November 2, 2023

The Honorable Gary Gensler
Chairman
U.S. Securities Exchange Commission
100 F Street, NE
Washington, DC 20549
Chair@sec.gov

Re: Request to Further Investigate RIA Mandatory Arbitration

Dear Chairman Gensler:

As organizations that advocate on behalf of investor protection and retail investors' rights, we write to express our concern regarding the use of mandatory arbitration clauses and similar contractual provisions by Registered Investment Advisers ("RIAs"). These contractual provisions are subject to oversight by the Securities and Exchange Commission ("SEC"). Our concern relates to the lack of transparency related to the SEC's findings in the June 2023 Report to Congress addressing the expressed concerns about the proliferation of mandatory arbitration clauses among SEC-registered investment advisers.

Specifically, the SEC's June 27, 2023, "Response to Congress: Mandatory Arbitration Among SEC-Registered Investment Advisers" ("the SEC Report" or "Report") found that the SEC did not possess quantifiable data to analyze arbitration claims or outcomes. The Report also revealed that the Commission had no data on RIAs using forced arbitration clauses, expensive private arbitration providers, and deceptive contractual hedge clauses designed to shield themselves from claims brought by their customers.

The SEC's inability to evaluate the "effects" of mandatory arbitration clauses on advisory clients from a lack of information underscores the need for increased oversight to ensure the protection of retail investors related to forced mandatory arbitration, exorbitant costs, deceptive hedge clauses, and the lack of public information on RIA arbitrations.

1. RIAs Routinely Force Investors into Expensive, Mandatory Arbitration

The SEC Report estimated that approximately 61 percent of SEC-registered advisers that serve retail investors incorporate mandatory arbitration clauses into their investment advisory agreements. Importantly, the SEC noted in its report that this figure might be "conservative." We agree – that figure is conservative.[1]

However, unlike brokerage firms, which, pursuant to FINRA rules are *required* to allow investors to arbitrate claims in the FINRA Dispute Resolution Forum, RIAs are not subject to any similar requirements. Instead, RIAs overwhelmingly designate expensive privately run dispute

[1] The high percentage correlates to the Public Investors Bar Advocate Association's ("PIABA's") analysis into this precise issue. Specifically, PIABA recently gathered and analyzed 189 contracts RIAs used with their clients. 28 contracts were from the larger SEC-registered investment advisers. 161 came from smaller state-registered investment advisers. Of those 189 contracts, 110 (58 percent) contained forced arbitration clauses.

resolution forums such as the American Arbitration Association or JAMS in their arbitration clauses. The SEC Report found that 92 percent of RIAs serving retail investors which incorporated mandatory arbitration clauses into their investment advisory agreements designate AAA or JAMS as the dispute resolution forum. Again, this high percentage correlates to PIABA's findings that 75 percent of the 189 forced arbitration clauses it analyzed mandated the use of JAMS and AAA.

These findings are important because the designated private dispute resolution forums are prohibitively expensive and thereby chill investors' ability to even *attempt* to bring claims to recover their losses. For example, if an investor wants to pursue their claims before an arbitration panel under the AAA Commercial Arbitration Rules, or with JAMS, they must pay unrealistically large filing fees and deposit huge sums of money with the forum for the arbitrators' fees and forum charges prior to any hearing. In addition to requiring a retainer from the investor, these forums also require that the respondent firms and individuals deposit their portion of the fees before the forum will proceed with the claims. If the firm or adviser has not paid their share, the forum will not allow the hearing to proceed unless the investor pays the respondent's share of the deposit. The investor may incur the full cost of the arbitration just to be able to pursue their rights.

The costs do not end with the initial deposit for RIA clients pursuing arbitration claims. Notably, the SEC's Report also found that, of the 60 percent of mandatory arbitration clauses that designated a venue for the arbitration hearing, 97 percent designated a location that does not consider the client's location or place of business. Many of these agreements designed venue locations "of the adviser's choosing" or "wherever the adviser is located." Accordingly, wronged investors must lose additional time and incur travel and lodging costs, to attend a distant hearing in person.

The staggering costs associated with private arbitration forums operate as a shield for RIAs and a barrier for investors. Consider the case of one particular RIA client who shared her story following the release of the SEC's report this past summer. The RIA client facing a potential bill from the arbitration provider of up to $202,000 for an arbitration hearing on a claim of principal losses of $228,000.[2] A complete win would net her nothing and losing the case would double her losses. The outsized fees put individual investors at a significant disadvantage against the deep coffers of large RIAs.

The significant costs of AAA and JAMS arbitration are in stark contrast to FINRA's Dispute Resolution Forum, where FINRA member firms subsidize the bulk of FINRA arbitration forum fees. While additional forum fees may be assessed against the investor at the end of a FINRA hearing, investors can proceed with their FINRA arbitration claim by paying only the initial filing fee set forth on a graduated scale ranging from $50 to $2,300, depending on the amount of damages sought. Indigent investors may also obtain a waiver of all or a portion of the initial FINRA filing fee. Even if the FINRA member firm or associated person does not timely pay their share of forum fees, FINRA allows the case to proceed. In our experience, most investors have no idea that the dispute resolution forum applicable to their brokers – who may or may not be fiduciaries,

[2] *See* https://www.wealthmanagement.com/regulation-compliance/piaba-will-look-congress-if-sec-doesnt-act-forced-arbitration, last viewed September 20, 2023.

depending on applicable state law – is often more accessible than the forum applicable to their RIA – who often boast that they *are* fiduciaries.

2. The Frequency of Hedge Clauses, Choice of Law and Venue Provisions in RIA Investment Advisory Agreements Raise Yet Another Alarm Warranting Regulatory Intervention

The SEC's Report also noted that hedge clauses are frequently used in RIA investment advisory agreements.[3] The SEC previously expressed concern that such clauses might violate the Advisers Act's antifraud provisions by misleading investors into not exercising their legal rights. These clauses are used to deceive investors into not bringing viable, compensable claims for wrongdoing, by making them believe they waived their rights at the time they entered into their advisory agreement with their advisers. Hedge clauses are not allowed in FINRA members' customer agreements.[4] This is a pervasive issue across the SEC-regulated RIA industry. Despite the SEC's public sanction issued in 2022 against an RIA for using hedge clauses in agreements with customers, the practice still persists.[5]

3. The Use of Choice of Law and Hearing Location Clauses Tilt Disputes in Favor of RIAs

In addition to hedge clauses, PIABA's study also found that RIAs used choice-of-law clauses to pick the law most favorable to them and hearing location selection clauses to set hearing locations far from their clients' homes. Such practices are expressly forbidden by FINRA for its member firms.[6] It is shocking that RIAs with the greater fiduciary duty owed to their customers are allowed to engage in such oppressive conduct.

4. The Lack of Publicly Available Information Concerning Complaints Made Against RIAs Harms Investors.

As previously noted, we are troubled by the lack of public information concerning RIA arbitrations. As the SEC acknowledged in its Report, RIAs do not uniformly disclose their arbitration clauses: "the opaque nature of adviser arbitration and difficulty accessing adviser

[3] Hedge clauses are exculpatory provisions in an investment advisory contract that attempt to limit the adviser's liability to instances in which the adviser was grossly negligent or acted with willful intent. Accordingly, they seek to strip the investor of common causes of action that arise when the adviser acts wrongfully.
[4] FINRA Regulatory Notice 21-16.
[5] *In re: Comprehensive Capital Management*, ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTIONS 203(e) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS, AND A CEASE-AND-DESIST ORDER, Investment Advisers Act of 1940 Release No. 5943 / January 11, 2022 Administrative Proceeding File No. 3-20700. It should also be noted that PIABA's study revealed 71 percent of the SEC-registered investment advisers used improper disclaimers of liability for wrongdoing.
[6] FINRA Regulatory Notice 21-16.

arbitration information raises questions about the ability of regulators to evaluate adviser conduct in the context of client disputes."[7] That opacity manifests itself in a number of critical manners.

First, even when an RIA has disclosed the existence of a mandatory pre-dispute arbitration clause in the Form ADV, a significant amount of information is missing because there is a lack of uniformity in the clauses. Many of these arbitration clauses lack information about the fees required to initiate and pursue the claim, the hearing location, any limitations on the ability to make claims, and any limitations on the dispute resolution process such as limits to discovery or the length of a hearing.

Second, RIAs do not uniformly disclose investor complaints or their outcomes. It is impossible to know how many investor complaints have been made against an RIA, whether the complaint resulted in an arbitration claim or lawsuit, and the outcomes of any arbitrations or lawsuits including whether any arbitration award or judgment has been paid. As a result, there is no clear picture on whether investors doing business with RIAs actually have access to their RIA's true history. The SEC Report noted that, while the Commission urges investors to check their potential advisers' background, a review of the publicly available information will in many instances lead to a false sense of security since no customer complaints or awards are disclosed.

Finally, there is a lack of meaningful data about whether RIA arbitration awards are actually paid. While the SEC Report notes that private dispute resolution forums do not track information about unpaid awards, and that such awards are rarely noted in the CRD system, previous analyses of this issue amongst FINRA broker-dealers paint a grim story. Since the SEC maintains *no* data concerning RIA/IAR award payments, it is reasonable to assume that the investment adviser industry's likelihood to pay an award is similar to the brokerage industry.[8] In 2020, FINRA reported 64 awards in customer claimant cases, with total awards of $20,895,826.21. PIABA's analysis showed that, of those totals, 19 customer awards and a total of $5,050,328.98 went unpaid. While the dollar amount of unpaid awards seems modest compared to other years' experience, it reflects 24 percent of all dollars awarded in 2020 were unpaid. Nearly three out of every ten awards in Claimants' favor went unpaid in 2020.[9] While we have every belief that the statistics will be no more favorable for the RIA industry, it is obviously crucial that the SEC gather such data for those under its jurisdiction.

---

[7] Securities & Exchange Commission, Response to Congress: Mandatory Arbitration Among SEC-Registered Investment Advisers as Directed by the House Committee on Appropriations, H.R. Rept. No. 117-393 (June 27, 2023), at p. 24. Accessible at https://lxrdc.com/wp-content/uploads/2023/06/mandatory-arbitration-among-sec-registered-investment-advisers.pdf

[8] NASAA's annual studies show that Investment Adviser Representatives ("IARs") face regulatory sanctions as often do broker/dealer Associated Persons ("APs") on a percentage basis. *See* https://www.nasaa.org/policy/enforcement-statistics/#:~:text=In%202021%2C%20they%20investigated%207%2C029,actions%2C%20and%201%2C284%20administrative%20actions.

[9] Hugh Berkson and David P. Meyer, FINRA Arbitration's Persistent Unpaid Award Problem: PIABA's Third Report Concerning FINRA's Refusal to Tackle the Unpaid Arbitration Award Problem Head-On (September 29, 2021), at https://piaba.org/system/files/2021-09/PIABA%20Report%20-%20FINRA%20Arbitration%27s%20Persistent%20Unpaid%20Award%20Problem%20%28September%2029%2C%202021%29.pdf.

Conclusion

RIAs are fiduciaries. Yet the unchecked use of pre-dispute mandatory arbitration clauses by RIAs continues to impose unfair and significant barriers for investors seeking nothing more than to exercise their legal rights after a dispute with their financial professional. The unfair practices result in unknown millions of dollars of otherwise recoverable investment losses, including retirement savings being effectively shielded from adjudication. The undersigned coalition contend that the use of clauses designed to act as a shield from liability by preventing the investor from obtaining a fair hearing is inconsistent with the advisers' fiduciary duty.

Accordingly, we urge the SEC to:

1. Use its examination authority to gather opening account documents, including client advisory contracts and agreements, customer account disclosures, or other client-facing documents that include mandatory pre-dispute arbitration clauses from each RIA under its jurisdiction to analyze the nature and extent of the mandatory pre-dispute arbitration clauses found to discern anti-investor trends therein;
2. Use its examination authority to investigate the nature, extent, and resolution of customer complaints against RIAs;
3. Require that RIAs under its jurisdiction both publicly report the existence of customer complaints (regardless of whether such complaints rise to the level of arbitration claims or lawsuits), and the resolution of those complaints – as the brokerage industry is required to do; and,
4. Once SEC has statistically significant data in hand, enact reforms to curb the abuse of mandatory pre-dispute arbitration clauses and problem with RIA unpaid awards.

Thank you for your attention to this matter. The SEC Report confirmed what we already feared to be the case, and we look forward to the SEC's ongoing efforts to curb the problems identified in the Report.

Respectfully submitted,

American Federation of Labor and Congress of Industrial Organizations (AFL-CIO)

Americans for Financial Reform Education Fund

American Association for Justice

Better Markets

Consumer Action

Consumer Federation of America

Public Citizen

Public Investors Advocate Bar Association

National Association of Consumer Advocates

Revolving Door Project

20/20 Vision

CC: The Honorable Hester Peirce
The Honorable Caroline A. Crenshaw
The Honorable Mark Uyeda
The Honorable Jaime Lizárraga
The Office Investor Advocate
The Honorable Steve Womack
The Honorable Steny Hoyer
The Honorable Matthew Cartwright