had violated Rule 11, including the district court's holding that the plaintiff's 10b-5 claims against the promoter did not violate Rule 11. *Id.* at 471-75. Yet while the Third Circuit found no abuse of discretion in the district court refusing to award the promoter his attorney's fees, it did conclude that it was an abuse of discretion for the district court to award no sanction at all for the Rule 11 violations. *Id.* at 475-77. The Court relied on the language of the PSLRA providing that the district court "shall" impose sanctions upon finding a violation of Rule 11 and found that this mandatory language does not allow the district court judicial discretion to award no sanction at all. *Id.* at 476. While the Third Circuit left the determination of the appropriate sanction to the district court's discretion, it noted available options run the gamut from "an award of attorneys' fees … to a written order admonishing by name the individual lawyers responsible for the Rule 11(b) violations." *Id.* at 477 (citation omitted).

This case is a warning to plaintiffs asserting federal securities claims that even where they can draft a complaint stating a claim that can survive a motion to dismiss, they should be careful that each count in their complaint is supported legally and factually, lest they run the risk of mandatory sanctions upon a later adverse decision.

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 *SR-FINRA-2023-007 – Proposed Rule Change To Adopt Supplementary Material .18 (Remote Inspections Pilot Program) Under FINRA Rule 3110 (Supervision)* was submitted to the SEC by Hugh Berkson on May 24, 2023. (prepared with the assistance of Daren Luma)

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

Re: SR-FINRA-2023-007 – Proposed Rule Change To Adopt Supplementary Material .18 (Remote Inspections Pilot Program) Under FINRA Rule 3110 (Supervision)

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") a proposed rule change to amend FINRA Rule 3110 (Supervision). At issue is FINRA's proposed rule change to adopt supplementary material .18 (Remote Inspections Pilot Program) under FINRA Rule 3110 (Supervision). The proposal to 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 under SR-FINRA-2022-021. 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, proposal SR-FINRA-2022-021 was published again on November 16, 2022, whereafter PIABA again asked the SEC to reject this proposal.

FINRA appears to believe that the third time is a charm as it proposes the misguided rule yet again. This rule proposal flies directly in the face of FINRA's stated objective, which is "dedicated to protecting investors."

Background

Beginning many years ago, SEC staff and FINRA have interpreted FINRA rules to require member firms to conduct on-site inspections of branch offices and unregistered offices (i.e., non-branch locations) in accordance with the periodic schedule described under Rule 3110(c)(1). FINRA now contends 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.

In its Amendment filing, FINRA, in part, argues:

> 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.

FINRA continues: "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." 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 a voluntary, three-year remote inspections pilot program.

PIABA submits this comment because the bar association believes this amendment, much like the recently proposed amendment to add Rule supplementary material .19 to allow a home office to be considered residential supervisory location and creating rules and procedures for the supervision of same (SR-FINRA-2022-019 and SR-FINRA-2023-006), is also a fundamentally flawed idea and runs counter to FINRA's stated objective of investor protection. While it is understood that FINRA is attempting to leverage the increased use of virtual technology, the rule proposal leaves considerable opportunity for advisors to skirt the rules. The amendments made to this rule proposal do not address the significant harm done to investors by rogue brokers working without someone adequately supervising them.

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 running without interference from the firm.

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); *In the Matter of Gary Rathbun and Douglas Scott Miller*, FINRA No. No. 2014041919401 (regarding a $72 million fraudulent scheme sold away at a remote office). Advisors like the those mentioned above, and the too-many-to-count advisors who also engage in selling away not mentioned in this list, are ample reasons to deny this proposal.

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. But under this rubric, brokers with a substantial number of customer complaints, those under regulatory investigations, those who were terminated for cause, and those who have significant judgments or liens would all be allowed to participate in this pilot program. The proposal therefore leaves a significant number of problematic brokers with less oversight than they would be subjected to under the current structure. One questions the utility of leaving such persons subject to less, rather than more, scrutiny.

Likewise, current surveillance of electronic communications has been insufficient. A review of all electronic communications that are made through the member firm's electronic data systems would be sufficient *only* if firms are required to engage in a robust review of emails and other electronic communications; 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 the wrongdoing for years (or ever) because the firm simply did not see or review the emails.

Not surprisingly, most of the comments in support of the earlier versions of the current rule proposal came from brokerage firms. However, FINRA and the SEC must look at how things have changed in the last year or so. 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.

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 people working remotely dwindles.

Many industries have moved increasingly towards work from home or hybrid approaches. PIABA does not contend that such arrangements 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, 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.

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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 May 5, 2023).

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).

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 would provide ample opportunity for a broker to engage in fraudulent conduct in the absence of a supervisor or auditor adequately supervising that broker's conduct. If anything, FINRA should require firms to develop and 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. Accordingly, PIABA urges the Commission to reject the rule proposal SR-FINRA-2023-007.

PIABA thanks the Commission and FINRA for the opportunity to comment.

Very Truly Yours,
Hugh Berskon
President, Public Investors Advocate Bar Association

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The following Comment Letter regarding *SR-SEC- S7-04-23– Proposed Rule Change regarding custody requirements for Registered Investment Advisers* was submitted to the SEC by Hugh Berkson on May 7, 2023. (prepared with the assistance of Ryan Cook)

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

Re: SR-SEC-S7-04-23–Proposed Rule Change regarding custody requirements for Registered Investment Advisers

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 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 the maintenance of custody of client assets.

PIABA generally supports the rule proposal. Due to the breadth of the proposal, this letter only addresses a few of the items which PIABA views as important for its membership and clients.

First, there clearly need to be changes related to the custody of cryptocurrency assets in order to promote consumer protection. The crypto industry is so rife with fraud that some securities regulators have gone so far as to keep a public running tally of the scams to try to warn the public at large. *See, e.g.*, California Department of Financial Protection and Innovation, *Crypto Scam Tracker*, https://dfpi.ca.gov/crypto-scams/ (last visited May 4, 2023). Many of these scams are actually being perpetrated by entities purporting to operate the trading platform itself, i.e., the custodians for the

assets. Action is absolutely required to try to prevent these scams which are, as of now, far too successful.

To the extent a RIA is trading cryptocurrencies for client accounts, the need for robust safeguards are *greater* than other, traditional, types of assets. Accordingly, PIABA supports a rule change to require advisers to only utilize crypto exchanges and trading platforms that meet or exceed the requirements of other types of custodians.

Similarly, to the extent a RIA holds holding crypto assets for clients, utliziling local computers, hard drives, or other electronic storage devices, those are *more* susceptible to an unknowing conversion of a client's assets by an unscrupulous RIA or custodian, as there is the ability to convert those assets anonymously without a client ever being aware. Accordingly, PIABA believes that any rule sets related to those assets under direct RIA custody must require routine audits of those assets.

Additionally, PIABA supports a proposed requirement to compel all third-party custodians being utilized by RIAs to include contractual protections for the underlying investors. For example, PIABA supports the prohibition, already in the proposal, whereby custodians not seek waivers for their own misconduct in failing to properly secure the assets with which they are being entrusted. Further, PIABA's membership often sees clients with third-party custodian contracts that go beyond a mere waiver and include terms whereby the custodian claims the right to seek indemnification ***from the client*** if the client has the temerity to seek damages for liability arising out of the custodian's misconduct. Such terms are directly contradictory to investor protection, and merely serve to threaten and intimidate a victimized client from trying to make themselves whole again. Accordingly, PIABA would advocate that any such provisions be banned entirely from the use of a custodian seeking to qualify as a "qualified custodian."

PIABA understands that RIAs are not typically parties to these agreements, other than, in some instances, being designated as a limited power of attorney. However, these contracts in practice are entirely contracts of adhesion. No consumer investor has the standing or leverage to negotiate any of the terms being offered by a third-party custodian. Instead, they routinely sign up with whatever company the RIA directs. RIAs, on the other hand, have economic leverage through scale. If all RIAs in the country were required to only utilize custodians who include fair and balanced contractual terms with their clients, there would be sufficient market pressure that companies will amend current terms to capture that amount of potential business.

PIABA further supports a requirement that qualified custodians verify a RIA's authorization for transactions. Obviously, one of the principal obligations of the custodian is to ensure that the assets being custodied are not

misappropriated by third-party bad actors. Unfortunately, unscrupulous RIAs may serve as such bad actors and misappropriate the assets being held by the third-party custodian. Thus, the third-party custodian should have some basis on which to follow the trade instructions of the RIA – especially when it comes to delivering the assets to recipients that do not appear to be the underlying investors themselves.

PIABA supports a proposal to require RIAs to notify all customers when an account is opened with a qualified custodian, specifically including all necessary identifying information about the custodian, including the custodian's name, address, and the manner in which the investments are maintained. One of the hallmarks of fraudulent investment management and investment vehicles is the lack of information, specifically including where a client's investment assets actually go once the funds are entrusted to the professional. A requirement to notify a client up front of a named, verifiable third party who could be contacted to confirm the relationship and the receipt of assets would help assure that client assets were not simply converted at the outset with promises that the funds had been sent to a custodian.

PIABA supports a proposal that advisors retain documents related to their public accountants, including "(1) all audited financial statements prepared under the safeguarding rule; (2) a copy of each internal control report received by the investment adviser; and (3) a copy of any written agreement between the independent public accountant and the adviser or the client, as applicable, required under proposed rule 223-1." However, PIABA believes that, in addition to requiring that such documents be retained, there should also be a requirement that such documents be provided to the RIA clients. Ultimately, it is the safety of the client assets that is being tested. The information about how it is being tested and the results of those tests should not a secret to the clients whose assets are at risk.

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 *Nevada Assembly Bill 75* was submitted to the Nevada Assembly by Hugh Berkson on May 2, 2023. (prepared with the assistance of the UNLV William S. Boyd School of Law students)

The Honorable Speaker Steve Yeager
The Honorable Senator Melanie Scheible
Chair, Senate Judiciary and Speaker, Nevada Assembly
401 S. Carson Street
Carson City, Nevada 89701

Re: Assembly Bill 75

Dear Speaker Yeager, Chair Scheible, and Members of the Senate Judiciary Committee,

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 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 laws promulgated by the Nevada legislature relating to exempt offerings in private markets.

Thank you for the opportunity to express our concerns with Nevada Assembly Bill 75 ("AB75"). As now proposed to be amended, AB75 would create an intrastate offering exemption which would allow issuers with no operating history, no audited financials, and no meaningful prospect of success to sidestep federal and state securities laws and sell illiquid private offerings to Nevadans earning at least $100,000.[1] AB75 proposes to allow sellers to solicit and obtain up to 10% of Nevadan's net worth (including 50% of the value of a person's home) on a per-transaction basis in these investments.

While the recent proposed amendment raises the income limit, this provision will shield some Nevadans for only a limited time. Without any indexing for inflation, the lasting impact of this increase will quickly diminish as the state income level approaches the new threshold.

1. Illiquidity in financial markets refers to investor's limited ability to sell their investment stake due to limited access to markets of willing buyers.

If passed, this legislation would threaten Nevadans' financial security and open the door to substantial fraud and abuse. For the reasons set forth below, we urge you to reject this legislation.

I. Securities Laws Provide Important Protections.

Public markets play an important role in the American economy. American issuers now have access to the world's largest and most well-developed capital markets. These markets allow businesses to raise capital and main-street Americans to save for retirement.

Investors benefit from public markets. If companies want to raise money from the public, securities laws require disclosure about the company's finances, governance, and operations. Market participants use this information to compare potential investment opportunities and to efficiently allocate their capital across the economy.

Public markets have thrived over the years because they instill trust and accountability amongst all participants. Businesses and their representatives conduct due diligence to ensure they provide accurate and complete information when they register new securities. In return, investors part with their hard-earned funds with the assumption that the information they receive has been properly scrutinized. Historically, public policy has favored this approach.[2] However, there has been a recent push to lower registration requirements and increase access to private markets. Yet private market offerings do not provide clear and uniform information to the public. This undercuts public markets and ultimately investors' interests.

AB75's proposed amendment lowers the standard for new securities registering with the state.[3] The amendment deviates from the enacting legislature's previously stated intent to direct stricter state attention to offerings that were not already federally registered.[4] While the proposed changes make it easier to issue new securities, they ignore the importance of

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2. North American Securities Administrators Association (NASAA), *Report and Recommendations for Reinvigorating our Capital Markets* (February 7, 2023), https://www.nasaa.org/wp-content/uploads/2023/02/NASAA-Report-and-Recommendations-on-Reinvigorating-Our-Capital-Markets-2.7.23-Final.pdf. [Hereinafter "NASAA Report"].

3. NEV.REV.STAT. § 490.091.

4. Minutes of the Assemb. Comm. on Com., Leg., 64th Sess. (Nev. 1987) https://www.leg.state.nv.us/Division/Research/Library/LegHistory/LHs/1987/AB457,1987.pdf.

maintaining the high standard of review that has promoted both public market success and investor protection.

II. Private Market Offerings Undermine the Benefits of Public Markets and Eliminate the Protections Individual Investors Rely Upon.

Congress and the SEC's expansion of exempt securities offerings has expanded private markets at an unprecedented rate. In fact, the number of exempt offerings has surpassed that of public offerings in recent years.[5] Unfortunately, the federal standard governing individual's access to risky private offerings leaves much to be desired.

The most substantial federal exemption, Regulation D, was designed "to simplify and clarify existing exemptions, to expand their availability, and to achieve uniformity between federal and state exemptions in order to facilitate capital formation consistent with the protection of investors."[6] Under Regulation D, individual investors must qualify as an "accredited investor," to participate in exempt private market offerings. The accredited investor standard aims to identify investors who possess the financial sophistication to evaluate the merits of private financial offerings and have the ability to bear the economic risk of the investment.[7] To qualify, an individual investor must either have a net worth of at least $1 million, excluding the value of their primary residence, or have an income above $200,000.[8]

The federal accredited investor standard has garnered considerable criticism.[9] The SEC's reliance on financial thresholds implies that wealthy

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5. SEC, Report to Congress on Regulation A / Regulation D Performance As Directed by the House Committee on Appropriations in H.R. Rept. No. 116-122 (Aug. 2020) at 41, https://www.sec.gov/files/report-congress-regulation.pdf.

6. Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389 (March 8, 1982), 1982 WL 35662.

7. Final Rule: Amending the Accredited Investor Definition Notice, 17 C.F.R. §230, 240 (Aug. 26, 2020), https://www.sec.gov/rules/final/2020/33-10824.pdf ("The final rules are tailored to permit investors with reliable alternative indicators of financial sophistication to participate in such investment opportunities, while maintaining safeguards necessary for investor protection and public confidence").

8. 17 C.F.R. § 230,501(a).

9. Thomas M. Selman, *Protecting Retail Investors: A New Exemption for Private Securities Offerings*, 14 Va. L. & Bus. Rev. 41 (2020); Wallis K. Finger,

investors possess the appropriate level of financial sophistication to assess private market offerings without needing to rely on mandated disclosures. Wealth, however, does not translate to investment acumen. Despite their considerable wealth and financial sophistication, many venture capital investors have fallen victim to private offering security frauds. Professor Fletcher, in her letter to the Assembly, put it aptly: "No amount of wealth or sophistication is a substitute for robust securities laws that provide all investors with the information needed to make informed investment decisions."[10]

The SEC's Investor Advisory Committee issued a recommendation for setting an appropriate dividing line for access to private markets. After carefully considering the issue, it found that an effective exemption standard should identify investors who are: (1) sufficiently sophisticated based on their knowledge and experience; (2) able to obtain or negotiate for access to important financial information; and (3) able to bear the economic risks associated with the private offering.[11] AB75's "Nevada certified investor" definition accomplishes none of these goals.

Like the federal accredited investor standard, AB75 improperly relies on financial metrics as a proxy for sophistication. In reality, private market investing often requires a high level of financial knowledge and expertise. In 2021, the median education level attained by Nevadans was that of "some college experience."[12] Without so much as an associate degree, individuals almost certainly be unable to accurately evaluate the validity and risks associated with private offerings. An effective metric should build upon the

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*Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition Under the 1933 Ac*t, 86 WASH. U. L. REV. 733 (2009); Howard M. Friedman*, On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291 (1994); *Syed Haq, Revisiting the Accredited Investor Standard*, 5 MICH. BUS. & ENTREPRENEURIAL L. REV. 59 (2015); Gregg Oguss, *Should Size or Wealth Equal Sophistication in Federal Securities Laws?,* 107 NW. U. L. REV. 285 (2012).

10. Gina-Gail S. Fletcher, Comment Letter on Assembly Bill 75, 2023 Leg., 82nd Sess. (Nev. 2023), available at https://drive.google.com/file/d/12c5i4Jfd_kPB2P HhVykMly0mEMzvEAAe/view.

11. Investment Advisory Committee, SEC, Accredited Investor Definition (October 9, 2014), https://www.sec.gov/spotlight/investor-advisory-committee-2012/ investment-advisor-accredited-definition.pdf.

12. U.S. Census Bureau, AMERICAN COMMUNITY SURVEY: 2021 ACS 1-YEAR ESTIMATES (2021), https://data.census.gov/table?q=education+in+Nevada+in+2021 &tid=ACSST1Y2021.S1501.

federal standard by imposing a minimum investment threshold, requiring professional credentials or relevant financial knowledge examination.[13] Instead, the proposed bill attempts to weaken standards even further to the detriment of Nevadans.

Nothing about the proposed class of Nevada certified investors suggests they will be able to negotiate for important financial information. AB75 imposes no disclosure obligations, meaning any disclosure will be voluntary. Functionally, Nevadans will depend on representations made by the issuer, which may contain overly optimistic (if not outright fraudulent) assumptions regarding future prospects.

Lastly, AB75's expansive intrastate exemption lowers the financial thresholds to the point that it exposes individuals who cannot afford to lose their investments. A Nevada certified investor, with half the income of a federal accredited investor, stands to lose just as much of their life savings in ill-advised investments.

III. AB75 Fails to Provide Adequate Protection to Nevadans Participating in Private Market Offerings.

AB75's income threshold assumes Nevadans earning at least $100,000 per year can protect their own interests in private markets. In reality, individual investors, regardless of income, may be taken advantage of in numerous ways that AB75 fails to address. We discuss these disadvantages as well as our specific concerns with AB75's shortcomings below.

a. Adverse Selection

The lack of disclosure requirements and the information asymmetry involved in exempt private market securities offerings can lead to significant adverse selection problems for Nevada investors. Consider the capital formation landscape a promising business venture would face if AB75 passed. It could either raise capital from a small group of relatively sophisticated

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13. SEC Staff Report, Report on the Review of the Definition of "Accredited Investor" (Dec. 18, 2015) https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf. The SEC staff recommended that the Commission consider permitting individuals to invest if they meet minimum investment thresholds, have professional credentials, have certain investment experience, are knowledgeable employees of private funds or pass an examination.

investors able to contribute larger sums under the existing rules and or it could pursue a mass of Nevadans making over $100,000 a year. Persuading a larger group to invest will consume more time and resources. Assuming the venture is not a fraud, communicating and coordinating with the larger group about their investment afterward will also take up more time than talking to a smaller group.

Promising businesses able to raise capital under the existing rules will likely continue to use the existing rules. To the extent AB75 would allow more businesses to raise capital, it would likely expand access to capital for the least promising and most ill-advised ventures currently unable to access capital. Put another way, this amendment makes it easier for new businesses to raise money who would otherwise not be able to, but not for good reasons. Businesses which are not considered creditworthy or investment worthy, and therefore unable to raise needed funds from banks and other sophisticated financial services institutions, will instead turn to these individual investors who bear lower degrees of sophistication and are therefore more likely to be drawn in by unrealistic representations of potential returns.

Moreover, the negotiating leverage for large investments differs from the leverage available for small investments. Even in a private market negotiation, a venture capital firm has bargaining power to obtain information and the resources to conduct some due diligence. In contrast, the individuals who will be fleeced under AB75 will not have the bargaining power to obtain truthful information or the resources to conduct any meaningful due diligence. As a result, the people who will suffer the losses when inevitably some, if not many or most, of these small capital raises fail, will be small individual investors least able to afford the loss.

b. Illiquidity Problems

Liquidity is another issue associated with private offerings. If investors buy offerings under AB75, no market will exist for them to sell the securities. Even if the investor located some interested potential buyer, the subsequent purchaser must incur additional costs of conducting their own due diligence to determine a fair price. This price will likely be at a steep discount to value because, again, no market for these securities will exist.

Ordinary investors often run into problems which cause them to need to sell investments. All too often, unexpected medical debts or job loss create unforeseen liquidity needs. Without any market for these securities, the investors will have no practical or timely ability to sell them. Moreover, these investments can be illiquid for an indeterminable amount of time. Investors

are frequently induced to invest in non-publicly traded investments with claims that they will get their money back within a relatively short period of time, maybe 5-7 years. What investors often don't realize is that those projections are non-enforceable guesses, and they may have to hold that investment for a decade or longer to get their money back, if they ever do.

Another meaningful problem is that the lower-income Nevadans most ready source of investment funds is their retirement funds. Using 401K rollovers or IRAs to purchase illiquid private placements puts those investors at risk should they find themselves of an age whereby they must take required minimum distributions per IRS rules. Obviously, those RMDs cannot be sourced from illiquid holdings.

c. AB75's Limitations Provide No Protection

AB75's limitation of the investment amount to 10% of the Nevada certified investor's net worth per transaction creates a serious loophole for private issuers to exploit. This per-transaction limitation does not prevent issuers from taking more and more from investors with subsequent transactions. Rather, when combined with the proposed amendment, it incentivizes issuers to repeatedly target the same investors, gradually draining them of their financial resources. Once an issuer has 75 certified investors, it may only raise additional funds from the same pool of investors. These issuers will likely pressure existing investors with rosy projections and broadcast the business' "growth" even if it's simply burning through investor capital. As the business will lack independent valuation, issuers can simply spin positive stories to separate investors from their cash. With a perceived increase in net worth, the investor may be persuaded to give more of their capital to the issuer. Ultimately, the 10% limitation is effectively meaningless; it does nothing to limit the investor's potentially grossly over concentrated investment in incredibly high risk endeavors, only slow it down slightly.

Issuers may alternatively bypass the amendment by selling a portion of equity into a separate entity, thus allowing the controllers of the new entity to draw funds from new investors. Without proper safeguards or financial disclosures to detect such behavior, this restriction is also ineffective.

d. Retirement and Primary Residence Assets Should be Excluded

AB75's inclusion of primary residence and retirement savings in net worth calculations further compounds the issues mentioned above. Excluding these

assets from the calculation of net worth is not only necessary for protecting vulnerable investors, but it is also a practical consideration. If an individual were to invest using their primary residence, they would likely need to take out a loan against it to access the liquidity needed to invest. This would increase their level of exposure to the investment, as they would be risking not only their investment but also their home. Excluding these assets is a common-sense approach to protecting investors from undue risk and ensuring that they can continue to rely on their primary residence and retirement savings for future stability.

e. Financial Intermediary Disclosure

Many businesses work with brokerage firms to raise capital. Businesses often agree to pay a commission whenever the brokerage firm recommends the business' securities to its customers. However, investors may not understand how this conflicted incentive structure drives the broker-dealer's recommendation. Brandon Dei, one of PIABA's member attorneys, described his experiences representing clients harmed in private placement offerings in the following statement:

> The most significant issue that I have seen when dealing with clients who lost an investment with a private placement offering is that the client has no knowledge that: 1) these private placement offerings are entirely commissioned incentive for the broker-dealer firm in the sale of the stock - not in the future performance of the stock; and 2) broker-dealers will usually do several offerings of the same company a few years in a row, thereby diluting the shares, decreasing the share price, and hurting their own client-investors. If the state of Nevada will allow for non-accredited investors to make investments in these offerings, the broker-dealers should also disclose all of their private placement offering deals to show a track record of how many of these companies actually succeed - most fail miserably for the investors.

Dave Liebrader, another PIABA member and a practicing Nevada securities attorney echoed Mr. Dei's concerns, adding:

> As a Nevada lawyer who regularly represents investors, I am concerned about the legislation including a person's house when calculating their net worth for this sort of exemption. It creates a real risk that Nevadans will end up losing their homes. The proposed exemption also lacks basic protections such as conflicts disclosures or a requirement for any financial history. Having seen too many people

hurt under the existing private offering rules, I hope the Nevada legislature does not make this mistake.

f. Frauds Abound in Private Markets

Fraud runs rampant in private markets. State regulators repeatedly point out unregistered offerings as a main source of securities fraud.[14] While not immune from fraudulent schemes, public market transactions are much less likely to be frauds. Recent events involving digital assets -including the FTX scandal- showcase the potential for harm when markets are allowed to operate outside of the parameters of securities laws.[15]

Consider for example, the recent Ponzi scheme that targeted members of the Mormon Church community for five years.[16] The perpetrators, including a Nevada attorney, operated under the guise of a risk-free investment opportunity involving advanced payments to tort victims.[17] Over 600 hundred individuals parted with roughly $449 million based on the promises of guaranteed returns. In reality, their money was used to finance the perpetrators' luxurious lifestyles and pay fictitious returns to keep the investment going.[18]

Affinity frauds such as this allow bad actors to exploit shared affiliations and conjure a false sense of trust. Those operating by selling unregistered securities have no obligations to substantiate the claims made to unsuspecting individuals. An intrastate exemption with lowered thresholds will only give these bad actors further opportunities to take advantage of a larger pool of unsuspecting investors.

g. AB75's Proposed Background Check Lacks Structure

Moreover, the proposed amendment's safeguards would do nothing to prevent such fraudulent schemes as they are not properly tailored to the

14. NASAA Report at 26.

15. Gina-Gail S. Fletcher, Comment Letter on Assembly Bill 75, 2023 Leg., 82nd Sess. (Nev. 2023).

16. Complaint at 1, *SEC v Beasley*, F.Supp. 2d (D.Nev. 2022).

17. *Id.* at 2.

18. *Id.* at 1-2.

securities markets. The amendment requires issuers to undergo a background check similar to that used for education licenses issued under N.R.S. 391.033. In private markets, however, the issuer is usually an entity seeking exemption. The statute has no process -unsurprisingly- for investigation into such entities, nor does it identify which executives, officers, and directors are subject to individual background checks. Further, the amendment offers no roadmap for regulators to rely upon should the background check reveal any problematic behavior. If, for instance, an executive of the issuing company has a criminal record, is the company automatically disqualified from the exemption? Is the issuer able to cure any deficiencies by terminating the executive's employment? Can the issuer rebut any substantiated reports revealed during the background check? While this requirement has the potential to benefit investors, in its current form, it falls significantly short of what is needed.

IV. Conclusion

Once again, PIABA appreciates the opportunity to comment on AB75. We urge the Nevada legislature to reject this bill that exposes far too many Nevadans to substantial financial harm.

PIABA would be happy to engage with the Nevada legislature further on this matter.

Respectfully submitted,
Hugh D. Berkson, President
Public Investors Advocate Bar Association

The following Comment Letter regarding *Pending Bills Before the HFSC set to Expand Access to Private Investments and Unregistered Securities* was submitted to the U.S. House Committee on Financial Services by Hugh Berkson on April 26, 2023. (prepared with the assistance of Joe Wojciechowski)

Chairman Patrick McHenry
Ranking Member Maxine Waters
U.S. House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

Re: Pending Bills Before the HFSC set to Expand Access to Private Investments and Unregistered Securities

Dear Chairman McHenry and Ranking Member Waters:

The Public Investors Advocate Bar Association (PIABA)[1] appreciates the opportunity to submit this letter relating to legislation that is currently pending before the House Financial Services Committee.

PIABA appreciates the interest in expanding access to private investment to a broader swath of Americans. The unfortunate reality is, repeatedly over history, private investments and unregistered securities victimize retail investors on an ever growing basis. It would be a potentially grave mistake for many retail investors if these many bills are passed into law without a scintilla of investor protection measures. As written, these bills seek to greatly expand the definition of "accredited investor" without adding any corollary language requiring certain safeguards be put in place by the Securities and Exchange Commission (SEC) to ensure proper governance and oversight.

At the outset, it is important to realize the accredited investor standard is imperfect and has faced criticism for years.[2] The SEC's reliance on financial

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

2. Thomas M. Selman, *Protecting Retail Investors: A New Exemption for Private Securities Offerings*, 14 Va. L. & Bus. Rev. 41 (2020); Wallis K. Finger, *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition*

thresholds implies that wealthy investors possess the appropriate level of financial sophistication to assess private market offerings without needing to rely on mandated disclosures. Wealth, however, does not translate to investment acumen. Despite their considerable wealth and financial sophistication, many venture capital investors have fallen victim to private offering security frauds.

Several bills in markup before the Committee seek to amend the accredited investor standard based on experience and acumen. In some instances, like amending the definition to include those individuals who are licensed financial advisors, makes sense. Other Bills seeking to expand the definition, however, will have a seriously negative impact on retail investor protection.

I. Current Bills in Mark-Up That Will Grossly Increase Fraud and Manipulation of Retail Investor Savings

a. PIABA Opposes Any Effort To Expand the Definition of "Accredited Investor" to Include Any Purchaser who is Solicited By an Investment Professional

The first bill which PIABA finds particularly troubling, expands the definition of "accredited investor" to include:

> any individual receiving individualized investment advice or individualized investment recommendations with respect to the applicable transaction from an individual described under section 203.501(a)(10) of title 17, Code of Federal Regulations.

This bill assumes that "an individual described under section 203.501(a)(10) of Title 17, CRF", has only made the recommendation in keeping with his or her fiduciary obligations as set forth in the Investment Advisers Act of 1940. In a perfect world that would be the case. The reality is private investments and unregistered securities actually represent a substantial percentage of all retail-investor related customer complaints and frauds.

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*Under the 1933 Ac*t, 86 WASH. U. L. REV. 733 (2009); Howard M. Friedman*, On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291 (1994); *Syed Haq, Revisiting the Accredited Investor Standard*, 5 MICH. BUS. & ENTREPRENEURIAL L. REV. 59 (2015); Gregg Oguss, *Should Size or Wealth Equal Sophistication in Federal Securities Laws?,* 107 NW. U. L. REV. 285 (2012).

According to the North American Securities Administrators Association (NASAA), in 2020, of the 595 investigations launched by state securities regulators, over 30% involved "unregistered securities", the largest of any single other investment type, and more than "traditional securities."[3] Statistics maintained by FINRA Dispute Resolution indicate that, in 2021, filed customer complaints which identify "limited partnerships" and "private equities" as being the investments at issue represent over 10% of investor complaints filed. The amount increases to over 33% if other "alternative investments" like non-traded Real Estate Investment Trusts and Business Development Corporations, are included.[4]

Under the current regulatory regime, access to private investments and unregistered securities is a substantial problem for retail investors. Under the proposed expanded regime, that problem will only get worse.

b. PIABA Opposes the Unlocking Capital for Small Businesses Act of 2023

The second proposed bill that PIABA opposes is the Unlocking Capital for Small Businesses Act for 2023. This law, if passed, would provide a safe harbor for private placement brokers and finders. This bill expands protections to "finders" of private investment and unregistered securities and allows them to earn substantial "finders fees" for their sales efforts. Despite any number of problems with this proposed bill, there is minimal language, beyond routine disclosures and a promise that the finders won't actively solicit investors, that either the SEC or the Congress considers for the protection of retail investors. By their nature, private investments lack the same level of disclosure information that securities subject to the strictures of public markets are mandated to provide. By their nature, they lack the requisite public market scrutiny of business plans and models, likelihood of success, routine background information, site visits, audited financial statements, and any other common due diligence obligations required of every publicly sold security. Allowing unlicensed and untrained "sellers" to broadly solicit the sale of this category of private investments to an even larger populace of retail investors is a catastrophe in the making.

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3. https://www.nasaa.org/wp-content/uploads/2021/09/2021-Enforcement-Report-Based-on-2020-Data-FINAL.pdf.

4. https://www.finra.org/arbitration-mediation/dispute-resolution-statistics#top15securitycustomers.

The Act allows non-registered finders to accept transaction-based compensation—up to $500,000 per year—for directing accredited investors to private placement deals. Yes, the Finders are still not supposed to "solicit" investments, but with incentives potentially that lucrative, it is difficult to think that an un-registered Finder will show much restraint. No doubt, investors will also view the presentations by these Finders as being endorsements for the products that are being peddled.

This bill revises the regulatory treatment of Private-Placement Brokers (brokers who receive transaction-based compensation for the sale of exempt securities for introducing an issuer and a buyer) and Finders (non-registered private-placement brokers who do not exceed a specified amount of compensation ($500,000 per year), transaction value (< 15MM per transaction per year or < 30MM per year total), or number of transactions in a year (< 16 per year).

Specifically, the bill:

(1) requires the Securities and Exchange Commission to establish registration requirements for Private-Placement Brokers that are no more stringent than those imposed on crowdfunding portals,

(2) allows for membership in any national securities association for private-placement brokers,

(3) requires that the Private Placement Broker disclose that they are acting as a Private Placement Broker, the amount of anticipated compensation, the person to whom the payment is made, and any beneficial interest in the issuer.

PIABA opposes passage of this bill which allows untrained and unqualified "finders" to solicit retail investors to invest in the most speculative, opaque, and illiquid securities in the marketplace.

c. *The Private Investment Marketplace is a Hot Bed for Fraud That Impacts Retail Investors*

The effort to expand the reach of private placements to a wider swath of Americans must be viewed in light of the ongoing issues with such products. Simply put, private placements and unregistered securities make up a substantial percentage of reported investor complaints. Consider Americans' experience in 2021 alone. In February 2021, the SEC charged GPB Capital Holdings, LLC, and other defendants with operating a "long running and

multi-faceted scheme" which defrauded investors out of almost $1 billion.[5] The United States Attorney for the Eastern District of New York brought criminal charges in 2021 and the defendants are awaiting trial. The investors GPB targeted to raise capital were retail investors. GPB used a network of over sixty broker/dealers and registered investment advisers to reach the pockets of retired and financial unsophisticated investors.

The year also featured two instances in which Texas-based private investments ruined the retirement of hundreds of retail investors: The DeepRoot Funds and Heartland Capital scandals. Both of these entities used unregistered "finders," or RIAs, to sell private equity interests in these companies to retail investors across the country.[6] Both ended up in liquidation amid SEC and Department of Justice allegations of securities fraud and have collectively cost retail investors about $150 million. Litigation poised to recover these funds from these "finders" usually goes nowhere because they are uncollectable and carry no viable liability insurance coverage. These problems for retail investors are compounding and the newsreel is filled with similar stories almost daily.

d. Numerous Bills Pending Markup which Expands the definition of Accredited Investor Must Also include Mandates from the Congress to the SEC to properly regulate.

There are six bills pending markup in your Committee which, in one way or another, expand the definition of Accredited Investor and as such expand access to this market. PIABA believes the passage of these Bills should be dependent upon additional language requiring the SEC to study the following issues in connection with retail investor complaints against RIAs generally.

5. *Securities and Exchange Commission v. GPB Capital, et al.,* 21-cv-00583 (E.D.N.Y.).

6. *Securities and Exchange Commission v. Robert J. Mueller, DeepRoot Funds, LLC, and Policy Services, Inc.* 21-cv-00785 (W.D. Tex.); *and Securities and Exchange Commission v. The Heartland Group Ventures, LLC, et al;* 21-cv-01310 (N.D. Tex.).

1) Require the SEC to study the number of investor complaints filed against RIAs that involve private securities;
2) Require the SEC to study and make available a report about the outcomes of these cases to determine success rates and collectability of any awards or judgments;
3) Require the SEC to study RIA disclosure of customer complaints;
4) Require the SEC to study whether RIAs are abusing the private arbitration process; and,
5) Require the SED to study, and to require the disclosure of, liability insurance maintained by RIAs who solicit investors to purchase private securities.

If the Congress is intent on expanding access to private securities, it must include some measure of oversight to ensure the SEC is cognizant of the serious issues faced by retail investors by RIAs. The bills, if passed without such strictures, will expose countless Boomers who are retiring in record numbers and susceptible to compelling sales pitches to invest (and ultimately lose) their irreplaceable 401K funds. PIABA does not believe it best for Congress to facilitate those hard-working Americans' need to turn to public social services after their retirement funds have been depleted by unscrupulous and unregulated financial professionals.

Very Truly Yours,
Hugh Berkson
President, Public Investors Advocate Bar Association

The following Comment Letter regarding *SR–FINRA–2023–006– Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Proposed Rule Change to Adopt Supplementary Material .19 (Residential Supervisory Location) Under FINRA Rule 3110 (Supervision)* was submitted to the SEC by Hugh Berkson on April 26, 2023. (prepared with the assistance of Daren Luma)

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

RE: File Number SR–FINRA–2023–006 – Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Proposed Rule Change to Adopt Supplementary Material .19 (Residential Supervisory Location) Under FINRA Rule 3110 (Supervision)

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 change to amend FINRA Rule 3110 (Supervision). FINRA has filed proposed rule 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 a residential supervisory location and then create rules and procedures for the supervision of same.

The proposed rule is substantially similar to the rule proposal FINRA filed with the SEC in July 2022, (SR-FINRA-2022-019) which was twice published for comment on August 2, 2022 and November 4, 2022. PIABA published two separate comment letters on August 23, 2022 and November 22, 2022 in response to that rule proposal asking the SEC to reject the rule proposal. As

discussed in detail below, PIABA again submits this comment asking the SEC to reject this proposal.

PIABA submits this comment because the bar association believes the amendment 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 and fosters new opportunities for those advisors to engage in sales abuses.

Background

As a result of the Covid pandemic, regulators eased regulatory requirements to accommodate brokerage firm employees working at home. This effort included the introduction of new technologies to permit remote supervision. As part of the rationale for this proposal, FINRA states that it "believes that this [work from home] model will endure" and that there is a "growing expectation for workplace flexibility."[1] FINRA further states that this was an opportunity to "consider aspects of Rule 3110 that may benefit from modernization."[2]

While PIABA appreciates FINRA's desire to accommodate new ways of working, the accommodation cannot come at the expense of investor protection: the stated purpose of FINRA, the SEC and the securities laws themselves. As such, any sort of "work from home" accommodation must ensure that investor protection is not reduced in any way. Such accommodations are a privilege, not a right, and should only be permitted with sufficient safeguards, restrictions and limitations as to ensure that the brokerage industry and FINRA's investor protection ability is not degraded at all.

FINRA withdrew its prior 2022 rules proposal (SR-FINRA-2022-019) concerning establishing residential supervisory locations after receiving intense criticism from PIABA and particularly NASAA. FINRA has now re-filled a substantially similar rule proposal for residential supervisory locations that does contain some improvements from its prior rules proposal, but still fails to adequately protect investors and should therefore be rejected by the SEC.

1. 88 Fed. Reg. 20568, 20569 (April 6, 2023).

2. *Id.*

Regular Periodic Schedule of Inspections (Once Every Three Years) is Insufficient

Just as in FINRA's prior proposal, the current rule proposal is for residential supervisory locations to be on a regular periodic schedule of inspections, presumed to be every three years, rather than an annual schedule of inspections that branch office locations must utilize. PIABA believes this is a mistake that unnecessarily increases risks to investors.

In our prior comment letter, PIABA cited a host of regulatory actions involving brokers running "selling away" or Ponzi schemes from residential or remote (often one-broker) offices, including regulatory actions by both FINRA and the SEC which recognized that supervision of smaller branch offices presented "greater supervisory challenges" than traditional brokerage firm offices.[3] As such, it makes no sense to have a looser audit schedule for such locations.

FINRA argues that a firm's remote "surveillance and technology tools" will ensure firm's adequately supervise representatives and that investor protection is not degraded. However, this understates the issues firms face with remote supervision. As PIABA previously noted:

> 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 in plain sight of their office. Obviously, a remote inspection would not uncover such problems.[4]

Accordingly, residential supervisory locations should at minimum be subject to annual in person audits, if not more frequent unannounced visits, rather than periodic inspections every three years.

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3. *See* PIABA Comment Letter to Vanessa Countryman, File No. SR-FINRA-2022-019 (November 22, 2022), pgs. 3-4.

4. *Id.* at pgs. 2-3.

Exclusions for Associated Persons with Multiple Customer Complaints or Arbitrations

In response to criticism from NASAA, FINRA expanded the residential supervisory location ineligibility criteria to include instances where "one or more associated persons at such location is currently subject to, or has been notified in writing that it will be subject to, any investigation, proceeding, complaint or other action by the member, the SEC, an SRO, including FINRA, or state securities commission . . . alleging they have failed reasonable to supervise another person subject to their supervision."[5]

PIABA supports this expansion of the ineligibility criteria to preclude associated persons who have subject to failure to supervise complaints or investigations by securities regulators, as such individuals pose a further enhanced risk to investor protection. However, PIABA believes that FINRA should have expanded the ineligibility criteria even further to preclude associated persons who have been the subject of multiple customer complaints, consumer-initiated, investment-related arbitrations or civil litigation.

In our members' experience, customer complaints and/or consumer-initiated, investment-related arbitration and/or civil litigation claims are often the "canary in the coalmine" that are the first sign of problematic associated persons. Regulatory proceedings frequently begin after a customer complaint, arbitration or civil litigation U4 disclosure filing is made and can take many months or years to conclude. There is no reason to wait for formal regulatory action to prohibit associated persons with multiple complaints, arbitration or litigation claims from operating at a residential supervisory location. Rather, FINRA's investor protection mandate dictates that associated persons with multiple customer complaints and/or arbitration or civil litigation claims should be disqualified from operating at a residential supervisory location where supervision poses a greater challenge. As noted above, the ability to operate at a residential supervisory location should be a privilege, not a right. Thus, any supervisory or compliance doubts concerning an associated person must be resolved in favor of investor protection by precluding such individuals from operating at a residential supervisory location.

5. 88 Fed. Reg. 20568, 20577 (April 6, 2023).

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 *SEC S7-32-22 Proposed Rule – Regulation Best Execution* was submitted to the SEC by Hugh Berkson on March 29, 2023. (prepared with the assistance of Dave Neuman and Daren Luma)

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

Re: SEC S7-32-22 - Proposed Rule – Regulation Best Execution

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 Securities and Exchange Commission ("SEC") and Financial Industry Regulatory Authority ("FINRA") relating to both investor protection and disclosure.

The SEC is proposing to enact Regulation Best Execution. While the NASD (FINRA's predecessor) created a best execution rule back in 1968, this is apparently the first rule of its kind proposed by the SEC, according to the SEC press release regarding this rule proposal. However, a lot has changed between 1968 and now. Trading volume has grown exponentially over the last few decades. As an example, U.S. Census Bureau data shows that: 1970 saw approximately 3.1 billion shares traded on the NYSE; 27.7 billion shares were traded in 1985; and, approximately 601 billion shares were traded in 2010[1]. As online discount brokerage firms like RobinHood have entered the market, we presume the trading volume has continued to increase. Simply put, the ever-increasing use of the financial markets by individual retail investors requires the SEC to enact regulations that protect those retail investors.

There are notable recent cases of firms failing to provide proper execution for customer trades, such as *Robinhood Financial*, Admin. Proc. 3-20171, SEC

1. *See* Volume of Trading on New York Stock Exchange, U.S. Census Bureau, available at https://www2.census.gov/library/publications/2011/compendia/statab/131ed/tables/12s1210.xls (last visited Mar 10, 2023).

Release No. 10906 (Dec. 17, 2020)(the firm failed to disclose it sought and received the best compensation for routing order flow, and clients did not receive best execution from those paying Robinhood for the order flow); and *Kahn Brothers Advisors*, Admin. Proc. 3-20880, SEC Release No. 95045 (June 6, 2022)(the investment advisory firm performed no tests to confirm its clients were receiving best execution as it exclusively used its affiliated broker/dealer to clear trades) These sorts of cases demonstrate the need for rules governing execution.

PIABA generally supports the proposal. In particular, PIABA hopes that the rules can provide uniformity to the securities brokerage industry and put investors, big and small, on an equal footing with one other. Uniformity will also bring clarity to all parties involved, including the industry participants and investors.

PIABA also asks that the Regulation Best Execution conform with the spirit of Regulation Best Interest, which was put into effect on June 30, 2020. In particular, PIABA is concerned about any potential conflicts of interest in execution. Regulation Best Interest seeks to mitigate those conflicts and PIABA hopes that Regulation Best Execution would also mitigate any conflicts as much as it practically can.

PIABA agrees with the Commission's proposal to require broker-dealers' best execution policies and procedures to address additional considerations with respect to "conflicted transactions," such as affiliate transactions, principal transactions or transactions for which the broker-dealer has received payments for order flow. PIABA believes this part of the proposal, which goes beyond the existing requirements of FINRA and MSRB's best execution rules, is a crucial addition to the best execution standard. PIABA further supports requiring broker-dealers to document their compliance with the best execution standard for conflicted transactions and agrees with the Commission that this would "assist broker-dealers in complying with proposed Regulation Best Execution and regulators in overseeing broker-dealers' compliance."[2]

PIABA looks forward to seeing how these efforts by the Commission to ensure broker-dealers appropriately manage any conflicts of interest they have in trade execution work to ensure retail investors actually receive best execution on their securities trades. Obviously, an investor's rational fear they are not receiving best execution as regulators and brokers say they are entitled to works to weaken confidence in the American securities exchanges and markets. PIABA therefore urges the Commission to continue its efforts to engage in additional focused rule-making as it seeks to fulfill its mandate to protect investors and ensure confidence in the American capital markets.

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2. SEC Regulation Best Execution, 88 Fed. Reg. 5440, 5468 (Jan. 27, 2023).

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

Very Truly Yours,
Hugh D. Berkson
President, Public Investors Advocate Bar Association

Notes & Observations