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CLOSED-END FUND IPO CONSIDERATIONS
Benjamin P. Edwards

CHURNING 2016
Brian J. Henderson, Craig J. McCann and Mike Yan

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CLOSED-END FUND IPO CONSIDERATIONS

*Benjamin P. Edwards**

INTRODUCTION

While closed-end funds (CEFs) have a long history, relatively recent research in economics and finance has provided new insights about these funds. This essay explains the unique structure of CEFs and argues that absent a compelling reason, investors should generally avoid purchasing CEF shares in an initial public offering (IPO).

Few investment options seem less attractive than buying the shares of a closed-end fund in an IPO, particularly if similar CEFs already exist. Indeed, the continuing existence of CEFs has puzzled economists for decades. Because the IPO shares are sold at a premium and will soon trade at a significant discount, economists cannot discern any good reason why a rational investor would purchase CEF shares in an IPO instead of purchasing the shares of a CEF already on the market.[1] If no rational investor would buy CEF shares during an IPO, then CEFs should eventually cease to exist because new CEFs would not be created.[2] Yet CEF IPOs persist, and stockbrokers continue to sell CEF shares to retail investors, despite a long record of underperformance.[3]

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1. *See* Charles M. C. Lee, Andrei Shleifer & Richard H. Thaler, *Anomalies: Closed-End Mutual Funds*, 4 J. ECON. PERSP. 153 (1990) [hearinafter *Anomalies*] ("So, puzzle one: Why does anyone buy these funds when they are first issued?"); Charles M. C. Lee, Andrei Shleifer & Richard H. Thaler, *Investor Sentiment and the Closed-End Fund Puzzle*, 46 J. FIN. 75, 75 (1991) [hereinafter *Investor Sentiment*] ("Few problems in finance are as perplexing as the closed-end fund puzzle").

2. *See* Kathleen Weiss Hanley, Charles M. C. Lee & Paul J. Seguin, *The Marketing of Closed-End Fund IPOs: Evidence from Transactions Data*, 5 J. FIN. INTERMEDIATION 127, 127 (1996) ("in a rational expectation equilibrium, these [CEFs] should not get started at all").

3. One recent study revealed that when compared against CEF shares already on the market (seasoned shares), shares purchased during a CEF IPO underperformed seasoned shares by 8.52% after six months and 11.05% after one year. DIANA SHAO, CLOSED-END FUND IPOS: SOLD NOT BOUGHT (Aug. 27, 2015) (unpublished

This essay breaks down some of the unique characteristics of CEFs and their IPOs. It then turns to consider whether broker-dealer firms conducting CEF IPOs act in a manner consistent with their customers' best interests. Ultimately, I argue that the sale of CEF IPO shares appears difficult to reconcile with the best interests of retail investors.

I. CLOSED-END FUND CHARACTERISTICS

A CEF is an investment company that differs from more common open-end mutual funds in important ways.[4] Unlike the ordinary open-end mutual fund, a CEF does not continually offer shares for investors to purchase. Rather, a CEF sells a fixed number of shares at one time.[5] If the CEF's investors seek to liquidate their holdings, they must find another market participant to buy their shares. A CEF share's value is determined by the supply of and demand for the CEF share. The CEF does not sell any assets to redeem shares until some later point when it may liquidate or convert into an open-end fund. This means that the market sets the price for a CEF's shares and that it may differ significantly from the net asset value (NAV) of the assets held by the CEF.[6] In contrast, the price of an ordinary mutual fund's shares is set by the value of its assets, which are sold or purchased as money flows out of or into the fund. This means that investors holding ordinary mutual fund shares may sell their shares in exchange for a payment approximating the mutual fund's NAV. This is not always the case with CEFs, which frequently trade at a discount to NAV because the secondary market value for CEF shares frequently settles at some point significantly below the CEF's NAV.

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manuscript), http://ssrn.com/abstract=2652432 or http://dx.doi.org/10.2139/ssrn.2652432.

4. For a description of the difference, *see* Daniel S. Alterbaum, *Control Share Acts, Closed-End Funds, and the Battle for Corporate Control*, 17 STAN. J.L. BUS. & FIN. 310, 316 (2012).

5. *See* SEC, *Closed End Fund Information*, FAST ANSWERS, available: http://www.sec.gov/answers/mfclose.htm (last modified Jan 16, 2013).

6. A fund's NAV is calculated by dividing the funds asset value by its number of shares outstanding.

A. The CEF Initial Public Offering Puzzle

CEF IPOs puzzle economists because the public pays more for a CEF's shares than the value of the assets held by the CEF. Put differently, investors purchasing CEF shares in an IPO seemingly pay more for the shares than they are worth.[7] Creating a CEF is not costless. The overall underwriting and promotion expenses may reach about eight percent of the offering price.[8] After raising these funds and paying offering expenses, the CEF uses the remaining proceeds to buy its portfolio of securities—assets which already have established market values. This raises an obvious question: why would any rational person pay $100 for $92 of assets? What justifies this significant premium?

If a CEF's shares increased in value after the IPO, that price increase could explain why investors would pay a premium for shares. But this is not what happens. CEF IPOs differ significantly from the IPOs of the securities of traditional industrial issuers, *i.e.*, firms that produce goods for sale. When an industrial firm goes public, the securities offered in the IPO usually increase in price by a significant amount, rewarding purchasers and making the decision to purchase IPO shares rational.[9] In contrast, CEF IPOs generally provide their purchasers with zero first day returns because the CEF shares do not ordinarily trade for an amount greater than the CEF's net asset value.

The different first day behavior for industrial firm IPOs and CEF IPOs makes intuitive sense. When an ordinary business sells shares to the public in an IPO, no established market value for the firm exists. As the shares begin to trade, the market sets a price for the shares and values the company. To induce investors to purchase the shares at the IPO, industrial firms ordinarily price their IPO shares at something below anticipated market price. When the shares hit the market, they frequently trade up—which is to say that the shares appreciate in price as other market participants bid to acquire the shares because they view the IPO price to be less than the firm's intrinsic value—or at least the value other market participants will likely assign it. In contrast, a CEF generally purchases financial assets that already have established market values; the CEF's shares do not ordinarily trade up. This indicates that market

7. *Anomalies*, *supra* note 1, at 162 ("To explain why investors buy funds initially at a premium *one needs to have noise traders, or 'suckers,'* who are sufficiently optimistic to buy overpriced assets") (emphasis added).

8. Hanley *et al.*, *supra* note 2.

9. Hanley *et al.*, *supra* note 2 ("While industrial IPOs have an average initial day return of approximately sixteen percent, closed-end fund IPOs show zero first-day returns").

participants do not view the CEF's creation as transformative enough to justify paying more than $100 per share for approximately $92 of net asset value per share.

B. The Puzzling Discount

The decision to purchase shares in a CEF IPO appears even more puzzling because the shares that are first sold at a premium soon sink to trade at a discount to the CEF's NAV as the fund seasons.[10] A "seasoned" CEF is one that has already been on the market for some time and is generally trading at a discount.

Why seasoned CEFs trade at a discount also puzzles economists because a CEF's assets have established market prices. When a seasoned CEF owns $92 of securities, a rational investor would seemingly want to buy a CEF share if it were priced below $92 because the investor would be able to acquire $92 worth of assets for something less than $92. Despite this, CEFs normally trade at significant discounts after six months, often as much as 10% or more.[11] While a variety of explanations for the usual discount and occasional premium have been proffered by academics, the discount phenomenon is so well established that the Securities and Exchange Commission requires CEF issuers to state that CEFs normally trade at a discount in their prospectuses.[12]

If, for some rational reason, an investor wanted to buy the shares of a CEF, the choice between buying IPO shares and seasoned shares appears clear.[13] If shares of a similar, seasoned CEF may be acquired at a discount, no rational investor should purchase shares in a CEF IPO. Investors purchasing in the IPO essentially forgo the opportunity to acquire a seasoned CEF at a discount and instead purchase an unseasoned CEF at a premium. To illustrate the decision, an investor purchasing shares in a CEF IPO may pay $100 for $92 worth of assets with a near certainty that she will only be able to sell her

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10. Of course, CEF shares may also trade at a premium to NAV but do so much less frequently.

11. *See* Edward S. O'Neal, *Closed-end Fund IPOs*, SEC. LITIG. AND CONSULTING GRP., at 2 (2007), http://www.slcg.com/pdf/workingpapers/Closed%20End%20Fund%20IPOs.pdf.

12. Registration Form For Closed-End Management Investment Companies, Securities Act Release No. 6842, 1989 WL 257682 (SEC) (July 28, 1989).

13. *See* Shao, *supra* note 3 (documenting the remarkable underperformance of CEF IPO shares when compared to similar, seasoned CEF shares).

interest in the CEF at a discount, e.g. for $82, after a holding the CEF for six months. In contrast, had the investor purchased a similar, seasoned CEF share at a discount in the market, she could have acquired a similar pool of assets with a NAV of $92 for only $82. It could be rational for an investor to purchase these discounted shares if she would be able to hold the CEF until it liquidates or converts into an open-ended structure, allowing investors to redeem their shares for NAV.

C. The Price Stabilization Problem

CEF IPOs are also unique because of the time it takes for the discount to emerge. This gap reveals that extensive price stabilization occurs in the weeks following the IPO with the lead underwriter or underwriters seemingly supporting the price for an initial period.[14] While ordinary industrial firm IPOs quickly move to an efficient market price, most of the price decline for CEF shares occurs somewhere between 30 and 100 days after the IPO.[15]

Initial price supports delay the inevitable adjustment to a fair market price. Illustrating the extent of price supports, one recent study found that "the ratio of the volume of seller-initiated to buyer-initiated trades on the first day is approximately 19:1."[16] This high sell-to-buy ratio indicates that, while many CEF IPO purchasers quickly dump their shares during the initial period, the market provides few willing buyers other than the underwriter providing price supports.[17] This rush of initial sales creates a problem for the underwriters providing financial support. If too many initial investors are "flippers" (persons that immediately sell IPO shares), it may be too costly for an

14. *See* Hanley *et al.*, *supra* note 2, at 2 ("We also observe several indicators of *considerable* price stabilization") (emphasis added).

15. *See* Kathleen Weiss, *The Post-Offering Price Performance of Closed-End Funds*, 18 FIN. MGMT. 57 (1989).

16. *See* Hanley *et al.*, *supra* note 2, at 15 (further explaining that "when foreign country funds are removed from the sample [of CEF IPO transaction data] the [sell to buy] ratio exceeds 70:1").

17. One additional factor causing the delay may be the inability of market participants to short the CEF as soon as it begins to trade. It generally takes at least a month for a CEF's shares to be formally delivered to broker-dealers and thus available for other investors to borrow and short.

underwriter to sustain price supports.[18]

Yet, why become a flipper with CEF IPO shares? Why would an investor pay a premium over NAV for IPO shares only to sell them back after the IPO for *the same* price-supported purchase price? What profit could come from this rapid turnover? One possible explanation is that brokers employed by members of the underwriting syndicate—particularly those members not providing the price support—may sell to flippers "to quickly collect the selling fees."[19] The flippers may agree to buy for two reasons: (i) a quick sell during the price stabilization period carries little risk; and (ii) brokers may "promise favors, including large allocations in future *underpriced* IPOs."[20] Thus, flippers may be seeking to profit not from the CEF IPO but from their relationship with a particular broker. By helping a broker obtain a large commission, the investor may curry favor and gain access to underpriced IPOs.

Buying back IPO shares from these flippers costs the underwriters money. Why do lead underwriters provide this price stabilization? There are at least three reasons for underwriters to stabilize secondary market prices for an initial period. First, a stable price may protect the "lead underwriter's relationship with investors as well as its reputational capital."[21] Second, a delayed drop may obscure reality—that the CEF's shares were overpriced in the IPO. Finally, the actual cost of price support may be mitigated if, anticipating a barrage of flippers, the underwriters sold more shares than actually issued, giving the underwriters a net short position that may be covered by buying back flipper shares post IPO.[22] Correctly anticipating flipper volume allows a lead underwriter to sustain price supports and avoid the reputational stigma associated with an immediate decline in price.[23]

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18. *See* Hanley *et al.*, *supra* note 2, at 2.

19. *Id.* at 7 (emphasis added).

20. One additional possibility is that some flippers may agree to purchase after the broker promises to split the generous selling commission.

21. *See* Hanley *et al.*, *supra* note 2, at 6. For a discussion illustrating the vital importance of reputation in a different economic context, *see* Jamila Jefferson-Jones, *A Good Name: Applying Regulatory Takings Analysis to Reputational Damage Caused by Criminal History*, 116 W. VA. L. REV. 497, 527 (2013).

22. For a description of the techniques underwriters use to manage the costs of flipping, *see* Hanley *et al.*, *supra* note 2, at 8-10 (describing the use of the over-allotment or "green shoe" option).

23 *See* Shao, *supra* note 3, at 4 ("To delay and camouflage the price decline,

D. Institutional Investors Avoid CEF IPOs

While price stabilization delays the decline and obscures the overpriced nature of CEF IPO shares, it does not induce all investors to buy CEF IPOs.[24] Recent empirical information regarding CEF holders tends to confirm the impression that sophisticated investors do not purchase CEF shares in IPOs.[25] The evidence indicates that "institutional ownership in recent CEF IPOs is extremely low compared to operating company IPOs."[26] This means that, when institutional money managers evaluate investment opportunities, they generally pass on CEF IPOs.[27]

E. Other Unique Attributes

To be sure, the closed-end fund structure does offer certain unique attributes that are not available to open-end funds—attributes which might theoretically justify a decision to pay a premium. For instance, unlike an open-ended fund, a closed-end fund does not have to liquidate investment positions when a shareholder wants to sell.[28] This allows CEFs to take less liquid positions without fear that investor demands for return of capital will force

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underwriters provide price support.").

24. *See* Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 J. CORP. L. 715, 725 (2003) ("institutions hold only a very small percentage of closed-end mutual fund shares, leaving individual investors as the central clientele for this type of investment.").

25. *See* Shao, *supra* note 3.

26. *Id.* at 3.

27. If an institutional money manager purchased and held CEF IPO shares, they would underperform and likely attract less capital than their competitors. *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 893 (2013) ("For-profit institutions like mutual funds have learned that investors follow relative performance and direct assets accordingly.").

28. *See* John P. Freeman, Stuart L. Brown & Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence and A Fair Fiduciary Duty Test*, 61 OKLA. L. REV. 83, 153 (2008) ("closed-end funds feature less liquidity pressure than mutual funds since their shares are not redeemable, and new shares are not constantly being sold.").

them to liquidate their positions. While CEFs have the ability to take these less liquid, longer-term positions, one recent study found that, in practice, CEFs tend to hold more short maturity assets than open-ended funds.[29]

CEFs may also employ more leverage than open-ended mutual funds.[30] Funds using more leverage may experience higher returns and greater volatility and risk.

II. CLOSED-END FUND IPOS & INVESTOR INTERESTS

Sales to retail customers are currently governed by the Financial Industry Regulatory Authority's controversial "suitability" standard.[31] Rather than attempting to parse the precise meaning of the suitability standard,[32] this essay simply considers whether recommending CEF IPO shares is generally consistent with most retail investors' best interests in light of the arguments frequently proffered to justify CEF IPOs.

It appears difficult to reconcile most sales of CEF IPO shares with the best interests of investors, raising questions about why the offerings occur. Economists and other experts studying the products have theorized that the

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29. *See* Edwin J. Elton, Martin J. Gruber, Christopher R. Blake & Or Shachar, *Why Do Closed-End Bond Funds Exist? An Additional Explanation for the Growth in Domestic Closed-End Bond Funds*, 48 J. FIN. AND QUANTITATIVE ANALYSIS 405 (2013), *available at* http://ssrn.com/abstract=1591157.

30. For a discussion about how closed-end funds may use more leverage than open-ended funds, *see* LOIS YUROW, TIMOTHY W. LEVIN, W. JOHN MCGUIRE & JAMES M. STOREY, MUTUAL FUNDS REGULATION AND COMPLIANCE HANDBOOK § 32:4 (2015).

31. For discussions about the distinctions between a best interests Financial Industry Regulatory Authority's current suitability standard, s*ee* Benjamin P. Edwards, *Fiduciary Duty and Investment Advice: Will A Uniform Fiduciary Duty Make A Material Difference?*, 14 J. BUS. & SEC. L. 105, 111 (2014); Christine Lazaro & Benjamin P. Edwards, *The Fragmented Regulation of Investment Advice: A Call for Harmonization*, 4 MICH. BUS. & ENTREPRENEURIAL L. REV. 47, 66-67 (2014) ("the Suitability Rule does not explicitly provide that a Broker's recommendations must be in the customer's best interests").

32. For an analysis and authority that the suitability standard requires recommendations consistent with customers' best interests, *see* James S. Wrona, *The Best of Both Worlds: A Fact-Based Analysis of the Legal Obligations of Investment Advisers and Broker-Dealers and A Framework for Enhanced Investor Protection*, 68 BUS. LAW. 1, 19 (2012) (collecting authority).

CEF IPO shares are bought by "noise traders, or 'suckers,' who are sufficiently optimistic to buy overpriced assets."[33] Some assert that "[i]nvestors who wish to hold closed-end funds should never buy them at the IPO and the suggestion that they should by financial advisors is suspect."[34] If only a "sucker" would buy the overpriced asset, there may not be a reasonable basis for concluding that the purchase is consistent with an investor's best interests.

A. Eventual Positive Share Price Return

Still, some weak arguments for buying CEF IPO shares have been made. For instance, to educate the public, one financial firm provides articles about CEFs in the "Learning Center" portion of its website.[35] One article contends that it would be "unwise" for investors to pass on CEF IPO because "[a] study we conducted of all CEF IPOs from Jan. 1, 2001, through Oct. 31, 2011, found that 73.7% of the IPOs had positive share price total returns since inception."[36] Based on this "limited study," the article's authors make the interestingly-phrased claim that they do *not* believe "that investing in CEF IPOs, in general, is a fool's game."[37]

Given the dynamics discussed above, the meager prospect of eventual positive share price returns does not seem appealing. Consider what eventual positive share price returns means in the context of the hypothetical CEF IPO

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33. *Anomalies*, *supra* note 1, at 162 (noting that "[i]t helps to have a gimmick" such as a famous asset manager). In the economics literature the term "noise trader" is frequently used as a euphemism for idiot. Lawrence Summers famously "began a paper on finance by declaring: 'THERE ARE IDIOTS. Look around.'" Paul Krugman, *How Did Economists Get It So Wrong?*, N.Y. TIMES MAG. MM36, Sept. 2, 2009, *available* http://www.nytimes.com/2009/09/06/magazine/06Economic-t.html?_r=0 (explaining that "the preferred term in academic literature" for idiots is "noise traders").

34. *See* O'Neal, *supra* note 11, at 2.

35. Morningstar, *Closed-end fund IPO Premium* (2012), https://www.fidelity.com/learning-center/investment-products/closed-end-funds/ipo-premium.

36. *Id.*

37. *Id.* The article also stresses that "[j]ust because a CEF is suitable for your portfolio doesn't mean it's in your best interests. There's a large difference between the suitability and fiduciary-duty standards." *Contra* Wrona, *supra* note 32, at 55 (arguing that "the widely held belief that broker-dealers are subject to substantially lower standards of conduct is illusory").

discussed above. At the IPO, the investor pays $100 for a share. After subtracting commissions and offering expenses, the CEF purchases $92 of assets per share. Even though the CEF only holds $92 of assets per share, the underwriter will likely stabilize the price for the first three months, after which the market will adjust and the CEF's shares will most likely trade at a discount to the CEF's NAV, meaning that if the CEF has $92 of net assets per share, the market price on offer to buy a share may be only $82. As months pass into years, the CEF's underlying investments may perform well and the CEF's NAV may rise significantly, perhaps even to $112 of NAV per share. If the CEF still trades at an approximate 10% discount, the market may then offer more than $100 per share—yielding the positive share price return.

Plainly, investor interests would be better served by purchasing the shares of CEFs already trading at a discount or by purchasing a lower-cost open-end fund that could be liquidated at something near NAV. At the least, fairly evaluating whether an investor should buy a CEF IPO share requires some comparative assessment to other products on the market. Here, CEF investors could buy seasoned CEF shares instead and experience a near certainty of significantly higher returns than they would obtain by buying unseasoned shares during the IPO. As mentioned earlier, one recent study found that CEF IPO shares underperformed comparable seasoned CEF shares by 11.05% after one year.[38] Given the performance differential, recommending IPO shares over similar, seasoned shares appears most likely to lead to significant underperformance.

B. Purported Long-Term Structural Benefits

Other arguments fail to address the IPO problem. For example, in defense of CEFs, generally, some supporters have contended that the CEF structure allows CEFs to take longer-term positions than could be taken with the redemption demands facing open-ended funds. Unlike open-end funds, CEFs do not need to unwind long-term positions if panicky investors seek to redeem their shares. This argument misses the point because it does not justify the purchase of CEF IPO shares whenever similar funds already trade at a discount.

Additionally, most CEFs may not actually use their purported ability to take longer-term positions. CEFs' actual holdings tend toward shorter-

38. *See* Shao, *supra* note 3, at 1.

maturity assets.[39] A CEF IPO featuring short-maturity strategies and holdings should not attempt to justify its existence by pointing out that it has the structural ability to do something it does not intend to do.

C. Managerial Skill

Some CEF IPOs have been justified by claims that the exceptional talent of the manager retained to manage the CEF's assets justifies the premium.[40] While this remains a theoretical possibility, it would require the accurate identification of a truly exceptional manager, one capable of rapidly outperforming the difference between the IPO premium and the seasoned CEF discount. Even if such a manager were identified, it would still appear preferable to wait until the fund seasoned and began to trade at a discount.

D. Unusual Market Circumstances

In limited circumstances, CEF IPOs might appear less ill-advised. For example, in times of high investor sentiment, seasoned CEFs have been known to trade at premiums to their NAV. While this does not occur regularly, it does happen and is associated with increased CEF IPO offerings.[41] When similar, seasoned CEFs trade at a premium, the value differential between IPO shares and seasoned shares diminishes. This, of course, does not mean that it is in an investor's best interests to purchase CEF shares in an IPO. The vast majority of the time, CEFs trade at a discount and CEF shares purchased in an IPO will most likely move to trade at a discount in the future.

CONCLUSION

Institutional investors generally pass on CEF IPOs for good reasons. The IPO shares tend to significantly underperform existing CEF shares and other mechanisms for gaining exposure to the underlying asset classes, such as

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39. *See* Elton *et al.*, supra note 29.

40. *See* SIMON LACK, WALL STREET POTHOLES 27 (Wiley 2015) (explaining that "[i]t's generally the dumb money that buys a CEF IPO at" issue price).

41. *See Investor Sentiment*, *supra* note 1 (arguing that CEF discounts and premiums may be used to measure investor sentiment).

buying open-ended funds that already exist. Moreover, the problems with CEF IPOs have been known, studied, and discussed for decades in the finance and economics literature. Given this reality, the continued sale of CEF IPOs to retail investors does not appear aligned with their best interests.

CHURNING 2016[1]

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In previous papers, we outlined the portfolio approach to assessing the excessiveness of trading in broker-customer disputes involving allegations of churning and argued that cost-to-equity ratios of more than 4 or 5% indicate excessive trading in common stock portfolios.[2] In this paper, we update our earlier results with recent individual stock returns and mutual fund turnover ratios. We show that rules of thumb advocated by the industry are likely to excuse trading costs when there is, in fact, no reasonable expectation that investors will benefit from the trading.

The main contribution of our paper is the empirical demonstration that the likely returns to a portfolio after any subset of trades are highly correlated with the likely returns to the portfolio prior to the trades and so it is very unlikely that any suspect trading costs can be justified. Since churned portfolios are typically turned-over over time, there is considerable overlap between the portfolio immediately before and immediately after any subset of trades. We conclude that cost ratios of 5% or more should be considered strong evidence of churning.

Introduction

According to FINRA Dispute Resolution statistics, a little over 200 cases filed in recent years – 5% to 6% of all cases filed – included churning allegations.[3] Churning cases seemed more prevalent 20 years ago, perhaps because market returns were so high in the 1990s that excessive trading costs

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2. *See* Craig J. McCann, *Economic Analysis in Broker Customer Disputes Involving Allegations of Churning*, J. OF LEGAL ECON., 9:1 Spring/Summer 1999 and Craig J. McCann & Dengpan Luo, *Churning Revisited: Trading Costs and Control* , *Securities Arbitration 2003 Handbook* PLI Ch. 27 (Aug. 2003).

3. FINRA Dispute Resolution Statistics *available at* https://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics.

could be charged to retail accounts which would nonetheless exhibit positive returns. We have continued to research churning allegations and in the past year have been involved in churning cases that resulted in substantial awards against Janney Montgomery Scott[4], First Midwest Securities[5], Stifel Nicholas[6] and Oppenheimer[7].

Our over-arching view of the correct churning analysis is, in fact, applied to cases well beyond traditional securities accounts. FINRA and the SEC identify the similarity of the mutual funds and variable annuities switched in and out of, the costs imposed on the customer, and the compensation of the broker as the key factors relevant to determining whether mutual fund and variable annuity switching has occurred.[8] More recently, a Securities and Exchange Commission Order Instituting Proceedings (OIP) identified trading in ETFs in which the ETFs bought and sold were sufficiently similar that there was not a reasonable expectation the customer would benefit from the switch given the trading costs incurred as part of a pattern of churning.[9]

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4. Schvey v Janney Montgomery Scott, FINRA Dispute Resolution Case No. 12-02533, (Aug. 13, 2015) *available at* http://finraawardsonline.finra.org/Search/ViewDocument/88163.

5. Artmire v First Midwest Securities, FINRA Dispute Resolution Case No. 12-02841, (Jul. 2, 2015) *available at* http://finraawardsonline.finra.org/Search/ViewDocument/87939.

6. Gilbert v Stifel Nicolaus, FINRA Dispute Resolution Case No. 12-02897, (Mar. 30, 2015) *available at* http://finraawardsonline.finra.org/Search/ViewDocument/71626.

7. LaBolle v Oppenheimer, FINRA Dispute Resolution Case No. 13-02460, (Feb. 13, 2015) *available at* http://finraawardsonline.finra.org/Search/ViewDocument/66055.

8. *See* for example, FINRA v Essex Securities, LLC (BD No. 46605), Letter of Acceptance, Waiver and Consent No. 2011025433901 (Nov. 7, 2014) *available at* http://disciplinaryactions.finra.org/Search/ViewDocument/37906; *see also* In the Matter of Dean Witter Reynolds Inc., Exchange Act Rel. No. 43215, 2000 SEC Lexis 1772 (Aug. 28, 2000).

9. In the Matter of Eli D. Okman, Before the Securities and Exchange Commission, Administrative Proceeding File No. 3-16218 *available at* www.sec.gov/litigation/admin/2014/33-9671.pdf.

Churning

Retail securities trading generates income for brokerage firms which charge explicit commissions, markups and markdowns and undisclosed commissions called "bid-ask spread" when brokerage firms buy stock from customers at "bid" prices that are lower than the "ask" prices at which the stock is simultaneously sold to other public customers.[10] The excessiveness of trading in an account is assessed by reviewing the volume of trading using turnover ratios and the costliness of the trading using cost-to-equity ratios.

Turnover Ratios

Turnover ratios have been used for 60 years.[11] The simplest turnover ratio divides total security purchases by the average equity balance or by the average value of the securities in the account, and then annualizes the turnover ratio by dividing it by the number of years covered in the analysis.

Retail account turnover ratios can be compared to turnover ratios observed in mutual funds.[12] If the turnover ratio in an account is not significantly different from the average turnover ratio for mutual funds with similar investment objectives, then the observed turnover ratio does not provide strong evidence that the account was churned. This approach is biased against finding excessive trading because institutional investors pay much lower trading costs than retail customers. In addition, while the potential conflict of interest over commissions is much less evident in the mutual fund industry, some institutional investors trade clients' portfolios to generate soft dollars.[13]

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10. *See* Zvi Bodie, Alex Kane & Alan J. Marcus, *Investments 4th Edition*, 16, Stephen M. Patterson ed., McGraw Hill Companies (1999) ("The dealer's profit margin is the "bid-asked" spread – the difference between the price at which the dealer buys for and sells from inventory"); *Id. at 86* ("In addition to the explicit part of the trading costs – the broker's commission - there is an implicit part – the dealer's **bid-ask spread**." (emphasis in original)).

11. *See* R.H. Johnson Co., 36 S.E.C. 467 (1955), R. H. Johnson & Co. v. SEC, 231 F.2d 523 (D.C. Cir. 1956), and In re Looper and Co., 38 S.E.C. 294 (1958).

12. *See* Donald A. Winslow & Seth C. Anderson, *A Model for Determining the Excessive Trading Element in Churning Claims*, 68 N.C.L. REV. 327 (1990); Craig J. McCann, *Economic Analysis in Broker Customer Disputes Involving Allegations of Churning*, J. OF LEGAL ECON. 9:1 Spring/Summer 1999.

13. *See Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds*, US Securities and Exchange Commission, September 22,

Turnover should be calculated based on the average value of the securities *traded* not based on the average value of the securities *held* or on the *average equity*. For accounts with significant cash holdings or in which individual holding periods vary greatly, turnover ratios should be calculated based on the part of the portfolio actually traded. For example, imagine an account has twenty-six securities and that twenty-four are held while the twenty-fifth security is switched out every two weeks for a year. The account would have been excessively traded even though a conventional turnover calculation would yield a turnover ratio of 1. Calculating a turnover ratio based on the value of the securities traded - that is, excluding the twenty-four securities held throughout the year - yields a turnover in this example of 26, which more accurately reflects the standardized level of trading.

Table 1 provides descriptive statistics for mutual fund turnover ratios. Ignoring additional fund classes or feeder funds, there were 4,739 distinct mutual fund portfolios reported by Morningstar as of December 31, 2014.[14] The average turnover ratio for all funds was 0.83 or 83% and the standard deviation across mutual fund turnover ratios was 1.35.[15] Only 7.3% of all funds had turnover ratios greater than 2 and only 2.4% of all funds had turnover ratios greater than 4.

(1998) *available at* https://www.sec.gov/news/studies/softdolr.htm ("The Commission has defined soft dollar practices as arrangements under which products or services other than execution of securities transactions are obtained by an adviser from or through a broker-dealer in exchange for the direction by the adviser of client brokerage transactions to the broker-dealer.").

14. 2014 turnover ratios are slightly lower than 1998 turnover ratios reported in our prior churning paper.

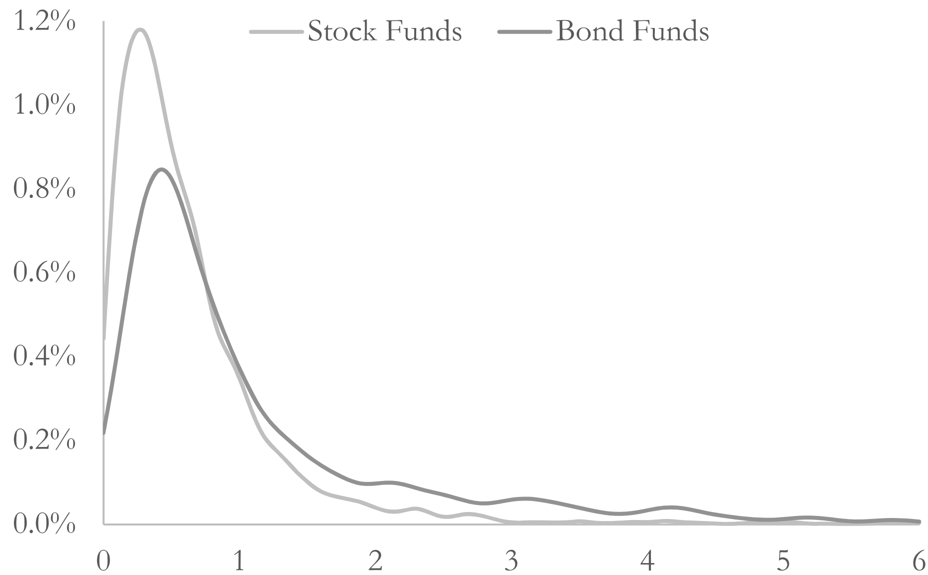
15. Standard deviation is a measure of how much the observed values deviate from the average value of a distribution. 70% of the observed values lie within one standard deviation of the average value, 95% lie within two standard deviations, and 99.7% lie within three standard deviations of the average value; David H. Kaye & David A. Freedman, *Weinstein's Evidence Reference Manual on Scientific Evidence Special Supplement* 1995, 333-400, Lisa Meisel ed., Matthew Bender & Co. (1995) (The Federal Judicial Center provides accessible introductions to statistical analysis.)

Table 1: 2014 Mutual Fund Turnover Ratios

		Turnover Ratios		% of Mutual Funds With Turnover as Great As		
Asset Class	**Number of Funds**	**Average**	**Standard Deviation**	**2.0**	**4.0**	**6.0**
All	4,739	0.83	1.35	7.26%	2.41%	1.14%
Equity	3,628	0.66	0.86	3.94%	1.10%	0.50%
Fixed Income	1,054	1.39	2.16	18.60%	6.93%	3.32%
Allocation	57	0.99	3.27	8.77%	1.75%	1.75%
Select Categories						
High Yield Bond	151	0.80	1.52	4.64%	1.32%	1.32%
Small Cap Equity	637	0.71	0.80	4.24%	1.41%	0.63%
Growth Equity	435	0.68	0.81	4.14%	1.15%	0.46%
Emerging Market Equity	206	0.67	0.53	2.43%	0.00%	0.00%
Global Equity	725	0.59	0.61	2.48%	0.41%	0.28%

Table 1 also presents turnover statistics for equity, fixed income, and asset allocation mutual funds. Average turnover for equity funds is 0.66 with a 0.86 standard deviation. Less than 4% of equity funds had turnover greater than 2. Fixed income funds have higher average turnover than equity funds at 1.39. A significant portion of fixed income portfolio turnover is attributable to redemptions when bonds mature and the proceeds are reinvested. Short-term bond funds have the highest levels of turnover. Asset allocation mutual funds, which blend equity, fixed income, and other asset classes have average turnovers of 0.99. Among equity funds, small cap funds have only slightly higher average turnover (0.71 versus 0.66). The distribution of turnover ratios across equity and bond funds is plotted in Figure 1.

Figure 1: Distribution of Mutual Fund Turnover Ratios, 2014



Courts have generally held that an observed value of more than two standard deviations different from the average value of a distribution is evidence that the observed value was not generated by the same factors generating the distribution.[16] In our context, if the turnover ratio observed in a retail account is more than two standard deviations greater than the average mutual fund turnover ratio we can conclude that different considerations motivated the trading observed in the retail account than what motivates trading by professional investment managers in the mutual fund industry.

Estimating how likely a turnover ratio is to be observed if an account is being managed to achieve the investor's stated objectives is determined by how likely it is to observe a turnover ratio as high in mutual funds with similar stated objectives. If the likelihood of observing a turnover ratio in a population of well managed portfolios as high as the observed turnover ratio in the retail

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16. *See* Paul Meier, Jerome Sacks and Sandy L. Zabell, *What Happened in Hazelwood: Statistics, Employment Discrimination and the 80% Rule*, 9 AM. B FOUND. RES. J. 139, 139-186 (Winter, 1984).

account is less than 2.5% we conclude that the retail account was not managed in the customer's best interests.[17]

Based on the distribution of turnover ratios reported in Table 1, there is only a 2.4% chance of observing a turnover ratio greater than 4 in a stock portfolio that was managed in the best interests of clients in 2014. Turnover ratios of 4 or greater are thus sufficiently rare in the distribution of stock mutual fund turnover ratios that they constitute strong evidence that the account was traded excessively.

While turnover ratios are simple, they do not directly measure trading costs or likely trading profits, which combined determine the likelihood that trading will benefit the customer. A turnover ratio of three or four times per year for a mutual fund involves lower total trading costs, and therefore is more reasonable, than a turnover ratio of only two times per year in a retail account.

Cost ratios

Cost ratios are better than turnover ratios as indicators of churning because they directly measure the costliness of trading. Properly interpreted, they provide sound guidance as to whether the trading could reasonably have been expected to benefit the customer. Cost ratios measure the fraction of an investment consumed by trading costs and are calculated by dividing the total fees, commissions, markups and markdowns, bid-ask spread and margin interest in an account by the average equity or the average value of the securities.

Unfortunately, the simplistic break-even interpretation and the focus on average returns have led to the widespread misuse of cost ratios. A correct assessment of cost ratios requires recognition that the expected return to trading is equal to the difference between the expected return to the portfolio

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17. Turnover ratios are not "normally" distributed because they cannot take on values below zero and because there are a few large ratios. The normal distribution is a symmetrical distribution and can be completely described by its average value and its standard deviation. Turnover ratios are approximately *lognormally* distributed and the probabilities reported in Table 1 are calculated using the average and standard deviation of the natural logarithm of the mutual funds' turnover ratios; *See* Mark Kritzman, *What Practitioners Need to Know …About Lognormality*, FIN. ANALYSTS J. *48* (Jul.-Aug. 1992).

after the suspect trading and the expected return on the securities held before the suspect trading.[18]

Cross-sectional Variation in Portfolio Returns

To demonstrate how quickly even small trading costs eliminate the chance of making money from trading, we formed market capitalization weighted portfolios of 1, 2, 5, 10, 20, 30 and 40 securities drawn randomly from the pool of the S&P 500 Index equities as of December 31, 2013.[19] For each portfolio size, we generated 1,000,000 portfolios at the beginning of 2014 and calculated the returns to each portfolio as if it were held for the whole year.

Table 2 reports the average return as well as the standard deviation in the cross section of returns for the 1,000,000 portfolios for each of the seven different portfolio sizes during 2014 and 2015. Consistent with portfolio theory, the standard deviation across the portfolios decreases dramatically with the number of securities included in the portfolios. When portfolio size increases from 1 security to 5 securities, the standard deviation drops more than 50%. When portfolio size increases to 20 securities, the standard deviation drops another 50%.[20] That is, the returns to a diversified 20-stock portfolio are unlikely to be very different from the average return to all diversified 20-stock portfolios.

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18. This point is developed more fully in Craig J. McCann, *Economic Analysis in Broker Customer Disputes Involving Allegations of Churning*, J. OF LEGAL ECON. 9:1 Spring/Summer 1999.

19. December 31, 2013 was the last trading day in 2013. In order to make the portfolios of different sizes track the market, we draw securities according to the probabilities weighted by their market capitalizations, i.e., securities with higher market capitalizations will have higher probabilities to be drawn from the sample. The securities in the portfolio then are equally weighted.

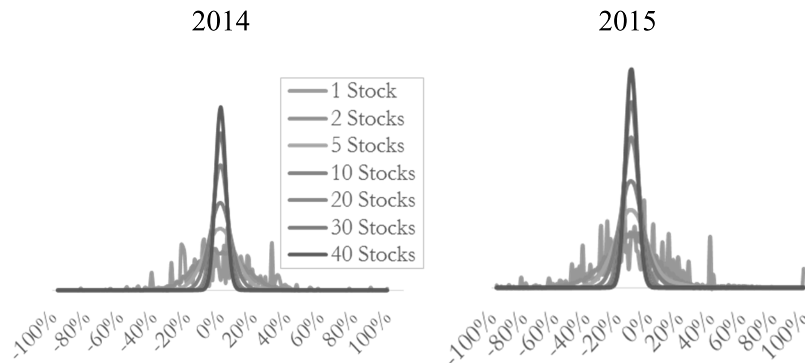
20. This observation is related to, but slightly different than, the oft-cited fact that the standard deviation of a portfolio's time series return declines as the number of securities included increases.

Table 2: Mean and Cross Sectional Standard Deviation of Portfolio Returns

		Number of Stocks						
		1	2	5	10	20	30	40
2014	Mean	13.36%	13.37%	13.35%	13.40%	13.43%	13.47%	13.52%
	Standard Deviation	18.69%	13.17%	8.25%	5.76%	3.97%	3.18%	2.70%
2015	Mean	1.44%	1.42%	1.43%	1.37%	1.27%	1.16%	1.07%
	Standard Deviation	23.53%	16.56%	10.40%	7.26%	5.00%	3.98%	3.37%

We use these results and similar results below to estimate the probability of overcoming different levels of trading costs as follows. In Table 2, we note that the cross-sectional standard deviation of returns to 20-stock portfolios in 2014 was 3.97% and in 2015 was 5.00%. Thus, approximately 15% of the portfolios had returns more than 3.97% (5.00%) greater than the average return in 2014 (2015) and 15% of the portfolios had returns more than 3.97% (5.00%) less than the average return in 2014 (2015). The probability distributions for each sized portfolio relative to the average return are plotted in Figure 2.

Figure 2: Distribution of Portfolio Returns By Number of Stocks



The frequency that portfolios of varying sizes outperformed the average portfolio during 2014 and 2015 are presented in Table 3. Only 18.73% (23.00%) of 10-stock portfolio's returns exceeded the average 10-stock portfolio's return by 5% in 2014 (2015), and only 4.3% (8.62%) of 10-stock portfolio's returns exceeded the average 10-stock portfolio's return by 10% in 2014 (2015).

Table 3: Returns Exceeding Average Portfolio Return by Various Thresholds

		Number of Stocks			
	Threshold	10	20	30	40
2014	5%	18.73%	10.31%	5.90%	3.37%
	10%	4.30%	0.75%	0.13%	0.02%
	15%	0.68%	0.02%	0.00%	0.00%
2015	5%	23.00%	15.70%	10.61%	6.99%
	10%	8.62%	2.68%	0.70%	0.17%
	15%	2.75%	0.23%	0.01%	0.00%

The percent of portfolios exceeding the average portfolio's returns decreases as the number of securities in the portfolio increases because, as we saw earlier, more diversified portfolios have more similar returns than less diversified portfolios. While 18.73% of 10-stock portfolios had returns that were 5% greater than the average return in 2014, only 5.90% of the 30-stock portfolios had returns that were 5% greater than the average portfolio.

Cross-sectional Variation in Portfolio Returns: All Trading on Day 1.

This cross-sectional variation captured by the standard deviations in Table 2 and the percentages in Table 3 understate the variation in the difference in the returns between a held portfolio and a traded portfolio. We develop the logic of the portfolio approach to assessing cost to equity ratios by first imagining that a portfolio is completely turned over on January 1 and then held to December 31 in 2014 and then again in 2015. The returns to the *trading* in this hypothetical is the difference between the returns earned on the traded portfolio and what the portfolio held right before the trading on January 1 each year would have earned if it had been held for the whole year.

We generated 2 million independent portfolios of 10 stocks, 20 stocks, 30 stocks and 40 stocks (8 million portfolios in total). The stocks were randomly drawn into the portfolio based on their market capitalizations but were equally weighted. We then took the difference in the returns of the 1,000,000 pairs of the portfolios for each portfolio size. Table 4 presents the means and cross sectional standard deviations of the differences in returns between the traded portfolio and the buy and hold portfolios.

Table 4a: Differences in Buy and Hold Portfolios' Returns, 2014

		Number of Stocks			
		10	20	30	40
2014	Mean	0.00%	0.00%	0.00%	0.00%
	Standard Deviation	8.14%	5.61%	4.49%	3.82%
2015	Mean	-0.01%	0.00%	0.00%	0.00%
	Standard Deviation	10.26%	7.07%	5.63%	4.76%

Table 5 reports the likelihood that the differences in returns to two randomly selected portfolios exceeded various thresholds. The percentages in Table 5 exceed the corresponding percentages in Table 3 because the standard deviations of the differences in returns reported in Table 4 exceeded the standard deviations of the portfolio returns reported in Table 2.

Table 5: Returns Exceeding Average Portfolio Return by Various Thresholds

		Number of Stocks			
	Threshold	10	20	30	40
2014	5%	26.72%	18.53%	13.21%	9.51%
	10%	10.82%	3.76%	1.34%	0.46%
	15%	3.29%	0.41%	0.05%	0.01%
2015	5%	30.92%	23.80%	18.71%	14.67%
	10%	16.12%	7.80%	3.80%	1.76%
	15%	7.08%	1.72%	0.39%	0.08%

The trading strategy implicit in the calculations reported in Table 4 and Table 5 assumes that the entire portfolio is turned over on January 1 and then is held for one year. In reality, portfolios are turned over gradually over time. Since gradually traded portfolios have many common securities at different points in time, the returns to a traded portfolio will be more similar to the returns to the original portfolio than we modeled above.

Cross-sectional Variation in Portfolio Returns: Trading Throughout the Year

To capture the more gradual turnover observed in suspect accounts, we assume that investors turn over a portion of their portfolio holdings at the end of each month. This is accomplished by randomly selecting a portion of the portfolio holdings and then randomly selecting their replacements from the universe of the S&P 500 Index as of December 31, 2013. We assume that investors liquidate their entire position in the traded stocks and use the entire sales proceeds to buy the replacement stocks.

For each of 1,000,000 randomly constructed starting portfolios for each of the four portfolio sizes, we simulated trading resulting in 1,000,000 traded portfolios. At the end of each month, a fixed number of securities in the existing portfolio was randomly liquidated with equal probability. A replacement set of securities, from outside of the existing portfolio was randomly purchased based on the market capitalizations. We computed the gains to trading by comparing the annual return to each of the 1,000,000 traded portfolios to the returns to the starting portfolio as if it had been held for the year with no trading as follows

$$\text{Trading Gains}_i = \text{Traded Portfolio Return}_i - \text{Held Portfolio Return}_i$$

where *i* denotes the 1,000,000 randomly selected initial portfolios.

Table 6 presents the results of the simulations across various portfolio sizes ranging from 10-stock portfolios to 40-stock portfolios, assuming 20% of the portfolio is turned over each month. The average annual trading "gains" are small, and not significantly different than zero. The standard deviation decreases with portfolio size, from 7.22% for 10-stock portfolios down to 3.50% for 40-stock portfolios. These numbers indicate that, on average, the gains to trading are small and even conservative estimates of turnover costs quickly eradicate any potential for trading profits.

Table 6: Returns to Trading, 20% per Month Turnover

		Number of Stocks			
		10	20	30	40
2014	Mean	0.02%	0.04%	0.07%	0.10%
	Standard Deviation	7.22%	5.04%	4.07%	3.50%
2015	Mean	-0.06%	-0.17%	-0.28%	-0.37%
	Standard Deviation	8.14%	5.65%	4.52%	3.86%

Table 7 presents the probability of trading gains exceeding certain thresholds of turnover costs, based on the simulations in Table 6 assuming 20% of the portfolio is turned over each month. As expected, as the number of stocks increases (i.e., the portfolios become more diversified), the probability of exceeding cost thresholds decreases. In a portfolio of 20 stocks, there is only an 16.16% (17.89%) chance that trading gains would have exceeded 5% costs in 2014 (2015). There is just a 2.47% (3.48%) chance that trading gains would cover costs of 10% in a 20-stock portfolio in 2014 (2015).

Table 7: Trading Gains Exceed Cost Levels – 20% Turnover per Month

		Number of Stocks			
	Threshold	10	20	30	40
2014	5%	24.28%	16.16%	11.30%	8.04%
	10%	8.29%	2.47%	0.77%	0.26%
	15%	1.97%	0.17%	0.02%	0.00%
2015	5%	26.46%	17.89%	12.09%	8.20%
	10%	10.52%	3.48%	1.15%	0.36%
	15%	3.11%	0.36%	0.04%	0.01%

Table 8 updates the probabilities in Table 7 under the assumption that 50% of the portfolio is turned over each month. There is a slightly higher likelihood of covering any given level of trading costs at the higher level of turnover because the initially held portfolio and the portfolio it is traded into are less similar the greater the level of turnover.

Table 8: Trading Gains Exceed Cost Levels – 50% Turnover Per Month

		Number of Stocks			
	Threshold	10	20	30	40
2014	5%	26.47%	18.75%	14.04%	10.66%
	10%	10.57%	3.81%	1.48%	0.56%
	15%	3.14%	0.42%	0.05%	0.01%
2015	5%	28.54%	19.82%	13.79%	9.67%
	10%	12.95%	4.94%	1.87%	0.69%
	15%	4.58%	0.72%	0.10%	0.01%

Extensions

Our results depend on the volatility of individual stock returns and on the covariance of returns across stocks and portfolios of stocks but not at all on the general direction of the market.[21] All that matters to our results is the variation in returns across portfolios. This fundamental point suggests two further considerations.

The trading in most retail accounts will be concentrated in a particular investment style. For instance, the securities passing through an account may be mostly technology stocks, value stocks or growth stocks. The stocks observed in retail accounts will be small in number relative to the universe of stocks we analyzed and the variation in returns across these stocks will be small relative to variation in returns across all stocks.[22] Applying our general framework to the stocks traded in a typical account will therefore lead to even lower estimated chances of overcoming trading costs.

Our analysis focused on the returns to common stock. There is much less cross-sectional variation in the returns to bonds than in the returns to stock

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21. There is some evidence that individual stocks have become more volatile and that covariance has declined slightly during the 1990s; *See* John Y. Campbell, Martin Lettau, Burton G. Malkiel and Yexiao Xu, *Have Individual Stocks Become More Volatile? An Empirical Exploration of Idiosyncratic Risk*, 56 THE J. OF FIN. *1-43* (Feb. 2001.)

22. Mutual fund returns are more similar within prospectus objective categories than across categories as a result of this clustering.

because stock holders receive the residual cash flows after bondholders received their fixed payments. Our theoretical framework and empirical analysis can readily be applied to bonds and would yield cost-to-equity thresholds of at most 1%.

Conclusion

We have updated the empirical analysis we first conducted nearly 20 years ago. As we found then, we find that cost-to-equity ratios of 5% including bid-ask spreads in a retail account trading common stock are excessive. We demonstrate that the likelihood of covering any given level of trading costs is independent of whether the market is going up as it was in 2014 or flat as it was in 2015. The critical determinant is how much variation there is in returns across portfolios not whether those portfolio returns are positive, zero or even negative.

Our estimates of potentially recoverable trading costs are an upper bound since for the slower the turnover in an account, the lower the likelihood that any given level of costs can be covered. The widely accepted belief that annual flipping of diversified mutual funds is excessive even if the costs are only 4 or 5% per year is an intuitive recognition of the patterns we have developed and explained.

Notes & Observations

A TALE OF TWO MARKETS: RECONCILING THE SECURITIES AND EXCHANGE COMMISSION'S IMPLEMENTATION OF THE UNIFORM FIDUCIARY STANDARD AND EQUITY CROWDFUNDING REGULATIONS.

Miles O. Indest

INTRODUCTION

It was the market of investor protection; it was the market of capital formation.[1] Investors currently stand in the crossroads between two polarized congressional directives to the Securities and Exchange Commission (SEC): (1) implementing a "uniform fiduciary standard" for broker-dealers and investment advisers, and (2) increasing access to capital for small companies. The SEC marches, albeit slowly, towards a heightened scrutiny of brokers who pursue commissions at the expense of retail investors.[2] On the other hand, the SEC aims to remove burdensome regulatory requirements from small companies who seek to raise capital from dispersed, unaccredited investors in the "crowd."[3]

After the 2008 financial crisis, the Dodd–Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act directed the SEC to study whether a uniform fiduciary standard should be applied to both broker-dealers and

1. *See* 15 U.S.C. § 78c(f) (2012) (requiring the SEC, when rulemaking to promote the public interest, to also consider whether the action will promote efficiency, competition, and capital formation). The introduction from A Tale of Two Cities reflects the themes of contrast that this Article hopes to convey. CHARLES DICKENS, A TALE OF TWO CITIES (1859).

2. *See* Mary Jo White, Chair SEC, Examining the SEC's Agenda, Operations and FY 2016 Budget Request, Testimony Before the U.S. H.R. Comm. on Fin. Servs. (Mar. 24, 2015), *available at* http://www.sec.gov/news/testimony/2015-ts032415mjw.html #_ftnref3 ("After significant study and consideration, I believe that broker-dealers and investment advisers should be subject to a uniform fiduciary standard of conduct when providing personalized securities advice to retail investors.").

3. *See id.* (discussing the SEC's proposed rules to exempt "the offer and sale of securities through crowdfunding, an evolving method to raise capital using the Internet").

investment advisers.[4] In January 2011, the SEC released a study that recommended rulemaking to enforce a uniform fiduciary standard for brokers and investment advisers "when providing personalized investment advice about securities to retail consumers."[5] Four and a half years later, the SEC struggles to implement this uniform fiduciary standard.[6]

In contrast to the sluggish implementation of a uniform fiduciary standard, the implementation of liberalized crowdfunding regulations has proceeded rather swiftly. On March 25, 2015, the SEC promulgated final rules—pursuant to the Jumpstart Our Business Startups (JOBS) Act—that allow smaller companies "to offer and sell up to $50 million of securities in a 12-month period, subject to eligibility, disclosure and reporting requirements."[7] These rules, initiated by Title IV of the JOBS Act, allow companies to "test the waters" and solicit both accredited and non-accredited investors through the internet, from the "crowd."[8] Similarly, the SEC is finalizing rules under Title

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4. Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified at 12 U.S.C. § 5301 (2015)).

5. U.S. SEC & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT vi (2011), *available at* https://www.sec.gov/news/studies/2011/913studyfinal.pdf [hereinafter SEC STUDY).

6. *See* Knut A. Rostad, *Fiduciary September 2015: A Historic Time for Fiduciary Advice*, THINKADVISOR (Sept. 1, 2015), http://www.thinkadvisor.com/2015/09/01/fiduciary-september-2015-an-historic-time-for-fidu; Lawrence Ritchie, et al., *Standardized Fiduciary Duties in the Future for Brokers and Advisers on Both Sides of the Border?,* RISK MANAGEMENT & CRISIS RESPONSE (Mar. 31, 2015), http://www.riskandcrisismanagement.com/2015/03/standardized-fiduciary-duties-in-the-future-for-brokers-and-advisers-on-both-sides-of-the-border/. According to former SEC Chair Arthur Levitt, the SEC is "locked" and "divided philosophically" on the uniform fiduciary standard, suggesting that the United States Department of Labor (DOL) is more prepared to handle the task. Melanie Waddell, *Arthur Levitt: SEC Deadlocked on Fiduciary, Advisors Need DOL Rule*, THINKADVISOR (Aug. 21, 2015), http://www.thinkadvisor.com/2015/08/21/arthur-levitt-sec-deadlocked-on-fiduciary-advisors ("We should try to move ahead on the standard put forth by the Department of Labor.").

7. Securities and Exchange Commission, Press Release No. 2015-49, SEC Adopts Rules To Facilitate Smaller Companies' Access To Capital (Mar. 25, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-49.html.

8. 17 C.F.R. § 230.254; *see also* Kendall Almerico, *Companies Can Now 'Test the Waters' Before Pursuing a Mini-IPO*, ENTREPRENEUR (June 4, 2015), http://www.entrepreneur.com/article/246733.

III of the JOBS Act that promote crowdfunding through "funding portals," which currently have no uniform or tested procedures to protect investors or comply with SEC-imposed due diligence requirements.[9]

Assuming that the SEC pursues investor protection as a primary goal, can it reconcile these facially divergent directives? This Article proposes that the SEC must strategically integrate both of these divergent directives in two ways: (1) implement the uniform fiduciary standard for broker-dealers who provide personalized investment advice, and (2) require and encourage that broker-dealers, as opposed to inexperienced funding portals, act as diligent intermediaries in crowdfunding transactions. Part I of this Article considers the current fiduciary framework for investment advisers that will apply to broker-dealers under the uniform fiduciary standard. Part II outlines the various methods of crowdfunding and SEC initiatives to exempt smaller companies from regulatory burdens. Part III contrasts the heightened fiduciary standard for brokers under SEC implementation of Dodd-Frank with the relaxed regulations for companies and intermediaries under SEC implementation of the JOBS Act. Finally, Part IV trumpets a call to action to implement the uniform fiduciary standard and heighten investor protection under crowdfunding regulations.

I. The Uniform Fiduciary Standard and its Delicate Fiduciary Framework

a. The Investment Advisers Act

The Investment Advisers Act of 1940 (the "Advisers Act") defines an investment adviser as a person who is compensated for advising others in connection with investments.[10] The Advisers Act reflects congressional

9. *See, e.g.*, JOBS Act, Pub. L. No. 112-106, sec. 302(b), § 4A (a)(4), 126 Stat. 306 (2012) (codified at 15 U.S.C. 77d-1 (2012)) (requiring that intermediaries ensure investor competency); Catherine Clifford, *In Crowdfunding, Who is Responsible for Preventing Fraud?*, ENTREPRENEUR (Feb. 5, 2014), http://www.entrepreneur.com/article/231283 ("Under the SEC's proposing release, a portal would need to demonstrate affirmative 'due diligence' efforts as a defense to an investor suit for a material misstatement or omission by the issuer of the securities appearing on the funding portal's site.").

10. The Advisers Act defines investment adviser as:

> [A]ny person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value

recognition of the fiduciary relationship between an investment adviser and its clients.[11] Congress intended to eliminate or expose all conflicts of interests that may motivate an investment adviser to render advice that was not disinterested.[12]

The federal fiduciary standard under the Advisers Act has had a recognizable impact in both federal and state jurisprudence. For example, the United States Court of Appeals for the Fifth Circuit approved of the application of this standard to promote uniformity:

> The Supreme Court has recognized the investment advisers' fiduciary status. Courts may refer to [its] cases instead of state analogies in deciding whether this status prohibits particular conduct. . . . [B]ecause state law is not considered, uniformity is promoted.[13]

Similarly, although the Advisers Act does not generally confer a private cause of action,[14] state courts and federal courts applying state law have utilized the federal fiduciary standard to address private causes of action against investment advisers.[15]

> of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.

15 U.S.C.A § 80b-2 (a)(11) (West 2013).

11. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-92 (1963) (determining that the Advisers Act "reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship'"); *cf.* Bullmore v. Banc of Am. Sec. LLC, 485 F. Supp. 2d 464, 470-71 (S.D.N.Y. 2007) ("Investment advisors owe fiduciary duties to their clients, much as general partners owe fiduciary duties to limited partners.").

12. *Capital Gains*, 375 U.S. at 191-92 (determining that the Advisers Act also reflected "congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested").

13. Laird v. Integrated Res., Inc., 897 F.2d 826, 837 (5th Cir. 1990).

14. Transamerica Mortg. Advisors v. Lewis, 444 U.S. 11, 24 (1979) (stating that the Advisers Act "confers no other private causes of action, legal or equitable" with the exception of private remedies for certain advisory contracts).

15. *See, e.g.*, State *ex rel.* Udall v. Colonial Penn Ins. Co., 812 P.2d 777, 785 (N.M. 1991) (citing *Capital Gains* and applying its standard to rule on a state law claim for breach of fiduciary duty against an investment adviser); Douglass v. Beakley, 900 F. Supp. 2d 736, 751 n.16 (N.D. Tex. 2012) (citing Texas law for breach of fiduciary duty claims, while noting that the United States Supreme Court in *Transamerica*

b. The Uniform Fiduciary Standard as Applied to Investment Advisers

Section 206 of the Advisers Act provides uniform fiduciary standards to govern the conduct of a registered investment adviser (RIA).[16] The federal fiduciary standard imposes the "'affirmative duty of utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation to 'employ reasonable care to avoid misleading' their clients and prospective clients."[17] SEC interpretations include (1) the duty of loyalty, and (2) the duty of care.[18] The following discusses obligations that the duty of loyalty and care encompass:[19]

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recognized "that Section 206 of the IAA 'establishes federal fiduciary standards to govern the conduct of investment advisers'"); *cf.* Belmont v. MB Inv. Partners, Inc., 708 F.3d 470, 500-01 (3d Cir. 2013) ("[T]he evolution of duties governing investment advisers as fiduciaries appears to have been shaped exclusively by the Advisers Act and federal common law.") (collecting cases).

16. *See Transamerica*, 444 U.S. at 17. For purposes of this Article, the terms "investment adviser" as an individual regulated by the Adviser Act and "RIA" (registered investment adviser) are used interchangeably.

17. SEC STUDY, *supra* note 5, at 22; ROBERT E. PLAZE, STROOCK & STROOCK & LAVAN LLP REGULATION OF INVESTMENT ADVISERS BY THE U.S. SECURITIES AND EXCHANGE COMMISSION, (Oct. 2015), *available at* http://www.stroock.com/site Files/PAFile120.pdf.

18. SEC STUDY, *supra* note 5, at 106 (stating that "the fiduciary duty of investment advisers includes a duty of loyalty and a duty of care (encompassing, among other things, a duty of suitability), with the duty of loyalty requiring investment advisers to act in the best interests of clients and to avoid or disclose conflicts").

19. In addition to the obligations discussed below, investment advisers must also fulfill detailed requirements in many other areas, including but not limited to: (1) ***truthful advertising***, (2) ***supervising persons*** to prevent violations of securities laws, (3) ***best execution*** of trades, and (4) ***proxy voting***. *See generally*, SEC STUDY, *supra* note 5, at 30, 35, 120-21; Plaze, *supra* note 17, at 33, 42-43, 52-55.

i. Duty of Loyalty

The duty of loyalty is fundamental to the fiduciary standard established by the Advisers Act.[20] The RIA is obligated to "serve the best interests of its clients" and must not "subordinate clients' interests to its own."[21] Primarily, the duty of loyalty requires: (A) full and fair disclosure of material facts, and (B) informed consent for principal trading.

A. Full and Fair Disclosure of Material Facts

Generally, at the firm level, "investment advisers must provide clients and prospective clients with a current firm brochure before or at the time an adviser enters into an advisory contract with the client."[22] This brochure must contain information about the investment adviser's services, conflicts of interest, and other information, such as its range of fees, methods of analysis, investment strategies and risks, and the adviser's disciplinary and financial information.[23]

This disclosure is intended "to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested."[24] Therefore, an investment adviser must affirmatively disclose all material facts to clients in a clear manner that fully apprises the clients of relevant facts.[25] A court will likely hold that a fact is material "if there is a substantial likelihood that a reasonable [client] would consider it important."[26] Ultimately, an investment adviser's obligation of full and fair disclosure of material facts is a fact-intensive inquiry and will depend upon the circumstances of each case.

The disclosure must also educate clients to enable them to give their informed consent for principal trading and conflict of interest transactions,

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20. SEC STUDY, *supra* note 5, at 112-13.

21. *Id.* at iii.

22. *Id.* at 114.

23. *Id.*

24. SEC v. Capital Gains Research Bureau, Inc, 375 U.S. 180, 191 (1963).

25. Arleen W. Hughes, Exchange Act Rel. No. 4048, 1948 WL 29537 (Feb 18, 1948), *aff'd. sub nom.* Hughes v. SEC, 174 F.2d 969 (May 9, 1949).

26. TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976).

discussed further below.[27] This meaningful and effective disclosure of material facts must be timely—provided before the completion of the transaction.[28] For example, when one adviser recommends another adviser to a client, the first adviser must disclose any compensation arrangements or conflicts between the advisory firms, and discuss how the firm resolves those conflicts.[29] The SEC has brought enforcement actions against advisers who unfairly assigned client trades to preferred clients without making the proper disclosure.[30] Similarly, the SEC has commenced several enforcement actions against investment advisers that allegedly improperly allocated trades to their own accounts while allocating less beneficial or unprofitable trades to their clients' accounts.[31]

B. Informed Consent for Principal Trading

An RIA engaging in principal trading with clients "represents a clear conflict for any fiduciary."[32] The Adviser Act expressly prohibits an investment adviser, acting as principal for its own account, from effecting any sale or purchase of any security for the account of a client, unless certain procedures are met.[33] Specifically, the investment adviser must disclose to the client—in writing—the capacity in which the adviser is acting before the

27. SEC STUDY, *supra* note 5, at 114.

28. *Id.*

29. *In re* Morgan Stanley & Co., Investment Advisers Act Release No. 2904, 2009 WL 2149210 (July 20, 2009) (settled order); *In re* Yanni Partners, Inc., et al., Investment Advisers Act Release No. 2642, 2007 WL 2492057 (Sept. 5, 2007) (settled order).

30. *See*, *e.g.*, *In re* Nevis Capital Mgmt., LLC, Investment Advisers Act Release No. 2214, 2004 WL 236571 (Feb. 9, 2004) (settled order); *In re* The Dreyfus Corp., et al., Investment Advisers Act Release No. 1870, 2000 WL 562449 (May 10, 2000) (settled order); *In re* Account Mgmt. Corp., Investment Advisers Act Release No. 1529, 1995 WL 579449 (Sept. 29, 1995) (settled order).

31. *See, e.g.*, *In re* Nicholas-Applegate Capital Mgmt., Investment Advisers Act Release No. 1741, 1998 WL 466733 (Aug. 12, 1998) (settled order); *In re* Timothy J. Lyons, Investment Advisers Act Release No. 1882, 2000 WL 1732527 (June 20, 2000) (settled order).

32. SEC STUDY, *supra* note 5, at 118.

33. *Id.* at 112-13.

completion of the transaction and obtain the client's consent.[34] The SEC has interpreted the term, "the transaction," to require "separate disclosure and consent for each transaction."[35]

The SEC is especially concerned with principal trading because of its heightened incentives for "price manipulation or the placing of unwanted securities into client accounts (*i.e.*, 'dumping')."[36] Accordingly, the SEC has taken a steady position that advisers must disclose both their capacity as principals and any compensation that the adviser receives in these trades.[37]

ii. Duty of Care

The duty of care requires an RIA to "make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information."[38] This reasonable investigation to acquire accurate and complete information extends to not only the recommended securities, but also the client's financial objectives and needs.[39] Thus, the duty of care requires: (A) reasonable investigation into recommendations, and (B) suitability of recommendations for each client.

A. Reasonable Investigation into Recommendations

An RIA must have a reasonable, independent basis for its recommendations.[40] The duty of care flows from the "delicate fiduciary nature of an investment advisory relationship," requiring that the adviser provide

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34. *Id.*

35. *Id.* at 118.

36. *Id.*

37. *See, e.g.*, Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act Release No. 1092, 1987 WL 112702 (Oct. 8, 1987); Opinion of Director of Trading and Exchange Division, Investment Advisers Act Release No. 40, 1945 WL 26477 (Feb. 5, 1945).

38. SEC STUDY, *supra* note 5, at 120.

39. *Id.*

40. *In re* Alfred C. Rizzo, Investment Advisers Act Release No. 897, 1984 WL 470013 (Jan 11, 1984).

clients with personal and competent "advice regarding the sound management of their investments."[41] An RIA must also corroborate the issuer's statements from independent sources rather than carelessly disseminate investment recommendations.[42] An investment adviser's failure to reasonably investigate its recommendations to a client is a breach of its duty of care, especially where independent verifications of information are "simple, inexpensive, and obvious."[43] The SEC has commenced enforcement actions against investment advisers who have allegedly omitted or misrepresented information regarding their recommendations.[44]

Similarly, investment advisers should carefully scrutinize the financial news and disclosures from lesser known companies and officials, because they may be more likely to defraud investors.[45] As the federal district court stated in *SEC v. Blavin*, "a reader of an investment newsletter has a right to expect the investment adviser to do more than merely reprint . . . glowing financial news gleaned from financial reports or conversations with companies or officers."[46]

B. Suitability of Recommendations for Each Client

Investment advisers owe their clients a duty to provide them only suitable investment advice.[47] The suitability obligation requires that the RIA make a reasonable inquiry into the client's financial needs, objectives and

41. *Id.* (citing SEC v. Capital Gains Research Bureau, Inc, 375 U.S. 180, 191 (1963)).

42. *Id.*

43. *Id.*

44. *See, e.g.*, *In re* George F. Fahey, Investment Advisers Act Release No. 2196, 2003 WL 22794456 (Nov. 24, 2003) (settled order); *In re* Gary L. Hamby, et al., Investment Advisers Act Release No. 1668, 1997 WL 581263 (Sept. 22, 1997) (settled order).

45. Sales of Unregistered Securities by Broker-Dealers, Securities Act Release No. 5168, 1971 WL 127558 (July 7, 1971).

46. 557 F. Supp. 1304, 1314 (E.D. Mich. 1983).

47. *See* SEC STUDY, *supra* note 5, at 120-21; Plaze, *supra* note 17, at 32.

circumstances, and that the adviser reasonably believe that the recommendations are suitable for its customer based on those factors.[48]

For example, in one case, the SEC pursued an enforcement action against an adviser who failed to appropriately diversify the discretionary accounts of clients with conservative investment objectives.[49] The investment adviser breached his suitability obligation by recommending speculative high-risk stocks to clients who were elderly or had little investment experience.[50] A court will likely measure an investment adviser's compliance with suitability obligations in the context of a client's overall portfolio.[51]

c. Broker-Dealer Exclusion From the Advisers Act and the Pursuit of Uniformity

Although the Advisers Act firmly establishes fiduciary duties for investment advisers, brokers and dealers who are registered with the SEC are largely excluded from the Advisers Act.[52] Pursuant to this exclusion, broker-dealers frequently offer investment advice and recommendations to retail customers in their capacity as intermediaries between investors and investments.[53] Retail investors may trust these broker-dealers to act in their

48. SEC STUDY, *supra* note 5, at 27-28; Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406, 1994 WL 84902 (Mar. 16, 1994).

49. *In re* George E. Brooks & Assocs., Inc., Investment Advisers Act Release No. 1746, 1998 WL 479756 (Aug. 17, 1998).

50. *Id.*; *see also*, *In re* Philip A. Lehman, Investment Advisers Act Release No. 1831, 1999 WL 740373 (Sept. 22, 1999) (enforcing suitability obligation against adviser who recommended risky investment for client's individual retirement account, despite client's conservative investment objective and age).

51. *See* Suitability of Investment Advice*, supra* note 48 (stating that "inclusion of some risky securities in the portfolio of a risk-averse client may not necessarily be unsuitable").

52. Broker-dealers are excluded from the Advisers Act if the advice given is: (i) "solely incidental to the conduct of its business as broker or dealer," and (ii) it does not receive any "special compensation" for providing investment advice." SEC STUDY, *supra* note 5, at 139.

53. *Id.* at 8. ("Of the 5,100 registered broker-dealer firms, 985 have indicated on Form BD that they engage in, or expect to engage in, investment advisory services constituting one percent or more of their annual revenue.").

best interests, often unaware that the "adviser" may be compensated more for recommending Product A over Product B.[54] One commentator highlighted that brokerage firms "engage in advertising that is clearly calculated to leave the false impression with investors that stockbrokers take the same . . . care as a doctor or a lawyer."[55]

Without the explicit recognition of fiduciary duties under the Advisers Act, courts have not established uniform fiduciary standards that apply to broker-dealers.[56] A broker's fiduciary duty to a client largely depends on their relationship, including the degree of discretion the client has entrusted to the broker.[57] A relationship consisting of non-discretionary and arm's length transactions will not give rise to fiduciary duties, while a relationship consisting of discretion and investment advice will give rise to such duties.[58]

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54. *See* April Rudin, *On the 75th Birthday of the 1940 Act, A Reminder of the F-Word's Power*, HUFFINGTON POST (Sept. 2, 2015), http://www.huffingtonpost.com/april-rudin/on-the-75th-birthday-of-t_b_8074238.html. ("Variable compensation arrangements—where a broker is paid one amount for recommending Product A, and a different amount for Product B—create an inherent conflict of interest that can impair the objectivity of advice given to an investor.").

55. Nick Thornton, *Witness Says Brokers Try To Pass Themselves Off as Fiduciaries*, BENEFITSPRO (Aug. 14, 2015), http://www.benefitspro.com/2015/08/14/witness-says-brokers-try-to-pass-themselves-off-as ("But, while brokerage firms advertise as though they are trusted guardians of their clients' best interests, they arbitrate any resulting disputes as though they are used car salesmen.").

56. *See* Andrew Melnick, *What's in a Name: The Battle over a Uniform Fiduciary Standard for Investment Advisers and Broker-Dealers*, 87 ST. JOHN'S L. REV. 415, 422 (2013) ("[C]ourts have generally held that broker-dealers, absent [special circumstances of discretion or trust and confidence], do not owe customers a fiduciary duty."); *see also* Barbara Black & Jill I. Gross, *Economic Suicide: The Collision of Ethics and Risk in Securities Law*, 64 U. PITT. L. REV. 483, 489-507 (2003) (discussing various instances where courts have not uniformly held broker-dealers to the duties recognized by their industry, such as the duty of fair dealing, suitability, 'Know Your Customer,' and churning).

57. *See* Romano v. Merrill Lynch, Pierce, Fenner & Smith, 834 F.2d 523, 530 (5th Cir. 1987) ("The nature of the fiduciary duty owed [by a broker to his client] will vary, depending on the relationship between the broker and the investor [and] the nature of the account is a factor to be considered.").

58. *See, e.g.*, Johnson v. John Hancock Funds, 217 S.W. 3d 414, 428 (Tenn. Ct. App. 2006) ("If the transaction is non-discretionary and at arm's length, i.e., a simple order to buy or sell a particular stock, the relationship does not give rise to general fiduciary duties. However, if the client has requested the broker or advisor to provide investment advice or has given the broker discretion to select his or her investments, the broker or

As one commentator explained, "When the custodian or manager has discretionary authority over investment, duties of loyalty and care are necessary to protect the interests of beneficial owners who may otherwise have limited legal power to direct the manner in which funds are invested or . . . fees are set for such services."[59]

While brokers have some obligations regarding suitability and disclosure, in practice, these obligations "have been more limited than with advisers and apply at different points in the customer relationship."[60] Brokers are accountable as fiduciaries "only to the extent that they execute specific tasks as agents for the account of and subject to the direction of the principal, such as placing orders, executing, clearing, and settling transactions, and holding customer funds or securities."[61] Where broker-dealers do not solicit customers or recommend securities, their obligations of disclosure are fairly narrow, including only the information related to the transaction.[62] In these circumstances, broker-dealers are not generally required to provide disclosures regarding the security or their self-interest in the security.[63]

This disunity between the fiduciary duties of investment advisers and broker-dealers has confused retail investors, even those aware that differences exist between the two.[64] Many investor groups believe that the current rules do

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advisor assumes broad fiduciary obligations that extend beyond the individual transactions."); De Kwiatkowski v. Bear Stearns & Co., 306 F.3d 1293, 1308-09 (2d Cir. 2002) (emphasizing that the extent of a broker or adviser's fiduciary duty depends primarily on the relationship between the broker or adviser and his or her client); Ascot Fund Ltd. v. UBS PaineWebber, Inc., 28 A.D.3d 313 (N.Y. App. Div. 2006).

59. Onnig Dombalagian, *Investment Recommendations and the Essence of Duty*, 60 AM. U. L. REV. 1265, 1285-86 (2011).

60. SEC STUDY, *supra* note 5, at 106. For an interesting discussion of limited protections offered by current suitability and disclosure requirements, *see generally* Onnig Dombalagian, *Principles for Publicness*, 67 FL. L. REV. 649, 674-76 (2015) (discussing the current suitability rule for broker-dealers and its unsatisfactory nature for private litigants); Dombalagian, *supra* note 59, at 1290-97 (discussing disclosure-based regulations for financial services and its shortcomings).

61. Dombalagian, *supra* note 59, at 1286; *see also* SEC STUDY, *supra* note 5, at 106 (stating that broker-dealers must primarily "deal fairly with customers and to observe high standards of commercial honor and just and equitable principles of trade").

62. SEC STUDY, *supra* note 5, at 55.

63. *Id.*

64. *Id.* at i ("Many investors are also confused by the different standards of care that apply to investment advisers and broker-dealers. That investor confusion has been a

not adequately limit conflicts of interests for brokers, who are compensated by mutual funds and other companies for recommending their products.[65] SEC administrative decisions have focused less on "whether the client's best interest is served" and more on "whether a conflict is disclosed."[66] Problematically, mere disclosure may not protect investors fully, considering that many customers trust their brokers to direct them towards the best transactions among a complex market of commercialized options.[67]

Accordingly, the SEC sought to resolve the discrepancies between each actor's regulatory regime, especially where they engage "in the same or substantially similar activity, . . . providing personalized investment advice about securities to retail customers."[68] In order to consistently protect investors across state borders and avoid esoteric distinctions, the SEC recommended a uniform fiduciary standard for broker-dealers and investment advisers:

> [T]he standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.[69]

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source of concern for regulators and Congress."); *id* at 94 ("Through the public comment process, many investors stated that they did not understand the standards of care applicable to investment advisers and broker-dealers, found the standards of care confusing, and in particular, were uncertain about the meaning of the multiple titles used by investment advisers and broker-dealers").

65. SIFMA, PROPOSED BEST INTERESTS OF THE CUSTOMER STANDARD FOR BROKER-DEALERS (June 3, 2015), *available at* http://www.sifma.org/issues/item.aspx?id=8589954937.

66. Rostad, *supra* note 6. ("Investors . . . are not necessarily able to appreciate, or adequately discount for, the many conflicts of interest to which financial services providers and their associated persons are subject."). Dombalagian, *supra* note 59, at 1282.

67. Dombalagian, *supra* note 59, at 1281-82 ("To the extent that these compensation structures mimic compensation structures in other consumer markets, the question becomes whether customers can make informed decisions about the frequency, size, or type of transactions best suited to their needs despite those conflicts. The nature of financial services, however, entails a much more complex and opaque web of relationships among service providers.").

68. SEC STUDY, *supra* note 5, at iii.

69. *Id.* at vi.

Because the SEC recommended a standard for broker-dealers that is "no less stringent than currently applied to investment advisers under the Advisers Act,"[70] the uniform fiduciary standard will essentially extend the aforementioned fiduciary duties of investment advisers to broker-dealers, harmonizing significant gaps and shortcomings.[71]

In March 2015, the SEC repeated its recommendation that "broker-dealers and investment advisers should be subject to a uniform fiduciary standard of conduct when providing personalized securities advice to retail investors."[72] Nevertheless, the SEC acknowledged the complexities and challenges of such rulemaking, including: (1) how to define a uniform fiduciary standard; (2) what is required under that standard; and (3) how to ensure compliance and enforcement of that standard.[73] Supporters of the uniform fiduciary standard seek to have the SEC "boldly move forward . . . to close the harmful gap between advice provided by investment advisers under a fiduciary standard and the merely 'suitable' advice currently allowed by broker-dealers."[74] Meanwhile, critics of the standard assert that it will impose additional costs and burdens on brokers, causing them to drop less wealthy clients and deprive investors of "reliable, reasonably-priced advice."[75]

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70. Securities and Exchange Commission, Press Release No. 2011-20, SEC Releases Staff Study Recommending a Uniform Fiduciary Standard of Conduct for Broker-Dealers and Investment Advisers (Jan. 22, 2011), *available at* https://www.sec.gov/news/press/2011/2011-20.htm.

71. *See* SEC STUDY, *supra* note 5, at 104-05 (discussing the current gaps, shortcomings or overlaps in existing investment adviser and broker-dealer regulation that commenters hope to harmonize in the areas of "disclosure; registration, licensing, competency and continuing education; obligation to act in the 'best interest' of the customer; suitability; oversight and examination; . . . supervision; advertising; books and records; financial responsibility; and investor remedies through a private right of action or arbitration").

72. White, *supra* note 2.

73. *Id.*

74. FIN. PLANNING COAL., FINANCIAL PLANNING COALITION APPLAUDS SEC CHAIR MARY JO WHITE'S SUPPORT FOR A UNIFORM FIDUCIARY STANDARD (Mar. 17, 2015), *available at* http://financialplanningcoalition.com/financial-planning-coalition-applauds-sec-chair-mary-jo-whites-support-for-a-uniform-fiduciary-standard/.

75. David Michaels, *SEC Joins Battle on Broker Bias That Could Remake Industry*, BLOOMBERGBUSINESS (Mar. 17, 2015), http://www.bloomberg.com/news/articles/2015-03-17/sec-will-develop-fiduciary-duty-rule-for-brokers-white-says.

The SEC has struggled to implement this standard for a variety of reasons. It faces competing interests that will "parse every nuance of a proposed rule and push back hard if some detail is not to their liking."[76] Barbara Roper, director of investor protection for the Consumer Federation of America, questioned whether the SEC could gather enough votes to implement this "strong, proinvestor rule" legally under Section 913 of Dodd-Frank "on a polarized commission."[77] Nearly five years after the SEC staff recommended a uniform fiduciary standard for broker-dealers, "the cement around SEC inaction . . . has hardened."[78] Investor protection groups must question whether this reform effort will become a reality, especially when this dream is overshadowed by the liberalization of crowdfunding regulations.

II. Equity Crowdfunding Regulations: Insufficient Protection of the Crowd

Two years after Congress enacted Dodd-Frank to heighten investor protection, Congress passed the JOBS Act to "increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies."[79] The JOBS act sought to pave the way for the expansion of online capital markets by relieving smaller companies from regulatory compliance costs and burdens.[80]

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76. Mark Schoeff Jr., *SEC's Mary Jo White Says Agency Will Develop Fiduciary Rule for Brokers*, INVESTMENTNEWS (Mar. 17, 2015), http://www.investmentnews.com/article/20150317/FREE/150319919/secs-mary-jo-white-says-agency-will-develop-fiduciary-rule-for.

77. Melanie Waddell, *SEC's White Supports Fiduciary Rule for Brokers, Third-Party Audits*, THINKADVISOR (Apr. 2, 2015), http://www.thinkadvisor.com/2015/04/02/secs-white-supports-fiduciary-rule-for-brokers-thi.

78. Rostad, *supra* note 6.

79. JOBS Act, Pub. L. No. 112-106, 126 Stat. 306 (2012), (codified at 15 U.S.C. 77d-1 (2012)).

80. *Id.*; *see also* Carols Berdejó, *Going Public After the JOBS Act*, 76 OHIO ST. L.J. 1, 3-4 (2015) ("The JOBS Act seeks to ease the regulatory compliance costs and burdens faced by smaller issuers accessing the public capital markets by relaxing the level of mandatory disclosures required during the IPO process and phasing in certain ongoing regulatory requirements following the completion of the IPO.").

a. Raising Capital in the Twenty-First Century

With the number of internet users in the world exceeding three billion—approximately 42.4% of the world population—social and economic interactions are becoming increasingly virtual.[81] Virtual communities have been established to provide social networking (e.g., Facebook and Twitter), the sharing of investment knowledge (e.g., Investopedia and the Financial Times), and transactions in the online marketplace (e.g., eBay and Amazon). Accordingly, many companies now target the large pool of investors on the internet and utilize innovative methods of raising capital, such as crowdfunding.

Crowdfunding is an innovative method of raising small amounts of capital from a large number of investors (i.e. the "crowd") for a specific purpose or new business.[82] Crowdfunding utilizes the accessibility of online investors, while invoking passionate, bandwagon responses on social media websites like Facebook and Twitter.[83] Crowdfunding investors face a high risk of losing their investment, because new business startups often fail and innovative ideas and prototypes rarely reach fruition.[84]

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81. INTERNET WORLD STATS, INTERNET GROWTH STATISTICS, http://www.internetworldstats.com/emarketing.htm (last updated June 12, 2015).

82. *See* Joan M. Heminway & Shelden R. Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 881 (2011) ("[I]instead of raising the money from a very small group of sophisticated investors, the idea of crowdfunding is to obtain it from a large audience (the "crowd"), where each individual will provide a very small amount.").

83. *See* K.K. Duvivier, *E-Legislating*, 92 OR. L. REV. 9, 41 (2013) ("[T]he ability of the printing press to disperse information is no match for the eye-popping numbers of the Internet for which the term 'going viral' was coined to capture the enormity of the phenomenon.").

84. *See* Andrew A. Schwartz, *Funding Innovation Symposium: The Nonfinancial Returns of Crowdfunding*, 34 REV. BANKING & FIN. L. 565, 573 (2015); John S. Wroldsen, *The Social Network and the Crowdfund Act: Zuckerberg, Saverin, and Venture Capitalists' Dilution of the Crowd*, 15 VAND. J. ENT. & TECH. L. 583, 615 (2013) (discussing "the economic risks [to crowdfunding investors] posed by start-up companies' follow-on rounds of financing and potential exit events"); C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 107-08 (2012) ("Even in the absence of fraud or self-dealing, many crowdfunded small businesses will fail.").

b. Four Methods to the Madness of Crowdfunding

There are four general methods of crowdfunding: (1) Donation-based and Product-based Crowdfunding; (2) Title II Crowdfunding; (3) Title III Crowdfunding; and (4) Title IV Crowdfunding. The first two types of crowdfunding are relatively simple and generally do not prompt regulatory concern.

i. Donation-Based and Product-Based Crowdfunding

Donation-based Crowdfunding allows companies raise money in the form of donations. The company offers altruistic satisfaction to its audience, but does not relinquish stock or promise to repay the money.[85] Occasionally, the company will give "tokens of recognition to its donors, such as a baseball cap or a free massage, but donors expect and receive little or nothing of value."[86]

Product-based Crowdfunding allows a company with an early-stage, innovative product to reach out to potential customers to fund development of that product. For example, Eric Migicovsky raised over $10 million to create a new Pebble watch, and gave the watch to every contributor of $99 or more.[87] Similar to donation-based crowdfunding, product-based crowdfunding does not give investors stock or rights to future profits. Because these two types of crowdfunding generally do not involve securities, they do not prompt regulatory concern by the SEC.[88]

ii. Title II Crowdfunding

Title II of the JOBS Act allows companies to generally solicit and raise an unlimited amount of capital from "accredited investors," pursuant to Rule 506

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85. Bradford, *supra* note 844, at 15.

86. Mark Roderick, *Four Kinds of Crowdfunding: Which is Right for My Company?*, CROWDFUNDING ATTORNEY (Jan. 28, 2013), http://crowdfundattny.com/category/product-based-crowdfunding/.

87. *Id.*

88. Bradford, *supra* note 844, at 31 (concluding that federal securities law does not apply to donation-based or product-based crowdfunding because the former's supporters "receive absolutely nothing in return for their contributions," and the latter's supporters "are promised only a product or service—a consumption item").

of Regulation D under the Securities Act of 1933 (Securities Act).[89] Accredited investors are generally sophisticated institutions or retail investors who meet certain wealth or income standards.[90]

Through a streamlined process online, Title II Crowdfunding provides entrepreneurs with access "to a very large pool of wealthy investors, a virtually unlimited amount of money, and a relatively simple and straightforward process."[91] Companies utilizing this provision can "place advertisements in the Wall Street Journal, advertise on local radio and television, and, most important, use Facebook, Twitter, and websites to look for money."[92] There is *no limit* on the amount of money that can be raised, and issuers are not required to provide any particular information to prospective investors, not even any particular financial information.[93] Title II Crowdfunding became effective on September 23, 2013.[94]

iii. Title III Crowdfunding

When finalized pursuant to Section 4(a)(6) of the Securities Act, Title III Crowdfunding will allow companies to raise up to $1 million per year through online platforms from an unlimited number of investors, accredited or unaccredited.[95] Notably, Title III Crowdfunding does not permit general

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89. JOBS Act, § 201, 301-305, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified at 15 U.S.C. 77d-1 (2012)); Rule 506 permits general solicitation of investors, provided that the solicitor takes reasonable steps to verify they are accredited. 17 C.F.R.§ 230.502(c).

90. Under current rules, an individual is accredited if the individual has (1) an income of at least $200,000 per year; or (2) a net worth, excluding principal residence, of at least $1 million. 17 C.F.R. § 230.501(a)(5),(6); Bradford, *supra* note 844, at 45.

91. Roderick, *supra* note 866.

92. FLASTER GREENBERG, *Crowdfunding*, , http://www.flastergreenberg.com/practices-Crowdfunding.html

93. JOBS Act § 302(a) Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified as amended in 15 U.S.C. § 77d (a)(6)(A)).

94. *See* Keith Higgins, SEC Director, Div. of Corp. Fin., Testimony Providing an Update on JOBS Act Implementation, Testimony Before the U.S. S. Comm. on Banking, Housing and Urban Affairs Subcomm. on Sec., Ins. and Inv. (Oct. 30, 2013), http://www.sec.gov/News/Testimony/Detail/Testimony/1370540151403.

95. *Id.*

solicitation or advertising outside of guiding prospective investors to the relevant online platform for each offering.[96] The amount that each investor may invest will be limited based on the investor's income and net worth.[97] A company seeking to raise capital from potential investors must provide extensive information regarding the company and intended use of the proceeds.[98]

Under the SEC's proposed rules, Title III Crowdfunding offerings would be "conducted exclusively online through a platform operated by a registered broker or a funding portal."[99] Essentially, these intermediaries facilitate the purchase of securities from issuers and conduct the crowdfunding transaction itself.[100] A registered broker may act as a crowdfunding intermediary, because

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96. JOBS Act sec. 302(b), § 4A(b)(2) Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified at 15 U.S.C. § 77d-1(b)(2)(2012)); *see also* Thomas G. James, *Far From the Maddening Crowd: Does the Jobs Act Provide Meaningful Redress To Small Investors for Securities Fraud in Connection with Crowdfunding Offerings?*, 54 B.C. L. REV. 1767, 1778 (2013) ("Although the amended Section 4A(b) prohibits the issuer or others acting on its behalf from advertising the terms of the offering, the issuer may direct investors to the intermediary conducting the offering.").

97. Over a 12-month period, investors would be permitted to invest up to: (1) "$2,000 or 5 percent of their annual income or net worth, whichever is greater, if both their annual income and net worth are less than $100,000;" or (2) "10 percent of their annual income or net worth, whichever is greater, if either their annual income or net worth is equal to or more than $100,000". Securities and Exchange Commission, Press Release No. 2013-227, SEC Issues Proposal on Crowdfunding (Oct. 23, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677.

98. Required disclosures for Title III Crowdfunding issuers include: (1) information about officers and directors as well as owners of 20 percent or more of the company; (2) a description of the company's business and the use of proceeds from the offering; (3) the price to the public of the securities being offered, the target offering amount, the deadline to reach the target offering amount, and whether the company will accept investments in excess of the target offering amount; (4) certain related-party transactions; (5) a description of the financial condition of the company; and (6) financial statements of the company. *Id.*

99. *Id.*

100. *Id.*

the activities involved in acting as an intermediary are within the scope of the current licensed activities of a registered broker.[101]

Title III Crowdfunding intermediaries will be highly regulated and have extensive obligations in their own right, including registering with the SEC and ensuring investor education and acknowledgement of risks.[102] Intermediaries must also take several measures to reduce the risk of fraud and ensure compliance with SEC requirements.[103] The SEC's implementation of Title III Crowdfunding has been repeatedly delayed—recently until July 2016.

iv. Title IV Crowdfunding

Title IV Crowdfunding was finalized by the SEC on March 25, 2015.[104] The SEC updated and expanded Regulation A, an existing exemption from registration for smaller companies. Through Title IV Crowdfunding, smaller companies are permitted "to offer and sell up to $50 million of securities in a 12-month period, subject to eligibility, disclosure and reporting requirements."[105] Title IV provides for two tiers of offerings:

- Tier 1 allows offerings of securities up to $20 million in a 12-month period, with no more than $6 million in offers by selling security-holders that are affiliates of the issuer.

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101. Iris K. Linder, *The Sec Crowdfunding Proposed Regulations: Intermediary Registration Requirements*, FOSTER SWIFT (Jan. 16, 2014), http://www.michiganitlaw.com/SEC-Crowdfunding-Proposed-Regulations-Intermediary-Registration.

102. Crowdfunding, Securities Act Release No. 33-9470, Exchange Act Release No. 70741, 2013 WL 5770346 (Oct. 23, 2013).

103. Other SEC-imposed obligations require that intermediaries: (1) take measures to reduce the risk of fraud; (2) make available to the SEC and to potential investors certain information provided by the issuer; (3) ensure that the issuer receives offering proceeds only after the aggregate capital raised equals or exceeds a targeted offering amount; (4) permit investors to cancel their capital commitments, in accordance with SEC rules; and (5) ensure that no investor purchases an amount of equity crowdfunding securities that exceeds the per-investor limit. *Id.*

104. Securities and Exchange Commission, Press Release No. 2015-49, SEC Adopts Rules To Facilitate Smaller Companies' Access To Capital (Mar. 25, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-49.html.

105. *Id.*

- Tier 2 allows offerings of securities of up to $50 million in a 12-month period, with no more than $15 million in offers by selling security-holders that are affiliates of the issuer. [106]

Both Tier 1 and 2 offerings are subject to certain eligibility requirements, while Tier 2 offerings are also subject to additional disclosure and ongoing reporting requirements.[107] While Tier II places investment limits on non-accredited investors, there are no such limits under Tier 1.[108]

Commentators believe that Title IV Crowdfunding overshadows the other JOBS Act methods, especially considering the SEC's swift implementation.[109] Title IV Crowdfunding generates two significant contrasts. First, unlike Title II, Title IV Crowdfunding issuers *may target unaccredited investors*, allowing companies to truly target the wealth of the masses.[110] Second, unlike Title III, Title IV Crowdfunding permits companies to *test the waters*, allowing companies to advertise and use social media to target potential investors.[111]

III. Glaring Dichotomy: The Tale of Two Cities

Similar to the SEC's approach to the uniform fiduciary standard, the SEC recognized that innovative technologies like crowdfunding brought a delicate

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106. *Id.*

107. *Id.*

108. "Individual non-accredited investors can invest a maximum of the greater of 10% of their net worth or 10% of their net income in a Reg A+ offering (per offering)." Kiran Lingam, *The Reg A+ Bombshell: $50M Unaccredited Equity Crowdfunding Title IV Takes Center Stage*, CROWDFUND INSIDER (Mar. 25, 2015), http://www.crowdfundinsider.com/2015/03/65007-the-reg-a-bombshell-50m-unaccredited-equity-crowdfunding-title-iv-takes-center-stage/.

109. "[T]he SEC did not mention Title III Equity Crowdfunding a single time either in this meeting or in Chairman White's recent testimony before Congress. This furthers the belief by many that Title III Equity Crowdfunding is dead in the water as it currently stands and may only be revived by an act of Congress." *Id.*

110. *Id.*

111. 17 C.F.R. § 230.254. According to the former President of the North American Securities Administrators Association (NASAA), under the JOBS Act, "We're opening the door to broad solicitation and advertising of these [small securities offerings]. . . . The lies are going to be easy to disseminate." Phyllis Diamond, *Litigation Reform May Be Problematic in New JOBS Act Era, NASAA's Abshure Says*, 44 SEC. REG. L. & REP. 1838 (Oct. 1, 2012).

balance of challenges and opportunities.[112] Nevertheless, while the SEC has struggled to implement heightened fiduciary standards for broker-dealers under Dodd-Frank, it left potential gaps in the protection of investors through its implementation of the JOBS Act. The SEC's equity crowdfunding regulations may not sufficiently address the potential risks of fraud and abuse. Crowdfunding's innovative method of raising capital has not quite abolished the prevalence of financial fraud; it has merely spread it further beyond physical boundaries and into cyberspace.[113]

For example, the SEC's equity crowdfunding regulations have not fully addressed the full scope of problems that could arise in this new frontier. First, although Title III Crowdfunding portals must register with FINRA, provide disclosure to investors, and conduct due diligence on crowdfunding campaigns, these funding portals do not have uniform policies and procedures for reviewing the issuer's offering.[114] Commentators question the "false sense of security" that a funding portal would faultlessly operate in accordance with SEC rules, especially "[c]onsidering the history of fraudulent acts by those registered with the SEC."[115] Broker-dealers, who have broad experience with

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112. Mary Jo White, Chair SEC, Keynote Address at the 41st Annual Securities Regulation Institute Coronado, California: The SEC in 2014, (Jan. 27, 2014), *available at* https://www.sec.gov/servlet/Satellite/News/Speech/Detail/Speech/1370540677500#.UvnT7rTl-70 ("It is not only our job to keep pace with this rapidly changing environment, but, where possible, also to harness and leverage advances in technology to better carry out our mission.").

113. Bradford, *supra* note 844, at 107 (concluding that crowdfunding allows entrepreneurs to take advantage of "opportunities for self-dealing, excessive compensation, [and] misuse of corporate opportunities").

114. *See, e.g.*, JOBS Act, Pub. L. No. 112-106, sec. 302(b), § 4A (a)(4), 126 Stat. 306 (2012) (codified at 15 U.S.C. 77d-1 (2012)) (requiring that intermediaries ensure investor competency); Clifford, *supra* note 9 ("Under the SEC's proposing release, a portal would need to demonstrate affirmative 'due diligence' efforts as a defense to an investor suit for a material misstatement or omission by the issuer of the securities appearing on the funding portal's site.").

115. *See* Scott Bailey, *A Job Creator or an Investor Peril?: A Texas Practitioner's Guide to the Crowdfunding Exemption Under Title III of the Jobs Act*, 46 TEX. TECH L. REV. ONLINE EDITION 1, 11 (2014), *available at* http://texastechlawreview.org/wp-content/uploads/Bailey.ONLINE.pdf; *see also* Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1736–37, 1757 (2012) ("The SEC's resources are limited, and the Commission cannot

executing transactions and conducting due diligence, may be more capable in this new frontier than untested funding portals.

Finally, because one facet of Title IV Crowdfunding expressly preempts state law, many investor-protection groups and state regulators fear that it will remove another necessary layer of investor protection.[116] Outside of securities fraud claims, these crowdfunding investors' only lifeline may be to pursue broker-dealers or investment advisers under a uniform fiduciary standard. Ironically, the crowdfunding regulations practically remove broker-dealers and investment advisers from the equity equation. Companies can solicit and target large pools of unaccredited investors directly through the internet and funding portals, raising serious concerns of whether investment limits offer enough investor protection.[117] Even with investment limits that objectively cap an individual's potential loss, funding portals have no guidance on ensuring investor compliance.[118] Crowdfunding may "attract investors with limited funds who cannot tolerate high investment risk, even for small amounts of money."[119] Further, large families and organizations of investors still face the risk of a consequential aggregate loss.

A glaring dichotomy exists between the SEC's implementation of Dodd-Frank and the JOBS Act. On the one hand, the SEC has strongly supported investor protection and the uniform fiduciary standard as a "high priority."[120] On the other hand, the SEC has promulgated crowdfunding regulations that insufficiently address investor protection and restitution. These two directives

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be expected to be effective in the crowdfunding arena—especially considering widely reported enforcement failures involving much larger economic stakes. ").

116. Some states have even sued the SEC to challenge the Title IV regulations for this reason. *See, e.g.*, Brief for Petitioners, Lindeen v. SEC, No. 15-1149, (D.C. Cir. Aug. 26, 2015), 2015 WL 5047630, at *25-27 (asserting that the SEC "failed to give due consideration to investor protection in its cost-benefit analysis of state-law preemption for Tier 2 offerings under Regulation A and other aspects of the rule").

117. *Cf.* Dombalagian, *supra* note 60, 675 ("[T]he crowdfunding rules suggest that Congress favors a regulatory approach that protects investors by imposing limitations on the amount invested in relation to their means.").

118. JOBS Act, Pub. L. No. 112-106, 126 Stat. 306, 316 (2012) (codified at 15 U.S.C. 77d-1 (2012)), (requiring intermediaries to ensure that investors meet statutory caps but providing no clear guidance on compliance).

119. Hazen, *supra* note 1155, at 1765–66.

120. Melanie Waddell, *For Once, Two Certainties in D.C.: New SEC Commissioners, DOL Fiduciary Rule*, THINKADVISOR (Aug. 31, 2015), http://www.thinkadvisor.com/2015/08/31/for-once-two-certainties-in-dc-new-sec-commissione?page=2.

must be integrated in a way that protects investors while restoring confidence in this unique area of capital formation.

IV. A Collaborative Opportunity: Reinforcing the Delicate Balance Between Investor Protection and Capital Formation

In light of the aforementioned dichotomy, this Article offers two recommendations. First, the SEC must immediately implement the uniform fiduciary standard for broker-dealers who provide personalized investment advice. According to estimates by the president's Council of Economic Advisers, adviser conflicts—including incentives to recommend higher-fee investments—cost U.S. investors approximately $17 billion a year.[121] The uniform fiduciary standard is necessary to ensuring that broker-dealers "act in the best interest" of their customers. Fiduciary duties should "continue to play an 'extracontractual' role to prevent abusive contracting, or at least a [supplementary] role when conflicts of interest cannot be adequately defined or addressed by contract."[122] Thus, the SEC must execute its authority to protect investors from broker-dealers who hold themselves out as unbiased and trusted financial advisers.[123]

Second, the SEC must heighten investor protection under the JOBS Act before it finalizes Title III Crowdfunding. While commentators have suggested increased standards for funding portals and other innovative measures,[124] this Article recommends a more collaborative approach that

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121. WHITE HOUSE COUNSEL ECON. ADVISERS, THE EFFECTS OF CONFLICTED INVESTMENT ADVICE ON RETIREMENT SAVINGS (Feb. 23 2015), *available at* https://www.whitehouse.gov/sites/default/files/docs/cea_coi_report_final.pdf.

122. Dombalagian, *supra* note 59, at 1322-23.

123. *See* William Alan Nelson II, *Broker-Dealer: A Fiduciary By Any Other Name?*, 20 FORDHAM J. CORP. & FIN. L. 637, 692-93 (2015) ("The current conflicting standards harm consumers by allowing financial service providers to present themselves as impartial and unbiased advisors, while in actuality they are salesman that are only providing advice as a way to sell more expensive and complex products.").

1243. *See, e.g.*, Tianlong Hu & Dong Yang, *Symposium: Crowdfunding Regulations and Their Implications: The People's Funding of China: Legal Developments of Equity Crowdfunding—Progress, Proposals, and Prospects*, 83 U. CIN. L. REV. 445, 474 (2014) (suggesting that crowdfunding in China would benefit from "a regulatory framework" that would allow "investors and capital-seekers to report any wrongdoings or improper handlings by crowdfunding platforms, thereby discouraging unfair service

unites the divergent directives of Congress: the SEC should *require* that broker-dealers, as opposed to inexperienced funding portals, act as diligent intermediaries in crowdfunding transactions. All funding portals engaged in crowdfunding transactions must partner with a registered broker-dealer to comply with this directive. Commentators question whether funding portals can adequately conduct due diligence or "ensure that potential unsophisticated investors have understood the nature of their investment."[125] Experienced broker-dealers would comply with these tasks more confidently and effectively than these funding portal start-ups.[126] Unfortunately, companies will likely choose funding portals as their intermediaries, because of their lower cost and less burdensome scrutiny of the company's disclosures.[127]

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terms and conditions in crowdfunding service contracts."); Benjamin P. Siegel, *Title III of the Jobs Act: Using Unsophisticated Wealth To Crowdfund Small Business Capital or Fraudsters' Bank Accounts?*, 41 HOFSTRA L. REV. 777, 808 (2013) (suggesting that the SEC can prevent fraud "[b]y creating a 'Semi-Accredited' class of investors who must complete an intermediary's or government-offered investor education course").

125. James, *supra* note 966, at 1784-85 (2013) ("Although the required educational material will likely not make unsophisticated investors sophisticated, merely alerting potential investors that some risk exists is insufficient."); *see also* Bradford, *supra* note 844, at 139 (contemplating the method of educating crowdfunding investors through short instructional videos, but conceding the inability to confirm that investors actually watched the videos).

126. "People associated with a funding portal are not subject to the licensing and qualification requirements applicable to people associated with broker-dealers." Michael J. Burwick, *Top 10 Traps for the Unwary Crowdfunding Portal*, LAW360 (Jan. 21, 2014), http://www.law360.com/articles/501731/top-10-traps-for-the-unwary-crowdfunding-portal; *cf.* Henry Truc*, Interview: KoreConX's Oscar Jofre on Why Equity Crowdfunding Will Still be the Biggest Thing in the World*, EQUITIES (Mar. 2, 2015), http://www.equities.com/editors-desk/crowd-investing/crowdfunding/interview-koreconx-oscar-jofre-equity-crowdfunding-still-biggest-thing-world#s thash.A6hekRQz.dpuf ("Could you imagine millions of companies coming at these portals, emailing them all their information, and they have to decipher and do due diligence on them? Then you have millions of investors to work with.").

127. *See, e.g.*, FundAmerica, *Portals Ask: Do We Need To Be a Broker Dealer?* (Feb. 2, 2015), http://www.fundamerica.com/blog/portals-ask-need-broker-dealer/ (discussing the excess costs and problems associated with crowdfunding through broker-dealers as opposed to funding portals); NASAA, ARE YOU AN INFORMED INVESTOR? CROWDFUNDING, at 2, (2012), *available at* http://www.nasaa.org/wp-content/uploads/2012/05/NASAA_Advisory_Crowdfunding.pdf ("Issuers using funding portals to raise money may be inexperienced. Their track records may be unproven,

Thus, the SEC must itself endorse broker-dealer involvement to ensure regulatory compliance and encourage investor protection.

The SEC is in a strong position to articulate a framework that a polarized Congress can agree to. Congress failed to develop a meaningful balance between investor protection and capital formation. Implementation of both the uniform fiduciary standard and Title III Crowdfunding has effectively stalled. Accordingly, to ensure that Congress requires broker-dealer oversight of crowdfunding transactions, the SEC must condition its final implementation of Title III Crowdfunding with congressionally mandated broker-dealer involvement as an intermediary.

The framework could be implemented through the following illustrative steps. First, the SEC creates an explicit exemption from the uniform fiduciary standard for broker-dealers who "engage in crowdfunding transactions" but "do not provide personalized investment advice." Second, Congress amends Section 4(a)(6) of the Securities Act to require that intermediaries are either (1) registered as a broker, or (2) as a funding portal, partnered with a registered broker. Finally, the SEC implements both the uniform fiduciary standard and Title III Crowdfunding regulations, restoring the delicate balance between investor protection and capital formation needs.

CONCLUSION

Congress directed the SEC to implement two facially-divergent goals: (1) implementing a uniform fiduciary standard for broker-dealers and investment advisers through Dodd-Frank, and (2) increasing access to capital for small companies through the JOBS Act. Investors stand in the crossroads, but the SEC can strategically integrate the directives in a way that both protects investors and promotes capital formation. The delicate balance of protecting investors and promoting capital formation must never give way to the clamoring of the crowds.

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unsubstantiated or outright fraudulent. . . . The information about the investment is limited to what is provided through the funding portal. Investors may need to rely on their own research to determine the issuer's track record.").

The purpose of "Investors, Cornered" is to look at what investors are experiencing today and what the Claimants' bar will see in the future. This edition reverses the pattern, to look at a practice the Claimants' bar experiences today, and what future arbitration Claimants may expect.

INVESTORS, CORNERED

Michael S. Edmiston

Brokerage-firm defense 101 is to isolate and contain the dispute to just the Claimant. Discovery objections are the most effective and efficient manner for defense counsel to corner a Claimant and Claimant's counsel. By unilaterally limiting the scope of documents to be produced to only the Claimant and Claimant's account, the defense reduces the claims to the most narrow fact pattern, and forces the case to be viewed in a vacuum without any regard to what the salesman-broker was doing across his entire book of business.

The identical claim looks very different when defense counsel, having successfully limited discovery can argue that the Claimant received special, individualized treatment compared to where Claimant's counsel has the documents to show the broker was profiting handsomely from selling the same investment to all of his clients.

Often, there is one document which can help the Claimant escape the corner, the broker's trade blotter. This Investors, Cornered will look at trade blotters, and List 1, Item 20 of the FINRA Discovery Guide. The key to escaping the corner is to understand what a trade blotter is, the data it provides, how List 1, Item 20 makes the data presumptively discoverable, and how it may be used.

A. Trade Blotters

The Securities and Exchange Commission provides the basic definition:

> "Blotters (or other records of original entry) containing an itemized daily record of all purchases and sales of securities, all receipts and deliveries of securities (including certificate numbers), all receipts and disbursements of cash and all other debits and credits. Such records shall show the account for which each such transaction was effected, the name and amount

> of securities, the unit and aggregate purchase or sale price (if any), the trade date, and the name or other designation of the person from whom purchased or received or to whom sold or delivered."[1]

According to the Securities and Exchange Commission, brokerage firms are required to maintain blotters for a period of six years, with the first two of which the blotters must be held in an easily accessible location.[2]

A broker's entire trading blotter can be incredibly important to a case and may contain data regarding trading patterns, sales practices, product sales, and related commission data. For example, an entire blotter may reveal a broker's practice of recommending closed-end funds at their initial public offering, or a concerted effort to sell a specific penny stock indicative of a pump-and-dump scheme, or in more recent times, selling alternative investments such as non-traded real estate investment trusts.

Firms and their registered representatives are all too willing and agreeable to providing a broker's trade blotter limited to the Claimant. Generally, they will fight to the ends of the earth to avoid producing a broker's entire trade blotter. The objections typically hit on relevancy, privacy, and burden. Below is a major wirehouse's objection to a request to produce a broker's trade blotter:

> Respondents object to this request on the grounds that it is vague and ambiguous as to the phrase "trade blotters." Respondents further object to this request to the extent it seek s documents concerning other […] customers. […] is obligated to protect the privacy interests of its former and current customers. See Gramm-Leach Bliley Act, 15 U.S.C. § 6801 et seq. ("It is the policy of the Congress that each financial institution has an affirmative and continuing obligation to respond the privacy of its customers and to protect the security and confidentiality of those customers' nonpublic personal information.") Without waiving the foregoing objections and subject thereto, Respondents will produce copies of trade runs for Claimants' accounts. If there are additional documents which Claimants seek pursuant to this request, Respondents will meet and confer to discuss the potential production of such documents.

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1. SEC Rule 17a-3(a)(1). *See also*, Investopedia, *Blotter*, at http://www.investopedia.com/terms/b/blotter.asp. (last visited Jan. 10, 2016).

2. SEC Rule 17a-4(a).

The underlying reason for the objections is that the firm and its counsel do not want the broker's patterns and practices revealed. Once introduced, a blotter can shift the case from the narrow, cornered, customer-specific analysis to an inquiry focused on the basis of the broker's recommendation and pattern of recommendations. One client solicited to buy a closed-end fund at its IPO is anomalous and is easily explained away by a coached broker. 50 clients solicited to buy closed-end funds at the IPO changes the case. The case goes from a client-specific suitability review, to an inquiry of what motivated the broker to engage in such a broad customer-unfriendly practice. Further, it brings to light the quality and reasonableness of the firm's supervisory practices. The trade blotter is a gold mine barred by Cerberus. Getting around that snarling, barking, and objecting three-headed dog is never easy.

B. List 1, Item 20

Enter FINRA Discovery Guide List 1, Item 20. In its entirety, List 1, Item 20 reads that the following documents are presumptively discoverable:

> (a) For claims related to solicited trading activity, a record of all compensation, monetary and nonmonetary, including, but not limited to, monthly commission runs for the associated persons, listing the securities traded, dates traded, whether the trades were solicited or unsolicited, and the gross and net commission from each trade. The firm shall provide this information for a period of time beginning three months before and ending three months after the trades at issue in the customer parties' accounts.
>
> (b) The firm may redact names and other non-public personal information concerning customers who are not parties to the claim, but should provide sufficient information to identify: (1) the non-party customers' accounts, including the last four digits of the non-party customers' account numbers; (2) the associated persons' own and related accounts, including the last four digits of the associated persons' account numbers; and (3) the type of account (IRA, 401(k), etc.)

Just like the trade blotter, List 1, Item 20 gives:

- monthly commission runs for the associated persons;
- a list of the securities traded, dates traded, and whether the trades were solicited or unsolicited;
- the gross and net commission from each trade; and

- sufficient data to distinguish the various accounts managed by the brokers; and
- instructions to redact non-party information to maintain client confidentiality.

Of course, the objection to List 1, Item 20, is virtually identical to a discovery request seeking production of a trade blotter. From the same wirehouse in the same case, here was its objection to List 1, Item 20:

> (a) Respondents will produce... a consolidated commission report relating to Claimants' accounts for the relevant time period, if such a report exists or can be generated. To the extent this request seeks additional information, Respondents object on the ground it is unduly burdensome, not reasonably calculated to lead to the discovery of relevant information, vague, overbroad, and seeks documents that exceed the scope of the matter in controversy.
>
> (b) Respondents will produce… a consolidated commission report relating to Claimants' accounts for the relevant time period, if such a report exists or can be generated. To the extent this request seeks additional information, Respondents object on the ground it is unduly burdensome, not reasonably calculated to lead to the discovery of relevant information, vague, overbroad, and seeks documents that exceed the scope of the matter in controversy.

Cerberus is still barking. Attacking that three-headed dog requires at least three arguments: 1) the responsive documents are presumptively discoverable; 2) the responsive documents already exist in the form of trade blotters, 3) the documents provide a complete report of Respondents' monetary and non-monetary compensation for the time period of the dispute. Additional arguments delving into issues of privacy, definitions, and availability of the data are often necessary, too.

The outline of the basic three arguments are:

1. All of the List Items Responsive to the FINRA Discovery Guide, Including List 1, Item 20, Are Presumptively Discoverable

The data and information contained in Respondents' reports responsive List 1, Item 20 is *presumptively discoverable* and should be produced.[3] FINRA specifically addresses the matter of parties' objections to the

3. FINRA Discovery Guide, at 1 (Dec. 2, 2013) *available at* https://www.finra.org/sites/default/files/ArbMed/p394527.pdf (last visited Jan. 27, 2016).

Discovery Guide: "arbitrators should generally assume that a document on the relevant List should be exchanged unless the party in control of the document demonstrates a compelling reason not to produce it."[4]

2. The Information Contained in List 1, Item 20, is the Same Information as in a "Trade Blotter"

Respondent is required by FINRA and the SEC to create, maintain, and retain a trade blotter for six years.[5] Just like List 1, Item 20, the blotters contain the names of the securities, time and date of each trade, the amount traded, the dollar amounts involved, the commissions earned, and most importantly, whether the each transaction was made on a solicited or unsolicited basis.

Trade blotters answer the questions about the nature and extent the broker used the member firm to purchase securities for his clients, whether the trades were solicited or unsolicited and the commissions the broker earned trading Claimant's accounts and all of his clients' accounts. The blotters also put into context the volume of "products at issue" the broker was recommending to his client base against recommendations of other unrelated securities.

The complete trade blotter, listing all of the broker's solicited and unsolicited trades, allows inquiry into how the broker developed ideas to recommend clients buy, sell, and/or hold certain investments.

The trade blotter locks Respondents into acknowledging their degree of supervision[6] as well as providing a daily roadmap of what the broker was doing while his clients' accounts suffered losses.

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4. FINRA Dispute Resolution, Discovery, Abuses & Sanctions Training and Exam at 5 (May 2012)..

5. SEC Rule 17a-3(a)(1) and 17a-4(a).

6. FINRA Rule 3110. *See also*, See also, FINRA Sanctions LPL Financial LLC $11.7 Million for Widespread Supervisory Failures Related to Complex Products Sales, Trade Surveillance and Trade Confirmations Delivery, May 6, 2015, available at https://www.finra.org/newsroom/2015/finra-sanctions-lpl-117-million-widespread supervisory-failures (last visited Jan. 10, 2016).

3. The Information Contained in List 1, Item 20, is a Complete "Commission Run"

The purpose of requesting production of the compensation documents, particularly, the bonus programs and compensation schedules for production volume, goes to Respondent's motivation to ignore Claimant's needs and put the broker's interest first.

The gross compensation records put the case into context of the broker's overall activities in the relevant time frame and answer the question of where the broker's attention was since it certainly was not on Claimant's accounts.

C. Electronic Format

Requesting a trade blotter or the data contained in List 1, Item 20 is asking for a "data dump" of hundreds if not thousands of pages of spreadsheet data, usually a couple of hundred pages long, and three pages wide. Unless there is a papier-mâché project due, insist on production in a reasonably usable format, the spreadsheet file.

The spreadsheet format and usability means that the data can be easily sorted (and redacted to address that pesky privacy objection). Sorting the data by multiple levels, for example, by security name and then by date of transaction, can reveal when a broker grew hot or cold on a stock, as well as the commissions earned. A sort by net commissions can reveal higher paying products. A sort by product and then whether the trades were marked solicited or unsolicited often defuses the defense of "the client wanted it" when a broad section of the client base is "getting" the same product. A sort by product and commission often vitiates the "market-went-down" defense when the broker's commissions reveal the true basis for the recommendations.

D. Conclusion

Looking to the future and the inevitable wave of customer cases following any market crash, obtaining the broker's blotter will be paramount in addressing trading claims, product claims, alternative investment claims, and even the ordinary suitability claim. Trade Blotters and List 1, Item 20 are invaluable tools in helping a Claimant and counsel to not only escape the corner but also cornering the broker.

CASES & MATERIALS

Joseph Wojciechowski

People v. Mendenhall, Case No. 12CA1171 (Col. Ct. App. Aug. 13, 2015).

In this case, convicted fraudster Michael Lee Mendenhall appealed his conviction for securities fraud based on the premise that the promissory notes he used to steal from his investors were not securities and thus, he could not be convicted of securities fraud. The court examined the definition of "security" under the Colorado Securities Act, specifically related to jury instructions which stated that the Colorado Securities Act defined "any note" as a "security". Mendenhall argued that this instruction was incomplete because any "note" cannot be a security. The Appellate Court agreed and reversed and remanded his convictions based on securities fraud because of this erroneous jury instruction. The court relied on the US supreme court in *Reves v. Ernst & Young*, 494 U.S. 56, 62-63 (1990) which stated the phrase "any note" in the federal 1934 Act should not be interpreted to mean literally "any note" because not all notes are securities.

Hantz Financial Services v. National Union Fire Insurance Co., Case No. 13-cv-11197 2015 U.S. Dist. LEXIS 124127 (E.D.Mich. Sep. 17, 2015)

In an insurance coverage dispute, a financial services company, Hantz Financial, sought summary judgment on a declaratory action filed against its insurance carrier for $2.6 million in losses stemming from theft from firm clients by an employee of the firm. National Union Fire issued a Financial Institutions Bond to Hantz and American Specialty International issued an Errors and Omissions Policy to Hantz. The bond and the policy each had limits of $1 million dollars, which Hantz sought to apply to the more than $3 million in losses.

The underlying fraud involved an insurance agent for Hantz Financial who stole in excess of $2.6 million from firm clients. A FINRA arbitration was filed by two of the victims who received an award of $593,569. In all, there were 23 clients who ultimately settled with Hantz. Both coverage providers agreed to the settlements with a reservation of rights to resolve coverage issues. National Union denied coverage on the bond and American Specialty never informed Hantz one way or the other whether coverage existed for these claims, so Hantz had to file suit seeking to compel coverage.

All parties filed motions for summary judgment. The court ruled in favor of the coverage defendants. It held the Bond specifically covered only "loss resulting from dishonest or fraudulent acts committed by an employee with the manifest intent to cause the insured to sustain such loss." The position taken by the Bond issuer was that the employee stole from firm clients, not the firm.

Hantz sought coverage from the E&O carrier based on the premise that the losses derived from negligent supervision claims. This obviously contradicted its position that its liability stemmed from direct loss as a result of its employee's action, thus making it impossible for the court to hold both the E&O and the Bond covered the claims. Further, because the employee's wrongful acts were intentional, there was no coverage under the E&O policy. Although it was argued Hantz's liability stemmed from negligent supervision, the court held that this negligence arose out of the employee's intentional wrongful act of theft.

Goldman Sachs & Co. v. Athena Venture Partners, L.P., No. 13-3461, 2015 U.S. APP. LEXIS 17122 (3rd Cir. Sep. 29, 2015)

After losing a FINRA arbitration, Athena Venture Partners had a background check performed on one of the arbitrators and after discovering an undisclosed potential conflict, successfully moved to vacate the award in the Eastern District of Pennsylvania. *Goldman v. Athena Venture Partners, L.P.*, 2013 U.S. Dist. LEXIS 107966 (E.D. Pa. Aug. 1, 2013). The arbitrator at issue failed to disclose several complaints made against him by various state bars for unauthorized practice of law along with additional complaints for writing bad checks. The district court held these non-disclosures meant FINRA failed to provide the parties with three qualified arbitrators and that vacatur was proper under 9 U.S.C. §§ 10(a)(3) and 10(a)(4).

On appeal, Goldman Sachs argued that Athena waived its right to challenge the arbitrator's participation on the panel until after the award. In addressing this question of first impression in the Third Circuit, the court ruled in favor of Goldman Sachs, holding that the parties had constructive knowledge of the arbitrator's undisclosed legal issues because they could have discovered the information on their own. Although his disclosures were woefully inadequate, the arbitrator did disclose one complaint for unauthorized practice of law, which should have led to further inquiry by the parties. The Court referred to Athena as "the 'sore loser' so to speak, trying for a second bite at the apple."

Yenchi v. Ameriprise Financial Services, Inc., No. 753 WDA 2014, 2015 PA Super 195 (Pa. Sep. 15, 2015)

In a case originally filed in 2003, the Superior Court of Pennsylvania reversed in part, remanded for retrial in part, and affirmed in part the judgment of the lower court 1) granting a motion for summary judgment as to plaintiffs' breach of fiduciary duty claim, and 2) a jury verdict in favor of Ameriprise. The court addressed case law holding that the sale of insurance is an arm's length transaction and thus not implicating any fiduciary duty. The court ruled here that the fact the advisor was compensated to create a financial plan for the Plaintiffs, and sold them an annuity in addition to life insurance, created a confidential relationship sufficient to make the issue of fiduciary duty a triable issue of material fact. The Court determined that the mere fact that an insurance transaction was at issue did not preclude the recognition of a confidential fiduciary relationship, stating "we have stopped short of prohibiting such recognition in all cases."

Mann v. Morgan Stanley Smith Barney, LLC. No. 2:15-cv-00217-GMN-PAL, 2015 U.S. Dist. LEXIS 106975 (D. Nev. Aug. 10, 2015)

Morgan Stanley sued its former financial adviser in this promissory note case in FINRA Arbitration seeking the repayment of an amount allegedly owed under the note of more than $170,207. The Panel awarded Morgan Stanley its damages plus attorney's fees in the amount of $30,000 and costs in the amount of $5,000. During the arbitration proceedings, one of the arbitrators initiated a lawsuit against a real estate developer for breach of contract related to a lease purchase agreement. The arbitrator failed to disclose this to the parties. The financial adviser filed a petition to vacate the award under the evident partiality standard codified in 9 U.S.C. § 10(a)(2) for the arbitrator's failure to disclose the pending lawsuit. The adviser also sought vacatur under 9 U.S.C. § 10(a)(4) arguing that the arbitrators exceeded their powers in that the award exhibited a manifest disregard of the law for awarding Morgan Stanley precisely $30,000 in attorney's fees and $5,000 in costs. There was no evidence presented during the arbitration as to these amounts.

The court determined that the failure to disclose the lawsuit the arbitrator was involved in did not create a reasonable impression of partiality. The lawsuit had no similarity of facts or parties to the arbitration proceedings, other than the mere fact both suits involved money. Further, the Court ruled that the adviser failed to provide any evidence that the arbitrators were aware of the

law and intentionally disregarded it with respect to the award of attorney's fees and costs. The petition to vacate was therefore denied in its entirety.

Barr v. Bishop Rosen & Co., No. A-2502-14T2, 2015 N.J. Super LEXIS 180 (N.J. App. Oct. 26, 2015)

In this appeal of a trial court decision denying a motion to compel arbitration of a dispute between a broker-dealer and its employee, the court refused to force the parties to arbitrate where the agreement to arbitrate relied upon by the brokerage firm was merely two U-4 agreements which did not specifically inform the employee that he was surrendering the right to sue. The brokerage firm argued that a memorandum to the employee delivered some years after executing his first contract did specify the waiver of his right to sue and that this, along with the signed contracts, collectively created a valid and enforceable agreement to arbitrate.

The underlying dispute arose from a customer complaint levied against the firm and the adviser which was ultimately denied by a FINRA Panel. The adviser, however, paid the entire cost of the legal defense for both the firm and himself in the amount of $214,549 and the FINRA forum fees of $21,375. These amounts were paid both from the adviser's pocket and through salary and commission deductions. The adviser sued the company for repayment under multiple theories in New Jersey state court. The brokerage firm sought to compel arbitration.

The court denied the motion to compel arbitration because the U-4 contracts did not in any way inform the adviser that he was waiving his right to sue in a court of law. The court held that in order for the agreement to arbitrate to be enforceable, it must "at least in some general and sufficiently broad way convey the parties are giving up their right to bring their claims in a court or have a jury resolve their dispute." The court also held the memorandum provided to the adviser three years after he signed the first U-4 agreement which did disclose the waiver of the right to sue in a court of law and to a trial by jury, was not binding because it was not provided in connection with signing a new Form U-4 agreement.

Wells Fargo Advisors, LLC v. Quantum Financial Partners, No. 15-9145-JAR-JPO, 2015 U.S. Dist. LEXIS 113038 (D.. Kan. Aug. 25, 2015)

Wells Fargo filed multiple claims against Defendants, which included a former financial advisor. The court initially granted Wells Fargo's motion for preliminary injunction, enjoining Defendants from continued use of the Wells

Fargo "Process Wheel," which was alleged to be intellectual property of Wells Fargo. Defendants each filed a motion to compel arbitration. Wells Fargo argued the arbitration agreement between it and its former financial adviser did not contemplate intellectual property disputes like copyright infringement. The Court disagreed and granted the former financial adviser's motion but denied Defendant Quantum's motion. In arguing in support of its motion, Quantum depended on case law which relied on NASD Rule 13200, which contained the phrase "between or among members and/or associated persons, *and/or certain others*." (Emphasis in original). New FINRA Rule 13200 does not contain the "and/or certain others" language and therefore, non-members who are not in privity with a FINRA member cannot compel arbitration. The court called Quantum's argument in favor of judicial economy and fairness tempting, but there was no case law in support of compelling arbitration under FINRA Rule 13200 merely because claims overlap or contain common questions or law and fact.

National Football League Management Counsel v. National Football League Players Association, Nos. 15 Civ. 5916 (RMB)(JCF), 15 Civ. 5982 (RMB)(JCF), 2015 U.S. Dist. LEXIS 117662 (S.D.N.Y. Sep. 3, 2015)

The "deflate-gate" decision, notwithstanding popular culture's interpretation or national sports talk's opinions about it, was a legal decision about the power of an arbitrator and the rights owed to parties in any arbitration forum. After losing the arbitration before NFL Commissioner Roger Goodell appealing Tom Brady's four-game suspension for allegedly instructing Patriots staff to lower the air pressure in game balls, the National Football League Players Association ("NFLPA"), representing Tom Brady, sought to vacate the arbitration decision. At the same time, the NFL sought to confirm the award.

The NFLPA made two central complaints about the arbitration process. First, it argued that Brady had inadequate notice of the punishment for doctoring game balls. Secondly, it argued that Goodell wrongly denied the NFLPA access to key discovery into the investigative reports, the Wells Report, and denied them access to a key witness.

In ruling on the discovery issues, the Court held that Goodell violated 10 U.S.C. § 10(a)(3) by improperly denying Brady access to a key witness – Jeff Pash, who was the co-lead investigator of the Wells-Pash Investigation – because it created a fundamentally unfair proceeding. The court noted that arbitrators need not follow "all of the niceties observed in federal courts" when deciding what evidence to admit. Still, arbitrators "must give each party to the

dispute an adequate opportunity to present its evidence and argument." Here, a specific procedural rule also stated that "players must be afforded the opportunity to confront their investigators." Although Goodell had legitimate grounds to deny access to this witness because his testimony would be cumulative, it was the arbitrator's obligation to explain why it would be cumulative, not simply conclude that it was.

Brady also argued he was prejudiced by not having the same access to the investigative files as the NFL's attorneys, which also denied him the opportunity to effectively challenge the conclusions of the Wells Report. The court agreed ruling that Goodell improperly denied Brady equal access to investigative files in connection with the Wells Report. The court held that arbitrators have an "affirmative duty to insure that relevant documentary evidence in the hands of one party is fully and timely made available to the other party" and that "failing to discharge this simple duty would constitute a violation of FAA § 10(a)(3), where the party can show prejudice as a result."

The court also held that because there was no notice of a four-game suspension for the alleged misconduct at issue, "Commissioner Goodell may be said to have 'dispense[d] his own brand of industrial justice,'" which was a violation of the collective bargaining agreement. "When it is clear that the arbitrator 'must have based his award on some body of thought, or feeling, or policy, or law that is outside the contract and not incorporated in it by reference…the arbitrator failed to draw the award from the essence of the collective bargaining agreement."

Zarecor v. Morgan Keegan & Co., No. 13-3315, 2015 U.S. App. LEXIS 15555 (8th Cir. Sep. 1, 2015)

The procedural history of this case begins with a FINRA arbitration award in favor of investors in the RMK Funds being vacated on the ground that the investors were not "customers" of Morgan Keegan, and thus the dispute was not subject to arbitration under FINRA rules. *See Zarecor v. Morgan Keegan*, No. 4:10CV01643SWW, 2011 U.S. Dist. LEXIS 130633 (E.D. Ark. Nov. 10, 2011). Investors then sued Morgan Keegan in federal court in Arkansas one week later. The District court dismissed the case based on the expiration of various statutes of limitations under Federal, Arkansas, and New Jersey law. The investors appealed the order dismissing their case to the Eighth Circuit, arguing: 1) the filing of an arbitration claim tolled the statute of limitation under federal law and 2) *American Pipe* tolling applied. The court of appeals affirmed the dismissal in part and denied it in part, holding that the District court properly dismissed the

federal and Arkansas state claims but erred in dismissing the New Jersey state securities claim.

American Pipe tolling, as espoused by the U.S. Supreme Court in *American Pipe & Construction Co. v. Utah,* 414 U.S. 538 (1974), stands for the proposition that statutes of limitation are tolled for all class members asserting identical claims in a subsequent action, pending the certification of the class. Here, the Court of Appeals disagreed with the investors, stating that the federal claims filed in the class action were not identical to the claims filed by the Zarecor Plaintiffs and thus, *American Pipe* did not toll the applicable statutes of limitation. The court also stated that filing an arbitration action did not toll the statutes of limitation. The court differentiated between filing a claim in the wrong judicial forum, *i.e.*, state versus federal court and filing a case in arbitration. The court, citing to both Fifth and First Circuit precedent, stated that a plaintiff has the option of filing its case in court to preserve the statute of limitation issue and seek a stay to proceed in arbitration if applicable.

The Court reversed the dismissal based on New Jersey law, stating that New Jersey has a liberal, equitable tolling provision under its state securities act. The court affirmed the dismissal under the Arkansas Securities act, refusing to apply equitable tolling or the discovery rule.

National Credit Union Administration Board v. Wells Fargo Advisors, LLC, No. 3:10-cv-00143-WWE, 2015 U.S. Dist. LEXIS 133132 (D. Conn. Sep. 30, 2015)

The National Credit Union Administration Board, as liquidating agent, sued Wells Fargo Advisors, as successor to Wachovia, and as successor to A.G. Edwards, for losses to a credit union as a result of a fraud perpetrated by an A.G. Edwards representative. The Credit Union was shut down after being declared insolvent in July 2008 after it was discovered that the $11 million investment account allegedly held with then Wachovia Securities did not exist. The parties filed cross motions for summary judgment.

Wells Fargo first argued on summary judgement that it was not the successor in interest of Moseley Securities, the entity which the adviser began the fraud at issue. A.G. Edwards purchased six branch offices from Moseley, including the New London, Connecticut branch office at issue. Wells Fargo argued merely purchasing a handful of branch offices out of twenty-eight total, did not constitute a sufficient enough portion of Moseley's business to impose successor liability upon Wells Fargo. The court disagreed, holding under Connecticut law, that the purchase of a smaller unit of a larger business can be deemed sufficient to impose successor liability upon the purchaser, if there is continuity of the business. Here, all of the agents, customers, and personnel of the Moseley office became

affiliated with A.G. Edwards, constituting a continuing enterprise. Wells Fargo also sought summary judgment on the issue of damages, which the court also denied, stating the "money in/money out" argument was unlikely to succeed, and that the disagreement between the parties as to how damages should be calculated was an issue of material fact in dispute.

RECENT ARBITRATION AWARDS

Robert Van De Veire

To many securities arbitration practitioners these days, the "hottest" place in the country is not Miami or Southern California – it is San Juan, Puerto Rico. Whether personally or professionally connected to the island or not, it is difficult not to have at least heard about the flood of cases that have been filed there over the past couple of years in the wake of the implosion of the Puerto Rican bond market in general and, more specifically, UBS's proprietary funds built on Puerto Rican municipal bonds (UBS's "PR Funds").

While a review of the BrokerCheck Reports for many brokers associated or formerly associated with UBS's Puerto Rican arm indicates that a number of cases have been settled, over the past few months, a handful have gone the distance. So just how did these cases turn out? This article will review the results and answer that question.

Yolanda Bauza, Claimant v. UBS Financial Services, Inc., UBS Financial Services of Puerto Rico Inc., Respondents

FINRA Case No. 13-03048[1]

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1. Claimant asserted the following causes of action: violation of the Puerto Rico Uniform Securities Act; securities fraud; constructive fraud; breach of contract; negligence; negligent supervision; failure to supervise; breach of fiduciary duty; misrepresentation; omission of facts; manipulation; unsuitability; common law fraud; constructive fraud; and respondeat superior. The causes of action relate to Claimant's purchase of shares of Puerto Rico Fixed Income Funds I, II and III and Puerto Rico Investors Bond Fund. Unless specifically admitted in their Answer, Respondents denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

In the Statement of Claim, Claimant requested: rescission of the closed end funds sold to Claimant by Respondents and/or compensatory damages in the amount of approximately $357,000.00 to $625,000.00; interest; costs; attorneys' fees; punitive damages; and such other and further relief to which Claimant may be justly entitled as determined by the Panel.

In her pre-hearing brief, Claimant requested compensatory damages between $399,297.00 and $702,003.00.

Claimants' Counsel: W. Scott Greco, Representative, Greco & Greco, P.C.

Respondents' Counsel: A. Inge Selden, III, Esq., Andrea Morgan Green, Esq., and Kathryn Dietrich Perreault, Esq., Bressler, Amery & Ross, P.C.

Arbitrators: Douglas Earl McLaren, Public Chairperson; Janet Stern Solomon, Public Arbitrator; James R. Stirn, Public Arbitrator.

Award: After considering the pleadings, the testimony and evidence presented at the recorded in-person hearing, and the post-hearing submissions (if any), the Panel has decided in full and final resolution of the issues submitted for determination as follows:

1. Respondents are jointly and severally liable and shall pay to Claimant compensatory damages in the sum of $200,000.00.
2. Respondents' request for expungement of this action from the CRD records of non-parties David Lugo and Carlos Gonzalez is denied.
3. Any and all relief not specifically addressed herein, including Claimant's requests for punitive damages and attorneys' fees, is denied.

In what was the first case that went to award involving UBS's Puerto Rico bond funds, the claimant received a six figure award. One thing that distinguishes this award from those that follow is the venue; this case was heard in Washington, D.C., rather than on the island of Puerto Rico.

While this award is in the majority, in that it does not include the Panel's reasoning, the dollar figure itself set a positive tone for claimants moving forward. When multiple cases arise from the same series of transactions or have similar facts, you can expect that one or both of the parties will highlight those past awards (which FINRA tells us are non-precedential, but can nonetheless be persuasive). As this was the first case tried at to a Panel, this was and still is a significant award.

Juan Burgos Rosado, Claimants v. UBS Financial Services, Inc., UBS Financial Services Incorporated of Puerto, Rico, Doel Rafael Garcia, Carlos Ubinas, Sumaya De Los Angeles Musa, Respondents
FINRA Case No. 14-00170[2]

In their Statement of Answer, Respondents requested dismissal of all claims and expungement of this action from the Central Registration Depository ("CRD") records of non-parties David Lugo and Carlos Gonzalez.

2. Claimant asserted the following causes of action: (1) violations of Section 10(b) of the Securities Exchange Act, Rule 10b-5 of the Securities Exchange Commission, NYSE and FINRA rules, and the securities laws and other laws and regulations of

Claimant's Counsel: Harold D. Vicente-Gonzalez, Esq. and Harold D. Vicente-Colon, Esq., Vicente & Cuebas and Francisco Pujol, Esq., Francisco Pujol Law Office, PSC.

Respondent's Counsel: For Respondents Doel Rafael Garcia ("Garcia") and Carlos Ubinas ("Ubinas"): Salvador J. Antonetti-Stutts, Esq., O'Neill & Borges, LLC. For Respondents UBS Financial Services, Inc. ("UBS"), UBS Financial Services Incorporated of Puerto Rico ("UBSPR") and Sumaya De Los Angeles Musa ("Musa"): Roberto Quinones, Esq., McConnell Valdes LLC, and Brian F. Amery, Esq., Bradley B. Rounsaville, Esq. and Jaime H. Scivley, Esq., Bressler, Amery & Ross, P.C.

Arbitrators: Robert H. Putnam, Jr., Public Chairperson; Ron Pekoe, Public Arbitrator; Herbert Branitsky, Public Arbitrator.

Award: After considering the pleadings, the testimony and evidence presented at the recorded in-person hearing, the Panel has decided in full and final resolution of the issues submitted for determination as follows:

1. Claimant opened an account with Respondents in or about December 2011 at age 66. On recommendation of his UBS registered representative, Respondent Musa (the "Broker"), he purchased $325,000.00 of UBS Puerto

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Puerto Rico; (2) securities fraud; (3) violation of Article 1802 of the Civil Code of Puerto Rico 31 Laws of Puerto Rico Annotated [L.P.R.A.] Section 5141; (4) breach of contract; and (5) breach of policies, law(s), rules, regulations and norms for the financial protection of elderly or handicapped persons. The causes of action relate to, among other things, Claimant's investment in Puerto Rico closed-end mutual funds ("CEFs") concentrated in Puerto Rico bonds and the use of loan proceeds to purchase securities.

Unless specifically admitted in their Answer, Respondents UBSPR, UBS, Garcia, Ubinas, and Musa denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

In the Statement of Claim, Claimant requested: compensatory damages in the amount of $1,033,596.10, plus legal interest thereon from the date of filing of the Statement of Claim through the date of full payment; disgorgement of commissions, interest and/or service for loan fees; rescission; punitive damages of not less than $1,000,000.00; costs and expenses, including filing fees, consulting fees and arbitration fees; attorneys' fees; and any amounts needed to liquidate the debit or loan-payable balances in Claimant's accounts after reimbursement to Claimant of his net worth in the accounts as of July 31, 2013.

In their Statement of Answer, Respondents UBSPR, UBS, Garcia, Ubinas and Musa requested that the Statement of Claim be dismissed and requested expungement of this matter from the Central Registration Depository ("CRD") records of Respondents Ubinas, Musa and Garcia.

Rico CEFs. The CEFs were leveraged perpetual baskets largely of Puerto Rico agency bonds; had significant tax advantages and an interest rate averaging in excess of 6%; and were legally available only to residents of Puerto Rico. UBS documents state that these securities were suitable as one component of a well-balanced portfolio. Money for Claimant's purchase came almost entirely from a maturing Certificate of Deposit ("CD") at a credit union. Claimant was seeking a commitment for return of his capital after some 3-5 years and a better return than renewed CDs would pay. Some months later, Claimant purchased some $200,000.00 of additional CEFs largely with the proceeds from the sale of a house. Claimant's business activities consisted largely of purchasing, repairing and renting or re-selling distressed properties. He also owned some commercial rental property in the form of a building that he had built. These activities generated an annual income in excess of $100,000.00. In January 2013, Claimant purchased some $600,000.00 of additional CEFs with the proceeds of another maturing CD. Purchased CEFs are still in Claimant's account, and although the underlying bonds have not defaulted and continue to pay interest to Claimant, the CEFs have sharply declined in value, there is no market, and Claimant has suffered unrealized losses of some $737,000.00. In this arbitration, Claimant asks for those losses, interest, punitive damages, expenses, attorneys' fees and that forum fees be assessed against Respondents. Respondents ask that all claims be dismissed and fees be assessed against Claimant.

The record shows, and the Panel finds, that Claimant moved from Puerto Rico to a Hispanic area of the Bronx as a young man. Always having been handy, he labored repairing and fixing up properties in the area. Having a very frugal nature, he spent little and saved his money, purchased a run-down bodega, improved and operated it, and later purchased distressed cars, fixed them and had them imported into Puerto Rico for resale. After some 15 years in the Bronx, he returned to Puerto Rico with a sizeable savings nest-egg. Looking for business opportunities, he determined that with his handiness and hard labor he could repair and renovate real properties for rent or resale. Having once borrowed money, and realizing that his amortization payments were mostly interest, he determined to borrow no more and financed his business activities himself from savings, which he maintained in banks and credit unions. He continued to do so until, in the month before he opened the account in question, a dangerous fall from a tall ladder while cutting a broken tree limb at a property rendered him incapable of continuing.

Claimant's lifetime pattern has been one of frugality, saving and employment of resulting capital and his own labor in business opportunities that he understands can earn a good return. He was not a securities investor, and although he has some English, it is limited and does not include much

investment terminology. The evidence shows that he received a brochure concerning these CEFs, in English, and that his monthly statements were in English and could not be issued in Spanish as he requested.

We find that, at the time Claimant first invested, the market for these CEFs, being limited to residents of Puerto Rico, was necessarily thin; that it had been to a large extent saturated and liquidity was limited; that UBS, though not required to do so, had essentially made a market until it determined to reduce its inventory of CEFs. In the process of reducing its exposure in the CEFs by some 75%, UBS undertook an internal push for its brokers to sell its inventory to customers. Claimant, whom we find to be the quintessential conservative investor, if "investor" describes him at all, was solicited to buy these securities, which UBS stated to be suitable for a well-balanced portfolio, putting 100% of his available money into them. Evidence shows that some other brokers received internal "excessive concentration" memos when concentrations in these securities hit some 50% in their accounts; the Broker here testified she never received such a memo on this account. But a memo is not needed for us to determine, as we do, that this account was extremely over-concentrated and clearly unsuitable for Claimant.

Claimant normally receives his monthly statements around the middle of the following month. When he received a statement subsequent to his last $600,000.00 purchase, he noticed a drop in account value. He was greatly concerned and sought advice from others including a friend who was a former broker and who testified that Claimant could not understand that he had an investment that could decline in value and not something that would necessarily return his full principal at the end of a specified time. Claimant scheduled an appointment with his Broker, took the friend, and was told the same thing by the Broker. But she assured him that fluctuations in value were expected and normal and that the value would come back. She further said, upon being asked, that if she had a million dollars she would invest in the CEFs. Claimant was still uncomfortable but neither the friend nor the Broker, properly, would tell him what he should do. He was reassured, however, when he received his April statement in mid-May and there had been an increase in value. That value fluctuated over the following few months. Claimant had another meeting with his Broker and the friend in June and again received reassurances, with the upshot that he retained the account. In the last week of August 2013, a Barron's cover article about risks in the Puerto Rican economy appeared, and that with several other factors led to a precipitous drop in value of the portfolio of some $205,000.00 plus. Claimant met with his Broker and her branch office manager in early September, when the account balance was some $816,000.00, and among other things the manager explained that even a skinny cow could give milk. Claimant expressed concern that the cow would

die, but nevertheless held on and continues to do so, even after the account lost another $310,000.00 in September and any market for the CEFs, already minimal, effectively ceased.

Respondents argue that Claimant was on notice in April 2013 that the account was not what he thought and that he "ratified" it by not selling then and thereby assumed the risk and the subsequent losses, which were caused by market forces beyond their control. We find, however, that while Claimant knew then that he did not have what he had thought, he reasonably did not know or understand what he in fact had. Fluctuations in the account value were unnerving but Claimant was assured they were normal and that he should not worry. He did not know that UBS was disposing or had disposed of its own inventory; he did not know that brokers were under pressure to sell these CEFs and to encourage customers with them in their accounts to keep them, even to the extent of offering loans against them to customers who needed cash so the securities themselves would not go on the market. Claimant did not know that there was little functional market liquidity and that his portfolio could become locked in and that he might not have ready access to his money. So while we do generally ascribe to the concept of an investor assuming the risk of an account after sufficient notice of its risk, we do not think it applies to this Claimant in the circumstances of April 2013. Certainly in September 2013, however, he was on notice through newspapers and other widely available sources that the Puerto Rican economy was in some trouble and its bonds and these CEFs were under pressure. In fact, later that Fall, when Respondents instituted a buy-back program in the absence of a functioning market, Claimant testified he considered selling his portfolio, carried at the time on his statements as worth some $450,000.00. His Broker only offered some $90,000.00 for it and he declined to sell.

Having carefully weighed the evidence, which is considerable and only some of which is outlined above, we hold that this account was unsuitable for Claimant, at age 66 essentially a first-time senior investor with no experience; that a proper effort to know her customer would have revealed that to his Broker; that the account was grossly over-concentrated; that any proper UBS branch office or other review should have detected such obvious unsuitability; and that any proper and required supervision could have prevented Claimant's losses or at least limited them greatly. The record instead shows that UBS intentionally transferred some of its risk in its CEF inventory to its customers, one of whom was Claimant. We enter this Award accordingly.

Claimant's March 2015 statement shows the account as worth some $398,000.00 with unrealized losses of $737,000.00 at that time. It is uncontested that Claimant has received some $190,000.00 in dividend payments during the life of the account. We do not see that he can retain those

dividends, which are the fruit of an unsuitably risky and therefore more lucrative portfolio. Instead, we apply what we understand to be a rate of return more commensurate with an appropriate risk to the amount we find to have been lost due to Respondents' violations of applicable securities industry rules, and include that in our rounded award.

2. Upon Claimant's tender to transfer his entire portfolio to Respondents UBS and UBSPR, jointly and severally, within 30 days of receipt of this award, Respondents UBS and UBSPR, jointly and severally, shall pay to Claimant the sum of $1,000,000.00 in full and complete satisfaction of all of his claims, of which sum $602,000.00 is compensatory damages and interest and $398,000.00 is payment for his portfolio. Claimant's request for post-award interest is denied.

3. The parties shall bear their own attorneys' fees and costs.

4. If the Arbitrators have provided an explanation of their decision in this award, the explanation is for the information of the parties only and is not precedential in nature.

5. Respondents' request for expungement of the CRD records of Respondents Garcia, Ubinas and Musa were not reiterated by Respondents at the final hearing and subsequently deemed moot by the Panel.

6. Any and all claims for relief not specifically addressed herein, including Claimant's request for punitive damages, are denied.

As the second award to come down against UBS regarding the PR Funds, this award was significant already. Making it even more significant were the factual findings made and harsh tone taken toward UBS by this arbitration panel. Specifically, the Panel found that the Claimant

> did not know that UBS was disposing or had disposed of its own inventory; he did not know that brokers were under pressure to sell these CEFs and to encourage customers with them in their accounts to keep them, even to the extent of offering loans against them to customers who needed cash so the securities themselves would not go on the market. Claimant did not know that there was little functional market liquidity and that his portfolio could become locked in and that he might not have ready access to his money.

Being the only fully explained award to come down to date, this remains the one look that attorneys have to view the situation from the Panel's point of view – always invaluable.

Francisco Antonio Ramis Galdo, also known as Francisco Ramis and Ines Maria Rivero de Ramis, also known as Ines Maria Ramis, in their respective personal capacities and as Representatives of the Conjugal Partnership Constituted by Them, Claimants v. Jose Gabriel Ramirez, Jr., Carlos Freire-Borges, Doel Rafael Garcia-Romero, Carlos Verner Ubinas-Taylor, UBS Bank USA, UBS Financial Services Inc., UBS Financial Services of Puerto Rico Inc., Respondents
FINRA Case No. 13-03062[3]

3. Claimants asserted the following causes of action: (1) violations of Section 10(b) of the Securities Exchange Act, Rule 10b-5 of the Securities Exchange Commission, NYSE and FINRA rules, and the securities laws and other laws and regulations of Puerto Rico; (2) securities fraud; (3) violation of Article 1802 of the Civil Code of Puerto Rico 31 Laws of Puerto Rico Annotated [L.P.R.A.] § 5141; and (4) breach of contract. The causes of action relate to, among other things, Claimants' investments in Puerto Rico closed-end mutual funds concentrated in Puerto Rico bonds.

Unless specifically admitted in their Answer, as amended, Respondents UBS, UBSPR, Freire, Ubinas and Garcia denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

Unless specifically admitted in his Response to Statement of Claim, Respondent Ramirez denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

In the Statement of Claim, Claimants requested: losses in the amount of at least $2,123,160.01 plus pre-judgment legal interest from the date of filing of the Statement of Claim; attorneys' fees; filing and consultant's fees; arbitration costs and expenses; any amounts needed to liquidate the debit or loan payable balances after reimbursement to Claimants of their net worth in their accounts as of July 31, 2013; punitive or excess damages in the amount of $1,000,000.00; disgorgement of commissions, markups, markdowns and/or trading profits and/or interests and/or other fees; reimbursement of any and all proceeds resulting from the partial or total liquidation of shares of UBS funds in Claimants' accounts and credited to Claimants' alleged loan(s) originated by UBS Bank and transferred to UBSPR; reimbursement of any and all dividends earned by the shares of UBS funds in Claimants' account(s) and used to reduce the aforesaid loan balances; an order prohibiting Respondents from taking any further action to collect the aforesaid loans; an order from the Panel declaring null and void ab initio any and all loans made to Claimants by UBS Bank, transferred to UBSPR, and supposedly collateralized by the prohibited and illicit pledge and hypothecation of shares of UBS funds in favor of UBS bank; and urgent injunctive relief prohibiting Respondents from making collection efforts of alleged margin, debit or loan balances other than through these arbitration proceedings, and from destroying or disposing of any documents and/or evidence related to Claimants'

Claimant's Counsel: Frank A. Dalmau, Esq. and Jose Luis Gonzàlez Castañer, Esq., Jose Luis Gonzàlez Castañer, PSC.

Respondent's Counsel: For Respondent Jose Gabriel Ramirez, Jr.: Guillermo Ramos-Luina, Esq. For Respondent Carlos Freire-Borges ("Freire"): Heriberto Lopez, Esq., Melendez Torres Law, PSC. For Respondents Doel Rafael Garcia-Romero ("Garcia") and Carlos Verner Ubinas-Taylor ("Ubinas"): Mauricio O. Muñiz-Luciano, Esq. and Ana Margarita Rodríguez-Rivera, Esq., O'Neill & Borges LLC. Respondent UBS Bank USA ("UBS Bank") did not appear in this matter. For Respondents UBS Financial Services Inc. ("UBS") and UBS Financial Services of Puerto Rico Inc. ("UBSPR"): Peter G. Neiman, Esq. and Patrick Mair, Esq., WilmerHale LLP and Roberto C. Quinones-Rivera, Esq., McConnell Valdes LLC.

Arbitrators: Barth Satuloff, Public Arbitrator, Public Chairperson; Steven Gerard Goerke, Public Arbitrator; Howard B. Scherer, Non-Public Arbitrator.

Award: After considering the pleadings, the testimony and evidence presented at the hearing, and the post-hearing submissions (if any), the Panel has decided in full and final resolution of the issues submitted for determination as follows:

1. Respondents UBS and UBSPR are jointly and severally liable and shall pay to Claimants compensatory damages in the sum of $250,000.00.
2. Respondents UBS and UBSPR are jointly and severally liable and shall pay to Claimants the sum of $600.00 representing reimbursement of the non-refundable portion of the claim filing fee previously paid by Claimants to FINRA Dispute Resolution.

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accounts and the transactions described in the Statement of Claim, including but not limited to electronic and digital records.

At the close of the hearing, Claimants requested compensatory damages between $2,000,000.00 to $2,500,000.00 plus the costs of arbitration.

In their Statement of Answer, as amended, Respondents UBS, UBSPR, Freire, Ubinas and Garcia requested dismissal of the Statement of Claim with prejudice, that all FINRA fees and costs be assessed against Claimants, that the Panel make specific findings to allow the expungement of any record of this matter from the Central Registration Depository ("CRD") records of Respondents Freire, Ubinas and Garcia and such other and further relief as the Panel deemed just and equitable.

In his Response to Statement of Claim, Respondent Ramirez requested dismissal of the Statement of Claim.

3. Any and all relief not specifically addressed herein, including Claimants' requests for attorneys' fees and punitive damages, is denied.[4]

As a threshold matter, it is notable that the Panel in this case bifurcated the expungement requests of Respondents Freire, Ubinas and Garcia from the claimants case on liability and damages, though both were ultimately heard by the same arbitrators. Despite finding that UBS and UBS PR were liable and awarding damages to the claimants, the Panel found sufficient grounds to warrant expungement for Freire, Ubinas and Garcia. In Case No. 15-01971, the Panel made affirmative factual findings under Rule 2080 that the three were not responsible for what had happened to Claimants, which warranted expungement for those three respondents.

Orlando Rodriguez Gonzalez, Milagros Vila Maldonado, Claimants v. UBS Financial Services, Inc., UBS Financial Services Inc. of Puerto Rico, Respondents

FINRA Case No. 14-00304[5]

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4. The expungement requests of Respondents Freire, Ubinas and Garcia were severed and heard in Case No. 15-01971. Expungement was awarded to each of the three by the same panel that heard this case.

5. In the Statement of Claim, Claimants asserted the following causes of action: omission of facts; respondeat superior; unsuitability; breach of fiduciary duty; negligence; failure to supervise; fraud; breach of contract; and violation of the Puerto Rico Uniform Securities Act. The causes of action relate to, among other things, Claimants' investments in Puerto Rico closed-end mutual funds concentrated in Puerto Rico bonds. Unless specifically admitted in their Answer, Respondents denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

In the Statement of Claim, Claimants requested: compensatory damages in excess of $1,000,000.00; rescission; punitive damages; interest; costs; attorneys' fees; and such other and further relief this Panel deemed just and proper.

At the close of the hearing, Claimants requested compensatory damages in the range of $3,000,000.00 to $6,000,000.00.

In the Statement of Answer, Respondents requested: dismissal of Claimants' claims in their entirety, with prejudice; an assessment of FINRA fees and costs against Claimants; a recommendation of expungement of all references to this matter from the CRD records of any financial advisors or other UBS personnel identified in the Statement of Claim or otherwise affected by the Statement of Claim; and such other and further relief as the Panel deemed just and equitable.

Claimant's Counsel: Jeffrey Erez, Esq. and Jeffrey R. Sonn, Esq., Sonn & Erez, PLC and Eliezer A. Aldarondo-Lopez, Esq. and Eliezer Aldarondo-Ortiz, Esq., Aldarondo & Lopez-Bras.

Respondent's Counsel: Peter J. Macdonald, Esq., Wilmer Cutler Pickering Hale and Dorr, LLP and Roberto C. Quinones, Esq., McConnell Valdes LLC

Concurring Arbitrators: Kenneth R. Starr, Public Chairperson; Edward R. Niederriter, Public Arbitrator; David Walton Earle, Public Arbitrator.

Award: After considering the pleadings, the testimony and evidence presented at the hearing, the Panel has decided in full and final resolution of the issues submitted for determination as follows:

1. Respondents are jointly and severally liable and shall pay to Claimants compensatory damages in the amount of $2,545,000.00.

2. Claimants' request for pre-judgment interest is denied.

3. Respondents are liable and shall pay to Claimants post-award interest as of August 7, 2015, in accordance with the Code of Arbitration Procedure (the "Code").

4. Respondents are liable for and shall pay to Claimants $600.00 as reimbursement for the non-refundable portion of Claimants' initial claim filing fee previously paid to FINRA Dispute Resolution.

5. Any and all relief not specifically addressed herein, including Claimants' requests for punitive damages and attorneys' fees, is denied.

This award is significant in that it was the first seven-figure award handed down in a PR Funds case against UBS. As of the date of this writing, this award remains the largest award handed down by an arbitration panel against UBS in a PR Funds case.

Nelia B. Lopez Del Valle Andres Gomez Alayon Andre Raoul Gomez, on behalf of himself and as Trustee for ARG Investments Trust Andres Ricardo Gomez Wave Management LLC, as Trustee for AG Investment Trust Carmen Delia Rodriguez-Brunet Isabel Angelica Donis Figueroa Angel M. Gonzalez Munich Margarita Alayon-Figueroa Gisela Coll-Alayon Ana Teresa Lopez-Gonzalez, Claimants v. UBS Financial Services Incorporated of Puerto Rico UBS Financial Services Inc., Respondents
FINRA Case No. 13-03784[6]

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6. Claimants asserted the following causes of action: fraud; breach of fiduciary duty (including violation of Regulation 6078 issued under the Uniform Securities Act of Puerto Rico); negligence; breach of contract; negligent misrepresentation and omission; unsuitability; over concentration; control person liability; alter ego liability;

and failure to supervise under federal securities laws, the Uniform Securities Act of Puerto Rico, Puerto Rican law and FINRA rules. The causes of action relate to Claimants' investments in UBSPR proprietary closed-end funds and other Puerto Rican municipal bonds, and the use of these investments as collateral to borrow funds through lines of credit.

Unless specifically admitted in their Statement of Answer and Counterstatement of Claim, as amended, Respondents denied the allegations made in the Statement of Claim and asserted various affirmative defenses. Additionally, Respondent UBSPR asserted the following causes of action against Claimants Andre Raoul Gomez, on behalf of himself and as Trustee for ARG Investments Trust and Andres Ricardo Gomez: breach of contract; unjust enrichment; and account-stated monies owed. The causes of action relate to Claimants Andre Raoul Gomez, ARG Investments Trust and Andres Ricardo Gomez's failure to pay Respondents sums allegedly due pursuant to the terms of fully-executed Credit-Line Agreements.

Unless specifically admitted in their Answer to Amended Counterclaim, Claimants Andre Raoul Gomez, ARG Investments Trust and Andres Ricardo Gomez denied the allegations made in the Amended Statement of Answer and Counterstatement of Claim and asserted various affirmative defenses.

In the Statement of Claim, Claimants requested: compensatory damages of approximately $10,000,000.00 and/or rescission or other appropriate equitable relief; cancellation of any and all outstanding loan balances; well-managed account damages; disgorgement of all fees and commissions earned by Respondents; recovery of pre and post-award interest, costs, expenses, attorneys' fees, expert fees and forum fees in this arbitration; and punitive damages in an amount deemed appropriate by the Panel.

In the Statement of Answer and Counterstatement of Claim, Respondents requested: that Claimants take nothing by their claims and that their claims be dismissed in their entirety, with prejudice; an award of compensatory damages in excess of $1,200,000.00 on Respondent UBSPR's Counterclaim against Claimants Andre Raoul Gomez, ARG Investments Trust and Andres Ricardo Gomez; assessment of all fees and costs against Claimants; and expungement of all references to this arbitration from the Central Registration Depository ("CRD") records of any financial advisors or other UBS personnel identified in the Statement of Claim or otherwise affected by the Statement of Claim; and such other and further relief as deemed just and equitable by the Panel.

In their Answer to Counterclaim, Claimants Andre Raoul Gomez, ARG Investments Trust and Andres Ricardo Gomez requested that the Counterclaim be dismissed in its entirety.

In the Amended Statement of Answer and Counterstatement of Claim, Respondents requested: that Claimants take nothing by their claims and that their claims be dismissed in their entirety, with prejudice; an award of compensatory damages in excess of $500,000.00 on Respondent UBSPR's Counterclaim against Andre Raoul

Claimants' Counsel: Jacob H. Zamansky, Esq. and Edward H. Glenn, Jr., Esq., Zamansky LLC.

Respondents' Counsel: Sanket Bulsara, Esq., Peter Neiman, Esq. and Jeremy Winer, Esq., Wilmer Cutler Pickering Hale & Dorr LLP and Roberto C. Quinones, Esq., McConnell Valdes LLC.

Arbitrators: Frances Johnson-Wright, Public Chairperson; Joseph John Mantione, Public Arbitrator; Stuart K. Furman, Public Arbitrator.

Award: After considering the pleadings, the testimony and evidence presented at the recorded in-person hearing, and the post-hearing submissions (if any), the Panel has decided in full and final resolution of the issues submitted for determination as follows:

1. Respondents are jointly and severally liable and shall pay to Claimant compensatory damages in the sum of $200,000.00.
2. Respondents' request for expungement of this action from the CRD records of non-parties David Lugo and Carlos Gonzalez is denied.
3. Any and all relief not specifically addressed herein, including Claimant's requests for punitive damages and attorneys' fees, is denied.

This award is noteworthy in that it continues the trend of awards in favor of claimants. It is also significant in that UBS made a substantial counterclaim against specific claimants in this action for seven-figures, ultimately amended down to a six-figure claim. Whether or not the arbitrators considered the counterclaims in an offset is not set out in the unreasoned award, but their existence alone makes this award unique.

Gomez, ARG Investments Trust and Andres Ricardo Gomez; assessment of all fees and costs against Claimants; and expungement of all references to this arbitration from the Central Registration Depository ("CRD") records of any financial advisors or other UBS personnel identified in the Statement of Claim or otherwise affected by the Statement of Claim; and such other and further relief as deemed just and equitable by the Panel.

In their Answer to Amended Counterclaim, Claimants Andre Raoul Gomez, ARG Investments Trust and Andres Ricardo Gomez requested that the Counterclaim be dismissed in its entirety.

Berta Ganapolsky and Tamara Corporation, Claimants v. UBS Financial Services, Inc., UBS Financial Services Inc., of Puerto Rico, UBS Trust Company of Puerto Rico, UBS Asset Managers of Puerto Rico, Puerto Rico Short Term Investment Fund, Inc., Puerto Rico Tax Free Target Maturity Fund, Inc., First Puerto Rico Tax Advantage Target Maturity Fund I, Tax Free Puerto Rico Fund, Inc., Puerto Rico Fixed Income Fund IV, Inc., Puerto Rico AAA Portfolio Bond Fund, Inc., Tax Free Puerto Rico Fund II, Inc., Puerto Rico GNMA & U.S. Government Target Maturity Fund, Inc., Puerto Rico AAA Portfolio Target Maturity Fund, Inc., David Jose Lugo, Respondents
FINRA Case No. 14-01784[7]

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7. Claimants asserted the following causes of action: fraudulent inducement; fraudulent misrepresentation; negligent misrepresentation; violations of Section 10(b) of the Securities Exchange Act and Rule 10b-5; violations of the Puerto Rico Securities Act (10 L.P.R.A. Sections 851, 852, 853, and 890); breach of implied duty of good faith and fair dealing; conspiracy to commit fraudulent misrepresentation/concealment; violation of the Investment Advisors Act of 1940; and aiding and abetting securities fraud. The causes of action relate to, among other things, Claimants' investments in Puerto Rico closed-end mutual funds concentrated in Puerto Rico bonds.

Unless specifically admitted in their Answer, Respondents UBS Financial Services, Inc., UBS Financial Services Inc., of Puerto Rico, UBS Trust Company of Puerto Rico, UBS Asset Managers of Puerto Rico and David Jose Lugo denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

In the Statement of Claim, Claimants requested: compensatory damages of not less than $3,150,000.00; rescission; punitive damages of not less than $1,500,000.00; costs; attorneys' fees; and pre and post-award interest.

At the close of the hearing, Claimant Berta Ganapolsky requested: $154,828.00 in well-managed account damages; $178,228.00 in a stipulated repurchase; AAA Bond "Buy Back" in the amount of $1,781,573.00 @ 9.049; AAA II Bond "Buy Back" in the amount of $30,002.00 @ 9.791; emotional distress damages in the amount of $1,000,000.00; punitive damages in the amount of $6,000,000.00; attorneys' fees; forum fees; and expenses.

In their Statement of Answer, Respondents UBS Financial Services, Inc., UBS Financial Services Inc., of Puerto Rico, UBS Trust Company of Puerto Rico, UBS Asset Managers of Puerto Rico and David Jose Lugo requested: dismissal of all claims and expungement of this matter from the Central Registration Depository ("CRD") records of any financial advisors or other UBS personnel identified in the Statement of Claim or otherwise affected by the Statement of Claim.

Claimant's Counsel: Jonathan F. Claussen, Esq. and Charles Lichtman, Esq., Berger Singerman LLP.

Respondent's Counsel:[8] For Respondents UBS Financial Services, Inc., UBS Financial Services Inc., of Puerto Rico, UBS Asset Managers of Puerto Rico and UBS Trust Company of Puerto Rico: Gregg M. McCormick, Esq. and Bradley B. Rounsaville, Esq., Bressler, Amery & Ross, P.C. and Roberto C. Quinones, Esq., McConnell Valdes LLC.

For Respondent David Jose Lugo: Seth E. Lipner, Esq., Deutsch & Lipner.

Arbitrators: Brian P. Jakes, Sr., Public Chairperson; Monroe Mitchel, Public Arbitrator; Richard Merritt Langway, Public Arbitrator.

Award: On or about July 21, 2015, in their Pre-Hearing Brief, Respondents UBS Financial Services, Inc., UBS Financial Services Inc., of Puerto Rico, UBS Asset Managers of Puerto Rico and UBS Trust Company of Puerto Rico requested, among other things, expungement of this matter from the CRD records of Respondent David Jose Lugo. Claimants did not object to the expungement request.

On or about July 23, 2015, Claimant Tamara Corporation filed a notice of dismissal with prejudice of all of its claims against Respondents UBS Financial Services, Inc., UBS Financial Services Inc., of Puerto Rico, UBS Trust Company of Puerto Rico, UBS Asset Managers of Puerto Rico and

8. For Respondent First Puerto Rico Tax Advantage Target Maturity Fund I: Jorge I. Peirats, Esq., Pietrantoni Mendez & Alvarez LLC, for the limited purpose of declining to submit to arbitration. Respondent Puerto Rico Short Term Investment Fund, Inc. did not enter an appearance in this matter. Respondent Puerto Rico Tax Free Target Maturity Fund, Inc. did not enter an appearance in this matter. Respondent Tax Free Puerto Rico Fund, Inc. did not enter an appearance in this matter. Respondent Puerto Rico Fixed Income Fund IV, Inc. did not enter an appearance in this matter. Respondent Puerto Rico AAA Portfolio Bond Fund, Inc. did not enter an appearance in this matter. Respondent Tax Free Puerto Rico Fund II, Inc. did not enter an appearance in this matter. Respondent Puerto Rico GNMA & U.S. Government Target Maturity Fund, Inc. did not enter an appearance in this matter. Respondent Puerto Rico AAA Portfolio Target Maturity Fund, Inc. did not enter an appearance in this matter.

Respondents Puerto Rico Short Term Investment Fund, Inc., Puerto Rico Tax Free Target Maturity Fund, Inc., First Puerto Rico Tax Advantage Target Maturity Fund I, Tax Free Puerto Rico Fund, Inc., Puerto Rico Fixed Income Fund IV, Inc., Puerto Rico AAA Portfolio Bond Fund, Inc., Tax Free Puerto Rico Fund II, Inc., Puerto Rico GNMA & U.S. Government Target Maturity Fund, Inc., and Puerto Rico AAA Portfolio Target Maturity Fund, Inc. are not members or associated persons of FINRA and did not voluntarily submit to arbitration. Therefore, the Panel made no determination with respect to Claimants' claims against these Respondents.

David Jose Lugo. Therefore, the Panel made no determinations with respect to any of Claimant Tamara Corporation's claims against these Respondents.

On or about August 4, 2015, Claimant Berta Ganapolsky filed a notice of dismissal with prejudice of all of her claims against Respondent David Jose Lugo. Therefore, the Panel made no determinations with respect to any of Claimant Berta Ganapolsky's claims against Respondent David Jose Lugo.

After considering the pleadings, the testimony and evidence presented at the recorded in-person hearing, and the post-hearing submissions (if any), the Panel has decided in full and final resolution of the issues submitted for determination as follows:

1. Claimant Berta Ganapolsky's claims are denied in their entirety.

2. The Panel recommends the expungement of all references to the above-captioned arbitration from Respondent David Jose Lugo's (CRD # 3109426) registration records maintained by the CRD, with the understanding that pursuant to Notice to Members 04-16, Respondent David Jose Lugo must obtain confirmation from a court of competent jurisdiction before the CRD will execute the expungement directive.

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

Pursuant to Rule 12805 of the Code of Arbitration Procedure (the "Code"), the Panel has made the following Rule 2080 affirmative findings of fact:

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

The claim, allegation, or information is false.

The Panel has made the above Rule 2080 findings based on the following reasons:

In making the above findings, the Panel considered the lengthy testimony and credibility of Respondent David Jose Lugo, reviewed all evidence and testimony, including cross and redirect examinations, of witnesses, expert witnesses and the parties and reviewed Respondent David Jose Lugo's BrokerCheck report. The Panel found that David Jose Lugo did not engage in any fraudulent course or conduct, was not involved in a scheme and did not mislead or breach any fiduciary duty to Claimant Berta Ganapolsky. It was Claimant Berta Ganapolsky who chose and took charge of Claimants' investments and had outside counsel from her family and her Certified Public Accountant in this regard. Respondent David Jose Lugo followed all of Claimant Berta Ganapolsky's instructions and kept her in the AAA bond funds she requested.

3. Any and all claims for relief not specifically addressed herein, including Claimant Berta Ganapolsky's requests for attorneys' fees and punitive damages, are denied.

This case is significant in that it remains, to date, the only arbitration award that bucks the trend of monetary damages awarded to Claimants. The Panel's finding that the Claimant in this case "took charge" of the investments at issue is telling and differentiates this case from its predecessors. This award illustrates the point that any case can live or die on its own unique facts.

As any seasoned practitioner in the securities arbitration field will readily admit even more generally, there is no such thing as a "sure thing" in a FINRA arbitration.

Said Mudafort Fara, Claimant v. UBS Financial Services Incorporated of Puerto Rico, Respondent
FINRA Case No. 14-00657[9]

Claimant's Counsel: Robert Wayne Pearce, Esq., Law Offices of Robert Wayne Pearce and Julio C. Cayere-Quidgley, Esq., Cayere-Quidgley Legal Services, P.S.C.

Respondent's Counsel: Matt Wolper, Esq., Wes Holston, Esq. and Richard Szuch, Esq., Bressler, Amery & Ross, P.C.

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9. In the Statement of Claim, Claimant asserted the following causes of action: misrepresentations; unsuitable recommendations; overconcentration; violation of FINRA's Code of Conduct and Puerto Rico securities laws; fraud; breach of fiduciary duty; negligence; and failure to supervise. The causes of action relate to, among other things. Claimant's investments in Puerto Rico closed-end mutual funds concentrated in Puerto Rico bonds.

Unless specifically admitted in its Answer, Respondent denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

In the Statement of Claim, Claimant requested: rescission or, alternatively, an unspecified amount of compensatory damages; lost opportunity damages; interest; punitive damages; costs; and attorneys' fees.

In the Statement of Answer, Respondent requested: denial of the Statement of Claim in its entirety, with prejudice; costs; expungement of all references to this matter from nonparty Ramon Manuel Almonte's Central Registration Depository ("CRD") record; and for such other and further relief as the Panel deemed just and equitable.

Concurring Arbitrators: John D. Mattingly, Public Arbitrator; James W. Geiger, Public Chairperson.

Award: After considering the pleadings, the testimony and evidence presented at the in-person recorded hearing, the Panel has decided in full and final resolution of the issues submitted for determination as follows:

1. Respondent UBSPR is liable for and shall pay to Claimant compensatory damages in the amount of $600,000.00.
2. Respondent UBSPR is liable for and shall pay to Claimant interest at the rate of 4% per annum from March 12, 2013, until paid.
3. Respondent is liable for and shall pay to Claimant $250.00 as reimbursement for the non-refundable portion of Claimant's initial claim filing fee previously paid to FINRA Dispute Resolution.
4. Claimant's request for costs is denied.
5. Respondent's request for costs is denied.
6. Any and all relief not specifically addressed herein, including Claimant's requests for attorneys' fees and punitive damages, is denied.

The break from the trend of claimants' victories against UBS was a short-lived one. This award came down only one day after the *Ganapolsky* award. Interestingly, this Panel awarded the claimant interest and a reimbursement of the non-refundable portion of the filing fee, yet specifically chose not to acquiesce to the claimant's request for costs.

Pedro Gomez and Fe Josefina Morales, in their respective personal capacities and as representatives of the Conjugal Partnership Constituted by and between them Emma Gomez De Perez, Claimants v. Ramiro Luis Colon, III, Carlos Freire-Borges, Doel Rafael Garcia-Romero, Carlos Verner Ubinas-Taylor, Jose Gabriel Ramirez, Jr., UBS Bank USA, UBS Financial Services Inc., UBS Financial Services of Puerto Rico., Respondent

FINRA Case No. 13-03403[10]

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10. Claimants asserted the following causes of action: (1) violations of Section 10(b) of the Securities Exchange Act, Rule 10b-5 of the Securities Exchange Commission, NYSE and FINRA rules, and the securities laws and other laws and regulations of Puerto Rico; (2) securities fraud; (3) violation of Article 1802 of the Civil Code of Puerto Rico 31 Laws of Puerto Rico Annotated [L.P.R.A.] §5141; (4) breach of contract; and (5) breach of the policies, laws, rules and regulations and norms for the financial protection of the elderly. The causes of action relate to, among other things,

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Claimants' investments in Puerto Rico closed-end mutual funds concentrated in Puerto Rico bonds.

Unless specifically admitted in their Answer, as amended, Respondents UBS, UBSPR, Freire, Garcia, Ubinas and Colon denied the allegations made in the Statement of Claim, as amended, and asserted various affirmative defenses. Unless specifically admitted in his Response to Statement of Claim, Respondent Ramirez denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

In its Counterstatement of Claim, as amended, Respondent UBSPR asserted the following causes of action: breach of contract; unjust enrichment; and account stated. The causes of action relate to Claimants' alleged failure to repay sums due Respondent UBSPR pursuant to fully-executed loans and credit line agreements.

Unless specifically admitted in its Answer to Counterclaim, Claimants denied the allegations made in the Counterstatement of Claim, as amended, and asserted various affirmative defenses.

In the Statement of Claim, as amended, Claimants requested: losses in the amount of at least $1,654,080.20 for the Morales Claimants, losses in the amount of at least $627,495.19 for Claimant Perez, and pre-judgment legal interest from the date of filing of the Statement of Claim on these amounts; attorneys' fees; filing and consultant's fees; arbitration costs and expenses; any amounts needed to liquidate the debit or loan payable balances after reimbursement to Claimants of their net worth in their accounts as of July 31, 2013; punitive or excess damages in the amount of $1,000,000.00 for the Morales Claimants; punitive or excess damages in the amount of $500,000.00 for Claimant Perez; disgorgement of commissions, markups, markdowns and/or trading profits and/or interests and/or other fees; reimbursement of all losses or, in the alternative, rescission of all unauthorized transactions and other proper remedies, including, without limitation, a reasonable return on all assets deposited by Claimants; reimbursement of any costs incurred by Claimants as a result of efforts by Respondent UBS Bank to collect the illicit loans; reimbursement of any and all proceeds resulting from the partial or total liquidation of shares of UBS funds in Claimants' accounts and credited to Claimants' alleged loan(s) originated by Respondent UBS Bank and transferred to Respondent UBSPR; reimbursement of any and all dividends earned by the shares of UBS funds in Claimants' account(s) and used to reduce the aforesaid loan balances; an order prohibiting Respondents from taking any further action to collect the aforesaid loans; an order from the Panel declaring null and void ab initio any and all loans made to Claimants by Respondent UBS Bank, transferred to Respondent UBSPR, and supposedly collateralized by the prohibited and illicit pledge and hypothecation of shares of UBS funds in favor of Respondent UBS bank; and urgent injunctive relief prohibiting Respondents from making collection efforts of alleged margin, debit or loan balances other than through these arbitration proceedings, and from destroying or disposing of any documents and/or evidence related to Claimants'

Claimant's Counsel: Harold D. Vicente Gonzalez, Esq. and Harold D. Vicente Colon, Esq., Vicente & Cuebas and Francisco Pujol, Esq., Francisco Pujol Law Office PSC.

Respondent's Counsel: For Respondent Carlos Freire-Borges ("Freire"): Heriberto Lopez, Esq., Melendez Torres Law, PSC. For Respondents Doel Rafael Garcia-Romero ("Garcia") and Carlos Verner Ubinas Taylor ("Ubinas"): Mauricio O. Muniz-Luciano, Esq. and Ana Margarita Rodriguez Rivera, Esq., O'Neill & Borges LLC. For Respondent Ramiro Luis Colon, III ("Colon"): Jaime E. Toro, Esq., Toro, Colon, Mullet, Rivera & Sifre PSC. For Respondent Jose Gabriel Ramirez, Jr. ("Ramirez"): Guillermo Ramos-Luina, Esq. Respondent UBS Bank USA ("UBS Bank") did not appear in this matter. For Respondents UBS Financial Services Inc. ("UBS") and UBS Financial Services of Puerto Rico ("UBSPR"): Peter J. Macdonald, Esq. and Brad Konstandt, Esq., Wilmer Cutler Pickering Hale and Dorr LLP and Roberto C. Quinones-Rivera, Esq., McConnell Valdes LLC.

Arbitrators: Allan R. Lazor, Public Chairperson; Edward J. Costello, Jr., Public Arbitrator; and Scott A. Eichhorn, Non-Public Arbitrator.

Award: After considering the pleadings, the testimony and evidence presented at the hearing, and the post-hearing submissions (if any), the Panel has decided in full and final resolution of the issues submitted for determination as follows:

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accounts and the transactions described in the Statement of Claim, including but not limited to electronic and digital records.

At the close of the hearing, Claimants requested actual damages for the Morales Claimants of $1,395,000.00, actual damages for Claimant Perez of $618,000.00, punitive damages, attorneys' fees and costs.

In the Statement of Answer and Counterclaim, as amended, Respondents UBS, UBSPR, Freire, Garcia, Ubinas and Colon requested: dismissal of the Statement of Claim, as amended, with prejudice; that the Panel award Respondent UBSPR damages in excess of $200,000.00 on its Counterclaim; that all FINRA fees and costs be assessed against Claimants; that the Panel make specific findings to allow the expungement of any record of this matter from the Central Registration Depository ("CRD") records of the affected individual Respondents and such other and further relief as the Panel deemed just and equitable. In their Answer to Counterclaim, Claimants requested dismissal, denial and/or rejection of the Counterclaim.

In his Response to Statement of Claim, Respondent Ramirez requested dismissal of the Statement of Claim.

1. Respondents UBS and UBSPR are liable and shall pay compensatory damages in the sum of $64,219.49 to the Morales Claimants and $21,406.49 to Claimant Perez.
2. Claimants' request for pre-judgment interest is denied.
3. Respondent UBSPR's Counterstatement of Claim, as amended, is denied in its entirety.
4. Respondents Freire, Ubinas, Garcia and Colon's requests for expungement are denied.
5. Any and all relief not specifically addressed herein, including Claimants' requests for punitive damages and attorneys' fees, is denied.

In yet another case, the Claimants do not leave empty handed. Though important, the award handed down by the arbitrators itself is not the most significant aspect of this case. What is significant is the following sentence from the text of the award, "Respondent Ramirez asserted[] that he has invoked his Fifth Amendment right against self-incrimination."

Prior to the date of the award but after the final hearing session had been held, the SEC announced that it had fined UBSPR for "fail[ing to] reasonably to supervise Jose G. Ramirez Jr. with a view to preventing and detecting his violations of the federal securities laws from at least 2011 through 2013." The SEC alleged that "Ramirez, a UBSPR registered representative, made material misrepresentations and engaged in a fraudulent scheme involving the use of proceeds of non-purpose lines of credit ("LOC") to purchase securities."

Mr. Ramirez, also known as "Whopper" is reported to be under investigation by the United States Department of Justice ("DOJ").[11] It is reported that the DOJ's investigation is also centered around Mr. Ramirez's alleged improper recommendation that clients use non-purpose credit lines to increase their holdings in the PR Funds.

The potential criminality of the conduct that was alleged to have occurred within the Puerto Rican arm of UBS and the amount of money lost and seeking to be recovered by customers makes Puerto Rico the "hottest" place in the securities arbitration world right now. Given the reported number of cases filed, this shows no signs of slowing down any time soon and bears continued attention.

11. U.S. Investigates Ex-UBS Puerto Rico Adviser Over Loans for Debt Funds, Wall Street Journal Online, http://www.wsj.com/articles/u-s-investigates-ex-ubs-puerto-rico-adviser-over-loans-for-debt-funds-1438190235 (July 29, 2015).

Notes & Observations

WHERE WE STAND

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

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

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

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

1. To review all PIABA Comment letters, visit www.PIABA.org. For more information, contact Joseph Peiffer at jpeiffer@praclawfirm.com, Hugh Berkson at hberkson@hcsattys.com or Robin S. Ringo at rsringo@piaba.org for assistance.

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The following PIABA Comment Letter regarding the *FINRA Regulatory Notice 15-36 and MSRB Regulatory Notice 2015-16* was submitted to the Financial Industry Regulatory Authority and Municipal Securities Rulemaking Board by Hugh D. Berkson on December 8, 2015 (prepared with the assistance of Christine Lazaro and Robert Van De Veire).

Submitted via email to pubcom@finra.org
Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Submitted electronically
Ronald W. Smith
Corporate Secretary
Municipal Securities Rulemaking Board
1900 Duke Street, Suite 600
Alexandria, VA 22314

Re: FINRA Regulatory Notice 15-36: Request for Comment on Pricing Disclosure in the Fixed Income Markets MSRB Regulatory Notice 2015-16: Request for Comment on Draft Rule Amendments to Require Confirmation Disclosure of Mark-ups for Specified Principal Transactions with Retail Customers

Dear Ms. Asquith & Mr. Smith:

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

FINRA has reissued its request for comment on a proposed FINRA rule that would require firms to disclose additional information on customer

confirmations for transactions in fixed income securities. Specifically, for corporate and agency debt securities, FINRA is proposing that firms disclose the price to the customer, the member's reference price, and the differential between those two prices, along with a reference and hyperlink, if available, to the TRACE publicly available trading data. However, this information must be disclosed only if certain conditions are met. The MSRB has also requested comment on a similar proposal to require confirmation disclosure of mark-ups for specified principal transactions in municipal debt securities.

PIABA generally applauds any effort to provide more transparency in the securities trading arena, and specifically with respect to debt securities. FINRA has restructured the proposed rule to eliminate the "qualifying size" aspect of the previous proposal, replacing it with a "retail customer" standard. PIABA supports this change and agrees that the rule should apply to all retail customer account regardless of the size of the transaction.

The proposed rule limits disclosure of this information to only those transactions where the firm has executed a transaction as a principal in the same security within the same day that equals or exceeds the size of the customer transaction. PIABA believes that this is too limited. PIABA would like to see fixed income trade confirmations disclose the actual markups/markdowns, not only for riskless transactions, but for all fixed income retail transactions.

As the rule stands now, the markup/markdown disclosure would be required only if there are corresponding firm trades on the same day. Regulatory Notice 14-52 provided several examples of possible scenarios which set forth when disclosure would and would not have to be made. For example, in RN 14-52 example 13, disclosure would not be required where Firm A sold 100 XYZ bonds to its customer on Day 2, if 50 of the bonds having been sourced at 15:30:00 PM on Day 1 and 50 of them having been sourced at 10:00:00 AM on Day 2. PIABA would prefer that all of the pricing information be disclosed, regardless of whether the bonds sold to the customer were sourced on Day 1 or Day 2. At a bare minimum, pricing information should be provided for the 50 bonds that were sourced on Day 2 – the day on which the bonds were sold to the client. Absent such a requirement, there is a meaningful incentive for member firms to game the system by sourcing a single bond for each customer sale from old inventory, thereby avoiding entirely the need to disclose the markup/markdown.

With respect to the approach proposed by the MSRB, PIABA feels the MSRB unnecessarily limits the time period it looks at when determining when information needs to be disclosed. The MSRB would only require disclosure if the principal transaction occurs within two hours preceding or following the customer transaction. This is unnecessarily limited. As stated above, PIABA

believes this information should be disclosed in all cases, but at a minimum, for transactions occurring in the same day.

The new proposal also permits a firm to not disclose pricing information if there has been a material change in the price of the security between the time of the principal transaction and the customer transaction. PIABA is concerned that the proposal allows the firm to exercise too much discretion in whether to disclose the price along with clarifying information explaining the change in price, or simply not disclose the price at all. FINRA should provide guidance on what it considers a material change. For example, FINRA should provide a minimum percentage change in price or other objective measure.

Further, PIABA does not understand the need for this discretion. The firm should be required to disclose the price and the reason for the material change in price. This information should be readily ascertainable and should be disclosed to the customer. Alternatively, the firm should be required to disclose that there had been a material change in price and that the customer should contact their broker for more information.

PIABA also believes that FINRA should work to unify its rule with the MSRB proposal. Customers should receive uniform information about debt securities, including corporate and agency bonds and municipal bonds. Firms should provide both the reference price and the mark-up or mark-down from the prevailing market price to the extent the two are different. PIABA is supportive of the MSRB proposal in that it looks through the firm to its affiliates for purposes of determining when a transaction is a "principal" transaction.

Abuse of undisclosed markups and markdowns is not a hypothetical problem. The last few years have seen FINRA pursue a number of disciplinary actions against member firms concerning excessive markups and markdowns of debt instruments. For example, in 2012, FINRA fined Citi International Financial Services LLC $600,000 and ordered more than $648,000 in restitution and interest to more than 3,600 customers for charging excessive markups and markdowns on corporate and agency bond transactions.[1] In 2013, FINRA fined StateTrust Investments, Inc. over $1 million for charging excessive markups and markdowns in corporate bond transactions and ordered the firm to pay more than $353,000 in restitution and interest to customers who received unfair prices. FINRA found that 85 of the transactions, in particular, operated as a fraud or deceit upon the customers.[2] Also in 2013, FINRA fined Morgan Stanley Smith Barney LLC and Morgan Stanley & Co. LLC $1

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1. *See* http://www.finra.org/newsroom/newsreleases/2012/p125821.

2. *See* http://www.finra.org/Newsroom/NewsReleases/2013/P288973.

million and ordered $188,000 in restitution plus interest for failing to provide best execution in certain customer transactions involving corporate and agency bonds, and failing to provide a fair and reasonable price in certain customer transactions involving municipal bonds.[3] Had the pricing information been available to the customers on the confirmations, perhaps the customers would have been charged fair prices.

To be clear: PIABA supports the amendments to FINRA Rule 2232 and MSRB Rule G-15 insomuch as they create greater transparency in retail fixed income trading. However, PIABA requests the amendments not be limited in scope or time and apply to affiliate transactions and to transactions that occur outside the limited windows proposed by both FINRA and the MSRB. There is nothing to indicate that unfair pricing or excessive markups and markdowns only occur when the transaction is sourced from a same-day principal trade.

Ultimately, PIABA requests that the MSRB and FINRA move forward on these proposals. Both entities issued initial proposals a year ago. The MSRB notes that the SEC has expressed concerns about transparency in the municipal securities market since 2012. The disciplinary actions cited above demonstrate that there have been issued in the corporate and agency debt markets for some time as well. However, neither entity has yet proposed a rule to the SEC. At the current pace, it will be some time before rules are enacted. PIABA urges each entity to expedite this process and act expeditiously to protect customers who are participating in the debt securities markets.

Thank you for the opportunity to comment on the rule proposal.

Sincerely yours,
Hugh D. Berkson
PIABA President

3. *See* http://www.finra.org/Newsroom/NewsReleases/2013/P317817.

The following PIABA Comment Letter regarding the *Regulatory Notice 15-37* was submitted to the Financial Industry Regulatory Authority by Hugh D. Berkson on November 30, 2015 (prepared with the assistance of Teresa Verges).

Ms. Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 15-37 – Proposed Rules Relating to Financial Exploitation of Seniors and Other Vulnerable Adults; Proposed FINRA Rule 2165

Dear Ms. Asquith:

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

Regulatory Notice 15-37 seeks comments on proposed rules to address the financial exploitation of seniors and other vulnerable adults.[1] New FINRA Rule 2165 (Financial Exploitation of Specified Adults) would permit "qualified persons"[2] of firms to place temporary holds on disbursements of

1. Regulatory Notice 15-37 also proposed amendments to Rule 4512 (Customer Account Information) that would require firms to obtain the name of and contact information for a trusted contact person for a customer's account. PIABA supports these proposed amendments because they will provide an outlet to immediately report suspicious activity to a trusted individual.

2. A "qualified person" is defined as "an associated person of a member who serves in a supervisory, compliance or legal capacity" that is reasonably related to the account

funds or securities from the accounts of specified customers where there is a reasonable belief of financial exploitation of those customers. The rule creates no obligation to place a hold on funds or securities were financial exploitation may be occurring, but provides a safe harbor to firms who exercise discretion to place the temporary hold in such circumstances.

PIABA is generally supportive of proposed Rule 2165 because, among other things, it recognizes that registered persons are often in the best position to learn of, and prevent or mitigate, the financial exploitation of their clients. However, PIABA believes that the proposed rule does not go far enough to reach its aim of protecting senior investors and other vulnerable adults because it does not obligate a firm to report financial exploitation to appropriate authorities or place a temporary hold on disbursements even when it has a reasonable suspicion of financial exploitation or abuse, and it does not create a penalty for willfully ignoring evidence of abuse. Therefore, PIABA proposes several important changes to the proposed rule that would better protect senior investors and vulnerable adults from financial exploitation.

A. Rule 2165 Does Not Obligate Firms to Report to Relevant Authorities Financial Exploitation and Abuse

There is a need for strong protection of the elderly investing population. With roughly one out of every five Americans 65 years and older being the victim of financial abuse,[3] the elderly are estimated to lose up to $2.9 billion per year from scams.[4] These figures are likely lower than the true figures since they only account for frauds that are reported, and seniors are "less likely" to

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of the specified adult. Rule 2165(a)(3). Subsection (a)(1) of the rule defines "specified adult" as a natural person who is age 65 or older, or a natural person age 18 and older "who the member reasonably believes has a mental or physical impairment that renders the individual unable to protect his or her own interests."

3. *See* E.S. Browning, Financial Scammers Increasingly Target Elderly Americans, WALL ST. J. (Dec. 23, 2013), http://www.wsj.com/articles/SB100014240527023 03330204579248292834035108. This is the equivalent of more than seven million Americans. *See* INVESTOR PROTECTION TRUST, *Preventing Elder Investment Fraud*, http://www.investorprotection.org/protect-yourself/?fa=protect-seniors (last visited July 29, 2015).

4. Mason Braswell, *Unraveling Minds*, INVESTMENTNEWS, (Nov. 3, 2014).

report being scammed.[5] Moreover, financial exploitation of seniors is expected to significantly increase as the U.S. population ages.

Registered persons are in the perfect position to recognize signs and symptoms of diminished capacity and dementia with respect to their clients' ability to handle their finances and prevent elder financial abuse.[6] Financial advisors frequently become aware of suspicious activity before family and friends.[7] As such, when there are reasonable grounds to believe its client is being financially exploited, the member firm should be obligated to report potential exploitation to proper authorities.

A mandatory reporting obligation is a central component of the proposed Model Legislation or Regulation to Protect Vulnerable Adults from Financial Exploitation ("Model Act"),[8] recently proposed The North American Securities Administrators Association, Inc. ("NASAA"). The purpose of the Model Act is to protect senior-aged investors from financial exploitation, ideally with uniform parameters that all states will adopt for investor clarity. The Model Act requires a "qualified employee"[9] to notify Adult Protective Services and the commissioner of securities if the employee reasonably believes that financial exploitation of an "eligible adult"[10] "may have occurred, may have been attempted, or is being attempted."[11]

NASAA's Model Act implicitly recognizes that requiring member firms to report suspected financial abuse to the appropriate authorities is a necessary step towards the goal of preventing incidents of financial abuse. Even if

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5. FEDERAL BUREAU OF INVESTIGATION, *Fraud Target: Senior Citizens*, https://www.fbi.gov/scams-safety/fraud/seniors (last visited July 29, 2015).

6. *See* Naomi Karp & Ryan Wilson, Protecting Older Investors: The Challenge of Diminished Capacity, AARP PUBLIC POLICY INSTITUTE 17 (Nov. 2011), http://www.aarp.org/content/dam/aarp/research/public_policy_institute/cons_prot/2011/rr2011-04.pdf.

7. *Id.*

8. NASAA's Board of Directors issued a notice seeking comments on the proposed Model Act on September 29, 2015; the comment period closed on October 2, 2015.

9. NASAA's Model Act defines "qualified employee" as any agent, investment adviser, representative or person who serves in a supervisory, compliance, or legal capacity for a broker-dealer or investment adviser. Section 2 (7), Definitions.

10. Subsection 2(3) of the Model Act defines "eligible adult" as "(a) a person sixty years of age or older; or (b) a person subject to [insert APS (Adult Protective Services) statute]."

11. NASAA Model Act, Section 3, Governmental Disclosures.

NASAA's final version of the Model Act retains the mandatory reporting obligation, however, not every state will adopt the Model Act, and those that do choose to implement a reporting requirement may not make it mandatory. This will invariably lead to uneven protection for vulnerable adults, which is apparent today in the emerging patchwork of inconsistent approaches among the states that have addressed this issue.

According to the 2013 Nationwide Survey of Mandatory Reporting Requirements for Elderly and/or Vulnerable Persons ("2013 Survey"),[12] while all states have passed statutes requiring certain professionals (i.e., attorneys, accountants, doctors, nurses and other health care workers, nursing homes and care providers) only twenty-one (21) states and the District of Columbia require financial institutions to report adhere to reporting requirements.[13] Three states - Iowa, Virginia and Washington - include "financial institutions" among the group of professionals who may report instances of financial abuse, but reporting is permissive, not mandatory. Finally, Washington State has a mandatory reporting requirement, but only in special circumstances, specifically, if the institution places a hold on a disbursement of funds due to suspected financial exploitation, it then must report the suspected abuse to authorities.[14]

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12. The 2013 Survey was published by New York District Attorney's Office and NAPSA Elder Financial Exploitation Advisory Board.

13. Fifteen (15) states require "any person" or "any individual" to report suspected financial exploitation to the relevant authorities, including: Delaware, Florida, Indiana, Kentucky, Louisiana, Mississippi, New Hampshire, New Mexico, North Carolina, Oklahoma, Rhode Island, South Carolina, Tennessee, Texas, Utah and Wyoming. The remaining six (6) states, Arizona, Arkansas, California, Georgia, Kansas and Maryland, and the District of Columbia, have specific references to "financial institutions" or persons having custody or control of the vulnerable adult's property. *See* 2013 Survey.

14. Effective since June, 2010, Washington has a permissive statutory scheme that allows (but does not require) financial institutions to refuse a transaction requiring disbursal of funds in the account of a "vulnerable adult" if it reasonably believes financial exploitation occurred, was attempted, or is being attempted. Wash. Rev. Code Ann. § 74.34.215. For purposes of Chapter 74.34 only, "financial institution" is defined to also include broker-dealers and investment advisers. §74.34.020(8). *If* the financial institution chooses to halt the disbursal of funds under the statute, then it "shall" make a reasonable effort to notify all parties authorized to transact on the account and "shall" report the incident to adult protective services and local law enforcement. Id. at § 74.34.215(4). Absent a court order extending the time period, the ability for the institution to refuse to disburse funds expires after either 5 days or 10 days (if involving the sale or offer to sell a security). *Id.* at § 74.34.215(5), (6). So

Even among the states that include employees of financial institutions within the category of persons either required or permitted to report suspected abuse to authorities, the definition of a "financial institution" may not include a broker-dealer or investment adviser. For example, in California, since January 1, 2007, officers and employees of financial institutions have been mandatory reporters of suspected financial abuse of an elder or dependent adult, with "elder" defined simply as a California resident age 65 or older. Cal. Welf. & Inst. Code §§ 15610.27, 15630.1.[15] However, the California law is limited because, among other things, "financial institutions" are specifically defined to include national banks, savings and loans, state banks and trust companies whose deposits are not limited solely to funds held in a fiduciary capacity, and federal or state credit unions. Id. at § 15630.1(b). Thus, while the California provisions appear to give parallel required reporting requirements as the Model Act, they exclude broker-dealers and investment advisors not otherwise falling under the definition of "financial institutions."

Adding a mandatory reporting obligation to proposed FINRA Rule 2165 would provide uniform protection for a particularly vulnerable portion of the nation's investors. Such a requirement would prompt member firms to provide training to its registered persons on recognizing signs of potential financial exploitation.. As FINRA recognizes in Regulatory Notice 15-37, "a customer's registered representative may be the first person to detect potential

long as the refusal was made in good faith, the financial institution or its employee following the statutory scheme is immune from criminal, civil, or administrative liability. *Id.* at § 74.34.215(7). Thus, while Washington's law is permissive, once a firm elects to halt a disbursement it must notify all persons on the account in addition to APS and law enforcement.

15. If an incident known or observed by the mandatory reporter reasonably appears to be financial abuse, or triggers reasonable suspicion of abuse, he or she must report "the known or suspected instance of financial abuse by telephone or through a confidential Internet reporting tool, as authorized pursuant to Section 15658, immediately, or as soon as practicably possible. If reported by telephone, a written report shall be sent, or an Internet report shall be made through the confidential Internet reporting tool established in Section 15658, within two working days to the local adult protective services agency or the local law enforcement agency." *Id.* at § 15630.1(d)(1). Reports of suspected financial abuse of the elder or dependent adult qualify as a "privileged publication or broadcast" under Cal. Civ. Code § 47(b). The mandated reporter is protected from civil and criminal liability with respect to the report. Cal. Welf. & Inst. Code § 15634. Interestingly, *nonmandated* reporters who report the abuse in the same manner as the mandated are also protected from liability, unless it can be proven that the report was knowingly false. Cal. Welf. & Inst. Code §§ 15631, 15634.

financial exploitation." Simply put, brokers and investment advisers should have the same mandatory reporting requirements as other professionals.

B. A Firm Should Have an Obligation to Place a Temporary Hold on Disbursement of Funds or Securities When It Has Reasonable Suspicion of Financial Exploitation or Abuse

As currently proposed, Rule 2165 would permit, but not require, member firms to place a temporary hold on disbursement of funds or securities from the account of a specified adult if the qualified person "reasonably believes that financial exploitation of the Specified Adult has occurred, is occurring, has been attempted, or will be attempted." Rule 2165(b)(1)(A). Within two days after placing the hold, the firm must notify the person(s) authorized to transact business on the account and the "Trusted Contact Person" or, if the firm believes that person is involved in the financial exploitation, an immediate family member, and must also conduct an internal review. 2165(b)(2)(b). The temporary hold expires after 15 days, unless extended under certain defined circumstances. 2165 (b)(1)(C). The rule provides a safe harbor for those firms that choose to exercise discretion and temporarily hold disbursements. 2165.01.

Importantly, should the member firm *choose* to exercise its discretion to place a temporary hold, the firm is then *required* to:

(1) Establish and maintain records related to the compliance with the rule, including evidence the request for disbursement, the finding of a reasonable belief of that financial exploitation has occurred, is occurring, has been attempted, or will be attempted, and records relating to the required notice and internal investigation. 2165 (b)(2)(C);

(2) Establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the rule, including, but not limited to, procedures related to the identification, escalation and reporting of matters involving the financial exploitation of Specified Adults, 2165.02; and

(3) Develop and document specific training policies or programs reasonably designed to ensure that registered persons comply with the requirements of this Rule. 2165.03.

The proposed rule would allow a broker-dealer to ignore evidence financial exploitation of a vulnerable adult because it is permissive. Indeed, as written, if a broker-dealer or registered person becomes aware of information sufficient to establish a reasonable belief of financial exploitation of a vulnerable adult, it does not have to place a temporary hold on the disbursement of funds or securities. Given the need for strong protection of the

elderly investing population, the member firm should be required to place a temporary hold in order to prevent or mitigate the dissipation of its client's assets.

Moreover, in the context of a permissive rule, the requirements imposed on those firms that do exercise discretion under the rule create a disincentive for firms to provide this important protection to its clients. The easier, less expensive choice for firms would be to simply do nothing. Requiring *all* member firms to establish and maintain written supervisory procedures and training programs for its registered persons related to the identification, escalation and reporting of matters involving the financial exploitation of its elderly clients would promote the interest of investor protection.

We recognize that NASAA's proposed Model Act includes a similar provision allowing, but not requiring, broker-dealers and investment advisers to delay disbursement of assets when there is a reasonable belief of financial exploitation. Model Act § 7. PIABA submitted a comment letter urging NASAA to obligate firms to act, and hopes that the final version of the Model Act will require firms to do so. However, even if the Model Act would require firms to delay disbursements under circumstances of suspected financial abuse, States are not obligated to adopt the Model Act. By making Rule 2165 mandatory, FINRA would set a uniform standard of protection to investors nationwide.

C. The Model Act Does Not Institute a Penalty for Willfully Ignoring Evidence of Abuse

In order to enforce the obligations that should be created by Rule 2165, there should be inclusion of a penalty. Broker-dealers are already provided with a safe harbor if they act under the rule. 2165.01. Conversely, if a broker-dealer fails to comply with its affirmative obligations and willfully ignores information sufficient to establish a reasonable belief that financial exploitation has occurred, is occurring or is about to occur, the firm should be subject to a penalty. Should FINRA amend the rule to impose mandatory obligations in order to enhance investor protection, it should also make clear that a private right of action would exist.

D. Amending Definitions Section to Include Definition of "Disbursement" and Adding Associated Persons to the Definition of "Qualified Person"

PIABA also proposes that FINRA amend the definitions section in the rule in two important respects. First, the rule currently does not define the term "disbursement." The rule should include a definition to ensure that the temporary hold is only placed on the particular disbursement(s) that raises the reasonable suspicion of financial exploitation, rather than the entire account(s) of the Specified Adult. Many elderly clients pay their monthly bills and expenses from their brokerage accounts; some payments to providers are automatic. As such, it is particularly important to define "disbursement" in a manner that will limit the temporary hold only to individual suspicious attempted disbursements.

Second, the rule currently defines "qualified person" to include persons who serve in a supervisory, compliance or legal capacity relative to the account at issue. The definition should be expanded to include registered representatives because they are usually the associated persons at the broker-dealer with the most contact with investors and, therefore, are in the best position to first identify any suspicious behavior or conduct. At minimum, the rule should require that the registered representative report any suspicious behavior or conduct to his or her supervisor or other legal or compliance personnel at the firm.

E. Conclusion

In summary, PIABA asks that FINRA amend proposed Rule 2165 to address the foregoing serious shortcomings in its current form. PIABA thanks you for the opportunity to comment on this important topic.

Very truly yours,
Hugh D. Berkson,
PIABA President

The following PIABA Comment Letter regarding the *Proposed Rule Change Relating to SR-FINRA-2015-040* was submitted to the Securities and Exchange Commission by Huge D. Berkson on November 18, 2015 (prepared with the assistance of Marnie Lambert and Brent Burns).

Robert W. Errett
Deputy Secretary
Securities and Exchange Commission
100 F. Street., NE
Washington DC 205491090

Re: File No. SR-FINRA-2015-040 - FINRA Proposed Rule Change to Adopt the Funding Portal Rules and Related Forms and FINRA Rule 4518

Dear Mr. Errett:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by regulatory and self-regulatory securities authorities to govern the conduct of securities firms and their representatives.

While PIABA understands why the JOBS Act was passed and signed into law by President Barack Obama on April 5, 2012, PIABA has always been troubled by the potential for investor fraud in the crowdfunding arena. The Securities and Exchange Commission (the "SEC" or "Commission") just released its final rules and forms under the Securities Act of 1933 and the Securities Exchange Act of 1934 to implement the requirements of Title III of the JOBS Act (referred to as "Regulation Crowdfunding") on November 6, 2015. PIABA is eager to review the new Regulation Crowdfunding rules and forms in conjunction with FINRA's proposed Funding Portal Rules, related forms and proposed Rule 4518 to identify any areas that may still leave investors vulnerable to bad actors in the crowdfunding arena.

Background

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934, FINRA must file with the SEC a copy of any proposed rule change along with a statement of the basis and purpose of such proposed rule change. The SEC and FINRA have previously solicited comments relative to rulemaking required by the JOBS Act including, but not limited to, Title III of the JOBS Act, which resulted in a new Section 4(a)(6) to the Securities Act of 1933.[1] Section 4(a)(6) provides an exemption from the registration requirements of Securities Act Section 5 for certain "crowdfunding transactions."

PIABA now offers comments regarding FINRA's proposed new Rules 100, 110, 200, 300, 800, 900 and 1200 (collectively, the "Funding Portal Rules" or "FP Rules") and related forms, as well as proposed new FINRA Rule 4518 ("Notification to FINRA in Connection with the JOBS Act").

Comments

As with many of PIABA's comment letters, in general PIABA supports the proposed rules because the Association knows that investors need protection against unscrupulous brokers, issuers and intermediaries in the crowdfunding space. However, as is sometimes the case, PIABA does not think that FINRA's proposed Funding Portal Rules go far enough in several instances. Despite not yet having sufficient time to fully evaluate the proposed Portal Rules and new Rule 4518 alongside the new Regulation Crowdfunding to determine how the new regulatory scheme may (or may not) work in its protection of investors,[2] PIABA submits this comment letter addressing certain obvious issues in the proposed Funding Portal Rules.

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1. *See, e.g.,* FINRA Regulatory Notice 12-34 (request for comment on Proposed Regulation of Crowdfunding Activities [http://www.finra.org/industry/notices/12-34]) and FINRA Regulatory Notice 13-34 (request for comment on Proposed Funding Portal Rules and Related Forms [https://www.finra.org/industry/notices/13-34]). PIABA filed a comment letter in response to RN 12-34 on August 30, 2012 [http://www.finra.org/sites/default/files/NoticeComment/p163714.pdf], in which it cautioned against creating special crowdfunding-related exceptions to the existing rules and regulations, instead emphasizing the importance of having a uniform set of all rules for all business activities (including crowdfunding activities).

2. FINRA has already acknowledged in its filing related to its proposed Funding Portal Rules that its rulemaking would be "informed by the SEC's rulemaking," but until November 6, 2015, FINRA only had the SEC's proposed Regulation Crowdfunding from which to work. Now that the SEC has finalized Regulation Crowdfunding,

Proposed Funding Portal Rule 100 (General Standards)

According to FINRA, proposed Funding Portal Rule 100 is meant to make funding portal members/associated person subject to FINRA By-Laws and FINRA Regulation By-Laws. This is a good thing as far as PIABA is concerned, but PIABA is concerned that FINRA's latest proposal seems to include the potential for an unknown exception. Rather than simply stating that the funding portal members/associated persons will be subject to the referenced By-Laws, FP Rule 100 then includes the limiting language, "unless the context requires otherwise …"[3] Without a better understanding of what "context" could require an exception to the funding portal members/associated persons being subject to FINRA rules and regulations, PIABA believes that investors would be best served by omitting the limiting (i.e., exception) language from FP Rule 100.

Proposed Removal of Funding Portal Rule 110(b) (Fidelity Bond)

FINRA is now proposing FP Rule 110 without any requirement that the funding portals obtain a fidelity bond (prior proposed FP Rule 110(b)). FINRA's removal of a fidelity bond requirement is inexplicable as it serves principally to add to the risk for unsuspecting crowdfunding investors. FINRA attempts to justify the removal of the requirement of a fidelity bond on:

the interest of reducing potential burdens on prospective funding portal members given the limited nature of the funding portal business and given that regulatory experience with funding portals is developing.

See Item 5A of the SR-FINRA-2015-040. In other words, the interests of those trying to raise money via crowdfunding trump the interests of investors in need of FINRA's protection. The fact that the funding portal business is developing, and therefore may contain unseen pitfalls, is the exact reason why additional protections for retail investors should be implemented. To argue such protection is not needed, FINRA must ignore the fact that one of the duties of the funding portals is to take measures to reduce the risk of fraud with respect to crowdfunding transactions, including obtaining a background and securities

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FINRA and the public should review and evaluate FINRA's proposed Funding Portal Rules, related forms and new Rule 4518 in light of the new crowdfunding regulations.

3. That same, or similar, limiting language that references "context" is included in several of the proposed Funding Portal Rules and PIABA does not know to what context the proposed rules are referring or why it means that some part of the proposed rules should not apply.

enforcement regulatory history check on each office, director, and person holding more than 20 percent of the outstanding equity of every issuer whose securities are offered by such person.
See SEC Release Nos. 33-9974; 34-76324, p.168.

Although the SEC did not go so far as requiring that funding portals conduct any type due diligence (as it is understood in the securities industry) regarding issuers, funding portals still have significant responsibilities and potential liability.[4] Thus, it would be prudent for funding portal members to be required to have some kind of insurance – be it a fidelity bond or something else – available to help defray avoidable losses suffered by investors while the SEC and FINRA experiment with crowdfunding.

Accordingly, PIABA advocates a new proposed funding portal rule that closely approximates FINRA Rule 4360 in terms of requiring funding portals to obtain a bond covering 'securities' since they will be selling unregistered securities to the general public. Additionally, funding portals should not be permitted to maintain fidelity bonds with deductibles because many of the funding portals will likely be thinly capitalized.[5] Further, the amount of the required minimum fidelity bond required by portals should be increased from $100,000 to up to $1 million to match the amount of investor funds that will be used to purchase these unregistered securities. Finally, the funding portals should be required to clearly disclose to investors what the "blanket fidelity bond coverage" covers and what it does not (e.g., if a funding portal's fidelity bond coverage merely covers fraud by the funding portal, and not the issuers, the funding portal should disclose that in plain English).

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4. Indeed, given the funding portals' responsibilities, their employees in charge of compliance should be required to pass a rigorous licensing test based on minimum requirements that are necessary to protect investors.

5. PIABA is actually of the opinion that the SEC should also require *issuers* to obtain at least minimal fidelity bond coverage—with no deductibles—to protect investors from issuers' potential fraud. The money needed to pay for this insurance can be included in the offering. If, after diligent effort, the issuer is unable to obtain any type of insurance or fidelity bond, that fact should be disclosed to investors. In such cases, the funding portals should be tasked with obtaining a certification from the issuer documenting what efforts the issuer made to obtain the coverage and making those certifications available to potential investors. Another alternative is for FINRA and the SEC to mandate that funding portals and/or issuers contribute to some type of managed group insurance fund akin to FDIC or SIPC insurance. Such a fund would help protect investors from outright theft by portals or issuers. Additionally, funding portals should be subject to net capital requirements.

Proposed Funding Portal Rule 200 (Funding Portal Conduct)

According to FINRA, it "further streamlined the rule vis-à-vis the version published in [Regulatory …] Notice [13-34] to reflect the limited scope of activity permitted by funding portals." However, when the original proposed FP Rule 200 is compared with the new proposed FP Rule 200, the only noticeable change is contained in FP Rule 200(c)(2)(B), which sets forth the content required in funding portal member communications. The change made by FINRA, without any substantive explanation, was to delete the requirement that funding portal member communications "provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service."

Thus, even though intermediaries like funding portals are required by Securities Act Section 4A(a)(5) to take measures necessary to reduce the risk of fraud related to crowdfunding transactions, they are not required to provide a sound basis for the evaluating the relevant facts. There is no logical reason that the requirement to provide a sound basis for evaluating facts should only apply to broker-dealers and not also to funding portals.

Proposed Funding Portal Rule 300 (Reporting Requirements)

According to FINRA, proposed FP Rule 300(c) is "largely based on current FINRA Rule 4530 (Reporting Requirements)." In reality, there is at least one portion of FP Rule 300(c) that is identical to FINRA Rule 4530, but needs to be modified for funding portal members/associated persons so that it is consistent with other modifications made to the FINRA Rules by the proposed Funding Portal Rules.

For example, proposed FP Rule 300(c)(1), provides 30 calendar days for a funding portal member/associated person to report to FINRA certain conduct of funding portal members associated persons. This is generally consistent with FINRA Rule 4350. However, while FP Rule 300(c)(1) provides broker-dealers with 30 calendar days to report, there are several other instances in which the time frames applicable to broker-dealers are shortened by the proposed Funding Portal Rules. As with broker-dealers, if not more so, disclosure and transparency related to funding portal members/associated persons and their conduct is critical as everyone embarks on the crowdfunding experiment. That fact, along with the fact that proposed FP Rule 110(a)(3) (Application to be a Funding Portal Member) requires a funding portal applicant to report any changes to information on its application "not later than 10 days following any change in such information," supports shortening the

time period in which funding portals must report misconduct from 30 days to 10 days.[6]

On the other hand, there is least one portion of proposed FP Rule 300(c) that has been modified to omit certain misconduct that is included in the equivalent FINRA Rule (4530). For example, FINRA Rule 4530(a)(1)(B) requires reporting to FINRA if a member/associated person "is the subject of any written complaint involving allegations of theft or misappropriation of funds or securities or of forgery." For some reason, proposed FP Rule 300(c)(1)(A)(ii) has changed the reporting requirement for funding portal members/associated persons such that they only need to report to FINRA when a written complaint involves "allegations of fraudulent conduct or misuse or misappropriation of funds or assets." PIABA questions why the reporting standard for one type of member is different than the reporting standard for another. If FINRA does not consider the reporting standards to be different, then PIABA questions why the wording was changed.

FINRA's disparate treatment of the reporting of written complaints is especially perplexing given that the remainder of proposed FP Rule 300(c)(1)(A) retains some of the very language that has been removed from FP Rule 300(c)(1)(A)(ii). For example, 300(c)(1)(A)(iv) still requires reporting to FINRA if a funding portal member/associated person is indicted, convicted of, or pleads guilty to, or pleads no contest to a list of different infractions including theft, forgery and misappropriation of funds or securities. PIABA questions why those same infractions are not included in the items that must be reported if they are the subject of a written complaint.

Moreover, proposed FP Rule 300 inexplicably omits the requirement found in FINRA Rule 4530(d) that mandates broker-dealers report to FINRA statistical and summary information related to written customer complaints. Presumably, the rationale in not requiring similar reporting for funding portal members is cost-related, but PIABA was under the impression that the SEC and FINRA wanted to evaluate how crowdfunding works in practice and such statistical and summary reports would help in that regard. The requirement in FINRA Rule 4530(d) is only quarterly and, frankly, if there are so many customer complaints against funding portal members/associated persons that this requirement would be too costly, then there is a larger and more fundamental problem with the crowdfunding experiment.

Similarly, FINRA provides no reasonable explanation why funding portal members/associated persons should not be subject to the same mandates as those found in FINRA Rule 4530(f), which simply require members to provide

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6. The same change from 30 days to 10 days should also be made in proposed FP Rule 300(c)(2).

FINRA with copies of the source documents from which reportable information comes. Again, the costs cannot possibly outweigh the benefits of having as much information as possible related to the conduct of funding portal members/associated persons in the hands of FINRA. Interestingly, additional evidence of FINRA treating funding portal members differently when it comes to reporting requirements can be seen in the fact that nearly all of the Supplementary Material to FINRA Rule 4530 is specifically applied to different sections of proposed FP Rule 300, except Supplementary Material .08 concerning customer complaints.

Otherwise, with respect to FP Rule 300, PIABA is generally supportive of the additions contained in proposed FP Rule 300(e) and proposed FP Rule 300(f) since they tend to increase the disclosure and transparency of financial information about the funding portal members/associated persons.

Proposed Funding Portal Rule 800 (Investigations and Sanctions)

According to FINRA, proposed Funding Portal Rule 800 is meant to apply portions of FINRA Rule 8000 Series (Investigations and Sanctions) to funding portals. Unfortunately, there are notable exceptions to the application of the equivalent FINRA Rules to funding portal members/associated persons.

First, FINRA Rule 8110 (Availability of Manual to Customers) is specifically excluded. FINRA Rule 8110 states that "[m]embers shall make available a current copy of the FINRA Manual for examination by customers upon request…" FINRA Rule 8110 also states that members can comply by providing customers with access to the FINRA Manual electronically. In its discussion of proposed FP Rule 800, FINRA summarily states that it does not propose to apply FINRA Rule 8110 as "the rule addresses availability of the complete FINRA Manual and FINRA is not proposing to apply the complete Manual to funding portal members." That may be, but PIABA questions why FINRA would not require that funding portal members provide investors with access to whatever FINRA rules are applicable to funding portal members. Consumers investing through funding portals have at least as much reason as customers of broker-dealers to know the rules by which FINRA members must abide.

Second, FINRA Rule 8312 (FINRA BrokerCheck Disclosure) is not proposed by FINRA to be applied wholesale to funding portal members/associated persons. Proposed FP Rule 800(b) (Public Disclosure of Information on Funding Portals) is meant to accomplish for funding portals what FINRA Rule 8312 accomplishes for broker-dealers. PIABA is not certain what it is that proposed FP Rule 800(b) actually requires to be given to

the public because the language in proposed FP Rule 800(b)(1) is merely permissive. This is particularly troubling as the previous version of the proposed rule mandated disclosures that are only voluntary in the current iteration of the proposed rule. The proposed rule sets forth what FINRA may provide access to – not what FINRA *shall* provide access to. The only disclosure mandated by proposed FP Rule 800(b) is found in Subsection 2, and it limited to a disclosure of whether a funding portal member/associated person is "subject to an event described in Section 3(a)(39) of the Securities Exchange Act."

The problem is that Section 3(a)(39) of the Securities Exchange Act only addresses someone subject to a "'statutory disqualification' with respect to membership or participation in, or association with a member of, a self-regulatory organization …" in certain specified circumstances. As far as PIABA is aware, events described in Section 3(a)(39) do not include all of the conduct that a funding portal member/associated person is required to report to FINRA and, thus, FINRA is proposing to disclose less than is required to be disclosed by broker-dealers. If reference to events addressed by Section 3(a)(39) alone is not enough of a public disclosure for a broker-dealer, then why does FINRA think that is sufficient for a funding portal?

It makes no sense, given the SEC's and FINRA's purported commitment to disclosure and transparency regarding crowdfunding activities, that so much pertinent information is proposed to be kept from investors. PIABA questions why investors using funding portals would not be entitled to obtain most (if not all) of the information funding portal members/associated persons will be required to report to FINRA pursuant to proposed FP Rule 300. This is particularly troublesome with respect to information such as historic written complaints, current approved registrations, summary information about certain arbitration awards with public customers or investors and the like (all of which are required to be disclosed by broker-dealers under FINRA Rule 8312). To the extent that FINRA is concerned about the costs of disclosure, such concern is unfounded. In reality, there should not be any significant additional cost since the funding portals are supposed to collect and disclose most (if not all) of the same information in any event, pursuant to other proposed Funding Portal Rules.

Proposed Funding Portal Rule 1200 (Arbitration and Mediation)

According to FINRA, proposed FP Rule 1200 is designed to provide that funding portal members/associated persons will be subject to various other series of rules, including FINRA Rule 12000 Series (Code of Arbitration). PIABA's objections/comments to certain portions of proposed FP Rule 1200

are the same general objections/comments that PIABA has articulated many times in relation to customer claims against broker-dealers.

Arbitration of crowdfunding disputes should be at the investor's election. Aggrieved crowdfunding investors must be given the right to opt out of arbitration agreements and pursue their claims in court (either individually or as part of a class action). The choice of forum and claims is especially important because, presuming issuers adhere to the investment limits set out in the Regulation Crowdfunding rules, many of the claims for monetary losses will be modest if not outright small. Any rule language that would serve to restrain aggrieved investors from filing class actions against funding portal members would essentially insulate those funding portal members from prosecution. The costs of pursuing an individual case (in arbitration or otherwise) could quickly usurp the benefits even if the case were to result in a favorable one for the aggrieved investor. Accordingly, the only opportunity aggrieved crowdfunding investors may have to pursue justice could be in the class action context. If FINRA is not willing to include the right to choose forums (and claims) in the proposed Funding Portal Rules then, at a bare minimum, FINRA should explicitly bar any arbitration agreement that would preclude an investor from participating in a class action against a funding portal member. Moreover, if aggrieved investors are forced to bring their crowdfunding claims in FINRA arbitration (as opposed to being able to alternatively file a court case) then they should be permitted to include their claims against the issuers in the same FINRA arbitration. If an issuer participates in crowdfunding through FINRA's funding portal members then that issuer should be subject to FINRA arbitration so that aggrieved investors are not forced to fight their battles in multiple forums.

Conclusion

PIABA believes that Congress has greatly increased risks to the investing public by implementing the JOBS Act and suspending laws that were created to protect investors from financial industry predators. In PIABA's opinion, that makes FINRA's rulemaking in the crowdfunding arena that much more important.

For the foregoing reasons, PIABA respectfully requests that: (1) the SEC reject FINRA's rule proposal at this time; (2) require FINRA to resubmit the rule proposal after it has reviewed and analyzed the newly issued Regulation Crowdfunding and decided whether further rulemaking is necessary; and, (3) extend the comment period to allow the public additional time to consider the

impact, any of, the newly issued Regulation Crowdfunding. Thank you for the opportunity to comment on such important issues.

Thank you for your consideration herein.

Sincerely yours,
Hugh D. Berkson
PIABA President

The following PIABA Comment Letter regarding the *Proposed Rule Change Relating to SR-FINRA-2015-034* was submitted to the Securities and Exchange Commission by Hugh D. Berkson on November 3, 2015 (prepared with the assistance of Christine Lazaro and David Neuman).

Via email to rule-comments@sec.gov
Brent J. Fields, Secretary
Securities and Exchange Commission
100 F. Street, NE
Washington, DC 20549-1090

Re: File Number SR-FINRA-2015-034 – Proposed Rule Change to Merge FINRA Dispute Resolution, Inc. Into and With FINRA Regulation, Inc.

Dear Mr. Fields:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by regulatory and self-regulatory securities authorities to govern the conduct of securities firms and their representatives.

We are particularly troubled by FINRA's current proposal to merge FINRA Dispute Resolution, Inc. into and with FINRA Regulation, Inc. The proposed rule is an important one, and one that evidences a complete reversal from the positions FINRA and the SEC have taken for the last fifteen years. The comment period is too short to allow interested parties to fully evaluate the proposal and offer their views. While PIABA has not had the opportunity to review and assess the proposal in detail, we submit this comment addressing certain obvious issues associated with the merger.[1]

1. Please note that there are undoubtedly additional issues which will come to light once the public has had sufficient opportunity to review the proposal.

In 1996, NASD had received recommendations related to its arbitration program from the Rudman Committee and the Ruder Task Force.[2] The Rudman Committee recommended the Arbitration Department be placed within NASD Regulation, and the Ruder Task Force recommended that the dispute resolution program be housed either within NASD Regulation or the parent company.[3] NASD followed the recommendation of the Rudman Committee and placed its Arbitration Department in NASD Regulation, and shortly thereafter changed the name of the department to the Office of Dispute Resolution.[4]

In 1999, NASD filed a rule proposal with the SEC to create a separate dispute resolution subsidiary.[5] In its rule filing, NASD stated:

Because there are significant differences between the disciplinary role of NASD Regulation and the sponsorship of a neutral forum for the resolution of disputes between members, associated persons, and customers, however, the NASD believes that creation of a separate dispute resolution entity will further strengthen the independence and credibility of the arbitration and mediation functions. A new dispute resolution subsidiary will benefit from the perception that it is separate and distinct from other NASD entities.[6]

As part of the rule proposal, NASD proposed that NASD Dispute Resolution would have a separate board of directors; determine its own policies, including developing and adopting rules for arbitration and mediation; determine allocation of dispute resolution resources; manage external relations; and oversee the NAMC including appointing the committee members.[7]

When the SEC approved the rule proposal in September 1999, it stated that it "believes that separating the dispute resolution role from the disciplinary role of NASD Regulation will result in a more neutral and independent forum for the resolution of disputes between members, associated persons, and

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2. *See* Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to the Creation of a Dispute Resolution Subsidiary, File No. SR-NASD-99-21, SEC Release No. 34-41510, June 10, 1999.

3. *Id.*

4. *Id.*

5. *Id.*

6. *Id.*

7. *Id.*

customers."[8] In June 2000, NASD issued a press release stating, "We believe the creation of a separate subsidiary will further enhance the perception of neutrality and increase the confidence and comfort-level of forum users."[9]

Now, fifteen years later, FINRA believes "there is no longer a need to maintain separate subsidiaries to execute its regulatory and dispute resolution functions."[10] FINRA seeks to undo the work it did fifteen years ago when it separated the two entities and combine Regulation and Dispute Resolution, thereby subordinating its dispute resolution department to Regulation.

Curiously, in the current proposal, FINRA states that it "believes that the reorganization and its continued commitment to dispute resolution would ensure that FINRA continues to protect investors and the public interest in an efficient manner."[11] This is directly contradictory to statements made by NASD in 2000, when it stated, "[i]n response to the growing importance of dispute resolution services to the marketplace, a subsidiary of NASD, Inc., NASD Dispute Resolution, Inc., was formed."[12] When the SEC approved the formation of NASD Dispute Resolution, Inc. in 1999, it found that in doing so, "the proposed rule change is consistent with Section 15A(b) of the Act in general and furthers the objectives of Section 15A(b)(6) in particular, in that it

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8. *See* Order Approving a Proposed Rule Change by the National Association of Securities Dealers, Inc. to Create a Dispute Resolution Subsidiary, File No. SR-NASD-99-21, SEC Release No. 34-41971, September 30, 1999.

9. *See* "NASD Launches New Dispute Resolution Subsidiary," July 17, 2000, available at https://www.finra.org/newsroom/2000/nasd-launches-new-dispute-resolution-subsidiary.

10. *See* Notice of Filing of a Proposed Rule Change to Merge FINRA Dispute Resolution, Inc. Into and With FINRA Regulation, Inc., File No. SR-FINRA-2015-034, SEC Release No. 34-76082, October 6, 2015.

11. *See* SEC Release No. 34-76082, pp.21-22. This statement is set forth as though it is an obvious result of the fact that one part of the rule change would increase the maximum number of FINRA Regulation board seats from 15 to 17 (while maintaining the "numerical dominance of public directors"). PIABA does not believe that FINRA's generic rhetoric regarding "the reorganization" and its "continued commitment to dispute resolution" (whatever that means), without more, is sufficient to demonstrate that the proposed merger will protect investors as much (or more) than they are protected now. Moreover, we question what FINRA means when it says it intends to "ensure that FINRA continues to protect investors and the public interest in an efficient manner.'

12. *See* 2000 NASD Annual Financial Report, available at http://www.finra.org/sites/default/files/Corporate/p009758.pdf.

is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect investors and the public interest."[13]

The SEC cannot approve the current rule proposal without contradicting its own previous findings. Nonetheless, FINRA offers several explanations for the proposed merger;[14] however, the purported justifications are troubling given the purpose behind separating the two entities initially.

First, FINRA states that the proposed merger would "align the legal structure with the public's perception of FINRA as well as its operational realities." FINRA has offered no support for this conclusory statement. FINRA contends that, from the public's perspective, FINRA, Inc., FINRA Regulation and FINRA Dispute Resolution have the appearance of a single organization.[15] FINRA's conclusion, and the core basis for its proposal of a merger, appears to be the natural result of a self-fulfilling prophecy. FINRA has not articulated its efforts spent over the last fifteen years to educate the public regarding the distinct nature of its various entities and the manner in which the separation of roles has contributed to investor protection. Instead, it issues statements like "FINRA operates the largest securities dispute resolution forum in the United States, and has extensive experience in providing a fair, efficient and effective venue to handle a securities-related dispute."[16] FINRA then feigns surprise that the public does not understand that Dispute Resolution is separate and distinct from the regulatory arm.

The fact remains that, at present, FINRA Dispute Resolution is independent of FINRA Regulation, which distinction serves an important purpose. The forum is intended to be neutral and should not be under the control of FINRA Regulation. If there is public confusion regarding the distinct nature of the entities, PIABA suggests the confusion results from FINRA, Inc.'s, FINRA Regulation's, and FINRA Dispute Resolution's failure to adequately explain to the public their distinct roles. Indeed, we do not know what FINRA means when it states that the proposed merger would "align the

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13. *See* SEC Release No. 34-41971.

14. We are troubled by the fact that many of FINRA's purported justifications supporting a merger consisting of little more than buzz words and industry jargon mixed together in an effort to make the proposed merger seem necessary when, in truth, it is not.

15. *See* Notice of Filing of a Proposed Rule Change to Merge FINRA Dispute Resolution, Inc. Into and With FINRA Regulation, Inc., File No. SR-FINRA-2015-034, SEC Release No. 34-76082, October 6, 2015.

16. *See* https://www.finra.org/arbitration-and-mediation.

legal structure … to its [FINRA's] operational realities," but it seems to suggest that FINRA has not been treating, or at least does not now treat, FINRA Dispute Resolution as separate from FINRA Regulation despite the fact that it is (and has been) separate.[17] FINRA should not be permitted to bring its conduct, to the extent it has been (or is now) outside of the regulatory scheme previously approved by the SEC, into compliance by simply changing the rules to conform to its conduct. Such a result would be nonsensical and yet the proposed merger seems to be attempting to do just that.

As recognized in 1999 when Dispute Resolution was created, FINRA's regulatory function is wholly separate from its sponsorship of a neutral dispute resolution forum. Regardless of the public perception of the two entities, it is important that Dispute Resolution be independent from Regulation and be able to adopt its own policies, determine the appropriate allocation of its resources, and manage its external relations. It is also important that the NAMC remain separate and apart from Regulation. If Dispute Resolution is a department within FINRA Regulation, it will be under the direction of Regulation and will not maintain autonomy. FINRA Regulation would then have say over arbitration rules as well as the administrative side of the arbitration process, including arbitrator training.

There may be other unintended repercussions as well. For example, if the proposed merger is approved and FINRA Enforcement declines to take action against a member firm for behavior that is the subject of a pending arbitration complaint, as it often does, the "no action letter" would no longer be issued by an entity separate and distinct from the dispute resolution role of the organization. We therefore expect that the industry will assert as a defense to a customer claim that FINRA Enforcement's refusal to act can be treated as a finding of the arbitration department that no wrongdoing took place since Enforcement and Dispute Resolution are the same entity.

Moreover, rather than simply state that the public is confused regarding the roles of the separate FINRA entities, FINRA should be taking steps to improve the public's understanding that its Dispute Resolution entity is

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17. FINRA actually admits that "the three corporate [FINRA] entities largely function as a single organization." *See* SEC Release No. 34-76082, p.5. FINRA refers to this as "operational cohesiveness that furthers FINRA's mission of protecting investors," but what does that mean and how does it protect investors? The example given is that FINRA Dispute Resolution staff work with the FINRA Department of Enforcement to "identify misconduct by individuals or firms involved in arbitration cases that court justify further action." Surely the separate entities have been working together in this way for years - why is it now necessary that they be merged and will the cooperation stop if the proposed merger is not approved?

separate, independent, and distinct from its Regulation entity, and thereby improve the confidence level of forum users. This was an issue in 2000, and clearly remains one today. In 2005, amid concerns about the fairness of the arbitration process, the Securities Industry Conference on Arbitration ("SICA") conducted a study of perceived fairness in the arbitration process.[18] SICA sent a survey to over 30,000 participants with questions assessing perception of the arbitration process. Particular emphasis was placed on: a) fairness of the SRO arbitration process; b) competence of arbitrators to resolve investors' disputes with their broker-dealers; c) fairness of SRO arbitration as compared to their perceptions of fairness in securities litigation in similar disputes; and d) fairness of the outcome of arbitrations.[19] Not surprisingly, the SICA study found that the overall perception of the securities arbitration process was negative.[20] Over sixty percent of customers perceived the process as unfair,[21] with nearly half perceiving arbitral panels as being biased.[22] And, most significantly, three out of every four customers found securities arbitration to be "very unfair" or "somewhat unfair" when compared with the judicial system.[23] Public perception will not improve by placing Dispute Resolution back within Regulation. Rather than simply refusing to educate the public about the distinct nature of the FINRA entities, and now giving up because the Public doesn't understand the current structure, FINRA should be taking steps to improve the public perception of Dispute Resolution, not ensure that the entity conforms with the public perception of the entity.

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18. *See* Barbara Black & Jill Gross, Perceptions of Fairness of Securities Arbitration: An Empirical Study, Report to the Securities Industry Conference on Arbitration (2008), available at http://www.publicjustice.net/Repository/Files/Perceptions%20of%20Fairness.pdf.

19. *See id*. at 1.

20. *See id*. at 3.

21. *See id*. at 45 (finding that approximately 63% of investors answered "Disagree/Strongly Disagree" when responding to the statement, "As a whole, I feel the arbitration process was fair").

22. *See id*. at 50 (finding that 47% of responses disagreed with the statement that "arbitration is conducted by the arbitrators in a way that is fair to all parties" and 44% disagreed with the statement that arbitrators conduct the arbitration without bias).

23. *See id.* at 47 (finding that 75.55% of customers found arbitration to be "very unfair" or "somewhat unfair" when compared to civil litigation).

Second, FINRA states that the merger will "reduce unnecessary administrative burdens required to maintain separate legal entities."[24] FINRA specifically points to savings it will realize by eliminating the need to file separate tax filings, state registrations and annual reports, and eliminating a separate payroll entity. FINRA does not provide a cost/benefit analysis or otherwise quantify these savings, nor does it state what it will do with these savings. This past year, FINRA paid compensation and benefits of $652.5 million of which $12.5 million was paid to its top ten executives, had net income of $129 million, and distributed a $20 million discretionary rebate to firms.[25] FINRA makes no mention in the rule proposal of passing any of these savings on to investors or using the savings to make improvements to the dispute resolution forum.

FINRA also states in the rule proposal that the merger will not have any impact on corporate governance, because "[m]embers of the FINRA Board's Regulatory Policy Committee currently serve as the directors of both the FINRA Regulation and FINRA Dispute Resolution boards."[26] Again, the mere fact that FINRA has chosen not to operate the two entities as separate and distinct as originally intended is not a reason to eliminate the actual distinction. The two boards are in fact separate and need not contain the same members. The FINRA Board contains sufficient members so that the two entities can have different boards.

The cross-pollination of the boards of directors serves is yet another example of FINRA attempting to operate Dispute Resolution as an alter ego of Regulation, in contravention of the intent of the original rule filing in 1999. When Dispute Resolution was first formed, it was intended to have several board members who were not FINRA Board members, allowing for a board that would be wholly independent of Regulation.[27] However, in 2010, FINRA amended the Dispute Resolution By-Laws so that all of the directors on its board would be drawn from the FINRA Board.[28]

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24. *See* SEC Release No. 34-76082.

25. *See* 2014 FINRA Year in Review and Annual Financial Report, pp. 9, 22 and 31, available at http://www.finra.org/sites/default/files/2014_YIR_AFR.pdf.

26. *See* SEC Release No. 34-76082, pp. 5-8.

27. *See* SEC Release No. 34-41510.

28. *See* FINRA Regulatory Notice 10-32, "Dispute Resolution By-Laws; SEC Approves Amendments to FINRA Dispute Resolution By-Laws," July 2010, available at http://finra.complinet.com/net_file_store/new_rulebooks/r/e/RegulatoryNotice10_32.pdf.

For the foregoing reasons, PIABA respectfully requests that the SEC: (1) reject FINRA's rule proposal at this time; (2) require FINRA to resubmit the rule proposal with additional information provided concerning the justifications for the merger and detail regarding the purported cost savings; and, (3) extend the comment period to allow the public additional time to consider the impact of this or a subsequent proposed merger of FINRA Dispute Resolution into FINRA Regulation. Thank you for the opportunity to comment on such an important issue.

Respectfully submitted,
Hugh D. Berkson
PIABA President

The following PIABA Comment Letter regarding *NASAA's Proposed Model* was submitted to the North American Securities Arbitration Association by Hugh D. Berkson on October 29, 2015 (prepared with the assistance of Adam Nicolazzo and Darlene Pasieczny).

Mr. Christopher Staley, Counsel
NASAA Legal Department
750 First Street, NE, Suite 1140
Washington, DC 20002

Re: Request For Comments Regarding NASAA's Proposed Model Legislation or Regulation to Protect Vulnerable Adults from Financial Exploitation

Dear Mr. Staley:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by regulatory and self-regulatory securities authorities to govern the conduct of securities firms and their representatives. In particular, our members and their clients have a strong interest in rules relating to the protection of elderly and retired investors and the supervision of associated persons who serve these investors.

PIABA supports, but proposes certain important changes to, NASAA's current proposed Model Legislation or Regulation to Protect Vulnerable Adults from Financial Exploitation ("Model Act"), which seeks to promote a uniform standard that may be adopted by state regulators and other industry participants. The Model Act would define key terms, as well as provide for disclosure, permit delay of disbursements and provide immunity for such disclosure and delay of disbursements under certain circumstances.

The purpose of the Model Act is to protect senior-aged investors from financial exploitation, ideally with uniform parameters that all states will adopt for the sake of clarity. PIABA is generally supportive of the Model Act, because it properly establishes a bright-line definition of the population sought to be protected.

However, PIABA believes that the proposed Model Act does not go far enough to reach this aim of protection of senior-aged investors, because it does

not obligate action by the firm that should be reporting and does not create a penalty for willfully ignoring evidence of abuse.

There is a need for strong protection of the elderly investing population. With roughly one out of every five Americans 65 years and older being the victim of financial abuse,[1] the elderly are estimated to lose up to $2.9 billion per year from scams.[2] These figures are likely lower than the true figures since they only account for frauds that are reported, and seniors are "less likely" to report being scammed.[3]

Broker-dealers, Investment Advisors and registered persons are in the perfect position to recognize signs and symptoms of diminished capacity and dementia with respect to their clients' ability to handle their finances and prevent elder financial abuse.[4] Financial advisors may actually become aware of suspicious activity before family and friends.[5]

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A. The Model Act Permits, But Does Not Obligate, Disclosure and Action

The Model Act contains three key provisions where there should be an obligation, not merely permission, for a "qualified employee" to act when they have a reasonable belief that financial exploitation of an Eligible adult may have occurred or will occur. Section 3 of the Model Act properly requires that if a qualified employee has such a reasonable belief, that "the qualified employee shall promptly notify" the requisite governmental authorities.

On the other hand, Sections 5 and 7 of the Model Act merely permit action by the qualified employee or firm. See Section 5 (Third-Party Disclosure… a

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1. *See* E.S. Browning, *Financial Scammers Increasingly Target Elderly Americans*, WALL ST. J. (Dec. 23, 2013), http://www.wsj.com/articles/SB10001424052702303330204579248292834035108. This is the equivalent of more than seven million Americans. See INVESTOR PROTECTION TRUST, *Preventing Elder Investment Fraud*, http://www.investorprotection.org/protect-yourself/?fa=protect-seniors (last visited July 29, 2015).

2. Mason Braswell, *Unraveling Minds*, INVESTMENTNEWS, (Nov. 3, 2014).

3. FEDERAL BUREAU OF INVESTIGATION, *Fraud Target: Senior Citizens*, https://www.fbi.gov/scams-safety/fraud/seniors (last visited July 29, 2015).

4. *See* Naomi Karp & Ryan Wilson, Protecting Older Investors: The Challenge of Diminished Capacity, AARP PUBLIC POLICY INSTITUTE 17 (Nov. 2011), http://www.aarp.org/content/dam/aarp/research/public_policy_institute/cons_prot/2011/rr2011-04.pdf.

5. *Id*.

qualified employee may notify any third party [previously] designated…); Section 7(1) (Delaying Disbursements… [a] broker-dealer or, investment adviser may delay disbursement…). Since the proposed language already contemplates limiting the disclosure to third-parties previously designated by the eligible adult, and who are not themselves the suspected abuser, there is no reason why the disclosure should not also be mandatory.

NASAA would find support from forward-looking statutes that have already been enacted that seek to protect the elderly.

California

Since January 1, 2007, officers and employees of financial institutions have been mandatory reporters of suspected financial abuse of an elder or dependent adult, with "elder" defined simply as a California resident age 65 or older. Cal. Welf. & Inst. Code §§ 15610.27, 15630.1. If an incident known or observed by the mandatory reporter reasonably appears to be financial abuse, or triggers reasonable suspicion of abuse, he or she must report "the known or suspected instance of financial abuse by telephone or through a confidential Internet reporting tool, as authorized pursuant to Section 15658, immediately, or as soon as practicably possible. If reported by telephone, a written report shall be sent, or an Internet report shall be made through the confidential Internet reporting tool established in Section 15658, within two working days to the local adult protective services agency or the local law enforcement agency." *Id.* at § 15630.1(d)(1). Reports of suspected financial abuse of the elder or dependent adult qualify as a "privileged publication or broadcast" under Cal. Civ. Code § 47(b). The mandated reporter is protected from civil and criminal liability with respect to the report. Cal. Welf. & Inst. Code § 15634. Interestingly, *nonmandated* reporters who report the abuse in the same manner as the mandated are also protected from liability, unless it can be proven that the report was knowingly false. Cal. Welf. & Inst. Code §§ 15631, 15634.

The California law is limited in some important respects. "Financial institutions" are specifically defined to include national banks, savings and loans, state banks and trust companies whose deposits are not limited solely to funds held in a fiduciary capacity, and federal or state credit unions. *Id.* at § 15630.1(b). Thus, while the California provisions appear to give parallel required reporting requirements as the Model Act, they exclude broker-dealers and investment advisors not otherwise falling under the definition of "financial institutions". Another gap in the California law is that the obligation to report may apply only if the employee or officer's knowledge or observation arises

in connection with providing financial services with respect to the elder, and within the scope of the reporter's employment or professional practice, with a direct relation between the potential abuse and the transaction or matter within that scope. *Id.* at § 15630.1(d). PIABA applauds the Model Act for specifically applying to broker-dealers and investment advisors, and for not limiting the reporting requirement to such narrow circumstances.

Washington State

Other states specifically include broker-dealers in the statutory scheme but are limited by being permissive rather than mandatory for reporting. Effective since June, 2010, Washington has a permissive statutory scheme that allows (but does not require) financial institutions to refuse a transaction requiring disbursal of funds in the account of a "vulnerable adult" if it reasonably believes financial exploitation occurred, was attempted, or is being attempted. Wash. Rev. Code Ann. § 74.34.215. For purposes of Chapter 74.34 only, "financial institution" is defined to also include broker-dealers and investment advisers. §74.34.020(8). *If* the financial institution chooses to halt the disbursal of funds under the statute, then it "shall" make a reasonable effort to notify all parties authorized to transact on the account and "shall" report the incident to adult protective services and local law enforcement. *Id.* at § 74.34.215(4). Absent a court order extending the time period, the ability for the institution to refuse to disburse funds expires after either 5 days or 10 days (if involving the sale or offer to sell a security). Id. at § 74.34.215(5), (6). So long as the refusal was made in good faith, the financial institution or its employee following the statutory scheme is immune from criminal, civil, or administrative liability. *Id.* at § 74.34.215(7). Thus, while Washington's law is permissive, once a firm elects to halt a disbursement it must notify all persons on the account in addition to APS and law enforcement.

Missouri Senate Bill 244

In June, 2015, Missouri enacted a law providing immunity from civil liability and authorizing broker-dealers to refuse a disbursement request from the account of an adult age 60 or older (or of a disabled adult), when the broker-dealer reasonably suspects financial exploitation. Missouri Senate Bill 244. The new Missouri law is permissive: the firm "may" refuse a disbursement request and it "may" notify the department of health and senior services and the commissioner of securities where there is a reasonable belief financial

exploitation has occurred, was attempted, or is being attempted.. It also permits (but does not require) the firm to notify "an immediate family member, legal guardian, conservator, co-trustee, successor trustee, or agent under a power of attorney" of the elder or disabled adult. Like the Washington statute, if the firm refuses a disbursement, it must make a reasonable effort within two business days to notify all parties on the account and must notify the agencies within three days.

B. The Model Act Does Not Institute a Penalty for Willfully Ignoring Evidence of Abuse

In order to enforce the obligations that should be created by the Model Act, there should be inclusion of a penalty. Already built it would be a waiver of indemnity; if the broker-dealer or investment advisor fails to comply with their affirmative obligations, they could not claim the protections of immunity.

The Model Act would also establish a duty to act, so it should be made clear that a private right of action would exist, within the respective statutes of limitation set by each implementing jurisdiction.

California does not require the officer or employee of the financial institution to investigate accusations of abuse. Cal. Welf. & Inst. Code § 15630.1(e). However, failure to report what reasonably appears to be abuse or when reasonable suspicion is triggered and thus reporting mandated "shall be subject to" civil penalties of $1,000 (or $5,000 if the failure to report is "willful"). *Id.* at § 15630.1(f). With this civil penalty California gives some enforcement mechanism to its reporting requirements, and PIABA encourages the Model Act to include a similar penalty for failure to report.

C. In Many States, Other Professionals are Mandatory Reporters of Elder Financial Abuse, and Brokers and Investment Advisors Should Be Included

Recognizing that professionals in frequent contact with elders are in positions to spot financial abuse, in many states various medical, mental health, religious, social service, law enforcement, and nursing home providers are already mandatory reporter of suspected financial abuse of elders (and even more mandate reporting of suspected abuse of "vulnerable" or incapacitated persons). For example, beginning January 1, 2015, attorneys licensed in Oregon became mandatory reporters of elder (age 65 and above) financial exploitation as defined in Or. Rev. Statutes 124.050(4). With certain

exceptions for attorney-client privileged information, the law requires a lawyer to report elder abuse when he or she has "reasonable cause" to believe the abuse has occurred, and the lawyer has had contact with the elder or the alleged abuser. See Or. Rev. Statutes 124.060. This mandatory reporting applies to lawyers at all times, and is not limited to the scope of providing professional services.

Likewise, doctors, lawyers and accountants in Arizona are required to report exploitation of a vulnerable adult immediately in person or by telephone, with a written report to follow within forty-eight hours. Ariz. Rev. Stat. § 46-454. A "vulnerable adult" is defined as "an individual who is eighteen years of age or older and who is unable to protect himself from abuse, neglect or exploitation by others because of a physical or mental impairment, while "exploitation" is defined as "the illegal or improper use of a vulnerable adult or his resources for another's profit or advantage." *Id.* at § 46-451.

Brokers and investment advisors are in an especially close position to spot potential financial exploitation of an elder, and should have no less than the same mandatory reporting requirements as other professionals.

In summary, PIABA applauds and supports NASAA's efforts to promote a model rule to protect seniors from financial abuse. We are concerned, however, that the permissive nature of the model rule and the lack of a penalty for compliance with the rule, will undercut the rule's value and leave vulnerable seniors subject to ongoing financial abuse. Accordingly, we ask that NASAA amend the proposed Model Act to address these issues. PIABA thanks you for the opportunity to comment on this important topic.

Very truly yours,
Hugh D. Berkson
PIABA, President

cc: Lynne Egan (MT), Chair, Senior Issues/Diminished Capacity Committee (via email at legan@mt.gov),

Patricia Struck (WI), Vice-Chair, Senior Issues/Diminished Capacity Committee (via email at patricia.struck@dfi.wisconsin.gov)

Joe Brady, NASAA Executive Director (jb@nasaa.org)

The following PIABA Comment Letter regarding the *Proposed Rule Change pursuant to SR-FINRA-2015-032* was submitted to Securities and Exchange Commission by Joseph Peiffer on October 19, 2015 (prepared with the assistance of Darlene Pasieczny and William Young, Jr.).

Robert W. Errett
Deputy Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: SR-FINRA-2015-032 Proposed Rule Change to Amend FINRA Rule 8312 (FINRA BrokerCheck Disclosure) to Reduce the Waiting Period for the Release of Information Reported on Form U5

Dear Mr. Errett:

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

PIABA continues to support and applauds any effort, on the part of FINRA, to make BrokerCheck more transparent and accessible for investors. PIABA supports the proposed rule as being in the best interest of the investing public. However the current proposal reducing the waiting period for the release of information reported on Form U5s, while well-intentioned, lacks substantive changes. FINRA must also address and correct a system that allows, for instance, the routine expungement of customer claims from the Broker Check system and fails to include critical CRD information in the first place. That is the type of meaningful change PIABA believes is necessary to show FINRA's commitment to making the BrokerCheck system a primary source of critical information for the public investor.

Background

Pursuant to Section 19(b) of Securities Exchange Act of 1934, before becoming effective, a proposed rule must be authorized for filing by the Board of Governors and must be filed with the Securities and Exchange Commission ("SEC") after a mandatory comment period. As such, FINRA is seeking comment on a revised proposed rule. FINRA has solicited prior comments relative to the BrokerCheck system, most recently in June 2014 and August 2015 (SR-FINRA-2014-19 and SR-FINRA-2015-022, respectively). PIABA submitted comment letters during both comment periods.

Comments

As was the case with prior comment letters, in general PIABA supports the proposed rule because the Association feels strongly that public investors would benefit from shortening the waiting period for releasing mandatory U5 disclosures. However, as was also the case with respect to the prior proposals, the limited scope of information currently provided to the public through BrokerCheck remains a concern. FINRA has not taken any steps to expand the information and make it more comprehensive. The information in BrokerCheck is derived from the Central Registration Depository (the "CRD"). However, BrokerCheck does not make most of the information contained within the CRD available to the investing public. There are significant gaps in the information available to investors in certain states if they request a CRD Snapshot from their state securities regulator compared with what would be available through BrokerCheck.

BrokerCheck continues to exclude critical information relating to reasons for a broker's termination and a firm's internal investigations. BrokerCheck does not disclose tax liens or bankruptcies if they occurred more than 10 years ago. BrokerCheck does not disclose how many times a registered person has taken an exam, or how many times they have failed it. This information is not uniformly available from state securities regulators due to variations in state public records laws. Also, unlike BrokerCheck where the information is provided instantaneously and for free, legacy CRD Snapshot reports requested from some states cost consumers money; must be requested either by telephone, by email, or through the state securities regulator's website; and may not be delivered for hours or days after the request. To avoid investor confusion and make disclosures consistent in all states, FINRA should make available through BrokerCheck this more comprehensive CRD disclosure information.

FINRA has taken the position publicly that BrokerCheck reduces the search costs for investors associated with acquiring valuable information about firms and registered persons. However, that is true only if the search done through BrokerCheck eliminates the need for further research. Currently it does not. For an investor to be truly informed under the current system, they must still contact their state securities regulator to ensure that BrokerCheck has not left out critical information about the firm or registered person they will often be trusting with their life savings and future livelihood. FINRA's description of BrokerCheck is conspicuously absent of a warning that a full picture of a broker's history can be achieved only if an investor checks with state regulators as well.

Conclusion

In summary, while PIABA supports the proposed rule as being a positive step and in the best interest of the investing public, PIABA feels strongly that FINRA must also address and correct the present system that allows for the routine expungement of customer claims from the BrokerCheck system. The BrokerCheck system must also include the important information that is currently only available through certain, but not all, state legacy CRD systems. Those are the type of meaningful substantive changes PIABA believes are necessary to show FINRA's commitment to making the BrokerCheck system a primary source of critical information for the public investor. PIABA thanks FINRA for the opportunity to comment on this proposal.

Very truly yours,
Joseph C. Peiffer
PIABA, President

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The following PIABA Comment Letter regarding *RIN 1210-AB32* was submitted to the Employee Benefits Security Administration by Joseph Peiffer on September 24, 2015 (prepared with the assistance of Christine Lazaro).

Office of Regulations and Interpretations
Employee Benefits Security Administration
Attn: Conflicts of Interest Rule
Room N-5655
U.S. Department of Labor
200 Constitution Avenue NW
Washington, DC 20210

Re: RIN 1210-AB32: Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice

To Whom It May Concern:

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

The Department of Labor (the "Department") has solicited comment on whether it should replace its 1975 regulations with a new definition of fiduciary investment advice. PIABA submits this second comment to supplement our initial comment and to address certain objections raised with respect to the Department's proposed rulemaking.

As with our original comment letter, this letter will primarily focus on the delivery of investment advice to retail investors and those contemplating whether they should roll over their employer sponsored retirement plans into IRAs. Members of PIABA represent investors who have received flawed investment advice from brokers and investment advisers, frequently in connection with their retirement savings. Our members have represented tens of thousands of investors who have been harmed by conflicted investment advice, which is often subject to FINRA's suitability standard. These investors will continue to be harmed by this conflicted advice, and forced to determine

the impact of the conflicts themselves, if changes are not made to the standards governing those who provide advice to retirees.

Throughout this process, it has been argued that the Department should wait for the SEC to adopt its fiduciary standard first. But that argument is flawed for a variety of reasons. First, the SEC has not yet given any indication it is even going to adopt a fiduciary standard. It has been studying the issue since Dodd-Frank was adopted in 2010, yet has not taken any steps to issue its own proposed rule. To suggest that the SEC is on the verge of proposing a rule which would impose a fiduciary standard on brokers does not recognize the reality that currently exists. Second, the Department is a separate entity with its own regulatory agenda. It is an agency separate and distinct from the SEC. Nothing in the statutory language of ERISA suggests that the Department should operate in a subordinate capacity to the SEC, or that the SEC has superior regulatory authority over the brokerage industry. The Department has been tasked with enforcing ERISA in the same manner the SEC has been tasked with enforcing aspects of the Securities Act of 1933 and the Securities Exchange Act of 1934. One does not preempt the other from acting.

Representatives of the securities industry have also set forth the "too many cooks in the kitchen" argument, claiming that adding another regulator with oversight over the industry will only serve to confuse those who try to sell investment products to retirees. This argument ignores the fact that the Department already oversees ERISA enforcement. Further, it the brokerage industry is a complex industry, and depending on the type of business it is engaged in, the industry may be subject to the oversight of the CFTC, the NFA, the MSRB, the Treasury, as well as every state securities and insurance regulator. Obviously, given the critical nature of the securities markets, close oversight is warranted. The industry has figured out how to work within these constraints. To argue that it will be overly burdensome to add the Department to the list of regulators is just not credible.

It has also been argued that adding a new standard of conduct that would only be applicable to retirement accounts may confuse investors. The proponents of the argument continue, claiming it would be better to leave brokers subject to the lesser suitability standard until the SEC adopts a standard which would be applicable to all investment accounts. As discussed above, the SEC has not indicated that it intends to adopt a uniform fiduciary standard at this time.

Moreover, under the current regulatory structure, investors are already confused about what standard governs their financial advisor. An investor may have a discretionary account with the financial advisor, which will require that the financial advisor act as a fiduciary. That same investor may also have an advisory account with the same financial advisor, which will require that the

financial advisor act as a fiduciary. The investor may have a third account, a commission-based brokerage account, which will allow that same financial advisor to act under the suitability standard. Under the current regulatory structure, investors are faced with varying standards covering the same financial advisor depending on the hat that person may be wearing at any given point in time. One must also consider the fact that some states impose a strong fiduciary duty upon financial advisors, regardless of which hat the advisors may be wearing. Neither FINRA nor the industry have been concerned that the investor may be "confused" under the current regulatory regime or eager to address the confusion.

In fact, the industry's conduct feeds into the confusion. Individuals with whom customers are interacting are calling themselves, "Financial Advisor," "Wealth Management Specialist," and "Vice-President of Investments," furthering investor confusion. Brokers do not call themselves "brokers" or "salespersons." More than three out of four investors don't understand that the current laws and rules may impose different duties on brokers and investment advisers, according to a 2010 survey conducted for the Consumer Federation of America (CFA), AARP, the Investment Adviser Association, the Financial Planning Association, the CFP Board, the North American Securities Administrators Association (NASAA), and the National Association of Personal Financial Advisors.[1] A 2015 study confirmed that most retail investors think their financial advisor – regardless of which type of advisor it is – is a fiduciary.[2] The industry is well-aware of the confusion. In a survey open to all brokers, investment advisers, and insurance consultants and producers, 97 percent of them said "investors don't understand the differences between brokers and investment advisers."[3] This confusion will be addressed

1. *See* Infogroup/ORC, "U.S. Investors & The Fiduciary Standard: A National Opinion Survey," September 15, 2010, available at http://www.cfp.net/docs/public-policy/us_investors_opinion_survey_2010-09-16.pdf?sfvrsn=2.

2. *See* Spectrem Group, "Fiduciary – Do Investors Know What It Means," 2015, available at http://349ab54c3b58919c6638-ff70f51d4942f2bbd11ba0e41cfec577.r51.cf2.rackcdn.com/Fiduciary%20Whitepaper.pdf

3. *See* "Trustworthy Advice and Individual Investors: Will Regulators Act in Investors' Best Interest?" issued in August 2013 to report the findings of the 2013 fi360-ThinkAdvisor Fiduciary Survey, available at http://www.fi360.com/uploads/media/fiduciarysurvey_resultsreport_2013.pdf; see also "Seeking Trustworthy Advice for Individual Investors – Financial Intermediaries Indicate Strong Support for Fiduciary Standard" issued in February 2015 to report the findings of the 2015 fi360 Fiduciary Standard Survey, available at http://www.fi360.com/uploads/media/2015fiduciarysurvey.pdf; and "Fiduciary Duty and Investment Advice: Attitudes of

to some degree by requiring financial advisors to conform to the standard to which investors believe they are already held. The Department's rule proposal is the first step in that direction.

PIABA agrees it would be ideal to have brokers held to a fiduciary standard when handling every account; however, the fact that the Department's rule proposal only reaches retirement savings is not a reason to reject the rule. Retirement savings are an important place to begin because this is the money that is meant to provide for individuals as they age and can no longer work. If this money is lost, is it more difficult to replace. FINRA itself has pointed out that retirement is a key liquidity event and transactions involving retirement money are deserving of special scrutiny:

> These events may heighten conflicts of interest because of the large sums of money that may be involved. When an individual changes jobs or retires, she must decide what to do with her 401(k) account—leave it in place, roll it over to a new employer's plan or roll it into an individual retirement account (IRA). Firms have a strong incentive to gather assets, and as a recent Government Accountability Office report noted, "(r)ollovers have become the largest source of contributions to IRAs." It is not always clear, however, that rolling over a 401(k) to an IRA—as opposed to keeping money within the plan or rolling it over to a new employer's plan—is the best option for an investor. The recommendations a representative makes at these points in time may have profound implications for the investor and deserve thorough scrutiny and review.[4]

As FINRA has recognized, retirement may free up large sums of money for a retiree and may heighten conflicts of interest between the customer and the financial advisor. Because of these heightened conflicts, a broker should have a higher duty when handling this money and providing advice with respect to these accounts. Unfortunately, the current system does not effectively manage the conflicts present when a broker gives advice to a retirement investor. FINRA's suitability rule falls short when it comes to protecting individuals as the following stories illustrate:

401(k) and 403(b) Participants," a report published by the AARP in September 2013 (majority of participants concerned investment advice by plan providers not held to fiduciary standard). All related documents available at http://www.aarp.org/research/topics/economics/info-2014/fiduciary-duty-and-investment-advice---attitudes-of-401-k--and-4.html.

4. FINRA Report on Conflicts of Interest, October 2013, available at https://www.finra.org/sites/default/files/Industry/p359971.pdf.

- *George and Phyllis both worked for a large manufacturing company. After working most of their adult lives for the same company, they decided to retire early after meeting broker Bob. Bob told them they could take the early retirement option in a lump sum payout and if they invested it with him, they would receive far more money every month than if they opted for the guaranteed pension benefit (which also provided them with medical insurance). George and Phyllis rolled over almost a half million dollars to Bob, agreeing to let him manage their retirement. He ended up investing them in risky mutual funds, and in two and a half years, Bob lost half their money.*
- *Perry was a machinist for two major manufacturing companies. He retired after meeting his broker, Charlie. Charlie convinced Perry that he would earn enough from his investments that he would not have to work. Charlie invested Perry's retirement savings in a number of different securities, including stocks, variable annuities and a ponzi scheme. Perry has since returned to work, teaching part-time. Charlie also handled Walter and Kaye's retirement accounts. Walter was a mechanic and Kaye was an office assistant. They counted on Charlie to help them manage their retirement savings as well. Like Perry, Charlie invested their retirement funds in speculative stocks and the same ponzi scheme.*
- *Mary was a bus driver. She received disability payments following a bout of lung cancer, but at the time, was still working as a bus driver. Broker Sam told her that if she died while on the job, her daughter would not receive any death benefits. He told Mary that if she retired and turned her pension over to him, he could earn her much more than her pension would pay her, and her daughter would receive the principal of the estate on her death. Sam showed her income plans demonstrating how much she would receive each month, but the hypothetical projections utilized unrealistic returns. Mary retired and turned her pension over to Sam, believing he was going to provide for her. She withdrew her living expenses from her account, believing she could based on the projections Sam had provided to her. Unfortunately, the account performance did not meet the projections, and the withdrawals severely depleted the accounts. Mary can barely pay her mortgage.*
- *Harry and Joyce met Steve at a retirement planning seminar. Harry was a cable splicer and Joyce was a secretary. As Harry approached retirement, Steve convinced Harry to sign away his*

> *pension and roll over his 401(k) into an IRA so that Steve could manage it. A year later, Joyce followed suit and rolled over her retirement savings to Steve. Steve told them he would invest the money safely and ensure that they could withdraw approximately 10% each year. In reality, he invested the accounts aggressively, and in a short period of time, they lost almost half the value of the two accounts. Larry worked for the same company as Harry and Joyce and met Steve at about the same time Harry began investing. Steve provided Larry with a retirement projection, showing that he could receive returns of 10 to 12% per year. Steve's presentation and the retirement projection induced Larry to retire early, sign away his pension as Harry had done, and turn over his million dollars in retirement savings to Steve to manage. Here too, Steve invested Larry's retirement funds aggressively, and in a short period of time, he had lost more than half his retirement funds. George worked for the same company. He and his wife, Barbara, also met Steve at a retirement planning seminar that he had hosted. After being offered an early retirement package, George sought Steve's advice. He convinced George that he had more than enough savings to retire if Steve could manage it as a rollover IRA. George retired, signed away his pension, and rolled over his retirement savings to Steve to manage. Shortly thereafter, Barbara transferred her IRA to Steve to manage as well. Steve invested George and Barbara's retirement savings in aggressive mutual funds, in an attempt to generate the income he promised they could receive each month. In two short years, they had lost half of their original investment.*

In each of these cases, the financial advisor encouraged his client to retire and cash out a pension so that it could be rolled over into an IRA. Absent those retirements, the financial advisor would not have any money to invest, and would not earn any money from his client. The suitability rule did not prevent the financial advisors from convincing their clients from cashing out their pensions and rolling their retirement funds over into IRAs so that the financial advisors would have access to the money. In each case, the clients would have been better served had they left their money with their company sponsored pension plans. However, their trust was betrayed by advisors they believed were acting in their best interests. None of these investors understood that the financial advisors were acting under a suitability standard, that conflicts of interest affected the advice to buy certain products, or even that the advice to roll over the retirement money in the first place was impacted by a conflict of

interest. They thought they were getting assistance from financial professionals regarding their retirement options.

As FINRA itself points out, IRAs are primarily funded by rollovers:

Rollovers from employer-sponsored retirement plans are the largest source of contributions to IRAs. A June 2013 Employee Benefits Research Institute report states that in 2011, assets rolled over into IRAs were almost 13 times the amount of direct contributions. This is not a new trend; ICI data indicates that from 1996 to 2008 more than 90 percent of funds flowing into traditional IRAs came from rollovers, primarily from plans. In 2013, 49 percent of the traditional IRAs held by U.S. households included rollover funds.[5]

The suitability rule may or may not govern the financial advisor's recommendation that an individual cash out a pension and roll that money into an IRA. According to FINRA:

A recommendation concerning the type of retirement account in which a customer should hold his retirement investments typically involves a recommended securities transaction, and thus is subject to Rule 2111. For example, a firm may recommend that an investor sell his plan assets and roll over the cash proceeds into an IRA. Recommendations to sell securities in the plan or to purchase securities for a newly opened IRA are subject to Rule 2111.[6]

There is ambiguity here. While the rule clearly applies to purchases and sales of securities, it does not address the advice preceding the opening of the IRA account in which the trading takes place. It does not clearly address the underlying recommendation to close a 401K or other retirement account and roll the funds into an IRA. This critical gap in regulation must be addressed. The gap leads, time and time again, to disastrous results for retiring investors, who must be protected and it is clear that the current regulations are not doing so.

Based on the number of assets being rolled into IRAs each year, it is obvious that financial advisors are not fully weighing the factors set forth by FINRA[7] when analyzing whether it is appropriate for an individual to roll over assets from an employer's plan. FINRA expects firms to maintain a commitment to high ethical standards and to putting customers' interests first

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5. FINRA Regulatory Notice 13-45, "Rollovers to Individual Retirement Accounts, FINRA Reminds Firms of Their Responsibilities Concerning IRA Rollovers," December 2013, available at http://www.finra.org/sites/default/files/Notice Document/p418695.pdf. (Internal citations omitted.)

6. *Id.*

7. *See* FINRA Regulatory Notice 13-45, pp. 2-3.

as a means of managing conflicts of interest.[8] However, as demonstrated by the conduct outlined above, expectation of a commitment to ethical standards is not enough to protect investors. More must be done. These conflicts must be eliminated to protect investors, rather than continuing to rely on the firms to manage them.

Moreover the FINRA rules do not cover insurance brokers. Not every transaction involves securities.

- *Mike had been a fire marshal and had participated in the State Public Employees Retirement System (PERS). He asked his insurance company for a broker to review his life insurance policy. He ended up being assigned to Larry, who, on his own initiative, created a financial plan for Mike and his wife, Jen. Larry recommended that Mike take a lump sum distribution of his PERS money and roll it into an IRA annuity. About four months later, Larry recommended that Mike withdraw almost half the funds from the IRA annuity and purchase two non-IRA annuities, one each for Mike and Jen. Four months later, Larry recommended Mike withdraw half the remaining value of the IRA annuity and deposit the funds in the non-IRA annuities. As a result of the withdrawals from the IRA annuity, Mike incurred significant tax penalties because he had not yet reached age 59 ½. He also incurred significant withdrawal charges by taking money from the IRA annuity so soon after the purchase. Mike lost over 40% of his retirement money due to the tax implications of the transactions and the surrender charges. Mike also lost his pension.*

Fixed annuities are not considered securities – they are considered life insurance products. Thus, while they are undoubtedly investment products, they escape regulation from the SEC and other securities regulators. While neither the SEC nor FINRA can or will step up and forbid the sort of conduct that destroyed Mike and Jen's retirement savings, the Department's rulemaking will address the gap in regulation and ensure that all advice to retirement investors is treated equally and that investors receive the same level of protection.

The Department's rule proposal must be enacted to protect retirement investors. PIABA supports the scope of the proposal to cover all retirement accounts, especially advice directed towards IRAs and rollovers considering the heighted conflicts such advice triggers.

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8. *See* FINRA Report on Conflicts of Interest, p. 2.

The Best Interest Contract Exemption and its timing

The Best Interest Contract Exemption allows brokers to engage in what would otherwise be prohibited transactions so long as they enter into a contract with retirement investors and agree to certain parameters on the relationship which are intended to protect these investors. For the reasons set forth in our original comment letter, PIABA is very supportive of the best interest contract exemption. It is essential that financial advisors acknowledge their fiduciary status under either ERISA or the Code with respect to any recommendation to a retirement investor to purchase, sell or hold an asset.

Arguments have been raised during the comment period that there should be a distinction between selling and advising; however, PIABA disagrees. The definition of recommendation, as set forth by FINRA, has been made clear over time. To the extent the interaction between a retirement investor and a financial advisor is an advisory relationship, and involves an otherwise prohibited transaction, the financial advisor should be required to use the Best Interest Contract Exemption. There is no need to expand any other exemption to cover the relationship. In that context, the financial advisor will not be acting as a seller.

This distinction is important for another reason. It is important that the relationship be memorialized in a contract which is fully enforceable by the investor. As described in our prior comment letter, financial advisors are currently subject to fiduciary standards under state law in a number of states. Courts in at least ten percent of the states across the country have recognized that the broker – customer relationship is a fiduciary relationship in all instances,[9] and courts in other states have recognized a fiduciary relationship when special circumstances exist, such as when the client is naïve with regard to financial matters.[10] Notwithstanding this case law, brokerage firms routinely disclaim any fiduciary relationship, taking the position that the financial advisor was acting solely at the direction of the customer, executing the transactions the customer demanded. The financial advisor and the firm take no responsibility for their role in advising the customer, beyond complying with the bare minimum requirements of the suitability rule. The brokerage industry has relied on the distinction between "selling" and "advising" for decades, arguing that they have been paid to execute transactions - for their services related to selling securities rather than for providing advice. The

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9. *See*, e.g. California, Georgia, Florida, Missouri, Puerto Rico, South Carolina, and South Dakota.

10. *See*, e.g. Massachusetts, Michigan, New York, Utah, and West Virginia.

industry ignores that the sales would not take place but for its representatives advising clients to buy or sell certain products. It is time for the illusory distinction between selling and advising to end.

Certain objections have been made with respect to the timing of the signing of the contract as currently contemplated by the proposed rule. PIABA does not object to adjusting the timing of the delivery of the Best Interest Contract, and requiring that it be signed once it agreed that the customer will do business with the financial advisor. However, the terms of the rule should make it clear that the financial advisor will be bound by the terms of the Best Interest Contract prior to its signing and may not engage in any prohibited conduct even prior to a customer signing the agreement.

As outlined in its initial comment letter, PIABA continues to support the prohibition of sales of certain types of securities to retirement accounts. There are a number of types of securities that are not appropriate investment options for retirement accounts, especially when sold by financial advisors given the conflicts of interest present. PIABA hopes the Department will continue to prohibit certain transactions in retirement accounts as outlined in the original rule proposal. In particular, PIABA urges the Department to ensure that annuities be prohibited in retirement accounts. The vast majority of annuities (be they fixed or variable) offer a single benefit: tax deferral. Those annuities are typically ridden with exceptionally high fees and surrender charges. Given that retirement accounts are, by their nature, tax deferred, the principal annuity benefit of tax deferral is redundant and there is no justification to saddle retirees with the costs and fees associated with these products.

Several commenters have suggested that adoption of the Best Interest Contract will eliminate options for smaller retirement savers. The industry has indicated its members may opt to migrate its IRA business from transaction based accounts to fee based accounts.[11] However, to do so would be wholly inappropriate. Such advice would itself violate the best interest rule and is simply a threat to replace one conflict with another:

Conflicts also may arise in recommending the type of account that a customer should open with a firm. A firm that is dually registered as a broker-dealer and an investment adviser should consider whether a commission-based or fee-based account is more appropriate for a customer. Many variables, including a customer's desire for ongoing advice and portfolio management, may affect the decision. Depending on the circumstances, fee-based accounts may be preferable for customers with a fair amount of trading activity or the

11. *See*, Testimony of Kenneth E. Bentsen, Jr., President and CEO, Securities and Financial Markets Assoc., August 10, 2015, available at http://www.dol.gov/ebsa/pdf/1210-AB32-2-HearingTranscript1.pdf.

desire for active account monitoring and ongoing advice. Commission-based accounts may be more cost-effective or appropriate for customers with low trading activity.[12]

This threat also fails to take into account the variety of fee based alternatives that exist. In addition to an asset-based fee, a firm may charge a one-time or periodic fixed fee for advice. As set forth during her testimony, Sheryl Garrett, Founder and President of Garrett Planning Network, Inc., outlined a number of different fee arrangements available to customers of financial advisors within her network.[13]

Several commenters suggested that investors should just receive greater disclosure. For example, Fidelity suggested replacing the Best Interest Contract with a three point disclosure that provides information about the scope of an advisor's services, the compensation payable to the advisor for the types of investment options the advisor might recommend, as well as any other material conflicts of interest, and a link to a website where an investor may obtain more detailed information about the cost of and compensation to related to any recommended investments.[14] Fidelity's suggestion ignores the fundamental nature of a client's relationship with his or her broker: one of trust. Clients do not believe they have to negotiate with their brokers to receive solid advice, nor do they think their brokers are trying to squeeze every last bit of compensation from their accounts. Simply put, clients do not think their brokers are lying to them and that it is the client's job to find the lies. PIABA does not believe that Fidelity's suggested disclosures are the right solution to the problems investors face today.

Providing greater disclosure does not appropriately mitigate the conflicts of interest inherent in the relationship between financial advisors and customers. It places the burden on the customers to fully understand the impact of those conflicts on the future of their retirement savings. However, the financial advisors have held themselves out to be professionals, to offer guidance to investors on important, life decisions. They should accept the responsibility that comes with the profession and with the trust they have sought to earn by managing the life savings of an individual.

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12. FINRA Report on Conflicts of Interest, p. 29.

13. *See*, Testimony of Sheryl Garrett, Founder and President of Garrett Planning Network, Inc., August 11, 2015, available at http://www.dol.gov/ebsa/pdf/1210-AB32-2-HearingTranscript2.pdf.

14. *See*, Testimony of Ralph Derbyshire, Senior Vice President and Deputy General Counsel of Fidelity Investments, August 11, 2015, available at http://www.dol.gov/ebsa/pdf/1210-AB32-2-HearingTranscript2.pdf.

Conclusion

PIABA thanks the Department of Labor for the opportunity to comment on this important rulemaking. We are hopeful that this opportunity to protect investors will not pass without action. If we can offer any further information, please feel free to contact us.

Very truly yours,
Joseph C. Peiffer
PIABA, President