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DEVELOPING A SECURITIES CASE AGAINST AN ONLINE BROKER-DEALER

Jeffrey P. Coleman and Jennifer Newsom[1]

The emergence of online broker-dealers is a phenomenon that was made possible by the internet. Discount broker/dealers came of age in the 1970's. With the advent of the internet, discount broker-dealers expanded their execution and custody services via the internet. It allowed discount firms to offer their services virtually exclusively through an internet platform. Anyone with a computer and an internet connection could have access to a range of research, execution, and custody services.

Online broker-dealers aggressively seek out new customers by touting the ease by which the investing public can open accounts, execute trades, access research materials, and even access support from representatives, all at a lower cost compared to more traditional broker-dealers. They emphasize, in their advertisements, that these self-directed accounts put the investor in control, implicitly suggesting that the public customer on the receiving end of these advertisements is well-qualified to select investments and strategies. Online firms have also successfully marketed their services to registered investment advisors and other third parties with authority to trade a customer's account. This approach has proved profitable. For example, a press release by TD Ameritrade reported its results for fiscal year 2015 as a year of "record earnings," the "seventh consecutive year of double-digit asset gathering," and "record average client trades per day of approximately 462,000 . . . ."[2]

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2. Press Release, TD Ameritrade Reports Record 2015 Earnings; Seventh Consecutive Year of Double-Digit Asset Gathering (Oct. 27, 2015), *available at* http://www.amtd.com/newsroom/press-releases/press-release-details/2015/TD-Ameritrade-Reports-Record-2015-Earnings-Seventh-Consecutive-Year-of-Double-Digit-Asset-gathering/default.aspx.

Easier access to trading and research can often result in irrational or excessive trading, the use of margin, or trading in options by the account owner or third party with authority to trade the account.[3] A common scenario involves a customer's grant of trading authority to a relative or an independent, sometimes unregistered, investment advisor. When pursuing recoveries for the resulting account losses from online firms, the firms usually provide a "no duty" answer in reliance on (i) the necessity of a "recommendation" by the firm or one of its associated persons for application of FINRA Rule 2111, the Suitability Rule[4] and (ii) exculpatory language in its customer agreements, including hold harmless and indemnification provisions. With a focus on online firms, this article will address the use of certain FINRA Rules as gateways to liability, some possible legal theories of liability, and the inapplicability of waiver or hold harmless provisions in customer agreements.[5] It is, of course, not intended as an exhaustive discussion of the foregoing three topics or a survey of the status of the law in the many jurisdictions in which PIABA members practice.

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3. *See* Douglas J. Schulz, *Swimming Naked When the Tide Goes Out Naked/Short Options*, 20 PIABA B.J. 75 (2013).

4. The components of the "Suitability Rule" were well addressed in a prior PIABA Bar Journal. *See* Seth E. Lipner, *Triple Play! FINRA's New Rules on Suitability, Communication and Supervision Analyzed*, 22 PIABA B.J. 141 (2015). Even though the Rule has been expanded to include recommended *investment* strategies, the Rule seems unlikely to come into play in filing claims against online firms where the customer has no communication with the firm or its representatives. *See* FINRA, RULE 2111.03 (2012). *But cf.* NASD, NOTICE TO MEMBERS 01-23 (2001), *Online Suitability*, 2001 WL 278614 (Mar. 19, 2001) (including as example of "recommendation," emails to customers urging purchases from a list of stocks with "buy" recommendations); Lewis E. Antone, Jr., FINRA Interpretive Letter to Name Not Public (May 18, 1993), *available at* http://www.finra.org/industry/interpretive-letters/may-18-1993-1200am (concluding "[t]he fact that an options account is opened through a discount broker/dealer on an unsolicited basis would not necessarily be an absolute protection against responsibility for the suitability of the securities in the account, without an analysis of the surrounding facts and circumstances").

5. For an earlier article addressing how to develop a case against an online, discount broker-dealer utilizing NYSE, RULE 405 (2008) (now, FINRA, RULE 2090 (2012)); NASD, RULE 3010 (2005); and the principles of account supervision, *see* Mark A. Tepper, *The Rules are Not Discounted for the Discounter*, 14 PIABA B.J. 51 (2007).

I. USING FINRA RULES IN CLAIMS AGAINST ONLINE BROKER-DEALERS

The rules of self-regulatory organizations ("SROs"), such as FINRA, (i) establish a minimum standard of care for all broker-dealers, (ii) are incorporated by reference in some Blue Sky Laws or administrative rules promulgated under them, and (iii) may be incorporated by reference in customer agreements of some broker-dealers. As a result, their violation can bolster a claim of (i) negligence or aiding breach of fiduciary duty, (ii) a claim for aiding violation of Blue Sky Laws, or (iii) a claim for breach of contract as a direct or third-party beneficiary. FINRA rules may be violated by an online, discount broker-dealer even in the absence of a "recommendation." Two Rules certainly applicable to "unaffiliated" investment advisors or family members controlling the account of a customer of an online firm follow.

A. FINRA Rule 2090 (Know Your Customer)

Initially articulated in New York Stock Exchange ("NYSE") Rule 405, the "know your customer" duty required firms to "[u]se due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried . . . and every person holding power of attorney over any account accepted or carried . . . ."[6] The duty is now embodied in FINRA Rule 2090 and requires all firms, including online, discount broker-dealers to use "reasonable diligence, in regard to the opening and maintenance of every account, to know the 'essential facts' concerning every customer . . . [including] those required to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules."[7]

The "know your customer" duty of a broker-dealer, including an online firm, is ongoing so as to allow the firm to "effectively service and supervise

6. NYSE, RULE 405 (2008).

7. FINRA, REGULATORY NOTICE 11-02, 2011 WL 127154, at *1 (Jan. 10, 2011) ("NOTICE 11-02"). *See also* FINRA, RULE 2090.01 (2015). "Know Your Customer" historically was included in NASD, RULE 2110 (2006) (Standards of Commercial Honor and Principles of Trade). NASD, NOTICE TO MEMBERS 01-23, 2001 WL 278614, n. 7 (2001).

the customers' accounts."[8] The obligation applies regardless of the absence of a recommendation.[9] The "customer" for purposes of the "know your customer" duty is the owner of the account.[10] Nonetheless, included within the scope of the "know your customer" duty is the obligation to obtain the essential facts of not only the customer, but also of the third party granted authority over the customer's account.[11] While FINRA Rule 2090 lacks an enumeration of the "essential facts," FINRA Rule 2360, often implicated in customer cases against online firms, does set forth a non-exclusive list of "essential facts" that the firms are obligated to address.

B. FINRA Rule 2360 (Options)

In the cases that the authors have seen arise against online broker-dealers involving investment advisors or other third parties in control of the customer account, most often excessive use of margin and trading in options occurs, resulting in rapidly mounting losses. FINRA's Options Rule – Rule 2360 – contains a number of provisions which, if adhered to by online, discount firms, should minimize the exposure of the customer to losses and the firm to claims of liability. It has, however, been the authors' experience that the following aspects of the Options Rule are ignored or given minimal attention at best by online firms.

FINRA Rule 2360[12] is rather lengthy. Paragraph (a) of the Rule contains almost forty (40) defined terms. Paragraph (b) lists the "Requirements" of the Rule and its applicability. Under paragraph (b), there are twenty-four (24) separate requirements or sub-paragraphs. Those sub-paragraphs impose, among other duties, requirements that all firms (i) "know their options

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8. FINRA, REGULATORY NOTICE 11-02, 2011 WL 127154, n.5 (2011).

9. *Id*. at *1.

10. *See In re* Richard DeCastro, AMEX Disciplinary Panel Decision 97-D-01, 1998 WL 295513, at *7 (Apr. 6, 1998) (sanctioning firm for failure to supervise customer account controlled by unaffiliated former registered representative, and stating: "The Panel believes that the existence of a third party power of attorney does not relieve a member organization or its supervisory personnel of their obligations under the Exchange's rules to supervise the accounts of their customers.").

11. *See* FINRA, RULE 2090 (2015) and former NYSE, RULE 405 (Diligence as to Accounts), 1995 WL 17845826, at *1 (1995).

12. Previously, NASD, RULE 2860 (2007).

customer," (ii) approve customers for options trading only if appropriate for the customer and only at an appropriate level of options trading, and (iii) supervise those customers' options accounts for irregularities.

1. Appropriate Approval or Disapproval for Options Trading

No firm, online or full-service, is required to approve a customer's account for options trading even if the customer is asking for options trading. Subparagraph (16) of paragraph (b) reads, in pertinent part, as follows:

> Based upon such information [***essential facts***], . . . a Registered Options Principal . . . shall specifically approve ***or disapprove*** in writing the customer's account for options trading . . . .[13]

In fact, all firms are prohibited from accepting orders for options trades from a customer unless the customer's account has been provided the "appropriate options disclosure document(s)"[14] and the customer's account has been approved in accordance with Rule 2360."[15]

To assure that the approval of a customer's account is appropriate, all firms, including on-line broker-dealers, must use "due diligence to ascertain the essential facts relative to the customer, his financial situation and investment objectives."[16] The Rule then lists the minimum essential facts that firms obtain with respect to customers who are natural persons, as follows:

> a. Investment objectives (e.g., safety of principal, income, growth, trading profits, speculation);
> b. Employment status (name of employer, self-employed or retired);
> c. Estimated annual income from all sources;
> d. Estimated net worth (exclusive of family residence);
> e. Estimated liquid net worth (cash, securities, other);
> f. Marital status; number of dependents;
> g. Age; and

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13. FINRA, RULE 2360(b)(16)(B) (2015) (emphasis added).

14. Delivery of the options disclosure document ("ODD") to the customer must occur prior to the approval of the customer's account for options trading. FINRA, RULE 2360(b)(11) (2015).

15. FINRA, RULE 2360(b)(16)(A) (2015).

16. FINRA, RULE 2360(b)(16)(B) (2015).

h. Investment experience and knowledge (e.g., number of years, size, frequency and type of transactions) for options, stocks and bonds, commodities, and other financial instruments.[17]

The foregoing information for those customers who are approved for options trading is to be maintained by the firm "at both the branch office servicing the customer's account and the principal supervisory office having jurisdiction ("OSJ") over that branch office."[18]

The subparagraph requiring the maintenance at branch offices and the OSJ of background and financial information for customers approved for options trading also requires maintenance of six (6) months of the options customer's account statements. The seemingly obvious purpose of requiring the maintenance of customer background information and account statements at a supervisory office as well as the branch office is to supervise or monitor the customers' options accounts for irregularities. And, indeed, that is what the Rule provides:

> Other records ***necessary to the proper supervision of accounts*** shall be maintained at a place easily accessible both to the branch office servicing the customer's account and to the principal supervisory office having jurisdiction [OSJ] over that branch office.[19]

Additional information required to be maintained is also set forth in the Rule. The additional information required includes (i) the name of the Registered Options Principal or similarly appropriate employee who approved the account for options approval, (ii) the date the account was approved, (iii) the dates the customer background information was verified, (iv) the date the options disclosure document was delivered to the customer, and (v) the nature of the options trading for which the customer was approved.[20] Particularly pertinent to accounts controlled by third parties such as investment advisors or family members, the Options Rule also requires the maintenance of the name of the person holding discretionary authority over the account, the person's relationship to the customer, and the person's experience.[21]

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17. FINRA, RULE 2360(b)(16)(B)(i) (2015). The firm is also required to verify the customer's background and financial information. FINRA, RULE 2360(b)(16)(C) (2015).

18. FINRA, RULE 2360(b)(17) (2015).

19. FINRA, RULE 2360(b)(17)(B) (2015) (emphasis added).

20. FINRA, RULE 2360(b)(16)(B)(ii) (2015).

21. *Id*.

2. Special Supervision of Options Accounts

If there was any question of a duty on the part of all broker-dealers, including online, discount broker-dealers, to supervise the accounts of their options customers, it should be put to rest by subparagraph (20) - "Supervision of Accounts" - of paragraph (b) of Rule 2360.[22] That subparagraph requires, of course, written supervisory procedures ("WSPs") adequately addressing the firm's public customer options business,[23] supervision of branch offices transacting options business by a registered options principal or similarly qualified person,[24] and ongoing, timely review of options accounts for the following activity:

- the compatibility of options transactions with the investment objectives for the customer account;
- the compatibility of the options transactions with the types of transactions for which the customer's account was approved;
- the size and frequency of the options transactions;
- undue concentration in any options class or classes;
- profits or losses in the account; and
- compliance with Regulation T of the Federal Reserve Board.[25]

In sum, FINRA Rule 2360, governing the opening and approval of a customer's account for trading in options has at least four (4) components that are potential pitfalls for online firms, given their limited interaction with customers. **First,** as described above, all firms, online, internet, or full-service alike, must "exercise due diligence to ascertain . . . essential facts," including the customer's personal situation, his financial situation, and his investment objectives. **Second,** a firm's registered options principal or similarly qualified person must use those "essential facts" in determining whether to approve or disapprove a customer's account for options trading. **Third,** all firms must

22. FINRA, RULE 2360(b)(20) (2015).

23. FINRA, RULE 2360(b)(20)(A) (2015). Indeed, firms may very well repeat requirements of FINRA Rule 2360 in their WSPs, yet, contend ignorance or inapplicability of the provisions to the case at hand. Failure of a firm to follow its own internal policies and procedures is evidence in support of a claim for negligence. *See, e.g.,* Miller v. Smith Barney, Harris Upham & Co., 1986 WL 2762 (S.D.N.Y. Feb. 27, 1986) ("When a defendant has disregarded rules that it has established to govern the conduct of its own employees, evidence of those rules may be used against the defendant to establish the correct standard of care.").

24. FINRA, RULE 2360(b)(20)(B) (2015).

25. FINRA, RULE 2360(b)(16)(20)(C) (2015).

maintain a written record of the "essential facts," along with the customer's account statements at the branch office and OSJ for the customer's account. **Fourth,** all firms are required to use this information in reviewing, on an ongoing and timely basis, the options customer's account for, among other things, the frequency of trading in the account, the profit or loss in the account, any undue concentration, and inconsistency between the trading in the account and the stated investment objectives.

The requirements of FINRA Rule 2360 for the approval, supervision, and monitoring of customer's options accounts are in line with those supervisory requirements seen in some state securities acts ("Blue Sky Laws") or the administrative rules promulgated under them. The combination of state securities laws and FINRA rules ought to establish an undisputable standard of care for purposes of negligence or aiding a breach of fiduciary duty. Firms that fail to take action in the face of mounting losses, excessive options trading, and trading incompatible with the customer's investment objective, experience, and financial situation, turn a "blind eye" at their peril.

C. Using Margin and Options Disclosure Obligations

1. Margin Disclosure Statement

Because of the additional risks of trading on margin, no firm can open a margin account for a non-institutional customer without first providing the customer, in paper or electronic form, a *separate* "Margin Disclosure Statement."[26] The content of the Statement is prescribed by FINRA Rule 2264 and consists of six bullet-points underscoring the dangers of margin. It includes bolded disclosures that the customer could lose more funds than are deposited into the margin account and that the broker-dealer can liquidate the assets in the customer's account to satisfy a margin call without first contacting the customer if there is a decline in value of the securities or other assets in the margin account.[27] Thereafter, firms are to provide the customers with annual disclosures.[28]

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26. FINRA, RULE 2264 (2015).

27. *Id.*

28. *Id.*

2. The ODD

Similarly, given the risks of trading in options, at or prior to approving a customer's account for options, all broker-dealers are required to provide the customer with a disclosure document entitled "Characteristics and Risks of Standardized Options," referred to as options disclosure documents ("ODD").[29] The required content is ***not*** set forth in FINRA's Options rule – Rule 2360. Rather, the ODD is described generally within FINRA Rule 2360(a)(12).[30]

An introductory paragraph to one such ODD, dated February 1994 with supplements through 2012, states as follows:

> Readers should be aware that this booklet has been written to meet the requirements of an SEC rule that requires the U.S. options markets to prepare, and brokerage firms to distribute, a booklet that briefly and generally describes the characteristics of options and the risks to investors of maintaining positions in options.
>
> *Readers should read and understand this booklet in its entirety,* since a number of the separate chapters will be relevant to every reader interested in buying and writing options. . . . Readers should also be aware that, although this booklet seeks to describe the various characteristics of options and the risks that are unique to being an investor in options, there are many matters which are beyond the scope of this booklet that are not discussed.[31]

This ODD, distributed by broker-dealers, consists of more than one-hundred-eighty (180) pages, including supplements.[32] It is not easy reading, but as the ODD (and thus the distributing broker-dealers) tell us, with emphasis, *"[r]eaders should read and understand this booklet in its entirety.*

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29. FINRA, RULE 2360(b)(11) (2015). An additional "Special Written Statement" is required for those customers approved for uncovered short options transactions. *Id.*

30. As described in the Rule, the ODD is to be prepared by "one or more options markets," meet the requirements of SEA Rule 9b-1 (that is, 17 C.F.R. § 240.9b-1), and be filed with the SEC. They are to "contain general explanatory information regarding buying, writing, exercising options, risks involved, transactions costs, margin requirements, tax consequences, and additional information." FINRA, RULE 2360(a)(12) (2015).

31. AMERICAN STOCK EXCHANGE, LLC ET AL., CHARACTERISTICS AND RISKS OF STANDARDIZED OPTIONS (Feb. 1994), *available at* http://www.optionsclearing.com/components/docs/riskstoc.pdf (emphasis in original).

32. *Id.*

. . ."[33] In other words, the ODD, like the Margin Disclosure Statement, ***contain material information***.

3. Hypothetical Illustration: School Teacher Opens an Options Account with Online Broker-Dealer

Suppose "Bob," a retired school teacher walks into the local office of "You-Trade," a fictional online, discount broker-dealer. Bob is enticed by the local registered representative's promises of low fees, easy access to accounts, and the ability to trade online, though he has never done so. He agrees to a few training sessions with the representative, learning how to trade online. Bob moves his accounts from a full-service broker-dealer to You-Trade and begins trading.

One day, Bob sees references on You-Trade's website to "options" and "margin." Unfamiliar with these terms, he goes back to the office and representative who was so helpful (he even got $100 deposited into his new, You-Trade account) to inquire. The representative puts Bob in touch with You-Trade's Options Specialist, "Frank," by phone.

Frank tells Bob that all he needs to do is complete a form, online. Frank directs Bob to You-Trade's online Options/Margin Account Application and walks Bob through the "clicking of the boxes," telling him that, following 48 to 72 hours after completion of the form, options and margin will be added to his account.

You-Trade emails Bob the required Margin Disclosure Statement and the ODD, which Bob neither sees nor reads. Bob begins his trading and use of margin, which he views as a loan to be later repaid, but fails to appreciate that the assets in his You-Trade account are collateral for the loan. He does well at first, then the market takes a deep dive and his account, virtually all of his liquid net worth, is sold to satisfy You-Trade's margin call.

For sake of this illustration, assume that there was some question whether Bob should have been approved for options trading, given his financial situation, though it was the use of margin that decimated his account. Assume, also, that You-Trade delivered the Margin Disclosure Statement and the ODD in a separate email to Bob prior to approving his account for Margin and Options, thereby meeting the disclosure requirements under the FINRA Rules

33. *Id.*

requiring delivery of those disclosures. Is there nothing more required of You-Trade?

Under the law of many jurisdictions, satisfying minimum industry standards does not preclude a finding of negligence, particularly, where, as in this case, it was reasonable and doable for Frank, the You-Trade Options Specialist, to, at the very least, orally go over the six bullet-points on the Margin Disclosure Statement and obtain some assurance that Bob understood what he was getting into. Similarly, there was nothing (or should have been nothing) preventing Frank, an options specialist, from warning Bob of the risks of options trading. Recorded phone calls and Bob's testimony provides evidence that Frank, the options specialist, only explained to Bob how to click the right boxes, without mentioning the risks of trading in options or the use of margin.

In the foregoing hypothetical, Frank's omissions, attributable to You-Trade, should support a claim of negligence, if not fraud or negligent misrepresentation (for failure to disclose material information), with or without supporting expert testimony. In addition, the questionable approval of Bob's Options/Margin form by You-Trade conceivably violates the requirement of FINRA Rule 2360(b)(16) that options accounts for public customers be approved ***or disapproved*** based on certain essential facts relating to the customer. In fact, the authors were successful in obtaining a favorable award for a public customer on facts and circumstances substantially similar to those stated in the hypothetical.[34]

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34. *See, e.g.*, *In re* Joseph Pappy v. TD Ameritrade, FINRA Case No. 11-04256, 2012 WL 6726652 (Dec. 21, 2012) (the arbitrator, after a final hearing, issued the award in favor of the Claimant citing negligent supervision, negligence and violation of industry standards).

II. THEORIES OF LIABILITY

A. Negligence [35]

The elements of a common law cause of action in negligence are fairly universal: (i) duty to conform to a certain standard of care for the protection of others against unreasonable risks; (ii) a failure to conform to the applicable standard of care; and (iii) damages proximately caused by the breach.[36] The initial hurdle, and the one emphasized here, is "duty."

1. Broker-dealers, particularly online, discount broker-dealers often argue "no duty."

The existence of a "duty" running from the defendant or respondent to the claimant/plaintiff is a threshold question, and its absence can end a negligence claim as a matter of law.[37] The threshold requirement of a "duty" explains the

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35. In Florida, until the decision of the Florida Supreme Court in *Tiara Condominium Ass'n v. Marsh v. McLennan Cos.*, 110 So. 3d 399 (Fla. 2013), a claim for economic losses arising from negligence was sometimes met with respondent's assertion of the "economic loss rule" as a bar to claims of negligence for purely economic loss. The Court, in *Tiara Condominium*, wisely retracted the scope, in Florida, of the economic loss rule to solely products liability cases, stating as follows:

> Our experience with the economic loss rule over time, which led to the creation of the exceptions to the rule, now demonstrates that expansion of the rule beyond its origins was unwise and unworkable in practice. Thus, today we return the economic loss rule to its origin in products liability.

Id. at 407. To the extent the doctrine applies in other jurisdictions, it has no place in FINRA arbitration, an equitable forum. Nor should it apply based on the parties' contractual relationship as broker-dealers are prohibited by FINRA rules from using contractual provisions to limit their liability. *See* Benjamin P. Edwards, *Rolling Back the Economic Loss Doctrine in Securities Disputes Against Financial Intermediaries*, 20 PIABA B.J. 39 (2013).

36. Curd v. Mosaic Fertilizer, LLC, 39 So. 3d 1216, 1227-28 (Fla. 2010); Clay Elec. Co-op., Inc. v. Johnson, 873 So.2d 1182, 1185 (Fla. 2003) (citing PROSSER AND KEATON ON THE LAW OF TORTS, at 164-65 (5th ed. 1984)); Akins v. Glens Falls City School Dist., 424 N.E. 2d 531, 535 (N.Y. 1981); Ladd v. County of San Mateo, 911 P.2d 496, 498 (Cal. 1996).

37. *See generally* 57A AM JUR 2D *Negligence* §§ 74-78 (2004).

fondness for the "no duty" chant of respondents. "Duty" is best defined by no one component and, instead, takes into consideration a number of factors.

Florida's Supreme Court neatly articulated four sources of "duty" as follows: (1) legislative enactments or administrative regulations; (2) judicial interpretations of such enactments or regulations; (3) other judicial precedent; and (4) a duty arising from the general facts of a case.[38]The fourth category encompasses "that class of cases in which the duty arises because of a foreseeable zone of risk arising from the acts of the defendant."[39] "Foreseeability" is also a component of causation in that "[f]or proximate cause to exist, the harm suffered must be found to be a foreseeable consequence of the act complained of . . . ."[40]

A word of caution is in order. Reliance on "foreseeability" alone is done at one's peril.[41] Indeed, some jurisdictions seemingly reject the concept that "duty" can be defined by foreseeability, and others require additional sources of duty and policy considerations in combination with foreseeability.[42] The fear articulated by the jurisdictions that reject reliance on foreseeability of the harm to establish duty is fear of unconstrained liability, no doubt a fear voiced vociferously by those lobbying on behalf of the business sector. The foreseeability of the loss, coupled with an obligation imposed by law, regulation, or industry standard, should, however, go far to satisfy the "duty" element.

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38. *Clay*, 873 So.2d at 1185 (citing McCain v. Fla. Power Corp., 593 So.2d 500, 503 n. 2 (Fla.1992)).

39. *Curd*, 39 So. at 1227-28.

40. 57A AM. JUR. 2D *Negligence* § 470. *See also* AUSA Life Ins. v. Ernst & Young, 206 F.3d 202, 233-34 (2d Cir.2000) (characterizing "foreseeability" as the touchstone of loss causation that varies depending upon the legal context).

41. *See* William N. Drake, Jr., *Foreseeable Zone of Risk: Confusing Foreseeability with Duty in Florida Negligence Law*, 78 Fla. B.J. 10 (Apr. 2004) (noting most jurisdictions will not base duty solely on "foreseeable zone of risk").

42. *See, e.g.,* 532 Madison Ave. Gourmet Foods, Inc. v. Finlandia Ctr., Inc., 750 N.E. 2d 1097, 1101-02, 727 N.Y.S. 2d 49, 53-54 (N.Y. 2001) ("As we have many times noted, foreseeability of harm does not define duty.") (citations omitted). *But see* Lopez v. Three Rivers Elec. Co-op., Inc., 26 S.W.3d 151, 156 (Mo. 2000) ("In the absence of a particular relationship recognized by law to create a duty, the concept of foreseeability is paramount in determining whether a duty exists."). *Cf.* Cameron v. Pepin, 610 A.2d 279, 282 (Me. 1992) (holding duty "is not entirely a question of the foreseeable risk of harm but is in turn dependent on recognizing and weighing relevant policy implications").

2. Contracts between the parties, securities laws, securities regulations, and rules of self-regulatory organizations, such as FINRA, articulate the "duty" AND APPLY TO ALL BROKER/DEALERS.

A reasonably constrained "duty" can be established by contract, by the relationship between the parties, by special facts and circumstances, as well as by laws and regulations regardless of whether they create a private cause of action.[43] In addition, violations of securities statutes and regulations may give rise to negligence per se or constitute evidence of negligence, depending upon the jurisdiction.[44] In either case, it is important to establish that the investor fell within the class intended to be protected by the applicable law or regulation to satisfy the "public policy" concern of unlimited liability.

Blue Sky Laws often contain provisions which state their purpose or the purpose of administrative rules as the protection of investors.[45] They thus provide a path for establishing negligence per se or, at the very least, evidence of negligence in a case against an online firm, depending upon the conduct regulated.[46] For example, administrative rules promulgated by Alabama's

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43. *See generally* 57A AM. JUR. 2D *Negligence* §§ 82-85 (2004).

44. 57A AM. JUR. 2D *Negligence* §§ 753-58 (2004). *See, e.g.*, Vitrano v. Florida Power & Light Co., 2015 WL 1334270, at *3 (Fla. Ct. App. Mar. 25, 2015) (finding negligence per se from violation of law intended to protect particular class of persons where injured person falls within class, injury suffered is of kind to be prevented by law, and violation proximately causes injury) (citing deJesus v. Seaboard Coast Line R. Co., 281 So. 2d 198, 201 (Fla. 1973); *Ex parte* Anderson, 867 So. 2d 1125, 1128 (Ala. 2003); Sill v. Burlington N. R.R., 87 S.W.3d 386, 392 (Mo. Ct. App. 2002)(substantially same). *Cf.* Yenem Corp. v. 281 Broadway Holdings, 964 N.E.2d 391, 394 (N.Y. 2012) (finding violation of statute as basis for negligence per se, violation of ordinance as evidence of negligence, and violation of an administrative code provision negligence per se or evidence of negligence, depending upon origin of provision).

45. *See, e.g.,* ALA. CODE § 8-6-23 (2015) (requiring Alabama Securities Commission to prescribe, make, and amend rules as necessary for protection of investors or in public interest); MO. ANN. STAT. § 409.6-605 (West 2015); CAL. CORP. CODE § 25612 (2015); N.H. REV. STAT. § 421-B:28 (2015).

46. For a thorough analysis of Florida's Securities Act, administrative code provisions promulgated under that Act, and the purpose of the foregoing law in finding a potential claim of negligence per se brought by investors against a broker-dealer for failing to accurately report the reason for a registered representative's termination, see *Palmer v. Shearson Lehman Hutton, Inc.*, 622 So. 2d 1085 (Fla. Ct.

Securities Commission require all broker-dealers to, among other requirements:

- designate qualified supervisors for their associated persons;
- supervise the approval of the opening of a customer account; and
- frequently examine customer accounts to detect and prevent irregularities or abuses.[47]

Missouri's Securities Division considers various factors in determining whether a broker-dealer has "failed reasonably to supervise," including the following:

- the firm fails to establish and implement procedures reasonably designed to achieve compliance with applicable securities laws, regulations, and FINRA Rules;
- the firm fails to take action upon indications of wrongdoing or "red flags;" and
- the firm fails to designate qualified supervisors for each agent or employee.[48]

Administrative rules promulgated by Florida's Division of Securities expressly prohibit a number of account-related wrongful activities related to, among other things, margin and execution of orders.[49] Florida's administrative rules also expressly prohibit violations of FINRA rules as violations of the Florida Administrative Code.[50] Delaware's Administrative Code includes as wrongful conduct failures to reasonably supervise and other violations of FINRA (or predecessor) rules.[51] In short, none of these provisions require a "recommendation" to be applicable; yet, they affirmatively impose duties for supervision of accounts and personnel that are implicated in all accounts of public customers, online or not.

Other duties are imposed by federal securities laws that require firms to establish and implement adequate supervisory systems for the protection of investors. Congress, through legislation, has permitted the Securities and Exchange Commission ("SEC") to delegate, subject to SEC oversight,

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App. 1993). *See also* Twiss v. Kury, 25 F.3d 1551, 1555 (11th Cir. 1994) (citing *Palmer* on same issue).

47. ALA. ADMIN. CODE r. 830-X-3-.13 (2016).

48. MO. CODE REGS. ANN. tit. 15, § 30-51.171 (2015).

49. FLA. ADMIN. CODE ANN. r. 69W-600.013(1)(a)-(f),(h) (2016).

50. *Id.*

51. 6 DEL. ADMIN. CODE § 609(b)(4), (28) (2015).

significant regulatory obligations to SROs in the promulgation of SRO rules.[52] The purpose and mechanism of SEC oversight of SROs is ***"to insure fair dealing and to protect investors from harmful or unfair trading practices."*** [53]

The Bylaws of FINRA similarly provide that its rules are "[t]o promote and enforce just and equitable principles of trade and business, to maintain commercial honor and integrity among members . . ., [and] to protect investors and the public interest . . . .").[54] Regardless, online firms consistently argue that FINRA rules do not establish a private cause of action for their breach. While there is no express creation of a private cause of action by FINRA rules, the standards articulated by these rules should establish a duty for all member firms, including online firms. [55]

3. Using expert testimony to support a standard of care in excess of industry standards

The existence of a legal duty is a question of law generally outside the purview of expert testimony.[56] Nonetheless, in securities cases, expert

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52. Legg, Mason & Co. v. Mackall & Coe, Inc., 351 F. Supp. 1367, 1371 (D.D.C. 1972).

53. Credit Suisse First Boston Corp. v. Grunwald, 400 F.3d 1119, 1128-30 (9th Cir. 2005).

54. FINRA, BYLAWS, Article XI, Section 1 (2007).

55. *See e.g.,* Miley v. Oppenheimer & Co., 637 F.2d 319, 333 (5th Cir. 1981) (finding NYSE and NASD rules excellent tools for assessing reasonableness broker's handling of investor's account), *abrogated on other grounds* in Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213 (1985); Petrites v. J. C. Bradford & Co., 646 F.2d 1033, 1035, n.1 (5th Cir. 1981) (noting no need to determine whether private cause of action under rules exists because admissible as evidence of industry standards and practices); Mihara v. Dean Witter & Co., Inc., 619 F.2d 814, 824 (9th Cir. 1980) (admitting testimony of NYSE "know your customer" rule "because the rules reflect the standard to which all brokers are held"); Javitch v. First Montauk Fin. Corp., 279 F. Supp. 2d 931, 938 (N.D. Ohio 2003) (finding SRO rules to reflect standard of care); Remington v. Newbridge Sec. Corp., No. 13-60384-CIV-COHN/SELTZER, 2013 WL 2444719, at *6 (S.D. Fla. June 5, 2013) (stating violation of SRO rules can be evidence of conduct falling below the applicable standard of care).

56. *See, e.g.*, Gebremedhin v. American Family Mut. Ins., No. 1:13-cv-02813-CMA-NYW, 2015 WL 4979742, at *5-7 (D. Colo. Aug. 21, 2015) (allowing expert

witnesses often opine on what conduct or actions constitutes reasonable, feasible procedures for (i) supervision of personnel, (ii) supervision of customer accounts, and (iii) adequate disclosures of risks associated with certain transactions. In testifying as to what reasonable, feasible actions, policies, or practices could have been established or implemented in a particular case, expert witnesses are not restricted to the standards imposed by statute, regulation, or industry norms, as the following excerpts from cases addressing that issue exemplify:

- Compliance with a legislative enactment or an administrative regulation does not prevent a finding of negligence where a reasonable man would take additional precautions[,] . . . while violating them requires a finding of negligence *per se*.[57]
- While evidence of a defendant's compliance with applicable industry standards may be relevant and admissible for purposes of determining whether a defendant breached a duty of care, . . . the duty of care is an objective standard determined by what an ordinary, careful and prudent person would have done under the same or similar circumstances.[58]

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testimony on industry customs and practices familiar to expert based on his relevant experience, but striking legal conclusions); Butler v. ENSCO Offshore Co., No. 07-1700, 2009 WL 859290, at *3 (W.D. La. Mar. 27, 2009) (excluding expert's conclusions on existence of duty and negligence, but otherwise finding engineering expert's testimony helpful to trier of fact); Hermitage Indus. v. Schwerman Trucking Co., 814 F. Supp. 484, 487-88 (D.S.C. 1993) ("[T]he existence and nature of the duty is a question of law to be determined by the court."); Park v. Exxon Mobil Corp., 429 S.W. 3d 142, 150 (Tex. Ct. App. 2014)("The existence of a legal duty is a matter for the court, rather than an expert witness, to decide.").

57. Henderson v. National R.R. Passenger Corp., 87 F. Supp. 3d 610, 617-18 (S.D.N.Y. 2015) (citations omitted) (denying defendant's motion to preclude evidence of standards other than those imposed by Federal Railroad Safety Act).

58. Jones v. LA Fitness, Int'l, LLC, No. 2:11-cv-00632, 2013 WL 3789807, at *8 (E.D. Pa. July 22, 2013) (citations omitted) (denying defendant's motion to preclude expert testimony on issue of failure to conform to reasonable standard of care). *See also*, Surles *ex rel.* Johnson v. Greyhound Lines, Inc., 474 F. 3d 288, 300-301 (6th Cir. 2007) (citations omitted) ("[I]ndustry standards may be proven as some evidence of care but are not conclusive on the matter. . . [as] there are precautions so imperative that even their universal disregard will not excuse their omission."); Bansemer v. Smith Labs., Inc., No. 86-C-1313, 1990 WL 132579, at *1 (E.D. Wis. Sept. 12, 1988) (citing W. PROSSER, HANDBOOK OF THE LAW OF TORTS 167, 203 (4th ed. 1971)) ("Statutory rules impose a minimum code of conduct, and industry practices carry only the evidentiary weight they deserve.)

- [C]ustoms of an industry are not conclusive on the issue of the proper standard of care; they are at most evidential of this standard . . . Such industry standards are not dispositive "because to allow [an industry] to set its own standard of conduct is tantamount to allowing it to set the limits of its own legal liability, even though those limits are below a level of care readily attainable."[59]

The foregoing case law findings should certainly be applicable against all broker-dealers who are required to observe "high standards of commercial honor and just and equitable principles of trade."[60] A firm's compliance with FINRA rules, applicable law, and applicable securities regulations should be only the starting point. For a firm to argue otherwise is at odds with the required high standard to which these firms are to be held.

For example, an online firm cannot simply ignore an account that has lost 90% of its equity through irrational or excessive trading. In the same manner that the firm has internal controls or exception reports to monitor losses in a margin account to protect the firm, it would be unreasonable for the firm to fail to take any corrective action, such as limiting or restricting trading in such a customer's account. And, customer agreements often give firms that right.[61]

Likewise, in a case where an unregistered or unlicensed third party is exercising discretion over a customer's account with the online firm's consent, the firm has some obligation to investigate, and potentially, limit the activities of an unlicensed or unqualified advisor that is engaged in excessive trading. Failing to establish and implement a system of supervision that is reasonably designed to detect and prevent violations of FINRA rules, securities laws, or securities regulations is evidence of negligence.[62] Arbitration panels will be more inclined to impose liability in a situation where the online firm had the opportunity to detect and prevent fraud or negligence, yet failed to do so simply because there was no specific requirement imposed by regulation or rule.

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59. Davis v. Brickman Landscaping, Ltd., 98 A. 3d 1173, 1181-82 (N. J. 2014) (citations omitted).

60. FINRA, RULE 2010 (2015).

61. *See, e.g.*, *infra* note 67 (section 6 of the agreement) and note 69 (section 14(f) of the agreement).

62. *See* FINRA, RULES 3110 (Supervision), 3120 (Supervisory Control System), and 3130 (Annual Certification of Compliance and Supervisory Processes) (2015) (all requiring a system of supervision reasonably designed to achieve compliance with securities laws, regulations, and FINRA rules).

In sum, online firms often have little or no conversations with their customers. They thus vigorously defend against the imposition of any liability to their online public customers for trading or account-related losses, relying on the general inapplicability of FINRA's Suitability Rule. Other sources of "duty" and potential liability in negligence do exist, and often can be found in the administrative code provisions promulgated pursuant to state securities acts, in the acts themselves, and in SRO rules, including FINRA rules. The foregoing sources often regulate account approvals, the use of margin, the monitoring of accounts for "red flags," disclosure requirements, supervision of personnel, and also require compliance with FINRA or other SRO rules, none of which are dependent upon a "recommendation" and all of which arguably establish "duty" to the harmed investors and the applicable standard of care, if not negligence per se. Lastly, compliance with industry standards does not rule out negligence in circumstances where other actions are reasonably feasible and necessary to prevent the losses sustained by the online customer, an area in which expert testimony may prove helpful.

B. Breach of Contract.

1. Direct Action Based on Customer Agreement

Implied in every agreement is a covenant of good faith and fair dealing.[63] Also implied are existing applicable laws and regulations as if expressly made a part of the contract.[64] SRO rules are implicitly included in customer

63. *See, e.g.*, Klock v. Lehman Bros. Kuhn Loeb Inc., 584 F.Supp. 210, 219, n. 16 (S.D.N.Y. 1984) (noting "[i]t is well-settled law in New York that "every contract contains the implied requirement of good faith and fair dealing"); Jonathan Neil & Assocs. v. Jones, 94 P.3d 1055, 1068 (Cal. 2004); Farmers' Elec. Co-op., Inc. v. Missouri Dep't. of Corr., 977 S.W.2d 266, 271 (Mo. 1998).

64. *See generally* 17A AM. JUR. 2D *Contracts* § 371 (2004). *See, e.g.,* Nat'l Franchisee Assoc. v. Burger King Corp., 715 F. Supp. 2d 1232, 1244 (S.D. Fla. 2010)(citations omitted)("As a matter of law, '[t]he laws in force at the time of the making of a contract enter into and form a part of the contract as if they were expressly incorporated into it.'"); Edwards v. Arthur Andersen LLP, 189 P.3d 285, 296-97 (Cal.2008) (substantially same); State v. American Tobacco Co.*,* No. ED1015432, 2015 WL 5576135, at *13 (Mo. Ct. App. Sept. 22, 2015) (substantially same); *see also* Travelers Indem. Co. v. Orange & Rockland Utils, Inc., 905 N.Y.S.2d 11, 13 (N.Y. App. Div. 2010) ("[A] contract generally incorporates the state of the law in existence at the time of its formation.").

agreements of online firms despite arguments to the contrary. Carving out online firms would be contrary to FINRA's requirement that **all** member firms "observe high standards of commercial honor and just and equitable principles of trade."[65] Additionally, carving out online firms contravenes FINRA's prohibition on customer agreements that include a condition that limits or contradicts any SRO rule.[66]

Furthermore, customer agreements often expressly incorporate SRO rules. For example, E*Trade Securities Brokerage Customer Agreement, effective December 21, 2015, includes, amongst the pages of fine print, the following terms:

> (b) Applicable Rules and Regulations
>
> All transactions in my Account will be subject to the constitution, rules, regulations, customs and usages of the exchange or market . . . . Where applicable, such transactions will be subject to the provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and the rules and regulations of the U.S. Securities and Exchange Commission, the Board of Governors of the Federal Reserve System and any applicable self-regulatory organization.[67]

Scottrade's Options Application, as of the writing of this article, contains the following, not so "Miscellaneous" provision:

> All transactions are also subject to the rules and regulations of the Securities Exchange Commission, the Board of Governors to the Federal Reserve System, the Commodity Futures Trading Commission, the Financial Industry Regulatory Authority and all other applicable federal agencies, state agencies and self-regulatory organizations.[68]

And, TD Ameritrade's Client Agreement, effective July 3, 2014, includes a "General Term" whereby the applicant (and presumably TD Ameritrade) agree to be bound by "FINRA, OCC, and exchange rules applicable to the trading of options contracts."[69]

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65. FINRA, RULE 2010 (2015).

66. FINRA, RULE 2268(d)(1) (2015).

67. E*TRADE Financial Corporation, *Securities Brokerage Customer Agreement, Section 6 – Trading Provisions* (Dec. 21, 2015) *available at* https://us.etrade.com/e/t/estation/help?id=1209031000.

68. Scottrade, Inc., *Options Application* (Nov. 2015) *available at* https://www.scottrade.com/documents/alt/SF1010_OptAppViaN_Agr_Without_BrokApp.pdf.

69. TD Ameritrade, Inc., *Client Agreement* (Jan. 19, 2016), *available at* https://www.tdameritrade.com/retail-en_us/resources/pdf/AMTD182.pdf.

At least one court has found a potential claim for violation of SRO rules by relying on a breach-of-contract theory of liability, despite agreeing that there is no private cause of action for violation of SRO rules. The court in *Komanoff v. Mabon, Nugent & Co*.,[70] found a potential claim for breach of contract for violation of SRO rules incorporated into a customer agreement. At issue in that case were the "know your customer" rule under the New York Stock Exchange ("NYSE") and the suitability rule under National Association of Securities Dealers, Inc. ("NASD").[71]

2. Breach of Contract Based on Status as a Third-Party Beneficiary of Broker-Dealer's Agreement with FINRA

Third parties may maintain an action for breach of a contract expressly intended to benefit them.[72] The By-Laws of FINRA require all member firms to agree to comply with securities laws, regulations, and FINRA rules in connection with their application for membership in FINRA.[73] Article XI of the Bylaws expressly sets forth the purpose of FINRA rules as the protection of investors and the public interest.[74] Public investors are thus intended

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70. 884 F. Supp. 848 (S.D.N.Y. 1995).

71. *Id.* at 860. The former NYSE, "know your customer" RULE 405 (2008) is now FINRA, RULE 2090 (2012) and the former suitability rule of the NASD is now FINRA, RULE 2111 (2012) as a result of the consolidation of the NYSE and NASD rules.

72. *See, e.g*., Cox v. NAP Const. Co., 891 N.E.2d 271, 274-75 (N.Y. 2008) (finding laborers had rights as third-party beneficiaries to enforce construction contract's provision requiring wages in compliance with labor laws); Peters v. Employers Mut. Cas. Co., 853 S.W.2d 300, 301 (Mo. 1993) ("A third-party beneficiary can sue to enforce the contract *if* the contract terms "clearly express" an intent to benefit either that party or an identifiable class of which the party is a member.") (emphasis in original); City of Indianapolis v. Kahlo, 938 N.E. 2d 734, 742-43 (Ind. Ct. App. 2011) (finding public taxpayers had standing as third-party beneficiaries to enforce restrictive covenant intended to provide public access); Bush v. Laggo Props., L.L.C., 784 So. 2d 1063, 1066 (Ala. Civ. App. 2000) (finding claim under third-party-beneficiary theory exists if contracting parties intended to bestow direct benefit on third party and contract breached).

73. FINRA, BY-LAWS, Article IV, Section 1(a)(1) (2007).

74. *Id*.

beneficiaries of all member firms' agreements with FINRA to abide by securities laws, regulations, and SRO rules.

Cases addressing an investor's "third-party beneficiary" breach of contract claim for violation of SRO rules are few, if any, given the industry's insertion of mandatory arbitration provisions in their customer agreement. Nonetheless, there are cases that provide an analytical framework for arguing liability for breach of contract based on "third party beneficiary" grounds. For example, the court in *Scobee Combs Funeral Home, Inc. v. E.F. Hutton & Co., Inc.*[75] granted an investor's motion to compel arbitration against a broker-dealer, relying on the firm's membership agreement with the NASD and NASD rules requiring arbitration of customer disputes, stating as follows:

> The NASD Code of Arbitration Procedure evidences an intent to promote the use of arbitration procedures. Indeed, the "Objects and Purposes" section of the NASD Manual, ¶ 1003 at (3) states: "To adopt, administer and enforce rules of fair practice and rules to prevent fraudulent and manipulative acts and practices, and in general to promote just and equitable principles of trade *for the protection of investors.*" Thus, one of the stated purposes of this association is to benefit investors.[76]

Other courts deciding investors' rights to arbitration in FINRA have found similarly.[77]

C. Liability for Aiding a Violation of State Securities Laws

Often a public investor will give trading authority to a third party, sometimes a trusted family member and sometimes an investment advisor, registered or unregistered. The advisor then trades, on behalf of the customer, through an online, discount broker-dealer. The advisor can do so even if the advisor is unaffiliated with the online broker-dealer. And, in fact, some online broker-dealers offer trading platforms or programs specifically targeted to

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75. 711 F. Supp. 605 (S.D. Fla. 1989).

76. *Id*. at 607 (alteration in original). The investor did not have a formal account with the broker-dealer and thus there was no customer agreement directly between the investor and the firm. *Id.*

77. *See, e.g*., Kidder, Peabody & Co. v. Zinsmeyer Trusts P'ship, 41 F.3d 861, 864 (2d Cir. 1994) (finding investor, as third-party beneficiary, entitled to rely on broker-dealer's obligation to arbitrate customer dispute pursuant to SRO rules); Washington Square Secs., Inc. v. Aune, 253 F. Supp 2d 839, 843-44 (W.D.N.C. 2003).

independent investment advisors with the stated purpose to keep them "independent" and "unaffiliated."

1. Examples of Online Firm Support for "Independent" or "Unaffiliated" Investment Advisors

As of the writing of this article, E*Trade offers a "Platinum Independent Advisor Platform" which touts an increased level of service from its "Platinum Independent Advisor Team," the ability to debit the advisor's customers' accounts for billing purposes consistent with the customers' authorizations, and a special advisor account that allows the advisor to view his or her customers' accounts, execute trades, and otherwise manage their accounts.[78] While the program asks about the "unaffiliated, independent" advisor's registration status, there appears no requirement that the advisor be registered with the SEC or state securities division.[79]

TD Ameritrade also offers support to those wishing to become an "independent RIA." Presumably the "RIA" stands for registered investment advisor. It notes that current "industry trends overwhelmingly support the RIA model."[80] Similarly, Scottrade's Advisor Services touts a commitment to giving registered investment advisors the support necessary to go independent. Included in its support are coaching services to assist in explaining to clients why the advisor is switching to Scottrade, reimbursement of up to $100 per account for transfer fees imposed by the current broker-dealer, and a team of Scottrade employees for ongoing assistance.[81] In short, the assistance

78. E*TRADE Financial Corporation, *Guide to E*TRADE's Platinum Independent Advisor Platform* (2013), *available at* https://content.etrade.com/etrade/estation/pdf/riawebuserguide.pdf.

79. *See* E*TRADE Financial Corporation, *E*TRADE Financial Business Brokerage Application* (2015), *available at* https://content.etrade.com/etrade/estation/pdf/Business_App1.pdf and E*TRADE Financial Corporation *E*TRADE Financial, Brokerage Customer Agreement* (2015), *available at* https://content.etrade.com/etrade/extras/Brokerage_Addendum_for_Advisors.pdf.

80. TD Ameritrade, Institutional, *Understanding Independence*, TD AMERITRADE, INC., *at* https://www.tdainstitutional.com/benefits-of-independence/understanding-independence.page (last visited May 6, 2016).

81. Scottrade, Inc., *Scottrade Advisor Brochure* (2013), *available at* https://advisor.scottrade.com/financial-advisors/Go-Independent/SASBreakawayAdvisorBrochure%202013_Digital_B.pdf.

provided by online firms to "independent" investment advisors opens the door to possible liability based on aiding violations of securities laws.

2. Examples of Blue Sky Laws allowing private causes of action against those who materially aid their violation[82]

Blue Sky Laws generally prohibit the giving of investment advice unless the advisor is registered with the SEC or with the state in which the advisor's clients reside, although there may be certain exceptions based on the institutional nature of the client, the number of clients within the state, or the amount of assets under management. In addition, these laws usually prohibit fraud in connection with the giving of investment advice and, may, by statute or administrative rule, deem certain acts to be deceptive or unlawful, including, for example, unsuitable investment recommendations and excessive or unauthorized trading.

For example, the Indiana Uniform Securities Act,[83] like other Blue Sky Laws, prohibits unregistered investment advisors from advising state residents, with certain exceptions.[84] An "investment advisor" is generally

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82. For a discussion of considerations in choosing among various applicable Blue Sky Laws, see Benjamin R. Picker, *Selecting the Appropriate Blue Sky Law(s) under Which to Bring a Claim – A Case Study*, 18 PIABA B.J. 353 (2011).

83. IND. CODE §§ 23-19-1-0.2 – 23-19-7-10 (2015).

84. IND. CODE § 23-19-4-3 (2015). Persons exempt from registration requirements include "federal covered advisors" and out-of-state advisors with no more than five (5) non-institutional clients who are residents of Indiana, among other exceptions. *Id.* "Federal covered advisors" are investments advisors who are registered under the Investment Advisors Act of 1940 (15 U.S.C. §§ 80b-1 – 80b-21 (2015)); IND. CODE § 23-19-1-2 (6) (2015). However, even federal covered advisors, again with certain exceptions, are generally subject to notice registration with the state. IND. CODE § 23-19-4-5 (2015). Examples of other Blue Sky Laws providing similarly include N.H. REV. STAT. §§ 421-B:5-502 (2016) and 421-B:6 (2015); IOWA CODE §§ 592.403 and 592.405 (2015); and MASS. GEN. LAWS ch. 110A, §§ 201 and 401(m) (2015). For a discussion of the Investment Advisors Act of 1940, including changes to the Act made by the Dodd-Frank Wall Street Reform and Consumer Protection Act pertinent to federal-state jurisdiction, see Kevin A. Zambrowicz, *Investment Adviser Regulation Post-Madoff: A Brave New World,* 6 J. BUS. & TECH. L. 373 (2011), *available at* http://digitalcommons.law.umaryland.edu/jbtl/vol6/iss2/5. *See also* U.S. SEC & EXCH. COMM'N, REGULATION OF INVESTMENT

defined as anyone who receives, or holds himself out as receiving, compensation for advising others regarding the value of securities or advisability of investing in securities.[85] If the wrong committed by an investment advisor is solely a failure to register, the remedy is often limited to a recovery of the consideration paid plus interest, costs, and reasonable attorney's fees, as determined by a court or arbitrator.[86] If the failure to register is coupled with deceptive conduct, however, the remedy includes the foregoing relief plus actual damages resulting from the deceptive conduct.[87]

While Indiana's Blue Sky Law prohibits deceptive investment advisory practices, it further allows the definition of deceptive conduct by administrative rule.[88] The non-exclusive list of deceptive practices in Indiana's Administrative Code includes (i) unsuitable investment recommendations, (ii) excessive trading, (iii) unauthorized trading, and (iv) misrepresentations or omissions concerning the advisors' qualifications, fees, or services.[89] Also

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ADVISERS BY THE U.S. SECURITIES AND EXCHANGE COMMISSION (Mar. 2013), *available at* http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf.

85. IND. CODE § 23-19-1-2(15) (2015). *Accord* MASS. GEN. LAWS, ch.110A, § 401(m) (2015); IOWA CODE § 502.102 (2015); N.H. REV. STAT. ANN. § 421-B:2 (2015).

86. IND. CODE § 23-19-5-9(c)(2) (2015). *Accord* IOWA CODE § 502.509(5) (2015); N.H. REV. STAT. § 421-B:5-509(e) (in effect Jan. 1, 2016). The Massachusetts Uniform Securities Act has no provision providing a civil remedy to investors who receive advice from an investment advisor lacking registration or providing deceptive or fraudulent advice. *See* Kaufman v. Magid, 539 F.Supp. 1088, 1099 (D. Mass. 1982) (dismissing count for relief under Massachusetts Uniform Securities Act for allegedly fraudulent investment advisory activities). The absence of a private right of action for violation of Massachusetts Uniform Securities Act illustrates the lack of uniformity among the "uniform" securities acts and underscores the need to carefully examine a state's Blue Sky Laws prior to bringing an action based on a violation. Also, some Blue Sky Laws have "prevailing party" attorney's fees provisions that must be considered.

87. IND. CODE § 23-19-5-9(c)(2) (2015). *Accord* IOWA CODE § 502.509(6) (2015); N.H. REV. STAT. § 421-B:5-509(f) (in effect Jan. 1, 2016) (substantially the same).

88. IND. CODE § 23-19-5-2 (2015). As would be expected, other states prohibit deceptive or fraudulent investment advisory practices. *See, e.g.,* N.H. REV. STAT. § 421-B:4 (2015); N.H. REV. STAT. § 421-B:5-502 (in effect Jan. 1, 2016); IOWA CODE § 502.502 (2015); MASS. GEN. LAWS, ch. 110A, § 102 (2015).

89. 710 IND. ADMIN. CODE 4-9-15 (2015).

prohibited, with certain exceptions, is performance-based compensation.[90] Other Blue Sky Laws similarly allow definition of deceptive, manipulative, or fraudulent investment advisory practices by administrative rule or define them statutorily.[91]

Indiana's Uniform Securities Act, like certain other (but not all) Blue Sky Laws, imposes joint and several civil liability upon those persons who materially aid violations of the Act or who have control over the violator.[92] Liability is imposed on the aider, including a broker-dealer, or control person unless the aider "sustains the burden of proof that the person did not know, and in the exercise of reasonable care, could not have known, of the existence of conduct" giving rise to the violation.[93]

3. A hypothetical illustration: E-Easy aids Independent Adviser

To illustrate how a case might develop for aiding a violation of Blue Sky Laws, consider the following hypothetical fact pattern:

> Suppose a former registered representative ("Independent Adviser") with a checkered past decides to become an independent investment advisor. He tells his clients, residing in Indiana, that he is leaving his firm and wants to move their accounts to a different broker-dealer, an online firm ("E-Easy"). They agree to follow him and sign new forms – provided

90. 710 IND. ADMIN. CODE 4-9-18 (2015).

91. The New Hampshire Uniform Securities Act (2015) describes investment advisory conduct that is fraudulent, deceptive, or manipulative to include unsuitable investment recommendations, unauthorized trading, excessive trading, misrepresentations and omissions regarding the advisor's qualifications, unreasonable compensation arrangements, performance-based compensation, and guaranteeing results, among other wrongful acts. N.H. REV. STAT. § 421-B:4 (2015), § 421-B:5-502 (in effect Jan. 1, 2016). Iowa's Uniform Securities Act permits definition of acts, practices, or course of business as fraudulent, deceptive, or manipulative investment advisory practices by administrative rule. IOWA CODE § 502.502 (2015). And, the Iowa Administrative Code contains an extensive listing of investment advisory conduct considered fraudulent, deceptive, or manipulative, including those previously mentioned. IOWA ADMIN. CODE r. 191-50.38(502) (2015).

92. IND. CODE § 23-19-5-9(d) (2015). *Accord* IOWA CODE § 502.509(7) (2015); N.H. REV. STAT. § 421-B:5-509 (in effect Jan. 1, 2016) (substantially the same).

93. *Id*.

by the online firm - giving him trading authority over their accounts. Independent Adviser strikes up a working relationship with the local branch office for E-Easy, which agrees to give him a high level of service, support in processing payment of Independent Adviser's advisory fees from his customers' accounts (based on a percentage of appreciation in the customers' accounts), and additional support as needed. E-Easy even assigns Independent Adviser an internal code to keep track of his customers and the revenue generated from their accounts. E-Easy's internal documents refer to Independent Adviser as one of their highest producers of revenue and as an RIA (presumably, standing for registered investment advisor).

This hypothetical fact pattern gives rise to violations of the Indiana's Blue Sky Laws.

First, Independent Adviser is not registered as an investment advisor with the SEC or the states in which he has customers, and E-Easy does nothing to verify his registration status. Nonetheless, E-Easy aids Independent Adviser's operations as an unregistered investment advisor through its support services, particularly the processing of advisor fees from its customers' accounts to Independent Adviser's accounts. If that were the only wrong under Indiana law, Independent Adviser and E-Easy would be jointly and severally liable only for compensation paid, interest, costs, and attorney's fees.

But, Independent Adviser's lack of registration is not the only wrong. Independent Adviser has touted his trading style as reflecting his special investment strategy, guaranteed to be profitable. In reality, he engages in risky and excessive trading reflecting no discernible trading strategy that results in significant losses in a very short period of time. He never tells his E-Easy customers that he is not formerly affiliated with E-Easy, never tells them that he is, in fact, affiliated with no firm, never tells them that he had problems with his prior broker-dealers because of non-compliance, and never tells them that he is required to be registered as an investment advisor under applicable Blue Sky laws.

All of the foregoing conduct constitutes fraudulent (by material omission), deceptive, or manipulative conduct under the Blue Sky Laws applicable to Independent Adviser's conduct. In addition, Independent Adviser's "performance-based" compensation likely violates these laws. Arguably, E-Easy is giving Independent Adviser material aid in the deceptive course of conduct he is perpetrating. But for the access and support provided by E-Easy, Independent Adviser could not have operated.

In short, a viable cause of action against E-Easy for violation of the Blue Sky Laws applicable to Independent Adviser exists based on the joint and several liability of those who materially aid the conduct giving rise to the violation. And, in fact, the authors did obtain a successful award in favor of all but one of a group of claimants based on facts and circumstances substantially similar to those of the foregoing hypothetical fact pattern.[94] The three-member Arbitration Panel also awarded attorney's fees under the applicable Blue Sky Laws.[95]

D. Common Law Action for Aiding and Abetting a Breach of Fiduciary Duty

1. Who is a "fiduciary"?

"Fiduciary" under the common law is nebulously defined as "one who owes to another the duties of good faith, trust, confidence, and candor."[96] Executors and personal representatives of estates, trustees of trusts, [97] holders

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94. *In re* Benjamin Bosowski v. E*Trade Securities LLC, FINRA Case No. 11-02285, 2012 WL 1795788, (May 7, 2012).

95. *Id*. As previously discussed, even if the state securities acts governing the investment advisory activities of Independent Adviser had not provided a private right of action or joint and several liability for aiders or control persons, the standards they establish should bolster claims of negligence against E-Easy, who ought to be aware of laws and regulations governing investment advisors and taking reasonable measures not to aid violations of those laws. *See, e.g., In re* Charles Schwab & Co., NYSE Exchange Hearing Panel Decision 05-110, 2005 WL 3068048, (Oct. 17, 2005) (fining Charles Schwab & Co. $1,000,000 for failing to establish and maintain appropriate supervisory procedures for accounts managed by its non-employee investment advisors).

96. BLACK'S LAW DICTIONARY at 658 (8th ed. 2004).

97. *See, e.g.,* FLA. STAT. § 518.10 (2015) (includes, as "fiduciary," executor, administrator, trustee, guardian, or other person or entity with responsibility, pursuant to written document, to acquire, invest, reinvest, exchange, retain, sell, or manage money or property of another). *See also* IND. CODE § 30-2-14-3 (2015) (defining "fiduciary" for purposes of Uniform Principal and Income Act as personal representative, executor, administrator, or person performing substantially same function with respect to decedent's estate, and trustee); MO. REV. STAT. § 469.240 (2015) ("fiduciary," under Uniform Fiduciaries Law, includes trustee under express or implied trust, executor, administrator, guardian, conservator, receiver, trustee in bankruptcy, partner, corporate officer, or "any other person acting in a fiduciary capacity for any person, trust or estate"); ALA. CODE § 19-1-2 (2015).

of powers of attorney, [98] and ERISA-covered employee benefit plans[99] are all fiduciaries as we commonly think of the term. Investment advisors are also fiduciaries under the laws and regulations governing them.

Blue Sky Laws often provide that investment advisors are fiduciaries by statute or by rule.[100] The Investment Advisers Act of 1940 (the "Act"),[101] lacks any express provision declaring investment advisers to be fiduciaries. Nonetheless, by case law and SEC pronouncements, the obligations of advisors under the Act, such as the duty of loyalty, avoidance of conflicts, and full disclosure, are considered to be fiduciary obligations.[102]

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98. *See, e.g.,* Russ *ex rel.* Schwartz v. Russ, 734 N.W. 2d 874, 302 (Wis. 2007) ("[A] POA [power of attorney] agent has a fiduciary duty to the principal, and that . . . agent is usually prohibited from self-dealing unless the power to self-deal is written in the POA document."); Smith v. Wachovia Bank, N.A., 33 So. 3d 1191, 1199 (Ala. 2009) ("[W]hen one accepts the power of attorney, . . . "[t]he [resulting] principal-agency relationship is fiduciary in nature and imposes upon the agent a duty of loyalty, good faith, and fair dealing . . . ."); *In re* Miller, 935 N.E. 2d 729, 738 (Ind. Ct. App. 2010) ("A power of attorney creates a fiduciary relationship between a principal and her agent, or attorney in fact.").

99. The definition of a "fiduciary" for purposes of the Employee Retirement Income Security Act ("ERISA") is a functional one and includes (i) those with discretionary control of the plan or its assets, (ii) those who receive, directly or indirectly, compensation for rendering investment advice or are in a position to do so, and (iii) those with any discretionary authority or responsibility in the administration of the plan. 29 U.S.C. § 1002(21)(A) (2015). *See also* Smith v. Provident Bank, 170 F. 3d 609, 613 (6th Cir. 1999) (noting definition of "fiduciary" under ERISA broader than common law notion of fiduciary); Hunt v. Hawthorne Assoc., 119 F.3d 888, 892, n. 2 (11th Cir. 1997).

100. *See, e.g.*, 710 IND. ADMIN. CODE 4-19-15 (2015) (providing "[i]nvestment advisers . . . are fiduciaries and have a duty to act primarily for the benefit of their clients . . . [and] shall not engage in unethical or dishonest business practices"); IOWA ADMIN. CODE r. 191-50.38(502) (2015); N.H. REV. STAT. § 421-B:5-502(b)(2) (in effect Jan. 1, 2016).

101. 15 U.S.C. §§ 80b-1 – 80b-21 (2015).

102. *See generally* U.S. SEC & EXCH. COMM'N, REGULATION OF INVESTMENT ADVISERS BY THE U.S. SECURITIES AND EXCHANGE COMMISSION at 22-60 (Mar. 2013), *available at* http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf.

2. Aiding a Breach of Fiduciary Duty

Some (but not all) jurisdictions provide for a common law right of action for aiding and abetting a breach of a fiduciary duty.[103] In those jurisdictions that do, the generally-required elements include (i) a fiduciary duty on the part of the wrongdoer, (ii) a breach of that fiduciary duty, (iii) knowledge of the breach by the aider and abettor, and (iv) substantial assistance from the aider and abettor.[104]

Under the hypothetical "E-Easy facts" previously postulated, the foregoing elements of aiding a breach of fiduciary duty should be satisfied. Under Indiana law, Independent Adviser is a fiduciary. E-Easy provided Independent Adviser the power-of-attorney forms signed by E-Easy customers granting Independent Adviser trading authority over their accounts. Thus, E-Easy is on notice of the fiduciary relationship.

Under Indiana Blue Sky Laws, conduct considered unethical and deceptive, includes excessive trading, performance-based compensation (with some exceptions), and material misrepresentations and omissions, including material omissions regarding Independent Adviser's qualifications. E-Easy is knowingly supporting Independent Adviser's trading with telephonic assistance, payment of performance-based fees from its customers' accounts, and easy access to customer-account information through its "independent advisor friendly" program. All that might be missing is actual (versus constructive) knowledge of Independent Adviser's deceptive conduct.

Whether constructive knowledge of the wrongdoing is sufficient under the jurisdiction in question must be explored in the absence of evidence of actual

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103. *See* DiMaggio v. Rosario, 950 N.E.2d 1272, 1275-76 (Ind. Ct. App. 2011) (citing cases from various jurisdictions allowing cause of action for aiding breach of fiduciary duty, but declining issue in case before it); Crystal Valley Sales, Inc. v. Anderson, 22 N.E.3d 646, 656 (Ind. Ct. App. 2014) (concluding legislature or Indiana Supreme Court should decide whether to allow cause of action for aiding breach of fiduciary duty under Indiana law). *See also* Jeanne Crandall, *Theories of Recovery Against Investment Advisers and Their Sponsors*, 2 PIABA B.J. 67 (2004).

104. *See, e.g.,* Pearlman v. Alexis, No. 09-20865, 2009 WL 3161830 (S.D. Fla. Sept. 25, 2009) (rejecting defendant's contention of no cause of action for aiding and abetting breach of fiduciary duty under Florida law); Cahaly v. Benistar Property Exch. Trust Co., 885 N.E.2d 800, 809-12 (Mass. 2008) (applying New York law on aiding breach of fiduciary duty). *Cf.* Darocy v. Abildtrup, 345 S.W.3d 129, 137-38 (Tex. Ct. App. 2011) ("A cause of action based on a contribution to a breach of fiduciary duty must involve the defendant's ***knowing participation*** in such a breach.") (emphasis added.)

knowledge on the part of the aider and abettor. Nonetheless, it should be inconsistent with the requirement that all firms "observe high standards of commercial honor and just and equitable principles of trade"[105] for a firm to turn a "blind eye" to indications of wrongdoing. This longstanding principle ought to apply particularly to elderly customers, and there are indications that FINRA is increasing its sensitivity to exploitation and abuse of the elderly in this regard.[106]

III. HOLD HARMLESS, WAIVERS, AND SIMILAR PROVISIONS

It is now standard practice in the industry for securities firms to include mandatory arbitration provisions in their customer agreements, by which public investors give up their right to litigate a claim in court in favor of arbitration, a process that, in theory, is to be more expeditious, yet fair and equitable. At some point, brokerage firms began inserting provisions intended to limit the rights of their customers, excuse themselves, or use choice of law provisions to restrict available remedies. FINRA frowned on this.

It is contrary to any notion of fairness or sound public policy to obligate public investors to waive rights to remedies for violations of securities laws, securities regulations, and SRO rules. "As a practical matter, customers usually have no ability to negotiate terms different than the standard pre-

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105. FINRA, RULE 2010 (2015).

106. In FINRA, REGULATORY NOTICE 07-43, 2007 WL 2685590, at *6 (Sept. 2007), FINRA warned member firms to watch for signs of financial abuse of elderly or incapacitated customers, including "red flags," such as atypical or unexplained withdrawals and drastic shifts in investment style. More recently, FINRA proposed amending FINRA, RULE 4512 (2011) (to require firms to obtain the name of a trusted contact person in the event the firm has concerns about transactions in the account. It also proposed new Rule 2165, allowing firms to place temporary holds on disbursements of funds or securities from accounts when there is a reasonable belief of financial exploitation. FINRA, REGULATORY NOTICE 15-37, 2015 WL 6408685 (Oct. 2015). Furthermore, certain states require the reporting of ***suspected*** financial exploitation of an elderly or incapacitated person to the appropriate adult protective services agency and make it a crime to fail to do so. *See, e.g.,* FLA. STAT. § 415.111 (2016). *See also* Sam Brannan, *Trends in Elder Abuse Law*, 20 PIABA B.J. 365 (2013).

dispute arbitration clause. It is important, therefore, that arbitration be a fair and effective alternative to court."[107]

FINRA Rule 2268(d) expressly prohibits any of the following provisions in customer agreements:

- Provisions that limit or contradict the rules of any SRO;
- Provisions that limit the ability of a party to file any claim in arbitration; and
- Provisions that limit the ability of arbitrators to make awards.[108]

FINRA's prohibition is in keeping with provisions found in most state securities laws deeming any contractual provision purporting to waive compliance with securities laws and regulations to be null and void.[109]

Consistent with the policy reflected in the anti-waiver provisions in state securities laws are provisions found in the Securities Act of 1933[110] and the Securities Act of 1934. [111] The latter Act provides as follows:

> (a) Waiver provisions
>
> Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of a self-regulatory organization, shall be void.[112]

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107. BARRY R. GOLDSMITH & THOMAS B. LAWSON, CHOICE OF LAW CLAUSES IN CUSTOMER AGREEMENTS: NASD CONDUCT RULE 3110(F)(4) (1998), *available at* http://www.gibsondunn.com/publications/Documents/Goldsmith-ChoiceofLaw ClausesInCustomerAgreements.pdf.

108. FINRA, RULE 2268(d) (2011).

109. *See, e.g.,* ALA. CODE § 8-6-19(h) ("Any condition, stipulation or provision binding any person acquiring any security or receiving any investment advice to waive compliance with any provision of this article or any rule or order hereunder is void."); MO. ANN. STAT. § 409.5-509(l) (West 2015) (substantially same); 15 U.S.C. § 78cc(a) (2015) (("Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of a self-regulatory organization, shall be void.").

110. 15 U.S.C. §§ 77a-77aa (2015).

111. 15 U.S.C. §§ 78a-78pp (2015).

112. 15 U.S.C. § 78cc(a) (2015). *See also* Schine v. Schine, 254 F. Supp. 986, 988 (S.D.N.Y. 1966) (noting release from anti-fraud provisions of exchange act void). *Cf.* Moseman v. Van Leer, 263 F. 3d 129, 133 (4th Cir. 2001) (finding release of federal securities claims of which plaintiffs had constructive knowledge is valid).

The 1933 Act's provision is substantially identical.[113] In short, as a matter of law, FINRA-member brokerage firms cannot require customers to waive remedies, exculpate them, or hold them harmless for violations of securities laws, securities regulations, and SRO rules. In fact, to insist upon the application of those or similar provisions exposes a firm to a risk of FINRA disciplinary proceedings.[114]

IV. CONCLUSION

Bringing a successful case against an online, discount broker-dealer is difficult and challenging, but not impossible, based on the authors' experience. The limited communications between the firm and the customer requires a determination of securities laws, securities regulations, and SRO rules applicable in the absence of a "recommendation." Discovery must be pursued of what the firm did (or did not do) to comply with those applicable securities laws, securities regulations, and SRO rules with respect to the customer's account for a case to begin to take shape. Lastly, proper expert testimony regarding feasible and reasonable actions that could have been taken by the firm, such as restricting trading in an account "gone wild," will likely prove helpful. It is the authors' hope that pressure on online, discount firms will continue so as to make the decimation of their customers' accounts by firm inaction less likely.

113. 15 U.S.C. § 77n (2015). *See also* Genesee County Employees' Retirement Sys. v. Thornburg Mortgage Sec. Trust 2006-3, 825 F. Supp. 2d 1082, 1190-92 (D.N.M. 2011) (citations omitted) ("The statutory framework of the 1933 and 1934 Acts compels the conclusion that individual security holders may not be forced to forego their rights under the federal securities laws due to a contract provision."); Special Transp. Servs. v. Balto, 325 F. Supp. 1185, 1187 (D. Minn. 1971) ("Buyer of securities cannot contract to waive, release or compromise subsequently maturing claims under federal securities laws, whether such waive is conscious or inadvertent.").

114. *See, e.g.*, Dept. of Enforcement v. Charles Schwab & Co., FINRA Disciplinary Proceeding No. 2011029760201, 2012 WL 335626 (Feb. 1, 2012) (filing complaint against Charles Schwab for violating Rules 3110(f)(4) and 2268(d) by inclusion in customer agreements provisions purportedly waiving customer right to participate in class actions against it).

Notes & Observations

MANDATORY SECURITIES ARBITRATION: AN IDEA WHOSE TIME IS STILL HERE?*

*Roni A. Elias***

INTRODUCTION

Arbitration is becoming an increasingly prevalent and important means of dispute resolution. A series of Supreme Court decisions[1] has made it easier to enforce arbitration agreements under the Federal Arbitration Act ("FAA").[2] As the law governing arbitration has become more uniform and more favorable to arbitration, more parties to commercial transactions have chosen make arbitration the default choice as a forum for dispute resolution. The expanding use of arbitration has come to affect consumer transactions in a variety of areas, as consumers are required to agree to arbitration as a condition of obtaining a product or service.

Agreements to arbitrate made at the outset of a transaction are known as "pre-dispute arbitration agreements" ("PDAAs"). The expansion of arbitration has engendered doubts about fairness of mandatory PDAAs, which seem to

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1. *See, e.g.,* Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1 (1983) (holding that the FAA "creates a body of federal substantive law establishing and regulating the duty to honor an agreement to arbitrate"); Southland Corp. v. Keating, 465 U.S. 1 (1984) (holding that the FAA could be applied in state court actions, as well as in federal court cases); Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614 (1985) (holding that the FAA applied to international agreements).

2. Federal Arbitration Act, 9 U.S.C. § 1, *et seq*. (2006).

many to be a mechanism for exploiting disparities in power. These doubts, in turn, have prompted a movement towards reform, which seeks legislation to check the burgeoning scope of the FAA and its strongly pro-arbitration policies by prohibiting mandatory PDAAs.

Mandatory arbitration has long been a part of securities transactions; virtually every relationship between brokerage firms and investors involves an arbitration agreement for disputes arising from the relationship. These arbitrations were carried out under a framework established by federal securities law. The bursting of the dot-com bubble and the capital markets crisis of 2008 caused widespread doubts about the integrity of the securities industry, which spread to the securities arbitration process, and these doubts have raised questions about whether mandatory arbitration is part of the problem. Those seeking pro-consumer changes in federal arbitration law include mandatory securities arbitration as one of the objects of reform.

Part I of this article reviews the federal law of arbitration and how the Supreme Court has interpreted the FAA to establish a strong federal policy favoring arbitration that can only be countermanded by an express statutory statement from Congress. Part II reviews how federal securities laws have treated arbitration as part of the statutory scheme for regulating securities transactions and whether those laws contain the kind of express statement required to override the FAA. Part III discusses previous Congressional responses to calls for regulating securities arbitration, including both the Arbitration Fairness Act, which was not enacted, and the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was signed into law and which gave the SEC discretion to decide whether to prohibit mandatory PDAAs in the securities business. Part IV discusses current ideas for reforms specifically aimed at securities arbitration. This paper concludes that the current securities arbitration system would not be undermined by legislation or administrative action assuring that investors would have the choice to arbitrate or go to court at the time that a dispute with a brokerage firm arose. In addition, this paper argues that securities arbitration procedures should be changed so that arbitration panels are more diverse and so that the parties to arbitration have more – and more accurate – information about the backgrounds and inclinations of prospective arbitrators.

I. THE FEDERAL ARBITRATION ACT AND THE STRONG FEDERAL POLICY FAVORING ARBITRATION

American courts were not always eager to refer disputes to arbitration at the first opportunity. Before Congress enacted the FAA in 1925, state and federal courts were generally reluctant to enforce arbitration agreements.[3] According to the predominant view of the FAA, Congress enacted the statute "to overrule the judiciary's long- standing refusal to enforce agreements to arbitrate."[4]

The FAA "creates a body of federal substantive law of arbitrability, applicable to any arbitration agreement within the coverage of the Act."[5] Although the FAA has been important since its enactment, it has acquired particularly expansive scope and effect during the last half-century. During this period, the Supreme Court has held that the FAA: governs virtually every arbitration clause arising out of a commercial transaction;[6] applies to require the arbitration of statutory rights as well as contractual rights;[7] and preempts any state law "to the extent that it 'stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress'" in widely promoting the enforcement of arbitration agreements.[8] The Supreme Court

3. Volt Info. Scis., Inc. v. Bd. of Trs. of Leland Stanford Junior Univ., 489 U.S. 468, 478 (1989); *see also* Buckeye Check Cashing, Inc. v. Cardegna, 546 U.S. 440, 443 (2006).

4. *Volt Info. Scis.*, 489 U.S. at 478.

5. *See, e.g., Moses H. Cone*, 460 U.S. at 24. The Court defined "arbitrability" as "the duty to honor an agreement to arbitrate." *Id.* at 25 n. 32.

6. The FAA provides that it governs agreements to arbitrate that involve "transactions in commerce." 9 U.S.C. § 2 (2006). The Supreme Court has held the term "transactions in commerce" includes any transaction that *in fact* involves interstate commerce, even if the parties did not anticipate an interstate impact. *See* Allied-Bruce Terminix Cos. v. Dobson, 513 U.S. 265, 273-74, 281 (1995); *see also* Howsam v. Dean Witter Reynolds, Inc., 537 U.S. 79 (2002) (holding the FAA applies to arbitration clauses in connection with securities transactions).

7. CompuCredit Corp. v. Greenwood, 132 S. Ct. 665 (2012).

8. *Volt Info. Scis.,* 489 U.S. at 478 (quoting Hines v. Davidowitz*,* 312 U.S. 52, 67 (1941)); *see also* Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395 (1967); Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1 (1983); *see also* Perry v. Thomas, 482 U.S. 483 (1987) (holding the FAA preempted a California statute that required wage collection actions to be resolved in court). According to Supreme Court authority, an act of Congress preempts state law when: (1) Congress intends that the federal law expressly provides it displaces state law (express preemption); (2) Congress intends that the federal law "occupy the field;" (3) state law conflicts with the requirements of federal law; (4) it is impossible for a party to comply with both the state and federal law; and, (5) the challenged state law "stands as an obstacle to the accomplishment and execution of the full purposes and

has also held that the FAA applies in both state and federal court.[9] Thus, the policies established by the FAA can supersede state policies regarding when to require arbitration and when to close off judicial forums – even in state courts.

Section 2 is the key provision of the FAA. It creates a right to the enforcement of arbitration agreements. It provides, for maritime transactions or transactions in interstate commerce, any agreement to arbitrate, whether made pre- or post-dispute, "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."[10] The Supreme Court has held that § 2 "embodies the national policy favoring arbitration and places arbitration agreements on equal footing with all other contracts."[11] In light of this purpose, the Court has held that the purpose of § 2 was to "require[] courts to enforce privately negotiated agreements to arbitrate, like other contracts, in accordance with their terms."[12]

Sections 3 and 4 of the FAA create a mechanism for enforcing contractual rights to arbitration. According to § 3, in any action that is already pending in "any of the courts of the United States," if there is an issue or issues that can be referred to arbitration pursuant to an enforceable arbitration agreement, the court "shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration."[13] Section 4 of the FAA also provides a mechanism for enforcing an arbitration agreement in disputes where no federal action is pending. If a party to an enforceable arbitration agreement fails or refuses to arbitrate in

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objectives of Congress." *See* Crosby v. Nat'l Foreign Trade Council, 530 U.S. 363, 372-73 (2000) (internal citations and quotations omitted).

9. *See* Southland Corp. v. Keating, 465 U.S. 1, 12 (1984) ("The statements of the Court in *Prima Paint* that the Arbitration Act was an exercise of the Commerce Clause power clearly implied that the substantive rules of the Act were to apply in state as well as federal courts.").

10. 9 U.S.C. § 2 (2006).

11. Buckeye Check Cashing, Inc. v. Cardegna, 546 U.S. 440, 443 (2006) ; *see also Moses H. Cone*, 460 U.S. at 24 (holding the FAA established a "liberal federal policy favoring arbitration agreements"); Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614 (1985).

12. Volt Info. Scis., Inc. v. Bd. of Trs. of Leland Stanford Junior Univ., 489 U.S. 468, 478 (1989).

13. 9 U.S.C. § 3 (2006).

accordance with the agreement, and if the arbitrable dispute would fall within federal jurisdiction, as defined under Title 28 of the United States Code, the aggrieved party to the arbitration agreement may petition "any United States district court . . . for an order directing that such arbitration proceed in the manner provided for in such agreement."[14] Upon such a petition, the district court will make a determination of what the arbitration agreement requires and shall issue any orders in accordance with those requirements.[15]

There are two circumstances under which federal courts will not enforce arbitration agreements. First, the agreement will not be enforced if it is void or unenforceable for any of the reasons that any other contract would be void or unenforceable.[16] Second, even a valid and otherwise enforceable arbitration agreement can be set aside if, through its enactment of another statute, Congress has expressed its intention that the relevant dispute should not be arbitrated, regardless of whether parties might have agreed between themselves to such arbitration.[17]

II. PDAAS IN SECURITIES TRANSACTIONS ARE ENFORCEABLE BECAUSE EXISTING FEDERAL SECURITIES LAW DOES NOT REFLECT CONGRESS' INTENTION TO LIMIT ARBITRATION IN SECURITIES TRANSACTIONS

A. Federal Securities Legislation

Federal law imposes substantial regulation on the economic relationships between consumers and those who sell securities and other investment products because of the economic importance of these relationships and "the possibility of investor abuse."[18] The regulation of these relationships is principally effected through three provisions of the Securities Exchange Act of 1934 ("the Exchange Act").[19] These provisions involve the regulation of broker-dealers through self-regulatory organizations ("SROs").

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14. 9 U.S.C. § 4 (2006).

15. *Id.*

16. 9 U.S.C. § 2 (2006).

17. *See* Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987).

18. NORMAN S. POSER & JAMES A. FANTO, BROKER-DEALER LAW & REGULATION § 1.01 (4th ed. 2007).

19. 15 U.S.C. §§ 78aa , *et seq.* (2015).

The statutory scheme created by Congress for regulating the broker-dealer industry assigns extraordinary regulatory authority to SROs, including securities exchanges and national securities associations.[20] The Securities and Exchange Commission ("SEC") has noted that industry self-regulation is "an essential and officially sanctioned part of the regulatory pattern."[21] Indeed, "it is doubtful whether any regulated industry has been allowed to regulate itself to the degree the securities industry has."[22]

The regulation of stockbrokers in the United States arose originally not from the government but from the brokers themselves, who used private rules and discipline as a means of making their services more exclusive and, therefore, more valuable.[23] The epitome of this early self-regulation was the New York Stock and Exchange Board, which, during the nineteenth century, created a "miniature legal system" that included rules governing trading and disputes among brokers.[24] This self-regulatory system did not apply to the vast majority of stock transactions, which happened in so-called "over-the-counter" transactions.[25] These transactions remained unregulated by government or private organizations until the New Deal.[26]

The private regulatory organization survived as a crucial part of the regulatory apparatus in the statutory scheme constructed around the Exchange Act. In this statutory scheme, the SEC had the authority to write new rules, but the existing SROs remained in place.[27] Through other New Deal legislation, a new SRO was created to regulate over-the-counter transactions – the National Association of Securities Dealers ("NASD").[28] Throughout the

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20. 15 U.S.C. §§ 78f, 78o-3 (2010).

21. U.S. SEC. & EXCH. COMM'N, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 88-95, pt. 4, at 501 (1963).

22. POSER & FANTO, *supra* note 18, § 4.01.

23. STUART BANNER, ANGLO-AMERICAN SECURITIES REGULATION 171–75 (1998).

24. *Id.* at 271. The New York Stock and Exchange Board was created in 1817, and its name was changed to the New York Stock Exchange in 1863. *See* ROBERT SOBEL, N.Y.S.E.: A HISTORY OF THE NEW YORK STOCK EXCHANGE, 1935-1975 (1975).

25. JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 140-41 (3rd ed. 2003).

26. *Id.* at 141-44.

27. *Id.* at 100.

28. William Birdthistle & M. Todd Henderson, *Becoming a Fifth Branch*, 99 CORNELL L. REV. 1, 17 (2013).

remainder of the twentieth century, this institutional structure, combining regulations by the SEC and enforcement by the SROs, constituted the primary means of regulating securities transactions.[29]

That regulatory structure changed at the opening of the twenty-first century, following a variety of events that raised questions about the integrity of securities markets, including the bursting of the dot-com bubble, scandals implicating the major accounting firms, and a series of corporate collapses. In 2007, the SEC approved the merger of the NASD and the enforcement arm of the New York Stock Exchange into a single industry SRO known as the Financial Industry Regulatory Authority ("FINRA").[30] "The creation of FINRA created a monopoly for broker SROs . . . and increased the interaction between the SEC and the SRO."[31] FINRA is registered with the SEC as a national securities association under § 15A of the Exchange Act and as an independent regulator for all securities firms doing business in the United States. Congress also adopted a comprehensive system of regulation over the SROs, in order that self-regulation could accomplish protecting investors and serving the public interest.[32]

FINRA's animating purpose is to carry out the statutory purposes and to enforce compliance by its members and associated persons with the provisions of the Exchange Act and its regulations, as well as FINRA's own rules.[33] The Exchange Act requires FINRA to adopt rules ranging from those preventing "fraudulent and manipulative acts and practices" to promoting "just and equitable principles of trade" and "in general, [protecting] investors and the public interest."[34] When it promulgates its own regulations, FINRA must file proposed rule changes with the SEC, and the SEC must publish notice and provide interested persons an opportunity to comment on the proposal.[35] All

29. *Id.* at 17-22.

30. *Id.* at 22-23.

31. *Id.* at 23.

32. POSER & FANTO, *supra* note 18, § 4.04[A].

33. 15 U.S.C. § 78o-3 (2010).

34. 15 U.S.C. § 78o-3(b)(6) (2010). The statute also lists certain improper purposes, including regulating "matters not related to the purposes of the Act. *Id*.

35. 15 U.S.C. § 78s(b)(1) (2010).

proposed FINRA rules must be approved by the SEC, upon a finding that it is "consistent" with the requirements of the Exchange Act and the applicable regulations.[36]

B. McMahon, Rodriguez, and the Enforceability of Arbitration Clauses in Securities Transactions

It was not until the 1980s that the Supreme Court conclusively ruled on the question of whether the statutory scheme created to regulate securities clearly reflected Congress' intention to preempt the expansive application of the FAA in securities cases. In a couple of cases decided in 1953 and 1974, the Court had issued apparently conflicting opinions about the enforceability of arbitration agreements in the securities context. But in *Shearson/American Express v. McMahon*[37] and *Rodriguez de Quijas v. Shearson/American Express, Inc.*,[38] the Court unequivocally held that, by enacting the statutes that created the system of securities regulation, Congress had not intended to create any special rules for arbitration in disputes arising from securities law.

The Court first addressed the enforceability of an arbitration agreement in the securities context in *Wilko v. Swan*.[39] In *Wilko*, the question was whether a pre-dispute agreement to arbitrate was enforceable with respect to a claim arising under § 12(2) of the Securities Act.[40] The *Wilko* Court concluded that the arbitration agreement could not be enforced because the substantive rights created by the Securities Act could only be adequately protected in a judicial forum. The Court explained that an arbitral forum was insufficient because "the protective provisions of the Securities Act require the exercise of judicial direction to fairly assure their effectiveness."[41]

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36. 15 U.S.C. § 78s(b)(2)(C)(i) (2010). By the same token, if the SEC does not make the requisite finding, the proposed rule change cannot be approved. 15 U.S.C. § 78s(b)(2)(C)(ii) (2010).

37. 482 U.S. 220 (1987).

38. 490 U.S. 477 (1989).

39. Wilko v. Swan, 346 U.S. 427 (1953).

40. 15 U.S.C. § 77*l*(2) (2010).

41. *Wilko,* 346 U.S. at 437.

In *Scherk v. Alberto-Culver Co.*,[42] the Court reached a different result, upholding a pre-dispute agreement to arbitrate in connection with an international securities transaction. The *Scherk* Court determined that an international contract "involve[d] considerations and policies significantly different from those found controlling in *Wilko.*"[43] In particular, the Court noted that it might be fruitless to compel a judicial resolution of the parties' claims because an international party seeking to avoid an American court could just make "speedy resort to a foreign court."[44] Thus, the Court concluded that, in light of the practical alternatives, arbitration was an adequate substitute for adjudication as a means of enforcing the parties' statutory rights.

The Court resolved the apparent tension between *Wilko* and *Scherk* in *McMahon.* In *McMahon*, individual investors had signed a pre-dispute arbitration agreement with a broker and later asserted a claim in district court against the broker under § 10(b) of the Exchange Act, along with other claims under state law and federal (non-securities) law.[45] Relying on the arbitration agreement, the broker moved to compel arbitration. The district court granted the motion, but the Court of Appeals reversed with respect to the Exchange Act claim.[46] In reaching this conclusion, the Court of Appeals relied upon *Wilko*, but it noted that *Scherk* seemed inconsistent with the holding in *Wilko*.[47]

The Supreme Court focused its analysis of arbitrability by deciding whether Congress intended to preclude arbitration for Exchange Act claims when it enacted § 29(a) of the Exchange Act,[48] which declares void "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of [the Act]."[49] The McMahons argued that § 29(a) applied to § 27 of the Exchange Act,[50] which granted exclusive jurisdiction to the district courts in Exchange Act claims.[51] In other words, the McMahons

42. 417 U.S. 506 (1974).

43. *Id.* at 515.

44. *Id.* at 518.

45. 15 U.S.C. § 78j (2010).

46. McMahon v. Shearson/American Express, Inc., 788 F.2d 94, 98 (2d Cir. 1986).

47. *Id*.

48. 15 U.S C. § 78cc(a) (2010).

49. *Id*.

50. 5 U.S.C. § 78aa (2010).

51. Shearson/American Express v. McMahon, 482 U.S. 220, 227-28 (1987).

contended that the anti-waiver provision of § 29 applied to procedural elements of the Exchange Act as well as substantive ones.[52]

The Court declined to read § 29 this way, concluding that it only reflected Congress' intention to preclude waiver of the substantive rights created by the Exchange Act.[53] In reaching this conclusion, the Court relied primarily upon the plain language of the statute:

> § 27 itself does not impose any duty with which persons trading in securities must "comply." By its terms, § 29(a) only prohibits waiver of the substantive obligations imposed by the Exchange Act. Because § 27 does not impose any statutory duties, its waiver does not constitute a waiver of "compliance with any provision" of the Exchange Act under § 29(a).[54]

The *McMahon* Court went beyond the statutory language to conclude that PDAAs in securities transactions were not contrary to Congress' intentions. In this connection, it also concluded that, as a general rule, arbitration adequately protected the substantive rights created by securities law, principally because of SEC oversight over the SRO arbitration forums.[55] Thus, the Court expected the SEC would assure that the process treated investors fairly and adequately protected their rights.[56]

Two years later, in *Rodriguez*, the Court confirmed its conclusion in *McMahon*. First, it held that *McMahon*'s reading of the Exchange Act could also apply to the Securities Act.[57] Second, it took a step that the *McMahon* Court had apparently been reluctant to take, explicitly overruling *Wilko*.[58]

As a result of its rulings in *McMahon* and *Rodriguez*, the Court could not have been more clear: at the time of those two decisions, there was nothing in federal securities law that reflected any Congressional intent to preempt the broad application of the FAA in securities law.[59] Thus, the Court put the onus

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52. *Id.*

53. *Id*. at 228.

54. *Id*.

55. *Id*. at 238.

56. *Id.*

57. Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477, 482-83 (1989).

58. *Id*.

59. *See id*. at 483; Shearson/American Express v. McMahon, 482 U.S. 220, 226-27 (1987).

on Congress to enact new legislation if it sought to prevent the enforceability of PDAAs in securities transactions. There have been efforts to pass such legislation, and, at the same time, there have been aggressive defenses of the status quo, based on the industry contention that mandatory arbitration in securities cases makes good policy sense.

III. PREVIOUSLY PROPOSED LEGISLATIVE REFORMS AFFECTING SECURITIES ARBITRATION

There has been increased advocacy for investor rights in the twenty-first century. With the bursting of the dot-com bubble, the mortgage-backed securities crisis, and the Great Recession of 2008, there has been increased attention on what can be done to protect investors from exploitation by the sellers of securities. Part of this attention has focused on whether the system of mandatory securities arbitration administered by SROs provides too much protection for the securities industry.

A. Arbitration Fairness Act

Since the mid-2000s, there have been repeated efforts in Congress to amend the FAA to make it harder for parties to use mandatory arbitration clauses, as they amount to being contracts of adhesion. A series of bills introduced in consecutive sessions of Congress, and generally known as the Arbitration Fairness Act ("AFA") have proposed this kind of reform in a variety of commercial contexts. Although this legislation has not emerged from Congress, its repeated submission demonstrates the strength of the movement to limit or eliminate mandatory arbitration.

Much of the ferment around the AFA has focused on the securities industry. In March 2005, a subcommittee of the House of Representatives Financial Services Committee held a hearing inquiring into the necessity or advisability of reform in the securities arbitration process.[60] The Committee heard testimony from expert witnesses with different views of many aspects of the process, including: (1) the virtually uniform practice of including an

60. *See The Securities Arbitration System: Hearing Before the Subcomm. on Capital Markets, Insurance & Government Sponsored Enterprises of the H. Comm. on Financial Services*, 109th Cong. 13-14 (2005).

arbitration clause in any agreement between an investor and broker-dealer;[61] (2) the NASD's rule requiring one industry arbitrator on every three-arbitrator panel,[62] which some argued created an appearance of bias and impropriety in every NASD arbitration;[63] and (3) a lack of transparency in arbitrators' decisions.[64]

This inquiry led to further advocacy in Congress. Two years after the hearing, at hearings on the 2007 version of the AFA, Senate and House subcommittees heard testimony critical of mandatory arbitration in the securities industry.[65] Senator Feingold, sponsor of the Senate bill, expressly

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61. *Id*.

62. Under the prior NASD and the current FINRA rules, when a claim involves more than $100,000, the arbitration panel generally consists of three arbitrators. NASD, Rule 10308(b)(1)(B) (2005); FINRA, RULE 12401(c) (2012). According to the NASD rule in effect in 2005, a three-person arbitration panel consisted of one non-public arbitrator, customarily referred to as an industry arbitrator, and two public arbitrators, or arbitrators who are not associated with the securities or commodities industry. NASD, RULE 10308(b)(1)(B) (2005). The current FINRA rule permits three-person panels comprised of all public arbitrators. FINRA, RULE 12403(c) (2012). In 2005, industry arbitrators included individuals who had been associated within the past five years with, or who were retired from, the securities or commodities industries, as well as professionals who had devoted at least twenty percent of their professional work in the prior two years to clients in the securities and commodities industry. NASD, RULE 10308(a)(4) (2005). This provision has since been amended to remove the time limitation. FINRA, RULE 12100(p) (2015). Individuals who are, or were, associated with the securities or commodities industries, at any time, will always be considered industry arbitrators. *Id.* In addition, attorneys or accountants who, within the past five years, have devoted twenty percent or more of their practice in any one calendar year to representing parties in securities matters will also be considered industry arbitrators. *Id.* Investor advocates contend that "the industry arbitrator presents an appearance of bias and impropriety to the investing public," *2005 Hearing*, *supra* note 60, at 105 (statement of the Public Investors Arbitration Bar Association), while the securities industry asserts that industry arbitrators provide valuable expertise.

63. *See 2005 Hearing*, *supra* note 60, at 105.

64. FINRA publishes its awards, but it does not require its arbitrators to explain their reasoning unless the parties request it. *See* FINRA, RULE 12904 (2009).

65. *See The Arbitration Fairness Act of 2007: Hearing on S. 1782 Before the Subcomm. on the Constitution*, 110th Cong. 13 (2007) (statement of Tanya Solov); *Hearing on H.R. 3010, "The Arbitration Fairness Act of 2007" before the H. Subcomm. on Comm. and Admin. Law*, 110th Cong.113 (2007) (statement of

stated that the proposed version of the AFA would apply to PDAAs in securities brokerage customer account agreements.[66] The 2007 AFA never emerged from committee.

In the fall of 2009, a new version of the AFA was proposed, and it too stalled in Congress.[67] Responding to the continued pressure for regulatory reform of the financial services industry, the Treasury Department issued a comprehensive policy statement that, among other things, recommended that "[t]he SEC should study the use of mandatory arbitration clauses in investor contracts."[68] Specifically, the Treasury Department asserted that:

> [b]roker-dealers generally require their customers to contract at account opening to arbitrate all disputes. Although arbitration may be a reasonable option for many consumers to accept after a dispute arises, mandating a particular venue and up-front method of adjudicating disputes—and eliminating access to courts—may unjustifiably undermine investor interests. We recommend legislation that would give the SEC clear authority to prohibit mandatory arbitration clauses in broker-dealer and investment advisory accounts with retail customers. The legislation should also provide that, before using such authority, the SEC would need to conduct a study on the use of mandatory arbitration clauses in these contracts. The study shall consider whether investors are harmed by being unable to obtain effective redress of legitimate grievances, as well as whether changes to arbitration are appropriate.[69]

Theodore G. Eppenstein, Testimony in Support of Prohibiting Mandatory Arbitration in Securities Cases).

66. *Senate Subcommittee Hearing*, *supra* note 65 (opening statement of Sen. Feingold) ("First, [the Act] is intended to cover disputes between investors and securities brokers. I believe that such disputes are covered by the definition of consumer disputes, but to clear up any uncertainty, we will make the intent even clearer when we mark up the bill in committee.") *Id*.

67. Jill I. Gross, *The End of Mandatory Securities Arbitration*, 30 PACE L. REV. 1174, 1181 (2010).

68. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 72 (2009).

69. *Id.* (emphasis added).

B. Dodd-Frank and SEC Discretion to Prohibit Mandatory PDAAs

The Treasury Department's position that the SEC should have discretion to prohibit mandatory PDAAs was incorporated in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"),[70] the comprehensive financial services regulatory reform legislation that President Obama signed into law on July 21, 2010. Dodd-Frank contains several provisions that reflect Congress' concern with the use of PDAAs. For example, § 922(c)(2)[71] prohibited the enforcement of PDAAs or similar waivers of substantive and procedural rights in connection with whistleblower claims arising under the Sarbanes-Oxley Act of 2002.[72]

More significantly, § 921 of Dodd-Frank provides that the SEC:

> by rule, may prohibit, or impose conditions or limitations on the use of, agreements that require customers or clients of any broker, dealer, or municipal securities dealer to arbitrate any future dispute between them arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors.[73]

The House Report supporting Dodd-Frank indicates that this provision was inserted due to a concern with "securities industry practices [that] have deprived investors of a choice when seeking dispute settlement, too. In particular, pre-dispute mandatory arbitration clauses inserted into contracts have limited the ability of defrauded investors to seek redress."[74]

Notwithstanding this objective, by giving the SEC discretion to ban mandatory PDAAs, Dodd-Frank fell far short of the AFA's proposal to ban mandatory PDAAs altogether. Dodd-Frank could be understood as a concession to Wall Street's desire to preserve arbitration as the primary dispute resolution mechanism for customer disputes.[75] The industry and its supporters in Congress argue that Dodd-Frank's deference to the SEC's judgment is the product of Congress' desire to take advantage of the SEC's long experience in

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70. Dodd-Frank Act, Pub. L. 111-203, 124 Stat. 1376 (2010) (codified at 12 U.S.C. § 5301 (2015)).

71. *See* Dodd-Frank Act § 922(c)(2), adding 18 U.S.C. § 1514A(e) (2011).

72. Sarbanes–Oxley Act, Pub. L. 107-204, 116 Stat. 745 (2002).

73. Dodd-Frank Act § 921(a), 15 U.S.C. § 78o(o) (2010) (emphasis added).

74. 156 CONG. REC. H5237 (daily ed. June 30, 2010) (statement of Rep. Kanjorski).

75. Gross, *supra* note 67, at 1182-84.

supervising SROs generally and the fairness of arbitration procedure specifically.[76]

Since Dodd-Frank, the SEC has not acted to ban mandatory PDAAs in securities transactions. Congress has considered additional proposed legislation curbing mandatory PDAAs, including renewed efforts to enact the AFA. So far, these efforts have not succeeded. Thus, the policy debate over mandatory PDAAs continues.

IV. FUTURE POLICY ALTERNATIVES FOR REGULATING SECURITIES ARBITRATION

A. Proposed Legislation Limiting PDAAs in the Securities Industry

Proposals for reform legislation persist, aiming at restricting or eliminating PDAAs in the securities industry. In 2015, Rep. Keith Ellison introduced a bill entitled the "Investor Choice Act of 2015,"[77] which would "end pre-dispute mandatory . . . arbitration agreements and ban prohibitions on class action lawsuits in customer service contracts between investment advisers and broker-dealers and their clients."[78] Although this kind of legislation does not seek the same kind of sweeping prohibition of PDAAs in a variety of areas, its focus on ending such agreements in securities transactions is motivated by many of the same concerns that lie behind bills such as the AFA.

The continued push for arbitration reform in securities law has been significantly prompted by events that suggest that brokerage firms are manipulating arbitration procedure to their own advantage. In late 2011, Charles Schwab & Co. sent its usual monthly account statements to over 6.8 million existing account holders, along with documents immediately amending their account agreements.[79] These amendments, which were also

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76. *Id.*

77. H.R. 1098, 114th Cong. (2014), *available at* https://ellison.house.gov/sites/ellison.house.gov/files/wysiwyg_uploaded/114C%20investor%20arbitration%20act%20Ellison.pdf.

78. Press Release, Rep. Keith Ellison, Rep. Ellison Introduces Investor Choice Act of 2015 (Feb. 26, 2015), *available at* https://ellison.house.gov/media-center/press-releases/rep-ellison-introduces-investor-choice-act-of-2015.

79. *See* Dept. of Enforcement v. Charles Schwab & Co., FINRA Disciplinary Proceeding No. 2011029760201 (Feb. 1, 2012), *available at* http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p210893.pdf

imposed in the agreements for new account holders, included the account holders' waiver of the right to participate in class actions.[80] Schwab made this decision in light of the Supreme Court's ruling in *AT&T Mobility v. Concepcion*,[81] which held the FAA pre-empted a state law prohibiting arbitration agreements on unconscionability grounds and that amendments to arbitration agreements could be imposed unilaterally on consumers. Schwab's action – and its accompanying restriction on consumer choice – contributed to doubts about PDAAs, not to mention the subsequent unilateral amendments of those PDAAs.[82]

Actions like those taken by Schwab contribute to a public perception that securities arbitration is unfair.[83] One survey conducted before the capital markets crisis of 2008 showed that: "(1) investors have a far more negative perception of securities arbitration than all other participants, (2) investors have a strong negative perception of the bias of arbitrators in the securities arbitration forum, and (3) investors lack knowledge of the securities arbitration process."[84] The admitted a lack of knowledge about the securities arbitration process makes it hard to conclude that the only factor motivating the results was an assessment of the substantive fairness of the forum.[85] Even so, the strength of the public reaction to securities arbitration is an indication of the popular impulse behind some kind of reform regarding the regulation of PDAAs.[86] This public perception has had an effect. In response to the survey results, FINRA enacted several reforms of its arbitration procedures, including requiring arbitrators to write an "explained decision" if all parties request it

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80. *Id*.

81. AT&T Mobility v. Concepcion, 563 U.S. 321 (2011).

82. *See* Gross, *supra* note 67, at 1189. In 2012, the FINRA Department of Enforcement filed a disciplinary action against Charles Schwab & Co. ("Schwab") alleging that Schwab violated industry rules by including the class action waiver. Dept. of Enforcement v. Charles Schwab & Co., Letter of Acceptance, Waiver & Consent No. 2011029760202 (Apr. 24, 2014) Schwab eventually agreed to an Acceptance Waiver & Consent which included a provision requiring Schwab to withdraw the class action waivers. *Id.*

83. Jill I. Gross & Barbara Black, *When Perception Changes Reality: An Empirical Study of Investors' Views of the Fairness of Securities Arbitration*, 2008 J. DISP. RESOL. 349 (2008).

84. *Id*. at 354.

85. *Id*. at 391-99.

86. Gross, *supra* note 67, at 1185.

and the elimination of the mandatory "industry arbitrator" on three-arbitrator customer panels.[87]

In addition to the Investor Choice Act, some have argued for modifying § 921 of Dodd-Frank so that the prohibition on mandatory PDAAs in securities is a matter of statute, not a matter of SEC discretion.[88] These commentators are frustrated by the SEC's failure to act with regard to PDAAs. They make the point that investors should have the opportunity to choose whether or not to arbitrate – not at the outset of the business relationship but when the dispute arises.[89] They also point out if arbitration really is a more efficient and fairer method of dispute resolution, investors will choose it freely: "[i]f arbitration truly offers investors the opportunity to efficiently and fairly settle disputes, then investors will choose that option. But investors should also have the choice to pursue remedies in court, should they view that option as superior to arbitration."[90]

B. Arguments that Mandatory Arbitration Is the Most Fair and Efficient Dispute Resolution Process for Investors

Whatever the problems might be with mandatory PDAAs in other commercial contexts, numerous commentators contend that dramatic reform of dispute resolution procedure is not needed in the securities industry.[91]

Order Approving Proposed Rule Change Relating to Amendments to the Codes of Arbitration Procedure To Require Arbitrators To Provide an Explained Decision Upon the Joint Request of the Parties, 74 Fed. Reg. 6928-29 (Feb. 11, 2009) (citing survey results as one catalyst for the revised rule change proposal).

88. Letter from A. Heath Abshure, President of North American Securities Administrators Association, to Rep. Keith Ellison (Aug. 2, 2013), *available at* http://www.nasaa.org/wp-content/uploads/2013/05/NASAA-Letter-in-Support-of-Investor-Choice-Act-of-2013-FINAL-8-2-13-PDF.pdf. The North American Securities Administrators Association, advocates for legislation banning mandatory securities arbitration.

89. *Id*.

90. *Id*. (quoting House Committee on Financial Services on H.R. 3817, H.R. Rep. No. 111-687, Part 1, at 50 (2010)).

91. *See, e.g.,* Barbara Black, *How to Improve Retail Investor Protection after the Dodd-Frank Wall Street Reform and Consumer Protection Act,* 13 U. PENN. J. BUS. L. 1 (2010); Barbara Black & Jill I. Gross, *Investor Protection Meets the Federal Arbitration Act*, 1 STAN. J. COMPLEX LITIG. 1 (2012); Gross, *supra* note 67; Kevin Carroll, *Ending Mandatory Arbitration Will Hurt Individual Investors*, SIFMA:

These advocates for the procedural status quo argue that arbitration provides a more time and cost-efficient process, which benefits both sides, and includes many structural advantages over courts, which provide investors with enhanced opportunities for relief.[92] Advocates for arbitration emphasize the substantial differences between securities arbitration through FINRA and arbitration conducted by commercial arbitration firms, such as the American Arbitration Association, which are usually the arbitration forums of choice outside the securities context.[93] They also contend that the benefits for investors of arbitration procedure may not last if arbitration becomes a matter of choice.

One of the principal differences between mandatory securities arbitration and ordinary commercial or consumer arbitration is apparent in the content of the PDAA itself. FINRA Conduct Rule 3110(f) sets minimum standards for the content of PDAAs, assuring that the brokerage firm will disclose to its customers that, by signing the agreement, they are relinquishing their right to a judicial forum.[94] That rule also precludes brokerage firms from including provisions limiting the rights and remedies available to investors in arbitration.[95] Specifically, unlike garden-variety PDAAs in the commercial/ consumer context, FINRA bars brokerage firms from including class action waivers in their PDAAs, and FINRA Dispute Resolution does not permit class arbitrations, which means that investors always retain the right to pursue class action claims in court.[96]

PENNSYLVANIA + WALL (Sept. 23, 2013), http://www.sifma.org/blog/ending-mandatory-arbitration-will-hurt-individual-investors/.

92. *See, e.g.,* Black, *supra* note 91 at 104-05; Gross*, supra* note 67, at 1189.

93. Gross*, supra* note 67, at 1189-90.

94. FINRA, RULE 3110(f) (2015).

95. FINRA, RULE 3110(f)(4) (2015) provides:

> No pre-dispute arbitration agreement shall include any condition that:
>
> (A) limits or contradicts the rules of any self-regulatory organization;
>
> (B) limits the ability of a party to file any claim in arbitration;
>
> (C) limits the ability of a party to file any claim in court permitted to be filed in court under the rules of the forums in which a claim may be filed under the agreement;
>
> (D) limits the ability of arbitrators to make any award.

96. FINRA, RULE 12204 (2008).

Advocates of mandatory arbitration also note that FINRA arbitration is more accessible to parties of modest means than other forms of arbitration and even more accessible than courts. Because FINRA charges securities industry parties a greater percentage of its costs than investors, FINRA arbitration is more affordable to the investor than either ordinary commercial arbitration, not to mention a judicial forum.[97] Moreover, upon a showing of financial hardship, FINRA's rules permit the waiver of filing fees.[98] FINRA rules also make it easier for parties to choose representation by attorneys or non-attorneys.[99]

Advocates of mandatory arbitration also point out that FINRA arbitration enjoys a substantial advantage over other forms of commercial arbitration because it is subject to regulation by the SEC.[100] As one commentator put it:

> This SEC oversight is designed to ensure that FINRA's rules, including its Code of Arbitration Procedure, are fair and protect investors. By contrast, no administrative agency reviews the rules, procedures or protocols of consumer or non-securities employment arbitration forums. In that context, no oversight agency exists to mandate reform if party participants perceive substantive injustices or procedural deficiencies.[101]

In addition, these advocates point out that arbitration offers procedural advantages not available in courts. Unlike courts, in an arbitration forum, the

> emphasis on equity allows arbitrators to fashion a remedy for investors that may not be supported by the law. . . . [a prohibition on PDAAs] would provide no advantage to investors with claims based on violations of any SEC standards of care or SRO rules, since courts would dismiss those claims for failure to state a claim. Consequently, eliminating the broker-dealer's right to require arbitration in a PDAA may have a serious negative impact on many retail investors that is not

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97. *See* Rick Ketchum, Chairman & CEO, FINRA, Testimony Before the Committee on Financial Services, 111th Cong. (Oct. 6, 2009), *available at* http://www.finra.org/Newsroom/Speeches/Ketchum/P120108 (stating "FINRA- registered firms pay for most arbitration costs and FINRA waives fees for individuals experiencing financial hardship."). *See also* FINRA, RULE 12901 (2014).

98. Gross*, supra* note 67, at 1188.

99. FINRA, RULE 12208 (2008).

100. *See* Black, *supra* note 91, at 102.

101. Gross*, supra* note 67, at 1186.

fully appreciated.[102]

Also with respect to procedure, those supporting the continuation of mandatory securities arbitration point out that FINRA arbitration already avoids many of the problems addressed by the AFA and similar proposed legislation that would regulate PDAAs. FINRA's arbitration rules include required notice of the claim,[103] an opportunity to be heard,[104] a right to be represented,[105] a hearing location convenient for the customer,[106] and decision by neutral arbitrator(s).[107] The Customer Code permits extensive document discovery while discouraging time- consuming and costly depositions.[108] It also explicitly empowers arbitrators to impose sanctions on any party for discovery intransigence.[109] The Code also stringently limits costly and potentially forum-prohibitive dispositive motions.[110]

Finally, at the conclusion of a dispute, FINRA rules make it easier for investors to collect any awards that they might win, as long as the losing party has any assets. Those rules make it harder for brokerage firms to stall on payment of an award by requiring that "[a]ll monetary awards shall be paid within 30 days of receipt unless a motion to vacate has been filed with a court of competent jurisdiction."[111] FINRA also retains the power to suspend or revoke the license of any broker-dealer that does not pay an award within thirty days, thereby freeing prevailing investors from the time and expense of things like creditor's examinations and other judgment collection processes.[112] These rules are important because customers win an award of damages in roughly

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102. Black, *supra* note 91, at 103 (footnotes omitted).

103. FINRA, RULES 12300 and 12301 (2014).

104. FINRA, RULE 12600 (2011).

105. FINRA, RULE12208 (2008).

106. FINRA, RULE 12213 (2013).

107. FINRA, RULES 12400, 12408, and 12414 (2008).

108. FINRA, RULES 12505 and 12513 (2008).

109. FINRA, RULES 12511 (2008).

110. FINRA, RULE 12504 (2008).

111. FINRA, RULE 12904(j) (2009).

112. *See* FINRA, BY-LAWS, Article Vi, Section 3(B), Suspension or Cancellation (2007); *see also* FINRA, RULE 12904 (2009).

forty percent of cases that proceed to a hearing.[113]

Moreover, some contend that these advantages may be lost if arbitration is not mandatory for all investors in all cases.[114] When arbitration is mandatory and universal, brokerage firms enjoy cost advantages, but if the parties are free to choose between arbitration and a judicial forum when a dispute arises, those advantages might be lost.[115] Consequently, brokerage firms might prefer judicial forums themselves, especially in cases where the unique procedural system of arbitration might benefit investors.[116]

C. Arguments that Mandatory Arbitration is Unfair for Investors

A significant problem with FINRA arbitration is that some important aspects of the FINRA arbitration process make it harder for investors to choose arbitrators with whom they can be comfortable. This is principally because the pool of FINRA arbitrators lacks diversity and because FINRA's rules do not provide for adequate disclosure of the arbitrators' interests and background.[117] According to a recent report, the pool of FINRA arbitrators is disproportionately older and more male than the general population.[118] According to that report, FINRA does not disclose how and why it targets individuals to become arbitrators.[119] In addition, and perhaps more importantly, the selection process has "inadequate" safeguards aimed at

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113. *See* FINRA, Summary Arbitration Statistics (Mar. 2016), *available at* http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/index.htm.

114. *See, e.g.,* Black, *supra* note 91, at 104-05; Samuel Estreicher, *Saturns for Rickshaws: The Stakes in the Debate over Predispute Employment Arbitration Agreements,* 16 OHIO ST. J. DISP. RESOL. 559, 568 (2001) (discussing the difference in regard for arbitration when employers and employees voluntarily agree to arbitrate at time of initial hiring); Peter B. Rutledge, *Who Can Be Against Fairness? The Case Against the Arbitration Fairness Act*, 9 CARDOZO J. CONFLICT RESOL. 267, 279 (2008).

115. Estreicher, *supra* note 114, at 563-65.

116. *See* Black, *supra* note 91, at 105.

117. JASON R. DOSS, THE IMPORTANCE OF ARBITRATOR DISCLOSURE (Oct. 7, 2014), *available at* https://piaba.org/system/files/pdfs/The%20Importance%20of%20 Arbitrator%20Disclosure%20%28October%207%2C%202014%29.pdf.

118. *Id*. at 28-30.

119. *Id.* at 33-34.

ensuring that arbitrators are impartial and that information on arbitrators' backgrounds is accurate and up to date.[120]

An inherent and unavoidable bias under the current system is the issue of the subsequent employment of arbitrators. Given that there is an opportunity to strike four arbitrators on each list of ten prospective chairpersons and public arbitrators, and up to all ten on the list of industry arbitrators, it is likely that certain arbitrators are never selected after ruling in a case against the industry. Arbitrators are aware that the "repeat customers" are the industry firms who participate in the process. Arbitrators learn that if they want to be included on a future panel, they must not rule against the industry participant too heavily or too often.[121] Consumers on the other hand are generally one-time participants in the system. Dr. Akshay Rao, a professor at the Carlson School of Management of the University of Minnesota, has said:

> Based on my review of FINRA's arbitrator disclosure process and its questionnaire, it is my opinion that the process is illusory and especially harms claimant public investors because the system is not designed to elicit meaningful or timely disclosures about actual or potential conflicts of interest and/or biases. FINRA's flawed arbitrator disclosure process provides respondent broker-dealers with an unfair advantage over public investors in securities arbitration disputes in part, because broker-dealers are repeat participants in securities arbitration proceedings and therefore have more information about arbitrators in the pool, due to experience.[122]

Perhaps not surprisingly, statistics show that investors were awarded financial compensation for damages in less than half of the arbitration cases decided from 2009-2014.[123] One commentator has suggested that more diversity on arbitration panels and more complete disclosure about arbitrators' backgrounds and interests will produce more equitable results. As she explains:

> FINRA has had over 20 years to develop a system of recruiting, screening and selecting arbitrators that fulfills its claim of providing a diverse pool. FINRA maintains it has created a diverse pool by making an effort to reach out to women and minorities. We can now see that what FINRA defines as diverse is a pool of arbitrators largely

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120. *Id.* at 33-41.

121. *Id.* at 35-36.

122. DOSS, *supra* note 117, at 35-36.

123. *Id.* at 4.

> comprised of older men. FINRA's skewed perception of diversity, coupled with its refusal to disclose important information about the way in which applicants are targeted and selected, cannot instill any confidence in FINRA's current system … FINRA's refusal to evaluate the diversity of its pool with respect to race further undermines its claim of a commitment to diversity. A system that is not transparent cannot be held accountable. Investors need access to the courts in order to obtain access to a dispute resolution system that ensures fairness through transparency and accountability.[124]

CONCLUSION

Both the critics and defenders of mandatory securities arbitration and PDAAs have persuasive points to make when it comes to investors' interests. On the one hand, there is inherent unfairness and potential for abuse in a system that imposes a choice of forum and procedure upon a potential litigant before a dispute ever arises. These problems are exacerbated by the fact that, under Supreme Court authority, virtually any kind of "agreement" calling for arbitration can be enforced, even if it is the product of an adhesion contract or is imposed unilaterally. Moreover, the standard process for choosing arbitrators is slanted against investors' interests because the persons appointed as arbitrators are relatively homogeneous in terms of gender and background and, for the most part, tend to have a bias towards the securities industry. This process leads to disproportionately favorable results for the securities industry. And, because the process also includes inadequate disclosures about the arbitrators' backgrounds and interests, it is difficult, if not impossible, for investors to have sufficient information upon which to make an informed choice about which arbitrators should be on a panel.

Of course, arbitration is not uniformly bad for investors. FINRA arbitration procedure generally permits investors to assert a wider variety of claims than they could assert in court, subjecting those claims to fewer formalities, and facilitating the collection of awards. In particular, FINRA arbitration makes it easier for a panel to consider equitable factors about the transaction and the relationship between the parties. At least in theory, the greater flexibility of arbitration can provide some advantages for investors that

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124. PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION, ARBITRATORS OF THE FINANCIAL INDUSTRY AUTHORITY LACK DIVERSITY (Oct. 20, 2014), *available at* https://piaba.org/arbitrators-financial-industry-regulatory-authority-finra-lack-diversity-—-public-investors-arbitrat

are not available in a judicial forum.

In assessing the scope of what reforms, if any, are needed, it is important to note that the benefits of securities arbitration procedure mitigate the severity of the problems with how arbitration agreements are formed. In other words, because arbitration in securities matters has some significant benefits for investors, it is less problematic that those investors lack free choice regarding arbitration. In this respect, securities arbitration stands in sharp contrast to arbitrations in other commercial contexts. For all of the problems that securities arbitration poses for investors, it is not irredeemable.

Providing effective reform of securities arbitration requires changes to expand the scope of investor choice about whether to arbitrate or go to court. Such change could be effected by legislation that permits investors with a claim against a brokerage firm to opt-out of any PDAA. This approach preserves the current system in which FINRA arbitration is the default means of dispute resolution, and it gives investors a measure of choice and self-determination that is lacking in the current regime. In addition, reforms of FINRA procedure are necessary to assure that the decision-making of arbitration panels is not unfairly prejudiced in favor of the securities industry. This means that there has to be better disclosure about the backgrounds and predilections of the individuals who are proposed for an arbitration panel. In addition, FINRA must make a greater effort to increase the diversity of its arbitrator pool, in terms of race, ethnicity, and gender and in terms of experience and allegiance. When such changes are put in place, investors will have the information and the opportunity to make sure that arbitration is a beneficial choice and provides a fair forum.

FROM THE PROFESSOR: ISSUE PRECLUSION IN FINRA ARBITRATION

Seth E. Lipner[1]

Most securities arbitration practitioners experience the repeat-case phenomenon because the victims of bad brokers and/or bad investment products often come in multiples.

Suppose you are in such a situation. You have multiple clients and multiple cases. You go to the first arbitration and get a great result. A complete victory. Maybe an award of punitive damages – indicating a finding of culpability and deliberate wrongdoing by the Respondent. Or maybe it was a selling away Ponzi-scheme case and implicit in the award is a finding that the employing broker-dealer was responsible. Or perhaps there had been an eligibility rule motion and it was denied.

You are now getting ready for case number two against the same Respondent. The story is the same. The defense is the same. The decision ought to be the same. But the arbitrators are different. You are smarter because you learned a lot from the first case, but you know that the defense is getting smarter too. Like you, they are unlikely to make the same mistakes they made in case number one.

You start to think about cases three to six. Are you going to experience this here-we-go-again sensation in every one of them? Do you have to let the respondent make the same losing argument over and over again? Do you have to fight the whole battle all over again and maybe face inconsistent results? You plan on attempting to introduce the prior award into evidence on these subsequent cases, but you know Respondent will move to exclude it as not "probative." How will you respond? You start thinking – preclusion! Such a repeat performance could never happen in court. No judge would ever let a party to a litigation keep making the same losing arguments, fomenting inconsistency and wasting everyone's time. Never mind arguing it's "probative." In court you would argue "preclusion." But this is arbitration, not court. Should that matter? Does collateral estoppel apply to prior arbitration awards?

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The answer is "yes." The preclusion doctrine applies to prior arbitration awards and, as this article shows, arbitrators in subsequent cases ought to apply the doctrine. [2] This article shows that, when you start case number two, you should be prepared to argue collateral estoppel. You are on solid legal ground.

I. THE DOCTRINE OF COLLATERAL ESTOPPEL IN LITIGATION

Collateral Estoppel – today it is often termed "issue preclusion" – is a member of the *res judicata* family.[3] Whereas *res judicata* itself precludes re-litigation of entire "claims" (and is thus today termed "claim preclusion"), collateral estoppel governs preclusion of individual issues. Both doctrines are judicially-created. Courts repeatedly describe the preclusion doctrine as more than just technical legal rules – they are said to be creatures of equity – perfectly appropriate to the arbitration context.[4]

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2. *See generally* DAVID ROBBINS, SECURITIES ARBITRATION PROCEDURE MANUAL § 14-11 (2015); Anne Conley, *Promoting Finality: Using Offensive, Nonmutual Collateral Estoppel In Employment Arbitration*, 5 U.C. IRVINE L. REV. 651 (2015) Ashley Perea-Crowell, *Broad Discretion: A Choice in Applying Offensive Non-Mutual Collateral Estoppel*, 40 ARIZ. ST. L.J. 1145 (2008); Brian Levine, *Civil Procedure Law: Preclusion Confusion: A Call for Per Se Rules Preventing The Application of Collateral Estoppel To Findings Made In Nontraditional Litigation*, 1999 ANN. SURV. AM. L. 435 (1999); Thurston K. Cromwell, *Arbitration and Its Collateral Estoppel Effect on Third Parties Vandenberg v. Superior Court*, 2000 J. DISP. RESOL. 425 (2000). *See also* G. Richard Shell, *Res Judicata and Collateral Estoppel Effects of Commercial Arbitration*, 35 UCLA L. REV. 623, 634 (1988) (concluding that preclusion ought, as a general rule, not to apply to arbitration awards).

3. *See generally* DAVID SIEGEL & PATRICK M. CONNORS, N.Y. PRACTICE § 442, *et seq.* (4th ed. 2005).

4. *See* Montana v. United States, 440 U.S. 147, 153-54 (1979) ("To preclude parties from contesting matters that they have had a full and fair opportunity to litigate protects their adversaries from the expense and vexation attending multiple lawsuits, conserves judicial resources, and fosters reliance on judicial action by minimizing the possibility of inconsistent decisions."); Houghton v. Thomas*,* 220 N.Y.S. 630 (N.Y. App. Div. 1927) ("We conclude that [Defendant] should not be permitted to assert his counterclaim under any technical rule of law when he has so conducted himself that it would be contrary to equity to permit him to profit at plaintiffs' or defendant Thomas' expense"); Ferrandino v. Cappelli*,* 208 N.Y.S.2d 750 (N.Y. App.

The multi-victim scenario described in the Introduction does not present a "claim preclusion" situation. In the multiple-case scenario, the Respondent is not making a claim (*i.e.*, asserting a cause of action); claim preclusion simply does not fit.[5] But in the multi-victim cases addressed here, a denial or a defense is being made; that defense – an issue in case two – is the target of the preclusion doctrine. Collateral estoppel – issue preclusion – is thus the subject to consider.

A. Basic Collateral Estoppel

Most states adopt the precepts of the Restatement (2d) Judgments with respect to issue preclusion.[6] Restatement (2d) Judgments § 27 ("Issue Preclusion—General Rule") provides a simple explanation:

> When an issue of fact or law is actually litigated and determined by a valid and final judgment, and the determination is essential to the

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Div. 1960); (Arizona v. Shamrock Foods Co*.,* 729 F.2d 1208, 1215 (9th Cir. 1984) "The policies underlying preclusion of inconsistent positions are 'general consideration[s] of the orderly administration of justice and regard for the dignity of judicial proceedings."). *See also* SIEGEL, *supra* note 3 at § 457.

5. *See generally* RESTATEMENT (SECOND) JUDGMENTS § 27, cmt. b (1982); SIEGEL, *supra* note 3 at § 443. For policy differences between claim preclusion and issue preclusion see 48 TEX. JUR. 3D *Judgments* § 363 (2014) (explaining that the preclusive effect of claim preclusion, or *res judicata*, is broader than that of collateral estoppel, in that, the prior judgment bars not only the assertion of claims and defenses actually litigated in the prior suit but also claims and defenses arising out of the same subject matter that, with the use of diligence, could or should have been litigated in the prior suit. Issue preclusion, or collateral estoppel, is narrower than *res judicata,* in that, it only precludes the relitigation of identical issues of fact or law actually litigated and essential to the judgment in the prior suit.); RESTATEMENT (SECOND) OF JUDGEMENTS § 27, cmt. k (1982) (pointing to the distinction between finality for purposes of claim preclusion and finality for issue preclusion),

6. *See, e.g.*, Coomer v. CSX Transp., Inc., 319 S.W.3d 366 (Ky. 2010); Kirchner v. Riherd, 702 S.W.2d 33 (Ky. 1985); Stanton v. Schultz*,* 222 P.3d 303, 305 (Colo. 2010); Mullins v. State, 294 S.W.3d 529, 535 (Tenn. 2009); Beaver v. John Q. Hammons Hotels, L.P., 138 S.W.3d 664, 668 (Ark. 2003); Jarosz v. Palmer*,* 733 N.E.2d 164, 168 (Mass. Ct. App. 2000) *aff'd* 766 N.E.2d 482 (Mass. 2002); Jean Alexander Cosmetics, Inc. v. L'Oreal USA, Inc., 458 F.3d 244, 249 (3d Cir. 2006).

judgment, the determination is conclusive in a subsequent action between the parties, whether on the same or a different claim.[7]

The requirements for issue preclusion are often broken down into five elements:

(1) *Same Party* - The party against whom preclusion is sought was also a party to the prior case;[8]

(2) Prior Litigation - The issue was actually litigated in the prior case;[9]

(3) Essential to Prior Decision - The determination of the issue was essential to the decision in the prior decision;[10]

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7. *See also* Parklane Hosiery Co. v. Shore, 439 U.S. 322 (1979); DAVID ROBBINS, SECURITIES ARBITRATION PROCEDURE MANUAL §14-11 (2014) ("[A]n outgrowth of the *res judicata* concept, collateral estoppel is the conclusiveness of a determination [of an issue] in a proceeding where the subsequent proceeding is upon a different cause of action.").

8. *See* RESTATEMENT (SECOND) JUDGMENTS § 29 (1982) ("Issue Preclusion in Subsequent Litigation with Others" dispenses with the [old] "mutuality of estoppel" doctrine, which required that all parties (plaintiffs and defendants) be the same. Instead, the Restatement simply provides that the doctrine applies whenever the party against whom preclusion is sought had "a full and fair opportunity to litigate the issue in the first action.") *See also* Sedley v. City of West Buechel, 461 S.W.2d 556 (Ky. 1971); *In re* Ellis' Estate, 333 A.2d 728, 730 (Pa. 1975); Blonder-Tongue Labs. v. Univ. of Ill. Found.*,* 402 U.S. 313 (1971); Witkowski v. Welch, 173 F.3d 192, 200 (3d Cir.1999); Allen v. McCurry, 449 U.S. 90, 94 (1980); Evan Taylor, *Kentucky Courts and Non-Mutual Collateral Estoppel*, 24 N. KY. L. REV. 297, 307 (1997) (holding that the old rule, called "mutuality of preclusion," no longer applies).

9. *See* RESTATEMENT (SECOND) OF JUDGMENTS § 27, cmt. a (1982) (explaining that "a judgment for the plaintiff in the first action may have the effect of enabling him to recover in in the second action without proving his claim, *provided that the controlling issues were litigated and determined in the prior action,* but the defendant is not precluded from defending the second action on the basis of an issue not litigated and determined in the first action." (emphasis added)); *see also* RESTATEMENT (SECOND) OF JUDGMENTS § 27, cmts. d & e (1982). The requirement that the matter be actually litigated is also rooted in principles of equity. *See Jean Alexander Cosmetics,* 458 F.3d at 249 ("Because litigants are likely to view an issue that is necessary to the resolution of a case as important and to litigate it vigorously, it is fair to give such a determination preclusive effect.") This requirement is specific to collateral estoppel; *see also* 48 TEX. JUR. 3D *Judgments* § 363.

10. *See* RESTATEMENT (SECOND) OF JUDGMENTS § 27, cmts. h & j (1982); Massengill v. Scott, 738 S.W.2d 629, 632 (Tenn. 1987) ("To sustain a plea of collateral estoppel it must be shown, inter alia, that the issue sought to be concluded

(4) *Finality* - The prior determination is final;[11]
(5) *Similarity* - The identical issue is presented in the subsequent case.[12]

The issue preclusion doctrine fits our scenario perfectly since: (1) the Respondent is the same; (2) identical issues are presented in the subsequent case; (3) the issue was fully litigated; and, (4) it was necessarily decided against the Respondent in the prior arbitration. Even if the prior award was not confirmed, most states will apply collateral estoppel; an unconfirmed award is considered final for preclusion purposes so long as the usually short time to seek vacatur has passed.[13]

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not only was litigated in the prior suit but was necessary to the judgment in that suit."); *Jean Alexander Cosmetics,* 458 F.3d at 249. In the criminal context, see State v. Thompson, 285 S.W.3d 840, 848 (Tenn. 2009); Dickerson v. Godfrey*,* 825 S.W.2d 692, 695 (Tenn. 1992).

11. *See* RESTATEMENT (SECOND) OF JUDGMENTS § 27, cmt. k (1982).

12. For factors to be considered in determining whether issues in subsequent cases are "identical," see RESTATEMENT (SECOND) OF JUDGMENTS § 27, cmt. c (1982); Starker v. United States*,* 602 F.2d 1341 (9th Cir.1979); Jackson v. Dist. of Columbia**,** 412 A.2d 948 (D.C. App. 1980); Kamilche Co. v. United States, 53 F.3d 1059, 1062 (9th Cir. 1995) *opinion amended on reh'g sub nom.* Kamilche v. United States, 75 F.3d 1391 (9th Cir. 1996); Reynaga v. Sun Studs, Inc., 97 Fed. App'x 729, 730 (9th Cir. 2004).

13. *See* Fisher v. Allstate Ins.*,* 961 P.2d 350, 353, 356–57 (Wash. 1998) (holding that an underinsured motorist insurer was bound by a judicially unconfirmed arbitration award between its insured and a tortfeasor when the insurer did not participate in the arbitration but had notice of it and an opportunity to intervene); Pike v. Freeman, 266 F.3d 78, 90-92 (2d Cir. 2001) (explaining the rule that preclusive effects can attach to "past determinations in arbitral proceedings" but finding the elements required for preclusion not met in the case at bar); Schattner v. Girard, Inc., 668 F.2d 1366, 1368-69 (D.C. Cir. 1981) (*per curiam*) (affirming the district court's preclusion of certain claims based on a previous commercial arbitration decision); Old Republic Ins. v. Lanier, 790 So. 2d 922, 929, 931 (Ala. 2000) (giving *res judicata* effect to a prior arbitration decision).

B. Offensive Collateral Estoppel

Collateral estoppel can be used both "offensively" and "defensively."[14] Defensive estoppel is the more common situation – a defendant or respondent uses preclusion to obtain dismissal of a plaintiff's case. Offensive estoppel is when the plaintiff or claimant uses the doctrine against a defendant. We deal here with its offensive use.

The offensive use of collateral estoppel is permissible and its use is not uncommon.[15] Whether or not to apply preclusion offensively in a given case is within the broad discretion of the trial court (or, in our case, the arbitrators).[16] In *Parklane Hosiery v. Shore*, the U.S. Supreme Court upheld a plaintiff's use of offensive collateral estoppel and the issue of its potential applicability has been settled ever since.

The *Parklane* Court, however, cautioned that there may be cases where the offensive use of collateral estoppel would be unfair to the defendant and it offered four illustrations of situations where offensive collateral estoppel would be inappropriate. The court listed:

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14. The "defensive" use of collateral estoppel occurs when a defendant seeks dismissal on preclusion grounds. The offensive use occurs when a plaintiff uses collateral estoppel to bar a defense. *See* Parklane Hosiery Co. v. Shore, 439 U.S. 322, 326 at n.4 (1979).

15. *See Parklane Hosiery*, 439 U.S. at 322; *see also* City of Covington v. Bd. of Trs. of Policemen's & Firemen's Ret. Fund of Covington, 903 S.W.2d 517 (Ky. 1995); Riverdale Dev. Co., v. Ruffin Bldg. Sys., Inc., 146 S.W.2d 852 (Ark. 2004); DeWitt v. Hall, 19 N.Y.2d 141, 148 (1967) ("there seems to be no reason in policy or precedent to prevent the 'offensive' use of a prior judgment"); Evan Taylor, *Kentucky Courts and Non-Mutual Collateral Estoppel*, 24 N. KY. L. REV. 297, 307 (1997); Howard E. Frasier, Jr., *Offensive Use of Collateral Estoppel in Kentucky: A Deadly Weapon or a Paper Tiger*, 76 KY. L.J. 237 (1987); Timothy J. Heinsz, *Grieve it Again: Of Stare Decisis, Res Judicata and Collateral Estoppel in Labor Arbitration*, 38 B.C. L. REV. 275 (1997); *see generally* James M. Westerlind, *The Preclusive Effect of Arbitration Awards*, 21 MEALY'S LITIG. RPTS: REINSURANCE 2-3 (2010);

16. *Id. See also Parklane Hosiery,* 439 U.S. at 326-31; Collins v. D.R. Horton, Inc., 505 F.3d 874, 882 (9th Cir. 2007) ("We have concluded that the preferable approach for dealing with these problems in the federal courts is not to preclude the use of offensive collateral estoppel, but to grant trial courts broad discretion to determine when it should be applied.").

> (a) the prior action sought small or nominal damages and defendant may have lacked an "incentive to defend vigorously";[17] (b) the judgment relied upon is itself inconsistent with one or more previous judgments;[18] (c) the subsequent action affords the defendant procedural opportunities unavailable in the prior action that could cause a different result;[19] or (d) the plaintiff in the subsequent action could have easily joined in the earlier action.[20]

None of these illustrated cases is likely present in our scenario, so long as the damages sought in the prior action were substantial and there are no other inconsistent decisions on the issue.

II. THE DOCTRINE APPLIES TO PRIOR ARBITRATION AWARDS

Nearly all state and federal courts, as well as the Restatement (2d) Judgments § 84, give arbitration awards preclusive effect so long as the arbitration possessed the main characteristics of litigation.[21] Those states that

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17. *Parklane Hosiery,* 439 U.S. at 330 ("If a defendant in the first action is sued for small or nominal damages, he may have little incentive to defend vigorously, particularly if future suits are not foreseeable.")

18. The requirement that the prior judgment itself is not inconsistent with another judgment is an important fairness requirement. Neither Plaintiffs nor Defendants should be able to whipsaw, *i.e.* in serial cases where there is no mutuality of estoppel, lose the first case or cases, then, upon finally winning one, try to use the preclusion doctrine based on the subsequent victory. *See also* Brainerd Currie, *Mutuality of Collateral: Limits of the Bernhard Doctrine,* 9 STAN. L. REV. 281, 285-86 (1957).

19. *See Parklane Hosiery*, 439 U.S. at 330 (pointing to choice of forum as a potential source of unfairness, particularly in offensive estoppel "because the defendant against whom estoppel is asserted typically will not have chosen the forum in the first action." This is plainly not the case in most securities arbitration proceedings.).

20. *See id.* (noting that offensive estoppel can encourage a plaintiff "to adopt a 'wait and see' approach," hoping to use a defendant's previous loss against the defendant. One who is a party to an arbitration agreement will be able to satisfy this requirement, because arbitration does not have liberal joinder rules the way courts do. *See*, *e.g.*, FINRA, RULE 12312(a) (2016) (requiring either (a) a claim or joint relief or (b) a showing that the claims arise out of the same transaction or occurrence).

21. *See, e.g.*, Postlewaite v. McGraw–Hill, Inc., 333 F.3d 42, 48 (2d Cir.2003)

have not yet ruled on the issue would likely find preclusive effect because they look to Restatement (2d) Judgments on matters of *res judicata* and collateral estoppel.[22]

Restatement (2d) Judgments § 84 recites the rule – that collateral estoppel (issue-preclusion) ought to be applied to prior arbitration awards so long as the prior arbitration afforded the party to be precluded a full and fair opportunity to present evidence. Official Restatement Comment § 84(c) explains that issue preclusive effect for arbitration awards is appropriate for "formal" arbitration because formal arbitration is "substantially similar in form and scope to judicial proceedings."[23]

(stating that under New York law, collateral estoppel may apply to issues resolved in arbitration); Beal v. Allstate Ins., 989 A.2d 733 (Me. 2009); Shuler v. Distribution Trucking Co., 994 P.2d 167, 172 (Or. Ct. App. 1999) ("the proposition that preclusion rules may apply to claims or issues decided through arbitration proceedings appears to be well-settled in this state…. [W]hether, in principle, issue and claim preclusion apply to arbitration proceedings has not been seriously doubted for decades"); Greenblatt v. Drexel Burnham Lambert, Inc., 763 F.2d 1352, 1360 (11th Cir. 1985) (citing RESTATEMENT (SECOND) OF JUDGMENTS §84 cmt. c (1982) for the proposition that "an arbitration proceeding [that] affords basic elements of adjudicatory procedure, such as an opportunity for presentation of evidence, the determination of issues in an arbitration proceeding should generally be treated as conclusive in subsequent proceedings, just as determinations of a court would be treated.''). The Sixth Circuit has twice given preclusive effect to an arbitration award. *See, e.g.*, Ivery v. United States, 686 F.2d 410, 413 (6th Cir. 1982) *cert. denied*, 460 U.S. 1037 (1983) (applying Michigan law); Cent. Transp., Inc. v. Four Phase Sys., Inc., 936 F.2d 256, 257 (6th Cir. 1991) (applying Michigan law). *See also* Commonwealth Ins. v. Thomas A. Greene & Co., 709 F. Supp. 86, 88 (S.D.N.Y. 1989); Tanox, Inc. v. Akin, Gump, Strauss, Hauer & Feld, L.L.P., 105 S.W.3d 244 (Tex. Ct. App. 2003) (citing RESTATEMENT (SECOND) OF JUDGMENTS §84 (1982) which states an arbitration award "has the same effects under the rules of *res judicata* as a judgment of a court."). *See also* United States v. Utah Constr. & Mining Co., 384 U.S.394 (1996) (citing Goldstein v. Doft, 236 F. Supp. 730 (S.D.N.Y. 1964), *aff'd*, 353 F.2d 484 (2d Cir. 1965), *cert. denied*, 383 U.S. 960 (1966) as a case "where collateral estoppel was applied to prevent relitigation of factual disputes resolved by an arbitrator," which suggests that the Supreme Court implicitly approved the use of collateral estoppel to arbitration decisions.).

22. *See* Voss v. Pujdak, 462 B.R. 560, 571 (Bankr. D.S.C. 2011); *In re* Schriver*,* 218 B.R. 797, 801 (E.D. Va. 1998); *In re* McMahon, 356 B.R. 286 (Bankr. N.D. Ga. 2006); *In re* Rounds, 2010 Bankr. LEXIS 6521 (Bankr. D. Colo. Aug. 6, 2010).

23. *See also* ROBBINS, *supra* note 2, §14-11 (citing numerous cases applying preclusion to arbitration awards). "Informal" arbitration is described as a labor grievance where "neither party is represented by counsel, no statement of claim, or

Commercial arbitration, securities arbitration and at least some consumer arbitration exhibit all the characteristics of "formal" arbitration. A Statement of Claim is filed; discovery takes place; parties are represented by counsel; and, they have the opportunity to call witnesses, elicit testimony, introduce evidence, brief relevant issues, examine each other's witnesses and make legal arguments.

Proponents of arbitration – such as the financial services firms that have so long advocated for (and routinely compelled) arbitration – cannot complain that the proceeding they required to do business with them is not substantially similar to a judicial proceeding. As Judge Learned Hand noted over half a century ago:

> [P]arties who choose to arbitrate their disputes must remain content with the award issued by the arbitrators: Arbitration may or may not be a desirable substitute for trials in courts; as to that the parties must decide in each instance. But when they have adopted it, they must be content with its informalities; they may not hedge it about with those procedural limitations which it is precisely its purpose to avoid. They must content themselves with looser approximations to the enforcement of their rights than those that the law accords them, when they resort to its machinery.[24]

Nor is it likely the loser in the prior arbitration can establish any of the Restatement's exceptions to issue preclusion. The exceptions in Restatement § 84(2)-(4) and § 83(2) include situations where preclusion would be "incompatible with a legal policy" or contrary to a provision in the arbitration agreement,[25] but none of these apply here.[26]

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discovery was permitted...." An award in such a case does not get preclusive effect. *Id. Cf.* Chapman v. Farris, No. 2002-CA-000573-MR, 2004 WL 1367117 at 3 (Ky. Ct. App. June 18, 2004) (applying preclusion to a prior administrative law judge's determination); RESTATEMENT (SECOND) OF JUDGMENTS § 83 (1982) ("Adjudicative Determination by Administrative Tribunal" entitled to collateral estoppel effect.).

24. Am. Almond Prods. Co. v. Consol. Pecan Sales Co., 144 F.2d 448, 451 (2d Cir. 1944). *See also* SIEGEL & CONNORS, *supra* note 3, at 733-35 (explaining that preclusion applies in arbitration, especially where the party against whom preclusion is sought was a proponent of arbitration as a method of dispute resolution); Westerlind, *supra* note 15.

25. *See* David S. Schwartz, *Claim-Suppressing Arbitration: The New Rules*, 87 IND. L.J. 239 (2012) (discussing the fairness of claim suppression in arbitration compelled by those who have bargaining power).

26. FINRA, RULE 12904(g) (2009) ("Explained Decisions") was inserted in the FINRA rules after much consternation about a FINRA proposal to give investors the

A Respondent in the subsequent securities arbitration simply will be unable to marshal any logical reasons why a prior FINRA award should be treated, for issue preclusive effect, any differently from a judicial judgment.[27]

III. THE DOCTRINE SHOULD BE APPLIED IN A SUBSEQUENT ARBITRATION

Appellate courts routinely give trial judges broad discretion as to whether to invoke preclusion.[28] Arbitrators, likewise, have discretion whether or not to apply the preclusion doctrine.[29]

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unilateral option to require the arbitrators to explain their award. That one-way choice proposal was accompanied by assurances given to forum participants that awards made under such circumstances would not be accorded precedential value. *See* LIPNER, ET AL., SECURITIES ARBITRATION DESK REFERENCE, §12904:1-3 (2015). The Rule that was eventually adopted provided for explained awards only where both parties consent. *Id.* FINRA's current training materials provide that explained decisions under the Rule have no "precedential value." FINRA's view, however, does not address preclusion (only precedent - a word meaning stare decisis). FINRA's comment, and the Rule, are designed to not discourage parties from invoking 12904. The situation posited in this article has nothing to do with awards made under 12904, and, in any event, to the author's knowledge, the Rule has never been invoked in an arbitration.

27. *See* Levine, *supra* note 2. (Calling for per se rules against preclusion in certain nontraditional litigation situations, arguing that application of the *Parklane Hosiery* balancing test itself makes arbitration too unpredictable, decreases efficiency and discourages further use of arbitration for fear of preclusion.).

28. Parklane Hosiery Co. v. Shore, 439 U.S. 322, 331 (1979). ("We have concluded that the preferable approach for dealing with these problems in the federal courts is not to preclude the use of offensive collateral estoppel, but to grant trial courts broad discretion to determine when it should be applied."); Raytech Corp. v. White, 54 F.3d 187 (3d Cir. 1995); McLendon v. Cont'l Can Co., 908 F.2d 1171 (3d Cir. 1990). For a discussion of the appropriate standard of review, see Jean Alexander Cosmetics, Inc. v. L'Oreal USA, Inc., 458 F.3d 244, 248 (3d Cir. 2006).

(delineating between defensive collateral estoppel and offensive non-mutual collateral estoppel).

29. *See* Collins v. D.R. Horton, Inc., 505 F.3d 874, 882 (9th Cir. 2007) ("We discern no basis for denying arbitrators the same broad discretion possessed by district courts.").

There is absolutely no authority for the proposition that arbitrators in a subsequent proceeding may never apply the doctrine to prior awards.[30] Indeed, the few cases that exist on the subject make clear that arbitrators – and not the courts – should decide whether the preclusion doctrine applies in a subsequent arbitration. However, attempts by parties asserting preclusion to either try to obtain an injunction against arbitration or vacate an award all routinely fail.[31]

All the reasons for applying the preclusion doctrine in a court justify its application – defensive and offensive – in arbitration. Preclusion promotes fairness because identically-situated parties deserve the same, not disparate, results. Indeed, preclusion prevents a losing party from fomenting and exploiting inconsistency and repetitively making the same losing argument to panel after panel. Importantly, because arbitration awards frequently lack the intellectual rigor of court decisions, arbitration is often viewed as "arbitrary." Arbitrators should thus be especially wary that the integrity of the forum not be undermined by identically-situated litigants receiving inconsistent results.

Preclusion promotes efficiency, reducing the overall cost of dispute resolution by eliminating potential duplication. In the context of a subsequent arbitration, the other exceptions to preclusion – such as there being different

30. The mere fact that courts have declined to vacate awards in which the arbitrators refused to apply the preclusion doctrine speaks only to that discretion. *See* Bd. of Maint. of Way Employees v. Burlington N. R.R., 24 F.3d 937, 940 (7th Cir. 1994) ("[T]he preclusive effect of the first arbitrator's decision is an issue for a later arbitrator to consider"). In addition, one must be careful to distinguish from commercial or consumer arbitration cases that stem from collective bargaining arbitrations. Many courts have held that, because labor cases necessarily involve interpretation of a collective bargaining agreement, arbitrators in labor disputes are not bound by the decisions of prior arbitrators unless the collective bargaining agreement so stipulates, *See, e.g.,* Int'l Union v. Dana Corp., 278 F.3d 548, 555 (6th Cir. 2002). *Cf.* Shell, *supra* note 2 (ongoing for extending the labor arbitration rule to commercial arbitration).

31. *See e.g.*, Intersecurities Inc. v. Lane, No. 07-720-C (M.D. La, Dec. 9, 2009) (cited in ROBBINS, *supra* note 2, denying a brokerage firm's request to a court for a preliminary injunction enjoining a FINRA arbitration panel from considering the preclusion question); *Collins*, 505 F.3d at 880 (denying a motion to vacate an arbitration award, ruling "arbitrators are not free to ignore the preclusive effect of prior judgments under the doctrines of *res judicata* and collateral estoppel, although they generally are entitled to determine in the first instance whether to give the prior judicial determination preclusive effect." (citing Aircraft Braking Sys. Corp. v. Local 856, 97 F.3d 155, 159 (6th Cir. 1996)).

"procedural opportunities" – are unlikely to exist.[32] Unlike many court cases where joinder rules are liberal, the joinder alternative is ill-suited to arbitration.[33]

An arbitrator faced with a preclusion motion can, just as well as a judge, determine the propriety of a preclusion request. The main issue an arbitrator will face is whether the issue to be precluded was necessary to the decision in the prior case. In many arbitrations involving preclusion based on prior arbitration awards, the party seeking preclusion will have a difficult time making the needed showing because of the lump-sum nature of most awards. In reasoned award cases, the job is made easier.

But even in lump-sum cases, there are situations where preclusion would be appropriate.[34] In such cases, the arbitrators can make an examination of the pleadings, the evidentiary record and the award in the prior case, and decide whether a rational factfinder could have reached a conclusion based upon an issue other than that which the claimant seeks to foreclose from consideration.[35] When the issue for which preclusion is sought is the only rational one the factfinder could have found, that issue should be considered "determined" by the factfinder, even if no explained finding on that issue was made in the prior award. The party asserting the preclusion of an issue bears

32. *See* RESTATEMENT (SECOND) OF JUDGEMENTS § 29 (2) cmt. d (1982) ("Preclusion may be withheld when the party against whom it is invoked can avail himself of procedures in the second action that were not available to him in the first action and that may have been significantly influential in determination of the issue"); *see also* discussion *supra* note 18 (citing *Parklane* which points to choice of forum as the source of procedural unfairness. As noted, this is not applicable to securities arbitration.).

33. *See* discussion *supra* note 17.

34. *See, e.g.*, Hybert v. Shearson Lehman/Am. Exp. Inc., 688 F. Supp. 320, 325 (N.D. Ill. 1988). *Cf.* Emich Motors Corp. v. Gen. Motors Corp., 340 U.S. 558, 569 (1951) (holding, with respect to a criminal verdict, that "the difficult problem, of course, is to determine what matters were adjudicated in the antecedent suit. A general verdict of the jury or judgment of the court without special findings does not indicate which of the means charged in the indictment were found to have been used in effectuating the conspiracy.... Under these circumstances what was decided by the criminal judgment must be determined by the trial judge hearing the [subsequent case], upon an examination of the record, including the pleadings, the evidence submitted.").

35. *See* Ashe v. Swenson, 397 U.S. 436, 444D (1970) (the court in the subsequent case must then decide "whether a rational jury could have grounded its verdict upon an issue other than that which the defendant seeks to foreclose from consideration").

the burden of showing what was determined by the prior judgment and that showing must be "clear and certain."[36]

For example, preclusion seems appropriate in selling away cases involving a broker who wronged multiple customers in a common scheme to defraud. If the first arbitration panel imposes liability on the firm for such activities, the *respondeat superior* issue has been decided and attempts to re-litigate that issue in subsequent arbitrations ought to be precluded. Also in a case where a broker perpetrated a Ponzi-type scheme on multiple customers of the firm and the firm contested and lost on the issue of whether it was liable to one victim, the firm should not be able to foment inconsistent results and waste everyone's time arguing that it was not liable for identical conduct in other cases. The same is true for cases involving, *inter alia,* registration violations, market manipulation and other securities law violations. A case from the Bankruptcy Court for the Western District of Kentucky, *In re Kennedy*, provides a straightforward framework an arbitration panel can approach issue preclusion. The court in *Kennedy* applied offensive collateral estoppel under Kentucky law to three findings against a debtor in a previous litigation. In that case, the court listed the elements of issue preclusion:

1. There was a final decision on the merits;
2. There is identity of the issues;
3. The issue involved was actually litigated and determined in the prior case;
4. the resolution of the issue was necessary to the decision in the prior case;
5. the defendant in the subsequent action was the prior losing litigant; and,
6. the defendant a full and fair opportunity to litigate.[37]

In *Kennedy*, Judge Roberts (relying in part on *Parklane*) next listed seven factors that may limit the preclusion doctrine's offensive application:

1. The broad discretion of the trial court;
2. Lack of procedures in the prior action that were available in the subsequent action;
3. An inconvenient forum in the prior action;
4. The possibility that the plaintiff could have easily joined in the prior action;

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36. *See* Jones v. City of Alton, 757 F.2d 878, 885 (7th Cir. 1985). *See also* Gale v. Transamerica Corp., 382 N.E.2d 412, 416 (Ill. App. Ct. 1978) (describing the burden as "heavy"); RESTATEMENT (SECOND) OF JUDGMENTS § 27 cmt. d (1980).

37. *See In re* Kennedy, 243 B.R. 1, 10 (Bankr. W.D. Ky. 1997), *subsequently aff'd*, 249 F.3d 576 (6th Cir. 2001) (citing May v. Oldfield, 698 F.Supp. 124, 126 (E.D. Ky. 1988) and City of Covington v. Bd. of Trs. of Policemen's & Firemen's Ret. Fund of Covington, 903 S.W.2d 517, 522 (Ky. 1995).

5. The bound party's lack of incentive to litigate in the prior action;
6. Lack of a full and fair opportunity to litigate in the prior action; and,
7. Any other reasons for unfairness to the defendant.

There is no reason arbitrators cannot undertake this analysis; nor should arbitrators hesitate to apply the preclusion doctrine in a proper case. Indeed, blanket refusal to apply the doctrine diminishes the fairness and the appearance of fairness of the arbitration process.

IV. THE ARGUMENT YOU WILL FACE

The defense will argue:

> While there are many legal decisions recognizing that arbitrators have discretion to apply collateral estoppel to prior arbitration awards, those cases generally uphold the arbitrator's refusal to apply the doctrine. Other cases, which have upheld a court's application of collateral estoppel based on a prior arbitration award, involved the defensive use of the doctrine. There is an absence of case law upholding one arbitration panel's application of offensive collateral estoppel based on a prior arbitration award.
>
> The panel should conclude that the application of the doctrine is uncommon/inappropriate to arbitration. The prior award was not subject to judicial review; there is nothing in the arbitration agreement authorizing the arbitrators to invoke collateral estoppel; and each arbitration panel should have an opportunity to hear all the evidence and arguments, and then decide for themselves.[38]

These arguments are, of course, rejected by the Restatement. The absence of case law proves too much; the cases upholding an arbitrator's discretion to decline to apply the doctrine establishes that arbitrators simultaneously possess discretion to apply the doctrine. Much as arbitrators are used to deciding issues based on their own sense of justice, Respondents should not be able to foment inconsistent results, whether in court or in arbitration.

One must nevertheless expect arbitrators to be vigilant, and, like courts, only apply the doctrine where all the elements are met and Respondent is clearly trying to re-litigate lost issues. Claimant's counsel should use the motion to educate the Panel what issues were previously at issue, what arguments were made and how the issues were decided.

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38. This argument was graciously provided by Kathryn Perrault of Bressler Amery & Ross. I am grateful to her for comments on a draft of this article.

V. CONCLUSION

All the reasons for the existence of the preclusion doctrine in litigation apply to arbitrations. A party who litigated and lost an issue in one arbitration should not be allowed a second bite in a subsequent arbitration.

Notes & Observations

EXPERT'S CORNER: PORTFOLIO CONSTRUCTION HIGHLY DEPENDENT ON THE INITIAL CONDITIONS

Horacio A Valeiras, CFA[1]

For many years, financial advisors have charged either a fee based on assets under advisement or commissions based on trading to provide portfolio construction advice based on many different models like mean-variance optimization, Monte Carlo simulation, or common sense. Often the smaller investors were left out. How should they allocate their assets between stocks, bonds, cash, commodities, absolute return products, etc.?

Enter the robo-adviser. With the rise of very inexpensive, and sometimes free, portfolio construction tools offered online, these robo-advisers trumpet themselves as the investment solution. However, as with so many so-called investment panaceas, many of the robo-adviser models can lead to flawed

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1. Horacio A. Valeiras, CFA, founded HAV Capital at the start of 2013. He is responsible for all aspects of the firm and for managing a global equity and a global macro strategy. Prior to HAV Capital, Horacio was the Chief Investment Officer of Allianz Global Investors Capital (which evolved from Nicholas-Applegate Capital Management), which managed approximately $50 billion in client assets. Horacio was responsible for all investment, trading and risk functions and was a member of the firm's Executive Committee. He also managed the firm's asset allocation accounts and the International Equity portfolios. He started his career at First Boston Corporation (later to become CSFB and now Credit Suisse) as a technology equity analyst and non-US investment strategist. He launched Credit Suisse First Boston's emerging markets research product in 1990. In 1992, he joined Miller Anderson and Sherrerd (MAS) as an International Equity portfolio manager. In 1994, he became head of the Asset Allocation Committee for MAS. Subsequent to the sale of MAS to Morgan Stanley, Horacio managed asset allocation accounts, international equities, emerging market equities and global equities, until 2002.

Mr. Valeiras has served as an expert witness in a number of civil cases involving firm, stock option and contract valuation, third party distribution, and impact of announcements on publically traded share prices.

Horacio has an MBA from the University of California, Berkeley, an MS in Chemical Engineering from the Massachusetts Institute of Technology, and a BS in Chemical Engineering from Virginia Tech. He serves on numerous boards, including InHand Electronics, Frontier Market Asset Management, Virginia Tech Board of Visitors, The Association of Governing Boards for Universities and Colleges, and The San Diego Foundation.

portfolio construction decisions caused by poorly analyzed assumptions and historical data.

When you combine the rise of robo-advisers with the proliferation of exchange traded funds, individual investors are told they have all the necessary tools to build a rational portfolio, take the emotion out of investing and eventually retire with enough assets to live comfortably. Some of these robo-advisers even incorporate tax strategies to minimize year-end tax bills from rebalancing.

But, should investors totally rely on these tools and sleep well at night, knowing their portfolios are based on some variant of modern portfolio theory? We don't believe so.

There are many issues an investor needs to consider when implementing the recommendations of the robo-advisers. First, all tools must make assumptions about future returns, volatility, and covariance across asset classes. Most of the advisers use historical averages of returns. By definition, these averages include periods of high and low valuations. If markets were valued at historical averages at all times, these inputs would not cause a problem. However, future returns vary widely depending on the starting conditions of the markets at any point in time. If the robo-adviser is implemented at a high point in the market, their program likely would overestimate future returns and, in turn, construct a sub-optimal portfolio.

Let's look at the historical data. We will focus on the most variable of inputs, the future expected return by market or asset class. Volatility and covariance (the other two inputs) vary, but nowhere near as much and over a prolonged period of time as the valuation of assets. Our research and conversations with various providers of these automated systems lead us to conclude that most of the robo-advisers do not adjust the inputs for initial valuation of the asset classes to take into present market valuations.

We have data for the US stock and bond market going back to the 1870's and the average real (after inflation) annual return for US stocks and US government 10-Year bonds are approximately 6.5% and 2.5%, respectively. But, are these the inputs to use in the portfolio models?

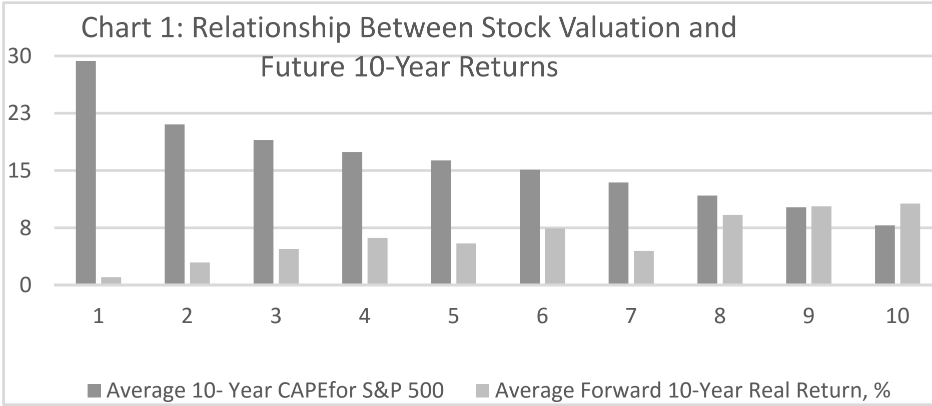
We don't think so. The initial conditions of the market when the portfolio is constructed are crucial to the outcome of the optimal portfolio. Fortunately, we have data for the US equity and bond markets going back almost 150 years that we can use to see if there is a relationship between initial conditions and future returns. The S&P 500 is a good proxy for stock returns in the US and government issued bonds, just as the 10-year Treasury bond is a good proxy for bond market returns. Academicians have done the hard work in cleaning and preparing the data.[2]

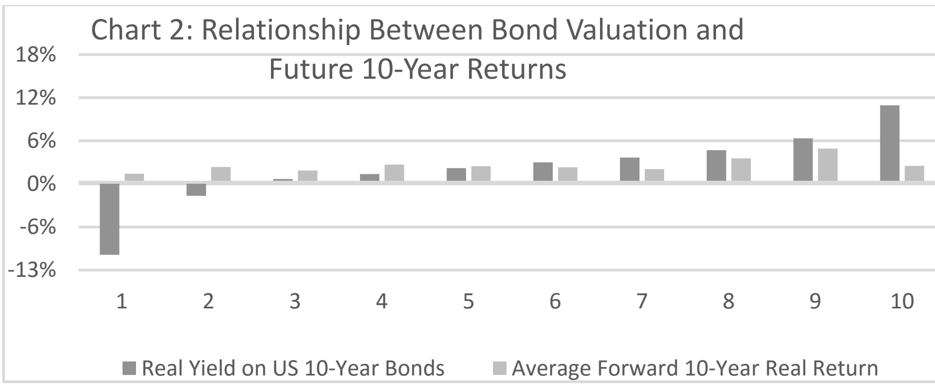
Let's think about two investors. One started investing in the mid-1970's and accumulated assets through 2005. During this period, stock prices and earnings rose and valuations on the stock market expanded. In addition, nominal interest rates in the 10-year US bond market dropped from around 7.5% to 4% during this period, after peaking at 14% in 1982. This combined to yield a real return of approximately 7.5% per year on the equity holdings in the portfolio and 6.0% for the 10-year bonds in the portfolio. Then let's look at a millennial that starts working and accumulating assets in the early 2000's. Earnings have grown, but stock market valuations have compressed through the early decades of the 21st century relative to the peak in 2000. Even if you assume that you started investing after the bear market of 2000-2002, investors have only achieved an annual real return of approximately 4.5% on US stocks while receiving 3.1% on US 10-Year bonds. As you can see, the initial conditions at which you buy and sell assets are crucial to the long term health of your portfolio.

Is there a relationship between initial market valuations conditions and future returns? We use the Shiller Price to Earnings Ratio (CAPE) as a proxy for the valuation of the US equity market. CAPE is defined as the stock market price divided by the average of ten years of earnings adjusted for inflation. For the valuation of 10-year US Treasury Bonds, we use the real yield on the 10-year bond, as measured by Robert Shiller.[3] Once the valuations have been calculated, we group each year into valuation deciles from highest valuation to lowest and compare subsequent 10 year returns for stocks and bonds to each valuation decile. The data is then analyzed for statistical significance and plotted as shown in Charts 1 and 2 below.

2. Robert Shiller, ONLINE DATA ROBERT SHILLER, http://www.econ.yale.edu/~shiller/data.htm (last visited May 3, 2016).

3. J.Y. Campbell & Robert Shiller, *Stock Prices, Earnings, and Expected Dividends*, 43 J. FIN. 661, 661-76 (Jul. 1988).





The relationship for stocks is very statistically significant. Present valuations predict 91% of the difference in future 10 year stock returns. The statistical significance for the relationship for bonds is still apparent, but not as strong. In addition, Norbert Keiming, of Star Capital in Germany, extended the analysis to other countries' stock markets and found the same relationship.[4] So, where are we today in valuation and how should an adviser, whether a robot or a person, use this information to help investors build long-term portfolios? Today, the CAPE valuation ratio for the US equity market is at 25, which definitely puts the valuation in the highest decile of equity valuations. From the chart above, you should not expect more than about 1% in real annual returns for equities looking forward to the next ten years. Real rates on 10-year

4. Norbert Keiming, *Predicting Stock Market Returns Using the Shiller CAPE* (Jan. 2016), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2736423.

bonds are around 0.5%, which puts them into the 3rd decile of historical valuation, and have delivered an average real return of 2% per year from this point. Both expected returns are below average and should cause some trepidation against building a traditional portfolio that consists somewhere around 60% stocks and 40% bonds. CAPE valuations for emerging market equities, at around 14 times, and for developed European equities, at 15 times, are below historical averages, so you might want to skew the equity piece of the portfolio towards foreign equities and not carry the usual US biased equity allocation. On the bond piece of the portfolio, most of Europe has negative interest rates all the way out to 7 year bonds. Japan also offers very low nominal and real interest rates to investors. Therefore, the bond portfolio should focus on US bonds.

This is not market timing. Rather, it is taking advantage of initial conditions to build a rational portfolio for the long term. Additionally, today's valuation may encourage investors to look for other assets, like market neutral and absolute return strategies that do not rely on equity and bond markets rising to meet retirement goals. Many investors, thinking they will be safe by using technology, may come to regret their reliance on automated portfolio construction.

Notes & Observations

INVESTORS, CORNERED
MAKE SECURITIES ARBITRATION
ELECTIVE, NOT MANDATORY

Jason M. Kueser[1] *and Bradley Stark*[2]

Over the past several years, mandatory arbitration has become a "hot button" issue in the securities industry. Prior to the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), many consumer and investor groups conducted studies and opined that arbitration is unfair to consumers and investors. After the Financial Crisis showed the impact the financial services industry has on both the economy as a whole and specifically to consumers and investors, Congress passed Dodd-Frank.

Section 921 of Dodd-Frank grants the SEC the power to "prohibit, or impose conditions or limitations on the use of, agreements that require customers or clients of any broker, dealer, or municipal securities dealer [or investment adviser] to arbitrate any future dispute between them arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors."[3] Section 1028 of Dodd-Frank also requires the Consumer Financial Protection Bureau (CFPB) to "conduct a study of, and … provide a report to Congress concerning, the use of agreements providing for arbitration of any future dispute between covered persons and consumers in connection with the offering or providing of consumer financial products or services."[4]

In March 2015, the CFPB released a report detailing its findings with respect to the use of pre-dispute arbitration clauses in consumer financial services contracts. In this report, the CFPB found that (1) a large number of consumers are affected by pre-dispute arbitration agreements; (2) 75% of consumers surveyed by the CFPB "did not know if they were subject to an

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1. Jason M. Kueser is the Editor-In-Chief of the PIABA Bar Journal. He is also Principal Attorney for The Kueser Law Firm, P.C., a law firm in Lee's Summit, Missouri, that focuses on representing investors in securities arbitration.

2. Bradley Stark is a member of the Board of Editors of the PIABA Bar Journal and an attorney with the Law Offices of Bradley R. Stark, P.A., in Coral Gables, Florida.

3. Dodd-Frank Act, 12 U.S.C. § 5518 (2010).

4. *Id.*

arbitration clause"; (3) "[c]onsumers are very reluctant to bring claims against companies on their own, particularly small claims"; and (4) there was "no evidence that arbitration clauses lead to lower prices for consumers."[5] Based on its findings, the CFPB has recently stated that it is considering rule making proposals that would limit the use of pre-dispute arbitration clauses in consumer financial services agreements. However, the CFPB's focus is limited to contracts for credit cards, checking accounts, payday and small dollar loans, general purpose reloadable prepaid cards, private student loans, auto purchase loans, and mobile wireless agreements.[6]

The SEC, on the other hand, has done very little to study the effect and implications of the use of pre-dispute arbitration agreements in the financial services industry. However, outside organizations, including PIABA, have conducted some studies related to the fairness of arbitration. Various pundits have also opined on this issue. While the studies raise concerning issues about the fairness of arbitration, the public opinion (as expected) varies.

Arguments that securities arbitration is fair tend to focus on the procedure in FINRA arbitration,[7] the "content and placement of arbitration clauses,"[8] the fact that the fees paid by investors are less than the fees paid by brokers and brokerage firms,[9] the locality of hearing locations (the final hearing is held in the location nearest to the investors' residences at the time of the alleged

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5. Will Wade-Gery, *We Took a Look at Arbitration Agreements and Here's What we Found*, CONSUMER FINANCIAL PROTECTION BUREAU: BLOG (Mar. 10, 2015), http://www.consumerfinance.gov/about-us/blog/we-took-a-look-at-arbitration-agreements-and-heres-what-we-found/.

6. *Id.*

7. *See, e.g.*, George H. Friedman, *CFPB Issues Final Report on Arbitration, Telegraphing a Ban or Limits on Arbitration. Should SEC Follow Suit*?, SECURITIES ARBITRATION COMMENTATOR: BLOG (Mar. 16, 2015), http://www.sacarbitration.com/blog/cfpb-issues-final-report-arbitration-telegraphing-ban-limits-arbitration-sec-follow-suit/.

8. *See, e.g.*, *id*.

9. *See, e.g.*, Kevin Carroll, *Ending Mandatory Arbitration Will Hurt Individual Investors*, INVESTMENTNEWS (Sep. 22, 2013), http://www.investmentnews.com/article/20130922/REG/309229984/ending-mandatory-arbitration-will-hurt-individual-investors.

events),[10] the limited (i.e., less costly) nature of discovery,[11] the ability of an investor to select an all public arbitration panel,[12] FINRA's "enforcement" of arbitration awards,[13] the SEC's "oversight" or "regulation" of FINRA arbitration,[14] the ability of an investor to opt out of arbitration to participate in a class action,[15] the expediency with which arbitration cases are resolved,[16] the fact that more arbitration claims are decided on the merits (i.e., decided by the arbitrators after a final hearing) than are court cases,[17] and that arbitration helps (securities firms) manage and control dispute resolution costs - and therefore can offer services at a lower cost to investors.[18] Proponents of mandatory arbitration also often tout the fact that, in arbitration, investors have the ability to recover money even if there is no legal grounds to do so because arbitration is an equitable forum.[19] Unfortunately, FINRA arbitrators continually find the "equities" lie with the financial services industry.[20]

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10. *See, e.g.*, Friedman, *supra* note 7.

11. *See, e.g.*, SIFMA, WHITE PAPER ON ARBITRATION IN THE SECURITIES INDUSTRY 28 (Oct. 2007), http://www.sifma.org/uploadedfiles/societies/sifma_compliance_and_legal_society/whitepaperonarbitration-october2007.pdf.

12. *See, e.g.*, George H. Friedman, *What's a Regulator to Do? Mandatory Consumer Arbitration, Dodd-Frank, and the Consumer Financial Protection Bureau,* 20 DISPUTE RESOLUTION MAG. 4 (2014), http://www.americanbar.org/publications/dispute_resolution_magazine/2014/summer/what-s-a-regulator-to-do--mandatory-consumer-arbitration--dodd-f.html.

13. *See, e.g.*, *id*.

14. *See, e.g.*, SIFMA, *supra* note 11, at 7-13.

15. *See, e.g.*, Friedman, *supra* note 12.

16. *See, e.g.*, SIFMA, *supra* note 11, at 3.

17. *Id.*

18. *See, e.g.*, Kevin Carroll, *Op-Ed: Why Banning Mandatory Securities Arbitration Would be a Mistake*, WEALTHMANAGEMENT.COM (May 27, 2015), http://wealthmanagement.com/commentary/op-ed-why-banning-mandatory-securities-arbitration-would-be-mistake?page=2.

19. *See, e.g.*, Tara Siegel Bernard, *Taking a Broker to Arbitration*, N.Y. TIMES (July 18, 2014), http://www.nytimes.com/2014/07/19/your-money/a-closer-look-at-the-arbitration-process-for-investors.html?_r=0.

20. To understand this, one needs to look no further than to the billions of dollars in fines from the conflicts of interest related to industry analysts that led to the "Tech Wreck" and to the billions of dollars in fines related to various industry practices that

However, many of the "benefits" cited by proponents of mandatory arbitration have corollary detriments to investors, are significantly more beneficial to brokers and brokerage firms than to investors, or could be implemented if investors were allowed to choose to file their case in court.

The procedure in arbitration (*i.e.*, the rules - the Code of Arbitration Procedure) may be fundamentally fair in that the rules satisfy Due Process requirements. Furthermore, the fact that FINRA requires firms to prominently display pre-dispute arbitration clauses in their account forms may be better than in the consumer financial services industry (i.e., credit cards, personal loans, student loans, etc.) may be perceived as a "benefit" to investors; however, since virtually no brokerage firm will open an account unless the investor signs this Arbitration Clause, its prominence is irrelevant.

Certainly, more can be done to protect investors. FINRA could/should impose a requirement that the arbitration clause be presented in a minimum (readable) font size, and/or that the arbitration clause be in a separate document (separate from the account application, where the clause usually resides buried within pages of boring and difficult to comprehend contractual language), and/or that the arbitration clause be written in plain English, and/or create a uniform script that explains arbitration, what arbitration is, what giving up your right to a trial by jury means, and require every financial advisor to verbally read that script to the investor and have the investor sign off that the financial advisor has done so. FINRA could also create a guide that explains these things in detail and require financial advisors to have every customer read the guide and sign off that they have done so.

Additionally, the fact that FINRA prohibits firms from using class action waivers (and does not provide for class arbitration) does preserve an investor's right to participate in a class action. However, the fact that proponents of mandatory arbitration raise this as a benefit is interesting because this "benefit" is actually a rule that allows investors to *avoid* having their claim decided in arbitration.

The fees paid by investors may be less than the fees they would pay in court, but this argument seems dubious. First, investors must pay a filing fee of between $50 and $2,250, depending on the amount of damages requested in the statement of claim. However, the filing fee for a civil action in federal court is $400. As such, the filing fee an investor pays is only less in arbitration if the amount they are seeking to recover is $10,000 or less. While a portion of that amount is refundable if the case settles more than 10 days before the

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caused the Financial Crisis of 2007-08. While the SEC and FINRA levied substantial fines against securities firms for their roles in these economic calamities, FINRA arbitrators' awards in these types of cases did not increase substantially.

hearing on the merits,[21] the non-refundable portion of the filing fee is between $25 and $750 (again, depending on the amount of damages requested in the case). For cases involving claims of $500,000 or more, the nonrefundable portion of the filing fee in FINRA arbitration exceeds the filing fee in federal court.[22] Furthermore, FINRA imposes various additional fees on parties in arbitration, including hearing session fees,[23] discovery motion fees,[24] contested subpoena fees,[25] explained decision fees,[26] as well as administrative costs.[27] In court, most, if not all, of these fees are avoided. It is not uncommon for an arbitration hearing to take three or four days. With a three person arbitration panel, a three or four day arbitration hearing can result in hearing session fees of thousands of dollars. These fees are not incurred in court. However, the problem for investors is not filing fees, but rather, the lack of a fair award and the fact that attorneys' fees and costs (including filing and other fees) are seldom awarded.

The fact that the FINRA Code of Arbitration Procedure provides that the hearing shall take place at "the hearing location closest to the customer's residence at the time of the events giving rise to the dispute"[28] is also only a potential benefit. The general venue rules that apply in federal court provide that venue is appropriate in "a judicial district in which a substantial part of the events or omissions giving rise to the claim occurred, or a substantial part of property that is the subject of the action is situated."[29] For cases that would be brought in state court, most state's long-arm jurisdiction laws would provide

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21. FINRA, RULE 12900(c) (2014).

22. *See* FINRA, RULE 12900(a), (c)(2014) (the filing fee for a claim of $500,000 - $1,000,000 is $1,750 and the partial refund amount is $1,300).

23. The fees arbitrators assess to parties for each hearing session. *Summary of Arbitration Fees*, FINRA, http://www.finra.org/arbitration-and-mediation/summary-arbitration-fees (last visited May 4, 2016).

24. The fee assessed when arbitrators decide a discovery motion without a hearing. *Id.*

25. The fee assessed when arbitrators decide a contested motion for the issuance of a subpoena without a hearing. *Id.*

26. The fee assessed when the parties agree that the arbitrators will provide a written explanation in the award. *Id.*

27. Cost assessed to the parties for special services requested by parties. *Id.*

28. FINRA, RULE 12213(a) (2013).

29. 28 U.S.C. § 1391 (2016).

for personal jurisdiction of securities firms in cases involving their customers,[30] and, if the state court could assert personal jurisdiction over the brokerage firm under the long-arm statute, venue would generally be appropriate in the county where the dispute arose.[31] Furthermore, allowing investors to sue in court would actually be more convenient than FINRA arbitration because, in many instances, they would be able to sue in the county in which they reside (if the dispute arose there), rather than have their hearing in the FINRA hearing location closest to their residence.[32]

The ability of an investor to select an all public arbitration panel is potentially a benefit - but only as compared to the previous rules that applied in arbitration. Prior to 2011, FINRA required that in every case decided by a three person arbitration panel, one of the arbitrators be a non-public (industry) arbitrator.[33] Because investor advocates successfully argued that the industry arbitrator had potential conflicts of interest, FINRA changed the rule to allow for all public arbitration panels. What is interesting about the public/non-public arbitrator discussion is that the *default* rule in small cases (cases with only one arbitrator) was cases were always decided by a single public arbitrator. Therefore, the old rule of requiring a non-public arbitrator only applied in larger cases. In other words, when the stakes were high, the financial services industry wanted one of the arbitrators to be "on their side." In court, the parties have more control over who serves on a jury, and recusal statutes offer protection from biased judges.

FINRA's "enforcement" of arbitration awards and the SEC's "regulation" of arbitration are certainly benefits, though, regardless of such a rule in arbitration, execution and seizing by the Sheriff of property at brokerage firms in front of other customers would certainly make payment of court ordered awards just as likely. Furthermore, while FINRA's rules provide for expedited suspension or cancellation of membership for firms who fail to pay arbitration

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30. *See, e.g.*, MO. REV. STAT. §506.500 (2016).

31. *See, e.g.*, MO. REV. STAT. §508.010.5(1) (2016).

32. FINRA only offers 71 hearing locations across the United States. *See Dispute Resolution Regional Offices and Hearing Locations*, FINRA, https://www.finra.org/arbitration-and-mediation/dispute-resolution-regional-offices-and-hearing-locations (last visited May 4, 2016).

33. *See* FINRA, NOTICE TO MEMBERS 11-05 (2011).

awards,[34] a recent PIABA study found that one in three arbitration awards in favor of an investor goes unpaid.[35] Is that effective?

The expediency with which arbitration cases are resolved is also a certain benefit to investors. However, that benefit should not be used to deprive them of the opportunity to file a case in court. If an investor is willing to have their case take longer to be decided or settled, it should be their right to do so. Furthermore, the increased potential costs to both parties, if having investor cases decided in court actually results in increased costs as the pundits for mandatory arbitration assert, as well as mandatory settlement conferences, as required by most courts, would actually put pressure on both sides to settle those cases more quickly than cases filed in arbitration where the costs to proceed are less and mediation is not required.

To that end, the argument that pundits for mandatory arbitration make that more arbitration claims are decided on the merits (i.e., decided by the arbitrators after a final hearing) than are cases that are filed in court is a bit of a dubious argument. While it is certainly possible that more cases that are filed in court would be dismissed prior to trial, the increased pressures to settle cases that are filed in court may also contribute to a reduced number of cases that are decided on the merits.

Regarding the "benefit" that arbitration helps (securities firms) manage and control dispute resolution costs - and therefore allows firms to offer services at a lower cost to investors, this is always the fallback cry of the securities industry. The lower cost certainly benefits financial services firms more than individual investors. Most investors who are a party to a securities arbitration case are involved in one arbitration case in their life. However, brokerage firms (especially the larger wirehouse firms - whose representatives are board members and officers of SIFMA)[36] are involved in hundreds or thousands of cases each year. Therefore, who receives the greater benefit of these cost "savings" in arbitration? The brokerage firms who tout the fairness of mandatory arbitration to investors. If securities firms truly believe that they would be able to get a larger number of cases dismissed before trial, then it

34. FINRA, RULE 9554 (2015).

35. PIABA, UNPAID ARBITRATION AWARDS 2 (Feb. 25, 2016), https://piaba.org/system/files/pdfs/Unpaid%20Arbitration%20Awards%20-%20A%20Problem%20The%20Industry%20Created%20-%20A%20Problem%20The%20Industry%20Must%20Fix%20(February%2025,%202016).pdf.

36. *See Board and Officers*, SIFMA, http://www.sifma.org/about/board-and-officers/ (last visited May 4, 2016).

would seem that allowing investors to file cases in court could effectively reduce dispute resolution costs.

If arbitration is fair to the investor, and relatively equivalent in outcome, as Wall Street - and other proponents of mandatory arbitration (that have ties to Wall Street or the arbitration process) - would lead us to believe, WHY does the financial services industry so vociferously oppose courtrooms? Several predominant reasons come to mind.

First, Wall Street would prefer to keep home field advantage. Rather than having to explain their actions to a jury, they would prefer to keep presenting their cases to arbitrators that are selected by FINRA. Again, FINRA is a self-regulatory organization, which means that it is an organization made up of members of employees of financial services firms that creates rules to "regulate" its own members. Among these rules are rules that govern who is allowed to serve as an arbitrator. Yes, although the parties are given an opportunity to rank and strike potential arbitrators in each case, the people who appear on the lists of arbitrators are selected by FINRA employees - and the people who are in the "pool" of potential arbitrators are selected by FINRA. To make matters worse, FINRA has absolute discretion as to who it allows to serve as an arbitrator. So, not only does FINRA (whose leadership are employees of firms in the financial services industry) have the authority to decide who is deciding arbitration cases, but perhaps more importantly, as noted in the PIABA study cited above, the selection process has inadequate safeguards to ensure that arbitrators are impartial and that information on arbitrators' backgrounds is accurate and up to date.

Second, and perhaps less obvious, is that by forcing investors to arbitrate *all disputes*, the financial services industry has succeeded in stagnating the evolution of securities laws. Stare decisis does not exist in arbitration. This means that arbitrators do not have to apply previous decisions (by other arbitration panels) in cases involving the same issues and/or parties. As such, you could have ten different cases involving the same financial services firm (and often the same broker/representative), and involving sales of the same products to similarly situated investors and end up with ten different results in those cases. Thus securities law has become a "dead language." Parties in arbitration are forced to cite cases from the 1980s or before. Furthermore, many states have modified their state securities acts (more than once in many instances) since the 1980s. However, because investors are forced to bring their claims in arbitration, and most other securities-related litigation ends up in Federal Court, there are very few court cases that have interpreted state securities laws in the context of customer v. broker cases. This is favorable to the financial services industry and detrimental to investors because many of these state securities laws provide for increased damages, plus the award of attorneys' fees, interest, and costs to the prevailing party.

Third, arbitration is an equitable forum. Essentially, this means that arbitrators do not have to apply the law in arbitration cases. Rather, the arbitrators can do what they think is "just" and "equitable." Keep in mind these arbitrators are individuals who have been approved by FINRA (i.e, the financial services industry). These are also arbitrators who have put themselves through training (provided by FINRA - i.e., the financial services industry) to become an arbitrator. As such, these individuals have a personal interest in serving as an arbitrator in cases. During the arbitrator selection process, the parties are given the opportunity to rank and strike potential arbitrators. Arbitrators who are on panels that routinely issue awards that favor investors are routinely stricken by attorneys representing the brokerage firms in arbitration.[37] Because the brokerage firms are much more likely to be "repeat customers" in arbitration,[38] arbitrators know that if they routinely issue awards in favor of investors, they will be stricken by the brokerage firms. Accordingly, if arbitrators want the opportunity to serve on future arbitration panels they have to temper their awards not to offend the brokerage firms. This often results in diluted awards when arbitrators find in favor of investors.

A fourth reason that financial services firms prefer arbitration is that there is no internal appeals process. As noted in the FINRA Arbitrator's Guide, "the arbitrators' award is final and binding, subject to court review only under limited circumstances" and "[t]here is no appeal process within FINRA under the Code of Arbitration Procedure for Customer Disputes or the Code of Arbitration Procedure for Industry Disputes."[39] While there are situations in which parties can appeal (vacate) an arbitration decision, those are substantially limited (almost non-existent).

The fifth reason financial services firms prefer arbitration is that FINRA alone determines who is eligible to serve and who will be removed as an

37. Admittedly, arbitrators who are on panels that frequently issue awards against investors are stricken by Claimants' counsel; however, the number of cases in which an attorney that represents investors has in arbitration pales in comparison to the number of cases in which many of the brokerage firms are involved in each year.

38. Whereas most investors are involved in one arbitration case in their lifetime, brokerage firms are often involved in multiple arbitration cases each year (and larger firms can be involved in hundreds of cases in a given year).

39. FINRA, ARBITRATOR'S GUIDE 9 (2015), https://www.finra.org/sites/default/files/arbitrators-ref-guide.pdf.

arbitrator. This discretion is total, secret and opaque.[40] This inequity was echoed in the Congressional testimony of William Galvin, Secretary of the Commonwealth of Massachusetts and chief securities regulator who describes it as a "rigged system" wherein the industry "gets to decide who is qualified to be an arbitrator and who is not. They and only they select the pool of arbitrators. There is no state in this union that gives to one party to litigation the unilateral right to choose the finders of fact or jury that will decide their case. Would anyone seriously suggest that we apply this approach to any other industry?"[41]

What is interesting to note is that the majority of the proponents for mandatory pre-dispute arbitration are the brokerage firms, and individuals and organizations whose interests are aligned with brokerage firms. For example, the Securities Industry and Financial Markets Association ("SIFMA") has written extensively on why it believes securities arbitration is fair to investors. SIFMA describes itself as "the voice of the nation's securities industry, bringing together the shared interests of hundreds of securities firms, banks and asset managers."[42] Another proponent of mandatory arbitration, Kevin Carroll, whose position on mandatory arbitration is cited above, is Managing Director and Associate General Counsel for SIFMA.[43] George Friedman, who

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40. "Criteria for Permanent Disqualification…**Director of Arbitration's Judgment** The Director of Arbitration, upon approval from the National Arbitration & Mediation Committee, may remove an arbitrator if in his or her judgment the arbitrator is not otherwise properly included in the list of eligible neutrals." *Disqualification Criteria*, FINRA, http://www.finra.org/arbitration-and-mediation/disqualification-criteria (last visited May 26, 2016). "Criteria for Temporary Disqualification…**Director of Arbitration's Judgment** The Director of Arbitration may temporarily remove an arbitrator, if, in his or her sole judgment, it is determined that the arbitrator is not otherwise properly included in the list of eligible neutrals." *Id*.

41. *The Securities Arbitration System*: *Hearing Before the H. Comm. on Fin'l Servs.*, 109th Cong. 6-7 (2005), (testimony of William Gavin, Secretary of the Commonwealth of Massachusetts), http://financialservices.house.gov/media/pdf/109-11.pdf. At a minimum Galvin believes it is necessary "to take it out of the hands of the industry. Put someone besides the self-regulators in charge. That is the best solution. In the short term, we need to increase the oversight of the arbitration process. The FCC, state securities regulators and perhaps even Congress need to take a hard look at arbitration." *Id.* at 8.

42. *About SIFMA*, SIFMA, http://www.sifma.org/about/ (last visited May 4, 2016).

43. Kevin Carroll, LINKEDIN, https://www.linkedin.com/in/kevin-carroll-86031a7 (last visited May 4, 2016).

has also written in favor of mandatory arbitration,[44] is principal of George H. Friedman Consulting, LLC, which provides "expert advice on arbitration and mediation in general and the FINRA dispute resolution forum in particular."[45] Mr. Friedman is also the former Executive Vice President - Dispute Resolution of FINRA.[46]

On the other hand, groups that advocate on behalf of investors, such as the North American Securities Administrators Association ("NASAA")[47] and PIABA, take a contrary position. Again, these are organizations that *represent the interests of investors*.

If mandatory arbitration is so beneficial for investors, why is it that the groups and individuals who favor it either have a vested interest in securities arbitration, or represent the interests of brokers and brokerage firms? And why is it that investor advocates oppose mandatory arbitration? Furthermore, can we honestly look ourselves in the eye and say that we should listen to the self-proclaimed "voice of the nation's securities industry" when determining the efficacy of mandatory arbitration? Let us also not forget that FINRA itself is a "self-regulatory organization" (i.e., members of securities firms regulating the very securities firms for whom the members work).

For the most part, proponents of mandatory arbitration, in highlighting the "benefits" to investors, ignore the more substantial benefits to brokers and brokerage firms. Essentially, these proponents say that mandatory arbitration is "good enough" for investors. One glaring example of this, as noted above, are proponents highlighting the fact that approximately 40% of investors whose arbitration cases go to a final hearing "win" their cases (and that more than 70% of investors recover "something" if you take into account settlements of arbitration claims). However, as investor advocates note, FINRA, and the proponents of mandatory arbitration, consider a case where an investor recovers as little as $1 a "win" for the investor.[48]

However, the low awards in arbitration also raise significant questions about the fairness of the process. One study revealed that "investors with

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44. *See, e.g.*, Friedman, *supra* note 7.

45. *About George Friedman*, GEORGE H. FRIEDMAN CONSULTING, LLC, http://www.gfriedmanadr.com/about-george/ (last visited May 4, 2016).

46. *Id.*

47. NASAA states that it is "is the oldest international organization devoted to investor protection." *See About Us,* NASAA, http://www.nasaa.org/about-us/ (last visited May 4, 2016).

48. *See* Bernard, *supra* note 19.

significant claims suing major brokerage firms could expect to recover only 12 percent of the amount claimed."[49] Furthermore, an award of attorneys' fees or punitive damages, in addition to compensatory damages, is virtually unheard of in FINRA arbitration, despite the fact that most states' securities fraud statutes provide for recovery of attorneys' fees to the prevailing party.[50]

Proponents of mandatory arbitration also cite the limited nature of discovery as a "benefit" of arbitration. They note that investors in arbitration are not subject to depositions and the limited scope of discovery requires investors to have to turn over fewer documents during the course of an arbitration proceeding than they would have to produce if their case was in court - smoke and mirrors. While the general prohibition on depositions may save investors some expenses in arbitration, the prohibition prevents them from learning valuable information about their case prior to the arbitration hearing. Furthermore, the prohibition on depositions prevents investors from learning whether other documents may exist that are relevant to their case.

Discovery in arbitration is generally limited to "requests for information" and "document requests."[51] Requests for more information, by their very definition, are more limited than standard interrogatories in court and are "generally limited to identification of individuals, entities, and time periods related to the dispute" and may "not require narrative answers or fact finding."[52] In fact, the FINRA Code of Arbitration generally prohibits "standard interrogatories."[53] To assist parties in arbitration, FINRA has also created a Discovery Guide that sets forth the categories of documents that are "presumptively discoverable in arbitration."[54] List 2 of the Discovery Guide sets forth 18 categories of documents that customers are presumptively required to produce in all cases (as well as an additional category of documents in cases with claims related to an insurance product that provides a death benefit). These documents include personal and business tax returns, account statements at securities firms other than the firm that is the subject of the

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49. Dan Solin, *Judge Slams FINRA Arbitration,* HUFFINGTON POST (Mar. 20, 2012), http://www.huffingtonpost.com/dan-solin/judge-slams-finra-arbitra_b_135286 5.html.

50. *See, e.g.*, MO. REV. STAT. § 409.5-509(b)(1) (2015).

51. FINRA, RULE 13506 (2008).

52. FINRA, RULE 13506 (a) (2008).

53. *Id.*

54. *See* FINRA, DISCOVERY GUIDE (Dec. 2, 2013), https://www.finra.org/sites/ default/files/ArbMed/p394527.pdf.

arbitration, personal and business financial statements, documents showing the investors' ownership of any businesses, their resumes, and virtually every document related to the investments at issue in the case, including documents they received from sources other than the firm that is subject of the arbitration. In all honesty, outside of these categories of documents, there is relatively little that an investor would likely have to produce if their case was filed in court.

Brokerage firms, while being presumptively required to produce 21 categories of documents (plus an additional category of documents in cases with claims related to an insurance product that provides a death benefit), often state that no documents exist that are responsive to a number of these categories of documents and take the position that producing several categories of documents would be "unduly burdensome" (i.e., it would be unfair to ask them to conduct an extensive search of all the documents in their possession because to do so would be time consuming and would subject the brokerage firm to excessive costs). In many of those instances, the brokerage firm is allowed to skirt their discovery obligation by hiding behind this cloak, as arbitrators infrequently order brokerage firms to incur these costs and produce the documents that they are "presumptively required" to produce. And these are not always "obscure" documents. Brokerage firms often fail to produce e-mails, or substantially limit their search for e-mails, related to the investor or the investor's accounts, stating that it would be "unduly burdensome" for them to have to search their e-mail archives for every message that references the investor or their accounts - or for e-mails referencing their financial "advisor." Brokerage firms also often object to, and do not produce research reports they have issued related to the very investments that are at issue in the arbitration claim. While e-mails and research reports are both included in categories of the Discovery Guide, brokerage firms get around these obligations by objecting to the undue burden they would allegedly be subject to if required to produce these documents.

FINRA itself has "recognized" flaws in the discovery process. In fact, in the past ten years, there have been three versions of the Discovery Guide for customer (investor) cases.[55] Unfortunately, these revisions have made only marginal (if any) improvements in the discovery process. All of these issues compromise the arbitration process.

The Rules of procedure that govern FINRA arbitration cases may be procedurally fair. The rules provide a notice requirement, and opportunity to be represented by counsel, an opportunity to be heard, a convenient hearing

55. *See id.*

location, and some limitations on discovery and dispositive motions. However, the fairness of the implementation of the rules is suspect.

The manner in which arbitrations are carried out goes beyond the rules. It also extends to the arbitrators who preside over cases. As noted in the 2014 study by PIABA, the ranks of arbitrators lack diversity and are more advanced in age, and "FINRA's arbitrator disclosure process fails to ensure that it provides updated and accurate background information and information related to potential conflicts of interest and bias to parties."[56] Furthermore, industry firms are "repeat customers," which results in an implied "bias" to firms so that arbitrators are not stricken from selection lists. This problem rears its ugly head throughout the arbitration process. Arbitrators frequently deny Claimants' discovery requests and/or motions, or limit their orders on these motions substantially, thereby significantly limiting the evidence investors are able to present during their hearings. Arbitrators have been known to fall asleep during hearings[57] (I suppose this could be unfair to both sides - however, given that the claimant is generally required to prove their case, it seems more harmful to them). Arbitrators also often issue awards that have no correlation to the damages requested.

At the end of the day, it does not matter as much what the rules say if the individuals charged with administering the process are able to "do what they see fit," have few, if any, repercussions for being "unfair," and are generally unsupervised by the regulators/SRO(s) charged with carrying out and administering the arbitration process.

Big businesses prefer arbitration over court because the rules in arbitration tend to favor businesses.[58] The financial services industry is no different. It is time for a change that benefits investors.

Solution: Make arbitration elective, not mandatory.

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56. Press Release, PIABA, Study: Industry-Run Finra Arbitrator Pool Lacks Diversity And Fails To Detect, Communicate Potential Biases (Oct. 4, 2014), https://piaba.org/system/files/pdfs/PIABA%20Press%20Release%20(October%207,%202014).pdf.

57. *See, e.g.*, Bill Singer, *Merrill Lynch Asks Court To Rule That Sleeping FINRA Arbitrator Engaged In Misconduct*, FORBES (Mar. 23, 2012), http://www.forbes.com/sites/billsinger/2012/03/23/merrill-lynch-ask-court-to-rule-that-sleeping-finra-arbitrator-engaged-in-misconductle-may-not-be-evidence-of-misconduct/#58a4f3593f45.

58. *See* Jessica Silver-Greenberg and Michael Corkery, *In Arbitration, a 'Privatization of the Justice System,'* NY TIMES (Nov. 1, 2015), http://mobile.nytimes.com/2015/ 11/02/business/dealbook/in-arbitration-a-privatization-of-the-justice-system.html.

The solution to this problem is easy. Make arbitration elective, rather than mandatory. If the benefits the proponents of mandatory arbitration truly exist, then many (or perhaps most) investors will continue to opt for arbitration to take advantage of these benefits. If an investor wants his day in court, however, and is willing to subject himself or herself to the potential "detriments" of litigation (i.e., increased costs, if any, the increased likelihood that his or her case would be dismissed or not heard on the merits, and the more extensive discovery obligations that may be imposed upon them), the investor should be allowed to accept those risks and file their case in court. In other words, Wall Street should no longer be allowed to say "arbitration is *good enough* for you, Mr. or Mrs. Investor."

This would address another important issue with arbitration. If an investor elects to proceed in arbitration, their ability to argue that the process is unfair is substantially lessened. For example, if an investor elects arbitration knowing that discovery is more limited, (s)he would not be able to argue, during or after her case, that the limited nature of discovery that is imposed on him/her during the case is/was unfair.

From a procedural standpoint, the FINRA Code of Arbitration Procedure already provides for elective arbitration.[59] FINRA could also impose many of the same benefits to investors that it already provides if arbitration were elective.

However, if FINRA is truly motivated to protect investors, it could even take steps to protect investors who decide to file cases in court. For example, one of the benefits of arbitration discussed above is FINRA's enforcement of arbitration awards. To address this, FINRA could amend Rule 9554 to include judgments against members in court cases, or settlements in court cases involving members. FINRA could continue to enforce arbitration awards as it has always done, and the SEC could continue to regulate FINRA arbitration. If FINRA were to oppose such an amendment, its true stance on investor protection would be somewhat exposed.

FINRA arbitration "is really a misnomer. Most often, the process is not about two evenly matched parties to a dispute seeking the middle ground and a resolution of their conflict from knowledgeable, independent and unbiased fact-finders. Rather, what we have here in America today is an industry-sponsored damage containment and control program, masquerading as a

59. FINRA, RULE 12201(2008).

juridical proceeding."[60] The proof of this fact is easily seen in nominal awards given to investors in arbitration during the 'Tech Wreck' and 'Subprime' market crashes despite industry fines in the tens of billions of dollars for fraud! Litigation is crucial to protecting the individual's property rights and to market efficiency.[61] FINRA arbitration destroys this foundation of our economy. Excess market inefficient[62] 'rents' (underserved inefficient remuneration) to the financial industry is estimated to be $348-383.2 billion a year. Forced arbitration protects this harmful largess for industry.[63] Think of the social benefits if this wasteful largess were more efficiently allocated in society!

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60. *The Securities Arbitration System*: *Hearing Before the H. Comm. on Fin'l Servs.*, 109th Cong. 7 (2005), (testimony of William Galvin), *at* http://financialservices.house.gov/media/pdf/109-11.pdf.

61. There is "little evidence that public enforcement benefits stock markets, but strong evidence that laws mandating disclosure and facilitating private enforcement through liability rules benefit stock markets." Rafael LaPorta, et al., *What Works in Securities Laws?*, 61 J. FIN. 1 (Abstract) (2006).

62. Ratna Sahay, *et al.*, Rethinking Financial Deepening: Stability and Growth in Emerging Markets 16 (Int'l Monetary Fund Staff Discussion Note No. 15/8, 2015).

63. Michael S. Edmonton and Bradley Stark, *The Financial Services Industry's Historic Pattern of Opposition to Reform: "Wolf" is The Only Cry*, 22 PIABA B.J. 172 (2015).

RECENT ARBITRATION AWARDS

Robert Van De Viere

Crime and Punishment: this is a phrase familiar to most people. Traditionally, people believe punishment to be the exclusive domain of the criminal and regulatory authorities. However, civil fact finders (both juries and arbitration panels) are regularly empowered to dole out their own brand of punishment to the parties appearing before them – in the form of punitive damages.

In the FINRA forum, punitive damages present an opportunity for arbitrators to deliver a message to the offending party that the misconduct must not happen again. For Claimants' attorneys, whose ultimate goal is to demonstrate to their arbitration panel that their client was a victim, an award of punitive damages can be the ultimate validation.

The questions then become *When? How?* and *Under what authority?* do arbitration panels award punitive damages. This article will review a few recent arbitration awards that illustrate the array of bases upon which arbitration panels have done so.

John E. Artmire, Claimant v. First Midwest Securities, Inc., Respondent
FINRA Case No. 12-02841[1]

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1. Claimant asserted the following causes of action: Violation of Texas Securities Act § 581-33; breach of fiduciary duty; common law fraud; breach of contract; restitution; negligence, negligent misrepresentation, and omission; and negligent supervision.

The causes of action related to Claimant's allegations that Respondent churned Claimant's account in combination with aggressively allocating Claimant's assets in highly speculative securities, including numerous speculative call options. Claimant further alleged that Respondent mismanaged his account by extensively using margin to leverage Claimant's account to the greatest extent possible, causing Claimant to lose a significant portion of his life savings.

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: $275,000 in Compensatory Damages, Punitive Damages, Interest, Attorneys' Fees, Other Costs, and Other Monetary Relief. At the close of the hearing, Claimant requested: $296,071 in Compensatory Damages, Punitive Damages, Interest, Attorneys' Fees, and Other Costs.

Claimant's Counsel: Bruce D. Oakes, Esq., Oakes & Fosher, LLC.

Respondent's Counsel: Brandon S. Reif, Esq., Winget Spadafora & Schwartzberg LLP.

Arbitrators: Robert L. Yeager, III, Public Chairperson; Arthur H. Gefren, Public Arbitrator; Joseph Anthony Girgenti, Non-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. Respondent is liable for and shall pay to Claimant the sum of $236,403.00 in compensatory damages;
2. Respondent is liable for and shall pay to Claimant prejudgment interest on the above-stated sum at the rate of 5% per annum from and including July 31, 2012, through and including the date of service of this Award;
3. Respondent is liable for and shall pay to Claimant post-judgment interest on the above-stated sum at the rate of 5% per annum from the date of service of this award, through and including the date this Award is paid in full;
4. Respondent is liable for and shall pay to Claimant the sum of $472,806.00 in punitive damages pursuant to Texas Civil Practice and Remedies Code § 41.003;
5. Respondent is liable for and shall pay to Claimant the sum of $78,000.00 in attorneys' fees pursuant to Texas Securities Act § 581-33;
6. Respondent is liable for and shall pay to Claimant the sum of $31,308.00 in costs;
7. Respondent is liable for and shall pay to Claimant the sum of $300.00 as reimbursement for the non-refundable portion of the FINRA filing fee;
8. Respondent's request for expungement on behalf of unnamed party Douglas Rosenberg (CRD # 3214215) is denied; and
9. Any and all relief not specifically addressed herein, including sanctions, is denied.

In this case, we see a panel entering an award of punitive damages pursuant to state statute. Specifically, Texas Civil Practice and Remedies Code § 41.003 reads:

Respondent requested that the claims asserted against it be denied and that it be awarded its costs of defense, including expert fees. Respondent also requested that all forum fees be assessed to Claimant and other appropriate relief.

At the close of the hearing, Respondent requested costs in the amount of $114,113.61 and expungement of all references to this matter from the registration records maintained by the Central Registration Depository ("CRD") on behalf of unnamed party Douglas Rosenberg.

> Sec. 41.003. STANDARDS FOR RECOVERY OF EXEMPLARY DAMAGES. (a) Except as provided by Subsection (c), exemplary damages may be awarded only if the claimant proves by clear and convincing evidence that the harm with respect to which the claimant seeks recovery of exemplary damages results from:
> (1) fraud;
> (2) malice; or
> (3) gross negligence.
> (b) The claimant must prove by clear and convincing evidence the elements of exemplary damages as provided by this section. This burden of proof may not be shifted to the defendant or satisfied by evidence of ordinary negligence, bad faith, or a deceptive trade practice.
> (c) If the claimant relies on a statute establishing a cause of action and authorizing exemplary damages in specified circumstances or in conjunction with a specified culpable mental state, exemplary damages may be awarded only if the claimant proves by clear and convincing evidence that the damages result from the specified circumstances or culpable mental state.
> (d) Exemplary damages may be awarded only if the jury was unanimous in regard to finding liability for and the amount of exemplary damages.
> (e) In all cases where the issue of exemplary damages is submitted to the jury, the following instruction shall be included in the charge of the court:
> "You are instructed that, in order for you to find exemplary damages, your answer to the question regarding the amount of such damages must be unanimous."

Based upon the language in the statute, it appears that the panel in this case found that the misconduct went beyond "ordinary negligence, bad faith, or a deceptive trade practice" and into the territory of "fraud, malice or gross negligence."

Given that this claimant's allegations stemmed from churning, this should not come as a surprise. For those less familiar with the concept, churning is a simple way for a broker to take his client's money and make it his money by effectuating numerous transactions in relatively short time frame and generating a very high rate of commissions. Such behavior is not typically explained away as "accidental." Rather, true churning is generally accompanied by a willful *mens rea*. In light of willful misconduct, one could understand the need to punish.

Scan Berlon, Claimant v. Cornerstone Wealth Management and Chris Lamont Meacham, Respondents
FINRA Case No. 14-00323[2]

Claimant's Counsel: Vincent D. Slavens, Esq., Krause, Kalfayan, Benink & Slavens, LLP.

Respondents' Counsel: John L. Staley, Esq., Law Office of John L. Staley. Arbitrators: Erwin Jay Shustak, Public Chairperson; Mandel E. Himelstcin, Public Arbitrator; Otis E. Hackett, 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 for and shall pay to Claimant $86,500.00 in compensatory damages. This total is comprised of $60,000.00 which Claimant invested in Scripps Fund I, plus pre-judgment interest, and reflects a $9,000.00 reduction for damages Claimant previously recovered directly from Scripps Fund I.
2. Respondents are jointly and severally liable for and shall pay to Claimant post-judgment interest on $60,000.00 of the aforementioned

2. Claimant asserted the following causes of action: fraud by intentional misrepresentation/concealment, negligent misrepresentation, and breach of fiduciary duty. The causes of action relate to Claimant's investment in Scripps Investment Mortgage Fund I, LLC ("Scripps Fund I").

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

Relief Requested: In the Statement of Claim, Claimant requested:

1. Unspecified compensatory damages against Respondents;
2. Punitive or exemplary damages in an amount to be determined at arbitration;
3. Pre-award and post-award interest at the maximum rate allowed by law; and
4. Cost of this arbitration, including reasonable attorneys' fees, expert witness fees, and such other relief as may be just and proper.

Respondents requested Claimant's claim be denied.

award at the rate of 10% per annum from May 22, 2015 until the award of $60,000.00 is paid in full.

3. Respondents are jointly and severally liable for and shall pay to Claimant $90,000.00 in punitive damages pursuant to California Corporations Code §25502.5 and California Code of Civil Procedure §3294 et seq.

4. Respondents are jointly and severally liable for and shall pay to Claimant post-judgment interest on the aforementioned punitive damages award of $90,000.00 at the rate of 10% per annum from May 22, 2015 until the punitive damages award of $90,000.00 is paid in full.

5. Respondents are jointly and severally liable for and shall pay to Claimant $250.00 as reimbursement for the non-refundable portion of the initial claim filling fee Claimant previously paid to FINRA Dispute Resolution.

6. Respondents' request for sanctions and attorneys' fees is denied.

7. Any and all relief not specifically addressed herein is denied.

This is yet another example of favorable state laws providing a compelling grounds for an arbitration panel to grant punitive damages to a prevailing claimant.[3]

Cal. Corp. Code §25502.5. states:

> (a) Any person other than the issuer who violates Section 25402 shall be liable to the issuer of the security purchased or sold in violation of Section 25402 for damages in an amount up to three times the difference between the price at which the security was purchased or sold and the market value which the security would have had at the time of the purchase or sale if the information known to the defendant had been publicly disseminated prior to that time and a reasonable time had elapsed for the market to absorb the information and shall be

3. A number of state securities statutes have also been used by panels recently as a basis for awarding punitive damages to claimants. *See* Goldman v. Transamerica Fin'l Advisors, Inc., FINRA Case No. 13-00438 (Feb. 18, 2014) (applying GA. CODE ANN. § 51-12-5.1 (2014)); Pearlman v. Wall Street Money Center Corp., FINRA Case No. 14-01611 (Mar. 20, 2015) (applying FLA. STAT. ANN. § 768.73(1)(a) (2015)); Kolow v. EKN Fin'l Servs. Inc., FINRA Case No. 11-04494 (Dec. 24, 2013) (applying COLO. REV. STAT, §§ 11-51-501, 11-51-604 (2013); Artmire v. First Midwest Secs., Inc., FINRA Case No. 12-02841 (July 2, 2015) (applying TEX. CIV. PRAC. & REM. CODE ANN. § 41.003 (2015)); Gribble v. Nat'l Planning Corp., FINRA Case No. 14-00193 (Mar. 26, 2015) (applying WIS. STAT. § 895.446(3)(c) (2014)).

> liable to the issuer of the security or to a person who institutes an action under this section in the right of the issuer of the security for reasonable costs and attorney's fees.
>
> (b) The amounts recoverable under this section by the issuer shall be reduced by any amount paid by the defendant in a proceeding brought by the Securities and Exchange Commission with respect to the same transaction or transactions under the federal Insider Trading Sanctions Act of 1984 (15 U.S.C. Secs. 78a, 78c, 78o, 78t, 78u, and 78ff) or any other act regardless of whether the amount was paid pursuant to a judgment or settlement or paid before or after the filing of an action by the plaintiff against the defendant. If a proceeding has been commenced by the Securities and Exchange Commission but has not been finally resolved, the court shall delay entering a judgment for the plaintiff under this section until that proceeding is resolved.
>
> (c) If any shareholder of an issuer alleges to the board that there has been a violation of this section, the board shall be required to consider the allegation in good faith, and if the allegation involves misconduct by any director, that director shall not be entitled to vote on any matter involving the allegation. However, that director may be counted in determining the presence of a quorum at a meeting of the board or a committee of the board.
>
> (d) This section shall only apply to issuers who have total assets in excess of one million dollars ($1,000,000) and have a class of equity security held of record by 500 or more persons.

Similarly, California Code of Civil Procedure § 3294 provides:

> 3294. (a) In an action for the breach of an obligation not arising from contract, where it is proven by clear and convincing evidence that the defendant has been guilty of oppression, fraud, or malice,
>
> the plaintiff, in addition to the actual damages, may recover damages for the sake of example and by way of punishing the defendant.
>
> (b) An employer shall not be liable for damages pursuant to subdivision (a), based upon acts of an employee of the employer, unless the employer had advance knowledge of the unfitness of the employee and employed him or her with a conscious disregard of the rights or safety of others or

> authorized or ratified the wrongful conduct for which the damages are awarded or was personally guilty of oppression, fraud, or malice. With respect to a corporate employer, the advance knowledge and conscious disregard, authorization, ratification or act of oppression, fraud, or malice must be on the part of an officer, director, or managing agent of the corporation.
>
> (c) As used in this section, the following definitions shall apply: (1) "Malice" means conduct which is intended by the defendant to cause injury to the plaintiff or despicable conduct which is carried on by the defendant with a willful and conscious disregard of the rights or safety of others. (2) "Oppression" means despicable conduct that subjects a person to cruel and unjust hardship in conscious disregard of that person's rights. (3) "Fraud" means an intentional misrepresentation, deceit, or concealment of a material fact known to the defendant with the intention on the part of the defendant of thereby depriving a person of property or legal rights or otherwise causing injury.
>
> (d) Damages may be recovered pursuant to this section in an action pursuant to Chapter 4 (commencing with Section 377.10) of Title 3 of Part 2 of the Code of Civil Procedure based upon a death which resulted from a homicide for which the defendant has been convicted of a felony, whether or not the decedent died instantly or survived the fatal injury for some period of time. The procedures for joinder and consolidation contained in Section 377.62 of the Code of Civil Procedure shall apply to prevent multiple recoveries of punitive or exemplary damages based upon the same wrongful act.
>
> (e) The amendments to this section made by Chapter 1498 of the Statutes of 1987 apply to all actions in which the initial trial has not commenced prior to January 1, 1988.

Again we have here a need to find “oppression, fraud, or malice.” In the securities context, fraud is a common allegation in customer disputes. Per the above, a finding of fraud is sufficient grounds in California to warrant an award of punitive damages.

Though not universal, this standard is certainly a justifiable one – in no small part to the fact that you are dealing with an intentional *mens rea*. It can be reasonably debated whether or not basic negligence can rise to the level that an arbitration panel could justify the imposition of punitive damages. Yet, one would be far more hard pressed to argue against an award of punitive damages where, as in this statute, you are presented with "clear and convincing evidence" an "intentional" deception "with the intention" of causing injury or depriving that person of legal rights.

In the broker-client context, such conduct could be viewed as even that much more egregious given the position of trust that the broker occupies. The dealings between a broker and client are regularly more involved than simply an arms-length business relationship. Therefore, the client-broker context would seem an even more appropriate place for the imposition of significant punitive damages in such egregious cases.

Vincent W. Romano, Claimant v. Morgan Stanley Smith Barney, LLC, Respondent
FINRA Case No. 12-03180[4]

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4. Claimant asserted the following cause of action: libel or slander on Form U5. Claimant alleged that Respondent terminated him to weaken his candidacy and improperly marked his U5 because Romano ran as the Republican Party candidate for representative in Illinois District No. 16. Romano alleged that MSSB feared loss of business with the City of Chicago and State of Illinois because MSSB has a relationship with the House Speaker, Michael Madigan, and Romano was running on a reform platform that could upset Michael Madigan's political power in the Illinois House. Claimant also alleged that Respondent failed to follow its own procedures regarding running for political office and fabricated a reason to terminate Romano.

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

In the Statement or Claim, Claimant requested an award in the amount of:

Actual/Compensatory Damages	$2,000,000.00
Punitive/Exemplary Damages	$6,000,000.00
Other Monetary Relief	Unspecified

At the close or the hearing, Claimant requested:

Actual/Compensatory Damages	$3,000,000.00
Punitive/Exemplary Damages	$6,000,000.00
Other Monetary Relief	Unspecified

Respondent requested that the claims asserted against it be dismissed in their entirety and that it be awarded its costs and attorneys' fees.

Claimant's Counsel: Nicholas P. Iavarone, Esq., The Iavarone Firm, and Alan F. Block, Esq., Block & Landsman.

Respondent's Counsel: Thomas F. Hurka, Esq. and Jeffrey J. Kmoch, Esq., Morgan, Lewis & Bockius, LLP

Concurring Arbitrators: Michael M. Malek, Public Chairperson; Michael I. White, Public Arbitrator; Loren H. Newman, Non-Public Arbitrator

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

1.) Respondent, Morgan Stanley Smith Barney, LLC, is liable for and shall pay to Claimant, Vincent W. Romano, the sum of $475,000.00 in compensatory damages;

2.) Respondent, Morgan Stanley Smith Barney, LLC, is liable for and shall pay to Claimant, Vincent W. Romano, the sum of $50,000.00 in punitive damages pursuant to Kipple v. Wells Fargo, 10-02871; Olson v. World Equity Group, 10-01803; Perales v. Chase Investment Services. *09-05959;* and Leahy v. Charles Schwab, 09-00260;

3.) The Panel recommends the expungement of the Termination Explanation from Section 3 of Claimant Vincent W. Romano's (CRD # 2812237) Form U5 filed by Morgan Stanley on June 5, 2012*,* and maintained by the Central Registration Depository ("CRD"). The Reason for Termination shall remain "Discharged." The Panel further recommends the expungement of the response to Question #3 in Part I of the Internal Review Disclosure Reporting Page ("DRP") as well as the expungement of the response to Question # 4 in the Termination DRP from Claimant Vincent W. Romano's Form U5 filed by Morgan Stanley on June 5, 2012, and maintained by the CRD.

The Termination Explanation and the responses both to Question #3 in Part I of the Internal Review DRP and to Question #4 in the Termination DRP shall be deleted and replaced with the following: "Concerns about the Financial Advisor running for elected political office, despite not having received prior firm approval for same, due to a misunderstanding between the firm and the Financial Advisor. The terminated employee violated no investment-related statutes, regulations or rules."

The above recommendations are based on the defamatory nature of the information, and the Panel recommends that these changes be made to any subsequent amendments maintained by the CRD.

Claimant's registration records are not automatically amended to include the changes indicated above.

Claimant Vincent W. Romano must forward a copy of this Award to FINRA's Registration and Disclosure Department for the amendments to be incorporated into his registration records.

4.) Other than Forum Fees which are specified below, the parties shall each bear their own costs and expenses incurred in this matter; and

5.) Any relief not specifically enumerated, including attorneys' fees, is hereby denied with prejudice.

This award is significant because the arbitration panel here relied upon the persuasive effect of prior arbitration awards to award punitive damages, rather than a statute or case law. Even more noteworthy is that the underlying arbitration awards were not consistent in what their respective panels relied upon in rendering their awards.

Experienced practitioners will almost certainly recall at least a case or two (or many more) where an adversary was sure to note in opposition papers that prior arbitration awards have no precedential effect. However, this award is a testament to their persuasive effect.

Douglas Allan Haviland, Claimant v. TD Ameritrade, Inc., Respondent
FINRA Case No. 14-02200[5]

Claimants' Counsel: Claimant appeared *pro se*.

Respondent's Counsel: Janine M. Lucas, Esq., Sarelsky Hart Michaels & Gould PC.

Arbitrator: William M. Howard, Sole Public Arbitrator.

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5. Claimant alleged that Respondent failed and continues to fail to disclose material facts concerning his investment in Bancorp International Group Inc. ("BCIT") and refuses to comply with a security entitlement demand Claimant made under Uniform Commercial Code 8-508. The causes of action relate to Claimant's purchase of 75,000 shares of BCIT common stock.

Relief Requested

1. Respondent deliver a physical share certificate for Claimant's 75,000 BCIT shares in Claimant's name;

2. $205.00 in actual damages;

3. $410.00 in punitive damages;

4. $50.00 in filing fees; and

5. Any such other and further relief as the Arbitrator may deem just and proper.

Award: The Arbitrator has decided and determined in full and final resolution of the issues submitted for determination as follows: 1) Respondent is liable for and shall pay to Claimant $205.00 in compensatory damages. 2) Respondent must deliver to Claimant a physical share certificate for 75,000 Bancorp International Group, Inc. shares registered in Claimant's name. 3) Respondent is liable for and shall pay to Claimant $410.00 in punitive damages pursuant to securities laws and the Uniform Commercial Code. 4) FINRA Dispute Resolution shall retain the $50.00 filing fee that the Claimant deposited previously. 5) All other relief requests are denied. 6) Respondent is liable for and shall pay to Claimant $50.00 to reimburse Claimant for the filing fee previously paid to FINRA Dispute Resolution.

This award is noteworthy for a number of reasons, not least of which is that this award was obtained by a *pro se* Claimant. A scan of awards will leave you with the impression that the victorious *pro se* Claimant is a rare find. Yet, here we have one who obtained an award (albeit small) for punitive damages.

The award of punitive damages is also notable largely for its ambiguity. Simple arithmetic tells us that the award is double damages. The $410 in punitive damages is twice the $205 in compensatory damages awarded. Yet from where this formula was derived remains a mystery. Arbitrator Howard simply states that the award is made "pursuant to the securities laws and Uniform Commercial Code" without further elaboration or specificity.

CASES & MATERIALS

Joseph Wojciechowski

AXA Advisors, LLC v. Lee, No. 1:15-cv-137, 2016 U.S. Dist. LEXIS 10684 (D. Idaho Jan. 27, 2016).

AXA Advisors filed a complaint against Defendant investors seeking to enjoin a FINRA Arbitration, arguing the Defendants were never AXA customers. The Defendants were defrauded by AXA's registered representative, Douglas Roberts, who ran a Ponzi-type scheme. The Defendants brought claims in arbitration against AXA for failure to supervise. At summary judgment, the Court ruled in favor of Defendants–investors, finding that the investors were customers of AXA's "associated person" and as such, AXA must arbitrate the dispute pursuant to Rule 12200. In so doing, the Idaho court relied on Second Circuit precedent, which, although not binding, was highly persuasive. The court specifically relied on *Citigroup Global Markets, Inc. v. Abbar*, 761 F.3d 268, 274 (2d Cir. 2014) by distinguishing its complex facts and holding that it clearly stood for the proposition that a member must arbitrate disputes with its associated person's customers. The court followed *John Hancock Life Ins. v. Wilson*, 254 F.3d 48 (2d Cir. 2001) and argued that since the decision in *John Hancock*, which also held members must arbitrate cases for its associated person's customers, FINRA has had 15 years to change or amend rule 12200 and FINRA has not done so.

Basis Yield Alpha Fund Master v. Morgan Stanley, 23 N.Y.S.3d 50 (N.Y. App. Div. 2015).

Plaintiff investment fund sued Morgan Stanley for fraud, fraudulent concealment, and negligent misrepresentation in connection with Morgan Stanley's sale and underwriting of CDOs. Morgan Stanley moved to dismiss, arguing the sophisticated investor was not reasonable in relying on representations made by Morgan Stanley. Secondarily, Morgan Stanley sought dismissal because contracts between the parties specifically included reliance disclaimers. The trial court dismissed the negligent misrepresentations claim but denied the motion to dismiss the fraud and fraudulent concealment claims. Morgan Stanley appealed and the court affirmed the ruling of the trial court.

Basis Yield's case against Morgan Stanley has to do with Morgan Stanley's knowledge that the ratings assigned to various tranches of the RMBS/CDO at issue were unreliable. Put another way, although the tranches were rated favorably by the ratings agencies, Morgan Stanley's due diligence into the securities indicated those ratings were not reliable. This information, critically, was not obtained from information generally available to the market, but was instead only available to Morgan Stanley, as the underwriter and broker of the securities. It was also alleged that Morgan Stanley convinced the ratings agencies to use an outdated methodology when rating the securities in order for the tranches to get higher ratings than they would otherwise have received. The Court held that Morgan Stanley's reliance argument – that Basis, as a sophisticated investor, was not reasonable in relying on the ratings – means that in Morgan Stanley's world, an investor can never be reasonable in relying on ratings and should presume they are fraudulent or unreliable.

The court similarly denied Morgan Stanley's contractual disclaimer argument, ruling that they do not negate justifiable reliance as a matter of law given the allegations of the complaint and the stage of the proceeding.

Goldman Sachs & Co. v. Athena Venture Partners, L.P., 803 F.3d 144 (3d Cir. 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.*, No. 1:13-MC-130, 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 by waiting until after the award to first raise the issue. 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."

Gomez v. Bank of America, N.A., No. 14-55129, 2016 U.S. App. LEXIS 3934 (9th Cir. Mar. 2, 2016)

A group of investors victimized by Kaveh Vahedi sued Bank of America, as successor to Countrywide Financial, for its role in facilitating a massive mortgage Ponzi scheme. The investors brought claims under the civil RICO statute, 18 U.S.C. § 1962(a)-(d) and various state laws. The District Court dismissed the investors' civil RICO claims and the Ninth Circuit affirmed. The Court ruled the investors could not adequately plead the Bank acted with the necessary intent to defraud them. Further, under the civil RICO statute, the investors had to plead the Bank actors proximately caused their damages. The investors' allegations that the Bank's representations that it "carefully screened" and "carefully selected" all of its mortgage brokers gave Vahendi an aura of credibility were not sufficient to establish causation when they separately alleged they trusted Vahendi. Furthermore, the investors' claims that the bank owed them fiduciary duties failed because under California law, a lender owes only those duties expressed in the loan agreement absent special circumstances. Lastly, the investors' agency theories failed because the principal can only be liable when the agent is acting in the interest of the principal.

Grigsby & Associates v. M Securities Investment, No. 13-15208, 2015 U.S. App. LEXIS 22677 (11th Cir. Dec. 28, 2015).

This case is a procedural maze about how far a party must go to waive its right to arbitration. M Securities filed four separate lawsuits against Grigsby seeking to recover fees and a share of profits owed from a municipal bond offering. Three of the lawsuits were filed in Federal court, where one was dismissed for failure to perfect service of process, another was dismissed because it was identical in all material respects to the first case, and the last resulted in a settlement between M Securities and Miami-Dade, but without ever having issued a summons to Grigsby. The fourth lawsuit was filed in state court and dismissed for lack of prosecution.

A few years later, in 2006, M Securities filed an action in NASD arbitration against Grigsby who sought to enjoin the arbitration arguing M Securities waived its right to arbitration. The district court denied the motion for temporary injunction and the arbitration proceeded and M Securities was awarded $100,201 in damages, plus interest and attorney's fees. Grigsby moved to vacate the award again based on waiver and it was denied. The appellate court ordered the district court to specifically consider the issue of waiver, not from the arbitrators' perspective, but as a matter of law. The district court again denied the motion to vacate.

On appeal, the 11th Circuit confirmed, ruling that the prior lawsuits filed by M Securities were "insubstantial" and thus did not constitute a substantial invocation of "litigation machinery prior to demanding arbitration" resulting in waiver.

Credit Suisse Securities (USA), LLC v. Tracy, No. 15-345-cv, 2016 U.S. App. LEXIS 1354 (2d Cir. Jan. 28, 2016)

In this appeal of a trial court decision ordering former employees to dismiss their FINRA arbitration and to pursue their claims in JAMS arbitration, the court recognized that the parties waived the default requirement to arbitrate before FINRA because they contractually agreed to arbitrate in another forum. The employees argued that FINRA, RULE 13200 required all members to arbitrate disputes arising out of the business activities of the firm and its associated persons through FINRA. They argued FINRA, RULE 13200 prohibited Credit Suisse from selecting a non FINRA arbitration forum. Credit Suisse argued the pre-dispute arbitration provision included in its employee contract constituted a waiver of the requirements of FINRA, RULE 13200 and was a separately enforceable agreement to arbitrate under the Federal Arbitration Act, 9 U.S.C. § 2.

The Second Circuit held that FINRA, RULE 13200 is a default rule and thus can be waived by a pre-dispute private arbitration agreement to utilize another dispute resolution forum. The agreement was not a waiver of the right to arbitration, which would have been unenforceable. Instead, it was an agreement to arbitrate disputes in another arbitration forum.

Schilling Livestock, Inc. v. Umpqua Bank, No. CV-14-54-H-CCL, 2015 U.S. Dist. LEXIS 161004 (Dist. Mont. Dec. 1, 2015)

Plaintiffs sought to vacate a FINRA arbitration award. The case was originally filed against Fintegra, LLC, and a financial adviser, in FINRA arbitration and with a separate action in Montana state court against Sterling Bank in connection with losses in a Tenant-In-Common investment. The financial adviser was dually employed by Fintegra and the Bank. The bank voluntarily submitted to FINRA arbitration. Plaintiff settled with Fintegra and dismissed the case against the adviser because of a bankruptcy stay. The hearing proceeded against the bank.

The Panel denied the claim against the bank and this petition to vacate followed. Plaintiffs argued the arbitrators committed misconduct by allowing the Bank's expert witness to give a legal opinion during his testimony regarding whether the bank was absolved from liability based on the Networking Exception found in the Graham Leach Bliley Act, 15 U.S.C. § 78c(a)(4)(B)(I). This statutory exception provides that when a bank fulfills the statute's exception criteria, the bank "shall not be a broker" when it enters into third-party arrangements to offer brokerage services on or off bank premises. The court stated Plaintiffs opened the door to the testimony by arguing the Network Exception was not applicable. Further, although not pleaded as an affirmative defense, Plaintiffs were on notice of the defense. The District Court, in denying the petition to vacate, also stated, "Petitioner's real conundrum is not that they did not have notice of the third-party networking exception that exempts Sterling from being held liable for Fintegra's errors, but that they cannot define the Bank's contractual and common law duties without resort to a derivative broker-liability theory."

William Beaumont Hospital v. Morgan Stanley & Co., No. 14-10404, 2016 U.S. Dist. LEXIS 5789 (E.D. Mich. Jan. 19, 2016)

This case is about the statute of limitation for fraud under Michigan law. Plaintiff sued Morgan Stanley over losses sustained in Auction Rate Securities. Morgan Stanley moved to dismiss based on the expiration of statutes of limitation under Michigan law. The Court dismissed the case, ruling under Michigan law the statute of limitations "for fraud accrues when the wrong upon which the claim is based was done, regardless of the time when the damage results." MICH. COMP. LAWS ANN § 600.5827 (2016). "There is no discovery accrual standard for claims of fraud or misrepresentation." The court also held that, even if the complaint was filed timely, it would have to be dismissed for failing to state a claim because written disclosures negated the possibility of an actionable omission.

Fosbre v. Las Vegas Sands Corp., No. 2:10-cv-00765-APG-GWF, 2016 U.S. Dist. LEXIS 5422 (Dist. Nev. Jan. 14, 2016)

This case is an excellent primer on the attorney-client privilege in complex corporate settings in Federal court. In this class action against Las Vegas Sands and Sheldon Adelson, the court had to make multiple rulings on Plaintiffs' motion to compel specific to the issue of attorney-client privilege. The motion sought the production of three sets of records: 1) documents withheld or redacted based on attorney-client privilege that were previously disclosed to employees of Goldman Sachs and Jefferies, LLC; 2) documents withheld or redacted that do not appear to have been made for the purpose of obtaining legal advice; and 3) production of documents withheld based on attorney-client privilege, but were produced in prior litigation. There was also an issue regarding documents produced by Goldman Sachs that were redacted at the direction of Las Vegas Sands.

The first issue decided was whether Goldman Sachs and Jefferies employees were the functional equivalent of employees of Las Vegas Sands. The court held that the documents sought between Goldman Sachs and attorneys for Las Vegas Sands were protected from disclosure by the attorney-client privilege because Goldman Sachs employees became the functional equivalent of employees of LVS for purposes of complicated financial advisory, financing and loan restructuring options presented to the board. The court determined that, although the existence of a fiduciary duty provides further support for functional equivalence, it is not required. The court did require LVS to supplement their privilege log to further demonstrate the applicability of the privilege to each individual employee.

The second issue determined by the court was whether certain withheld communications concerned business advice rather than legal advice. Because determining whether a particular communication is legal advice or business advice requires review, the court ordered limited in camera inspection of documents to rule on the privilege on a document by document basis.

Finally, the court determined that LVS had not waived the attorney-client privilege regarding a report prepared with the assistance of counsel for prior litigation. The court's ruling seemed to fall back on the relatively irrelevant nature of the report confusing the issues somewhat.

JP Morgan Chase Bank, N.A. v. McDonald, No. 11 C 6902, 2015 U.S. Dist. LEXIS 150798 (N.D. Ill. Nov. 6, 2015)

Investors sued J.P. Morgan Securities and J.P. Morgan Bank because notwithstanding their instructions to invest less than 14% of their accounts in "hedge funds", their advisors invested nearly all of their $6.5 million account in the JP Morgan Global Access Portfolio or "GAP Fund". When the financial crisis hit, the investors ordered their advisors to sell out of the fund, but were told, for the first time, that the fund was illiquid and could not be sold until December 31, 2008. As a result, investors argue, they lost over $1.5 million.

In 2011, when the McDonalds filed a claim before FINRA, J.P. Morgan Bank – the entity which actually contracted to perform investment services, filed a complaint seeking declaratory and injunctive relief to stay the arbitration against J.P. Morgan Securities and the two investment advisors. The District Court initially granted the preliminary injunction, but six months later ruled that the Bank lacked standing to seek an injunction on behalf of an affiliate and two employees. The Seventh Circuit reversed and remanded the case because the arbitration violated a forum selection clause and because the individual defendants were not indispensable parties. *J.P Morgan Chase Bank, N.A. v. McDonald,* 760 F.3d 646 (7th Cir. 2014). The McDonalds then counter-claimed the Bank claiming relief under both the Indiana and Illinois securities laws and both Indiana and Illinois consumer protection statutes. They also brought common law claims for negligence, breach of fiduciary duty, breach of contract, misrepresentations, and omissions. J.P. Morgan now seeks to dismiss the investors' counter-claims.

Initially, the Court had to determine whether the New York choice of law clause contained in the parties' General Terms Agreement governs the dispute. The McDonalds argued the choice of law clause was inoperative because they never signed the agreement and because both the Illinois and Indiana statutes negate any choice of law clause that would forbid statutory claims. The court ruled the New York choice of law clause governed the dispute, overruling the McDonald's anti-waiver argument and thus dismissing all Illinois and Indiana statutory claims, leaving common law claims only.

The Bank then sought dismissal of the common law negligence, breach of contract, breach of fiduciary duty, and ordinary negligence claims pursuant to an exculpatory clause in the contracts which state the Bank could only be held liable for gross negligence or willful misconduct. The court ruled that the exculpatory clause necessitated dismissal of the McDonald's breach of contract, breach of fiduciary duty, and ordinary negligence counts.

The court denied the motion to dismiss the gross negligence count, holding that the "decision to invest nearly all of the McDonalds' money in a single illiquid fund was 'an extreme departure from the standards of ordinary care' in the securities industry, as they not only failed to diversify their client's investments but also ignored the McDonalds' express orders to build a conservative, low-risk portfolio." The court also denied the motion to dismiss the fraudulent misrepresentation and omission claim, ruling that fraudulent statements made after the contract was signed were not included in a contractual merger clause. The court also ruled that the complaint sufficiently pled fraud under FRCP Rule 9(b), noting the difficulty inherent in pinpointing exact timing and content of oral statements.

WHERE WE STAND

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

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

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

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

1. To review all PIABA Comment letters, visit www.PIABA.org. For more information, contact Hugh Berkson at hberkson@hcsattys.com, Marnie Lambert at mlambert@mclinvestlaw.com or Robin S. Ringo at rsringo@piaba.org for assistance.

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The following PIABA Comment Letter regarding the *California AB 2610 (Holden; Brown) Opposition and Concerns* was submitted to the California Assembly Committee on Banking and Finance by Hugh D. Berkson on April 13, 2016 (prepared with the assistance of Scot Bernstein).

Via Email Only to
assemblymember.Dababneh@assembly.ca.gov

Honorable Assembly Member Matthew Dababneh
Chair
Assembly Committee on
Banking and Finance
1020 N Street
Suite 360B
Sacramento, California 95814

Re: AB 2610 (Holden; Brown) - OPPOSITION AND CONCERNS

Dear Assembly Member Dababneh:

The Public Investors Arbitration Bar Association (PIABA) is a national association of more than 400 attorneys who represent victims of investment frauds and stockbroker and financial planner misconduct in securities industry arbitration forums and the courts. On a daily basis in our practices, we see devastating losses resulting from violations of investor protection laws and regulations that govern the securities industry and issuers of securities. Disproportionately, those losses fall on elderly and vulnerable savers and investors. We believe that further loosening of longstanding standards for securities offerings would be a predictably damaging mistake.

The current and longstanding rule for the duration of the effectiveness of a securities offering qualification by permit under California's Corporate Securities Law is contained in Corporations Code section 25114, which provides in relevant part as follows:

> Every qualification under this chapter is effective for 12 months from its effective date, unless the commissioner by order or rule specifies a different period . . . .

AB 2610 would triple the effective period for small company offerings under Corporations Code section 25113(b)(2) to three years. PIABA believes that such a lengthening is undesirable for multiple reasons.

First, the public has a longstanding and reasonable expectation that a permit to offer securities in an issuer transaction is good for one year. Changing that creates the potential for unfair surprise. And changing it by a factor of three for small company offerings – which are among the riskiest of offerings – would be all the more surprising and counterintuitive. Why, for example, would a reasonable investor expect riskier securities to be able to be offered three times as long after regulatory review as less risky securities?

Second and more importantly, three years can be a very long time. A lot can change in three years. Consider, for example, the housing boom that was happening in mid-2006. Next, consider that same market in mid-2009. In less than three years, the boom had turned into the worst bust since the Great Depression. Can it really be said that an offering qualified for sale to the public in mid-2006 should have be able to continue being conducted, with the imprimatur of regulatory review that comes with being qualified by permit, during economic times that were as nearly opposite as one could imagine?

The recent economic meltdown is just one example of the radical changes that can impact the viability of investment offerings. Energy costs and the viability of energy-based business models can change dramatically in short, multi-year time periods. And the fortunes of anything technology-based can reverse at great speed. Indeed, the purpose of new technologies often is to render earlier technologies obsolete.

Third, consider what it says about the prospects for a company or project that it takes three years to raise the minimum offering proceeds that are required to break impound and turn the money over to the issuer. If it takes that long, what does that indicate about the attractiveness of the offering and the prospects of the investment? And what does it say about the investment acumen of those who do invest?

Compounding our concerns is that all too often, the people who find themselves in inordinately risky investments are elderly retirees. The reason? They're disproportionately the ones with money. Their homes have had longer to appreciate, their retirement plans have had longer to grow, and they may have received life insurance proceeds from the loss of a spouse. They are particularly vulnerable to promises of higher returns because returns on fixed-income investments such as bonds and certificates of deposit are at historic lows. So they risk their principal to get a few extra dollars of hoped-for return, only to find that they have lost savings they never will have any way to replace.

All of this is compounded by the reality that many seniors are more trusting than they should be, and often are particularly vulnerable to sales people who are friendly and attentive and sound knowledgeable. And sadly, many do not have the energy or alertness they once had. Combine all of these factors and you have a recipe for a nearly limitless number of personal financial disasters. Retirees whose savings would have been sufficient to see them through the rest of their lives suddenly cannot afford to stay in their homes because their Social Security checks, now their sole source of income, simply won't cover all the bills. Worse, they may require other forms of public assistance, including MediCal – or may require it far sooner than would have been the case otherwise.

PIABA believes that money lost by investors in stale offerings is likely never to be recovered. First, there is a collectability issue. By the time savers or investors in a non-viable investment sue, and certainly by the time they obtain a judgment or award, there often is no defendant with funds to pay it. That is all the more likely when changing economic fortunes caused by the passage of time have made the issuer less economically viable than might have been the case when the offering began.

Second, even when the funds might exist, securities litigation is so expensive that it may be impossible or impractical to pursue the matter. Much of this is due to the high cost of expert witnesses in these cases. Thus, for example, a $150,000 loss, which might be devastatingly large to the senior who has suffered it, might well be too small to pursue due to the high cost of securities litigation, especially when combined with the collectability risk. Third, the promoters are very likely to include forced arbitration clauses, class waivers, choice-of-law clauses, choice-of-forum clauses and other gimmicks in the subscription documents to make pursuing a remedy both unaffordable and all the more unlikely to yield a recovery for the investor.

We as a people have a long history of learning and relearning the harsh lessons of the past. We have been battered mercilessly in the last eight years for forgetting repeated lessons about the dangers financial industry deregulation, including the lessons of the 1920s and 1930s. We must resist continuing efforts at further deregulation of financial and securities markets. We should remember and move back toward the regulatory environment that, for the approximately six decades that ended in the mid-1990s, imbued U.S. capital markets with a level of honesty and transparency that made them the envy of the world. And closer to home, we should maintain for California's savers and investors, and for seniors and retirees in particular, the level of protection that currently exists.

Thank you for your consideration of our concerns about AB 2610.

Sincerely,
Hugh D. Berkson, PIABA President
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Cleveland, OH 44115
Telephone: (216) 696-1422
Email: hdb@mccarthylebit.com

cc: Assembly Member Holden
Via Email Only to assemblymember.holden@assembly.ca.gov
Assembly Member Brown
Via Email Only to assemblymember.brown@assembly.ca.gov
Kathleen O'Malley
Assembly Committee on Banking and Finance
Via Email Only to Kathleen.OMalley@asm.ca.gov
Scot Bernstein
Via Email Only swampadero@sbernsteinlaw.com

The following PIABA Comment Letter regarding the *California AB 2178 – (Chiu) Opposition and Concerns* was submitted to the California Assembly Committee on Banking and Finance by Hugh D. Berkson on March 30, 2016 (prepared with the assistance of Scot Bernstein).

Via Email Only to
assemblymember.Dababneh@assembly.ca.gov

Honorable Assembly Member Matthew Dababneh
Chair
Assembly Committee on Banking and Finance
1020 N Street
Suite 360B
Sacramento, California 95814

Re: AB 2178 (Chiu) - OPPOSITION AND CONCERNS

Dear Assembly Member Dababneh:

The Public Investors Arbitration Bar Association (PIABA) is a national association of more than 400 attorneys who represent victims of investment frauds and stockbroker and financial planner misconduct in securities industry arbitration forums and the courts. On a daily basis in our practices, we see devastating losses resulting from violations of investor protection laws and regulations that govern the securities industry and issuers of securities. Disproportionately, those losses fall on elderly and vulnerable savers and investors. We believe that further deregulation of securities offerings would be a predictably devastating mistake.

AB 2178 is the latest in a series of bills that, in the name of making capital formation easier, would endanger seniors and other savers and investors by weakening longstanding investor protections. SB 875, AB 2081, AB 783, AB 2096 and AB 722 all have been stopped sort of passage since 2010.[1] The first three took the form of proposed exemptions. AB 2096 started out that way as well, only to be converted into a bill that would have allowed offerings that

1. Note that the last three of those were defeated ***after*** the enactment of the JOBS Act, which was signed into law on April 5, 2012.

had undergone no regulatory review whatsoever to pretend that they had and masquerade as having been “qualified by notification” – a type of qualification that always has been reserved exclusively for Securities Exchange Act publicly-traded companies and for investment companies (generally, mutual funds) regulated under the Investment Companies Act of 1940. Such a result would have been unfair to investors, unfair to competitors whose securities actually deserved to be deemed “qualified,” and unfair to the capital markets themselves. It is a good thing that the five predecessor bills did not become law.

AB 2178 takes an approach similar to that in AB 722, proposing to allow small offerings to be qualified under a new and easier permit process. It is a process that, as with the predecessor bills, runs the serious risk of exposing a trusting public – trusting because it has the right to expect that a permit from the Department of Business Oversight (DBO) is an indication of having undergone meaningful regulatory scrutiny – to securities that may have received no vetting but look as though they had and ***can be advertised*** as though they had.

The DBO’s review under AB 2178 will be more limited and may be nonexistent. For example, under AB 2178, if the DBO has not acted on an application within 60 days, the permit will be issued automatically. It is analogous to enacting a rule that if a person took medical board exams and the examining board did not grade the exams within 60 days, the applicant would become an M.D. automatically, whether or not he or she actually had passed the exams.

There are multiple ways in which such permits-by-default could happen. The most obvious is that if there is a flood of applications, it simply might not be possible for DBO to investigate and process them all within 60 days. The result would be that securities that had received not a glance from a regulator tasked with protecting the investing public could be advertised as though they had, the implication being that they had been examined and determined to be fair, just and equitable to the investors – the standard for issuing a permit.

Even in times of normal levels of applications, the DBO could be busy enough or short enough on personnel to be unable to do all necessary vetting of an application within the allotted time. Studying a proposed securities offering and determining whether it is fair, just and equitable to investors is not a perfunctory task. So even in times of lower application levels, offerings that had received no review could receive a permit by default and be sold as though they had received meaningful vetting.

Either way, if DBO cannot review an issuer’s application within 60 days, the offering will be worse than exempt. It will be as un-vetted as if it were exempt but it will be marketed as though it had been qualified by permit.

And for those applications that are reviewed by DBO, what assurance do we have that review of an offering seeking qualification under Corporations Code section 25113.1 will be subjected the same level of scrutiny as an offering qualified under section 25113?

The Human Cost of Reducing Protection of Seniors' Savings

PIABA understands that businesses sometimes need additional capital. Our concerns are the people who are the sources of that capital and the methods by which they are approached. The concerns are greater when the target population, by virtue of age, cannot reasonably expect to recoup losses and when those most likely to say "yes" to an investment "opportunity" lack the investment acumen necessary to evaluate the offerings.

The enterprises that raise capital under the proposed statute will likely fit one of two molds:

(1) small or start-up companies that may be making good faith attempts at building new, growing enterprises but which are too risky for traditional capital sources to be willing to invest in them; and
(2) companies whose key personnel believe that the real money is made by putting investment deals together, not by putting years of hard work into growing a business after the capital is raised. The economics of capital formation – the reality that the quick money is made in the capital formation itself, not in the steady growing of a business – make it likely that large sums of money raised as a result of the legislative changes in AB 2178 will be in this latter category.

Finding capital for the risky but possibly promising businesses that make up the first group might seem a laudable goal. But one should question whether business should be permitted to find capital for ventures that are too risky for traditional funding sources by targeting the life savings of senior citizens and retirees who cannot replace the savings they lose and from other unsophisticated savers and investors who might lose 10% of their net worth multiplied by some unknown number of risky investments. Shouldn't the startups' funding come from investors who understand risk capital investments and want to be involved rather than inexperienced individuals who respond to an enticing advertisement?

The second group will consist largely of repeat purveyors of cookie-cutter investment programs with no societal value. There simply is no justification for exposing California's seniors, retirees or anyone else to their sales efforts. Yet the bill, as drafted, applies equally to both categories of issuers of securities. The dangers of that are obvious. All but the most sophisticated and experienced savers and investors are vulnerable to promises of higher returns with safety. Promoters know this, so they promise higher returns and safety and make confident predictions about the future. PIABA members see this every day in our practices.

All too often, the victims of those misrepresentations and risky deals are elderly retirees. The reason? They're disproportionately the ones with money. Their homes have had longer to appreciate, their retirement plans have had longer to grow, they may have received life insurance proceeds from the loss of a spouse. They are particularly vulnerable to promises of higher returns because returns on fixed-income investments such as bonds and certificates of deposit are at historic lows. So they risk their principle to get a few extra dollars of promised return, only to find that they have lost savings they never will have any way to replace.

All of this is compounded by the reality that many seniors are more trusting than they should be, and often are particularly vulnerable to sales people who are friendly and attentive and sound knowledgeable. And sadly, many do not have the energy or alertness they once had. Combine all of these factors and you have a recipe for a nearly limitless number of personal financial disasters. Retirees whose savings would have been sufficient to see them through the rest of their lives suddenly cannot afford to stay in their homes because their Social Security checks, now their sole source of income, simply won't cover all the bills. Worse, they may require other forms of public assistance, including MediCal – or may require it far sooner than would have been the case otherwise.

And why is this even being considered? The sponsors promise job creation. The theory is that the small businesses whose prospects are not promising enough to attract risk capital from traditional sources will raise money from people who respond to advertisements and invest in the companies, and that the companies will create jobs. But note that **nothing in the bill requires the companies raising the money (called "issuers") to use the money in a way that creates jobs anywhere, let alone in California.** There is nothing to prevent the promoters behind the issuers from setting up a series of cookie-cutter entities to raise money for tax shelter programs or other programs that have no social utility and instead simply move assets around and benefit primarily the promoters at the expense of seniors and the rest of the saving and investing public.

The promise of job creation has great appeal in the best of times. When unemployment rates are high, it has all the more. The irony is that the bill that would enable issuers and promoters of securities to sell investments by making false promises to savers and investors is being sold to the legislature by making unsupported statements about job creation. Any tie-in between AB 2178 and the creation of real jobs in California is itself speculation.

Inadequacy of Remedies

The bill's $5,000-per-issuer limit for investors who are not accredited is not much comfort. Exposing people of lesser means to losses of $5,000 times as many different speculative investments as they can be talked into buying is fundamentally unfair. And people of greater means are likely to be tapped multiple times – or, once the contact is made, to be steered by the sales people into programs that are not subject to the same limitations. ***Indeed, a key consequence of this bill may be that the advertising it permits will be used to establish small investment relationships with investors, mostly elderly, who then can be steered into unadvertised private placements that have no limit on the amount invested.***

Further, for the reasons discussed below, violations of the bill's meager limits on sales of speculative securities are likely to occur on a broad scale because the only viable remedial mechanism – private litigation – is not practical on the scale that many of these investments are likely to take.

Aggressive advertising is very effective when directed at non-professional investors, who will be the vast majority of offerees under the proposed section. The initial sales pitch drives the yes-or-no decision regarding an investment. An advertisement that makes promises is likely to be relied upon, even though the inches-thick, already-filled-out official documents in the stack of paper that the investor is required to sign will disclaim the representations made in the ads or by the salespeople.

In the current market especially, with interest rates on savings at all-time lows, large numbers of seniors and retirees are especially vulnerable to promises of higher returns. The money they lose is, in many cases, unrecoverable. They suffer not just financially but emotionally and physically as well when they lose the nest-egg that they have accumulated over a lifetime. To be put at that kind of risk so that their capital can be made available for ventures too risky to merit bank or traditional venture capital financing is inappropriate. To allow their savings to be lost in cookie-cutter deals devoid of social value is worse still.

PIABA believes that money lost by investors in these deals as a result of wrongdoing is likely never to be recovered. First, there is a collectability issue. By the time bilked savers or investors sue, and certainly by the time they obtain a judgment or award, there often is no defendant with funds to pay it. Second, even when the funds might exist, securities litigation is so expensive that it may be impossible or impractical to pursue the matter. Much of this is due to the high cost of expert witnesses in these cases. Thus, for example, a $150,000 loss, which might be devastatingly large to the senior who has suffered it, might well be too small to pursue due to the high cost of securities litigation, especially when combined with the collectability risk. A series of $5,000 losses presents an even more daunting prospect. Third, the promoters are very likely to include forced arbitration clauses in the subscription documents and thereby make pursuing a remedy both unaffordable and all the more unlikely to yield a recovery for the investor.

Sadly, PIABA's members have seen this scenario play out far too many times. The likely futility of attempts to remedy these losses after they occur makes it imperative that laws designed to prevent the losses be allowed to operate in their current form, unimpaired by this proposed rollback in investor protection. This is an area where prevention is by far the best medicine, where the law must be proactive rather than reactive.

PIABA believes that the broad and pervasive advertising that will be brought about by AB 2178 will invite large-scale losses, with seniors vastly overrepresented among those harmed. Allowing that to happen is wrong. So is telling California savers that securities that may have received no regulatory oversight whatsoever are "qualified."

A Non-Exhaustive Discussion of Other Problems with AB 2178

Nothing Requires Funds Raised to Be Used to Create Jobs in California. Nothing in the statute requires funds raised to be used to create jobs anywhere, let alone in California. A startup desiring to hire programmers in India or China to service European customers could raise money from California investors under this bill – a far cry from the sponsors' promises of job creation. And even within California, nothing in the bill would prevent the bill from being used to fund endless strings of cookie-cutter asset-acquisition investment programs that are great for the sponsors but terrible for investors. In fact, the entity raising the money does not even have to be a California corporation.

No Limit on Number of Investments. The bill limits the investment in any one program but does not limit the number of programs in which an investor may invest. Thus, even with the limit that the bill imposes, an investor who was latched onto by a salesperson with multiple deals to peddle could be wiped out in short order.

No Suitability Standards. Despite any claims that may appear in promotional materials about suitability requirements, what would constitute "suitability" is not defined in the bill.

No Effective Limit on Amounts Raised. The $1,000,000 limit in a 12-month period may be less effective than one might think because it is a limit ***per issuer***. There is nothing in the bill to prevent promoters from getting around that limit by setting up multiple corporations to act as issuers/applicants.

Direct Advertising Rather Than Investment Portals. The JOBS Act provides for investment portals to be the sole provider of marketing of securities offerings under the JOBS Act. That provides a measure of uniformity because a few portals will be controlling the advertising communications. It can be expected to provide some measure of caution as well, because the portals will have assets to lose and will receive five to ten percent of the amount raised rather than the entire amount. This bill, in contrast, allows direct advertising by issuers of securities. Issuers can be expected to be far more aggressive in their advertising, both because they have less to lose and more to gain, and because it is in the nature of entrepreneurs to be enthusiastic about their prospects. Overly aggressive advertising and solicitation can be expected to lead to significant losses for investors. Investments in startups are extremely risky, and conservatism in marketing them is appropriate.

Sales by Securities Law Violators – Proposed Corp. C. Section 25113.1(b)(2)(B). The bill would allow money to be raised by companies that already have raised money in violation of the federal Securities Act of 1933. In other words, a federal securities law violation would not disqualify an issuer from using the bill to raise money from California investors.

Non-Integration Provision – Proposed Corp. C. 25113.1(b)(2)(C). The bill contains a provision that prevents offers under the proposed rule from being integrated with a long list of other kinds of offerings. ***That suggests that offerings under the proposed rule may turn out to be one small part of a larger collection of offerings and, by virtue of that, to facilitate advertisements of small-increment investments as a way of establishing pre-existing investment relationships with investors who then can be tapped for much larger – and potentially financially devastating – sums in private placement offerings that have no investment ceiling.***

And at a minimum, a non-integration provision is dangerous because it can effectively invalidate limitations on amounts raised.

The Real Investment Limit – Proposed Corp. C. 25113.1(b)(2)(D). The bill's limitation on investment amounts to the lesser of $5,000 or ten percent of the investor's net worth has a tag line: "or such amount as the commissioner may provide by rule or order." So the limit could rise substantially in the future. Thus, the investment limits currently in the bill, if they give any comfort at all, should be viewed as temporary.

Inadequate Fees for the Review Required – Corp. C. Section 25608(e). The fee for an offering under the bill would be $200 plus 0.4% of the offering amount. That means that a $500,000 offering would require a $2,200 fee – hardly enough for attorneys and others to perform a thorough vetting of the offering, particularly given the risky nature of the issuers for which the bill is designed.

Allowing Offers to be Made Before Any Review Whatsoever – Corp. C. Sections 25102(b) and 25104(g). The bill contains two so-called "testing the waters" provisions that allow offers ("but not sales") to be made before a permit is received. The first and most obvious problem with this is that once investors have made a decision to buy, subsequent changes to the deal – such as additional disclosures that might be required by the DBO – are unlikely to cause them to change their minds. ***This, in turn, creates an incentive for promoters to make the initial "testing the water" disclosures inadequate.*** The second problem is that "testing the waters" offers generally are associated with issuers that have filed registration statements or Regulation A offering statements and are inappropriate for offerings that might simply get a permit by default if the DBO lacks the staff or resources to vet them within 60 days.

Allowing Sales Designed to Cash Out the Promoters – Corp. C. Section 25104(g). One of the two "testing the waters" provisions takes the form of an exemption in Corporations Code section 25104, the code section that exempts offers and sales of securities in ***non-issuer*** transactions. Those are transactions in which individuals who already own a company's shares are selling them. If the sponsors thought to include a "testing-the-waters" exemption in not just section 25102 (exemptions for issuer transactions) but in section 25104 as well, it must be because they contemplate investors' money being used to cash out existing insiders. Such an "investment" does not go into the company's coffers and, almost by definition, cannot increase employment.

Similarity to Corporations Code Section 25113 (b)(2). The bill is similar in many respects to a qualification provision that already exists. If the bill will not weaken substantially the investor protections inherent in offerings under section 25113(b)(2), we are forced to wonder what difference it will make in the availability of capital to businesses. In other words, we wonder why anyone would use it and whether there is any benefit to offset the cost of writing and adopting regulations for its use. Conversely, if the bill will weaken investor protections substantially, it should not be enacted for that reason. Either way, there seems to be either no reason to enact the bill or a strong reason not to enact it.

We as a people have a long history of learning and relearning the harsh lessons of the past. We have been battered mercilessly in the last eight years for forgetting repeated lessons about the dangers financial industry deregulation, including the lessons of the 1920s and 1930s. We must resist continuing efforts at further deregulation of financial and securities markets. We should remember and move back toward the regulatory environment that, for the approximately six decades that ended in the mid-1990s, imbued U.S. capital markets with a level of honesty and transparency that made them the envy of the world. And closer to home, we should maintain for California's savers and investors, and for seniors and retirees in particular, the level of protection that currently exists.

Thank you for your consideration of our concerns about AB 2178.

Sincerely,

Hugh D. Berkson, PIABA President
McCarthy, Lebit, Crystal & Liffman Co., LPA
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Telephone: (216) 696-1422
Email: hdb@mccarthylebit.com

cc: Assembly Member Chiu
Via Email Only to assemblymember.chiu@assembly.ca.gov
Kathleen O'Malley
Assembly Committee on Banking and Finance
Via Email Only to Kathleen.OMalley@asm.ca.gov
Scot Bernstein
Via Email Only swampadero@sbernsteinlaw.com

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The following PIABA Comment Letter regarding *NASAA's Passage of the Model Legislation or Regulation to Protect Vulnerable Adults from Financial Exploitation* was submitted to the NASAA President/Maine Securities Administrator Department of Professional & Financial Regulation by Marnie C. Lambert on March 11, 2016

Via Email Only [Judith.m.shaw@maine.gov]

Judith M. Shaw
NASAA President/Maine Securities Administrator
Dept. of Professional & Financial Regulation
121 State House Station
Augusta, ME 04333-0121

RE: NASAA's Passage of the Model Legislation or Regulation to Protect Vulnerable Adults from Financial Exploitation

Dear Ms. Shaw:

I am writing on behalf of the Public Investors Arbitration Bar Association ("PIABA")[1] to congratulate NASAA on its recent passage of the Model Legislation or Regulation to Protect Vulnerable Adults from Financial Exploitation ("Model Act"). PIABA believes that the Model Act is an important step forward in continuing efforts by investor advocates, state regulators, Financial Industry Regulatory Authority ("FINRA") and other industry participants concerned with protecting vulnerable investors from being victimized by those who may try to financially exploit them.

More specifically, PIABA particularly praises the following elements of NASAA's Model Act:

• The definition of "eligible adult" draws a bright-line at age 65 for identifying adults who may be in need of the increased protective measures provided by the Model Act while still including other vulnerable adults such as those who qualify for protection under a state's adult protective services statute.

1. As you know, PIABA is an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct.

• "Financial exploitation" is broadly defined to include acts or omissions of someone for the purpose of obtaining control of, or converting, money, assets or property of an eligible adult. Thus, the Model Act applies to not only the actual wrongful or unauthorized taking of money, assets or property of an eligible adult, but also steps leading up to such a wrongful or unauthorized taking.
• In contrast to States that do not specifically include broker-dealers or investment advisors among those who have reporting obligations, the Model Act defines certain people at broker-dealers and investment advisory firms as "qualified individuals" who have the right or obligation to protect an eligible adult and, thus, the Model Act can
be used to bridge gaps in existing statutory or regulatory schemes that do not include broker-dealers or investment advisors.
• Section 3 of the Model Act properly mandates that a qualified individual with a reasonable belief that an eligible adult is being, may be, or may have been financially exploited "promptly notify" Adult Protective Services and the securities commissioner of such belief.
• The inclusion of administrative and civil immunity for qualified individuals that comply with the Model Act should encourage compliance as long as such compliance is in good faith and reasonable, which will hopefully extend to even the sections of the Model Act that do not mandate action but merely permit it.[2]

PIABA hopes that the NASAA Model Act will be used by states and by FINRA to compliment, supplement, and/or bolster existing statutes, regulations and/or rules that protect vulnerable investors from financial abuse. However, PIABA also expects NASAA and FINRA to continue to broaden and strengthen investor protection going forward and PIABA will continue to make itself available, on behalf of investors, to assist in those efforts.

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2. On October 29, 2015, PIABA filed a letter in support of NASAA's proposed Model Act, but also identified the following two areas of the proposed Model Act that did not go far enough in the protection of vulnerable investors: (1) Sections 5 (third party disclosures) and 7 (delaying disbursements) only provided permission to act rather than mandating action like Section 3 (governmental disclosures); and, (2) there were no penalties for willfully ignoring evidence of financial abuse of vulnerable investors. PIABA's opinion that the Model Act should be stronger in those respects has not changed, but does not detract from the important benefits that vulnerable investors can reap from the Model Act as passed by NASAA.

Thank you for taking on a difficult task and reaching enough of a consensus to be able to pass a Model Act that has some very important investor protections that may not otherwise exist in certain States. PIABA also thanks you for the opportunity to stay involved on this important matter.

Very truly yours,

Marnie C. Lambert
PIABA EVP/President-Elect
Chair of NASAA Committee

cc: Michael Canning [*via* email only to mc@nasaa.org]

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The following PIABA Comment Letter regarding *SR-FINRA-2015-057 Proposed Rule Change to Adopt FINRA Rule 2273* was submitted to the Securities and Exchange Commission by Hugh Berkson on January 20, 2016 (prepared with the assistance of William B. Young, Jr.).

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

Re: File No. SR-FINRA-2015-057-Proposed Rule Change to Adopt FINRA Rule 2273 (Educational Communication Related to Recruitment Practices and Account Transfers)

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 submits this comment because although we believe the proposed rule is certainly a positive step, as stated in our comment letter regarding Regulatory Notice 15-19, PIABA believes the rule should go further in terms of education communication content and application. PIABA also is concerned that certain key provisions in the prior proposed disclosure have been eliminated to the potential detriment of the investing public.

PIABA generally supports the proposed rule because the bar association feels strongly that public investors would benefit from knowing the potential impact on their accounts if they move them to their broker's new firm, as well as the potential motivations their broker may have to recommend moving their accounts to the new firm. Indeed, PIABA believes the proposed rule should go even further and require similar disclosures to customers by the departing broker's former firm if it is fighting to keep the customer's accounts.

As previously expressed by PIABA (in its July 13, 2015 comment letter on Notice 15-19), PIABA strongly believes that former customers should be informed if their broker is being paid additional "enhanced" compensation for merely bringing client assets to the new firm or for generating new commissions and fee income above the usual payout grid during his or her first few months or years at the new firm. Such customers need to know about, and understand, any potential conflicts of interest resulting from that compensation agreement. PIABA believes the educational material, while helpful, does not go far enough. It does not require the firm to specifically disclose potential or actual conflicts. It instead merely shifts the burden to investors to ask their current firm or their departing (or departed) broker to disclose these conflicts. Unlike the previous versions of the proposed rule, the current proposal, does not require the recruiting firm to even disclose enhanced compensation to FINRA. Obviously, such compensation arrangements may color a broker's recommendations and approach to overall account management. PIABA also still firmly believes the education communication requirement rule should apply not only to existing customers transferring from the broker's former firm to the new firm, but also to any new (*e.g.*, not pre-existing) customers that the broker brings into the new firm.

PIABA also reiterates its prior suggestion that the proposed rule require a verification mechanism to ensure receipt of the communication by the customer(s) affected. FINRA's most recent Notice (SR-FINRA-2015-057) said that it will "assess the effectiveness of educational communication requirement without a verification requirement" after the rule is implemented and reconsider a verification requirement if the "educational communication alone is not attracting the attention of customers to influence their decision-making process ...." PIABA does not know what factors FINRA would review to make such an assessment, but has difficulty believing that the inclusion of a properly-worded, uniform verification (including a prominent reference to the fact that no accounts can be moved without receipt of a signed affirmation) would not increase the chances of the educational communication being taken more seriously by a customer.

Moreover, while FINRA understandably does not want to make the process of moving accounts more onerous than it needs to be, it certainly should not be concerned if a customer's transfer is delayed because they are weighing the important considerations set forth in the educational communication before signing the verification. It also bears noting that the departing broker and his team will no doubt continue to follow-up with the former customers until a final decision is made by the customer and the verification is signed. Thus, delay in transfers due to lack of a signed verification would fall squarely on the former customer whose accounts would simply stay where they are. Such a result simply does not justify omitting a verification from the educational communication.

PIABA was disappointed to see that FINRA not only refused to lengthen the "duration of delivery" requirement in the proposed rule, but instead shortened it from six months to three months. PIABA echoes its request that the proposed rule have a duration of one year (for the reasons previously provided in its July 13, 2015 comment letter on Notice 15-19), but also requests FINRA to at least reconsider its decision to shorten the six-month period to only three months.

Further, for all of the reasons set forth by PIABA in its July 13, 2015 comment letter on Notice 15-19, PIABA echoes its sentiment that the recruited broker's former firm should also be required to disclose similar potential conflict-related financial information if it could influence those vying to keep the customer at the firm from which the broker is leaving (or has left).

Finally, PIABA still firmly believes that investors would be best served by additional guidance from FINRA on the types of information they should seek from their broker with respect to areas ripe for potential conflicts of interest. As previously proposed by PIABA (in its July 13, 2015 comment letter to Notice 15-19), FINRA should consider adding to the uniform educational communication certain questions, the answers to which may assist investors in their decision-making.

Conclusion

In summary, PIABA supports FINRA's proposed rule requiring educational communications be sent to retail customers of a recruited broker, disclosing all enhanced compensation agreements and the potential conflicts of interest inherent in such agreements. However, PIABA believes the proposed educational communication rule does not go far enough in that it should be expanded to include disclosure of all enhanced compensation plans (including at the former firm); should include a verification requirement prior to transfer of accounts; should require communication to former, as well as new, retail clients for a longer period of time than currently proposed; and should include additional guided questions that would assist investors. PIABA thanks FINRA for the opportunity to comment on this proposal.

Sincerely yours,
Hugh D. Berkson
PIABA President

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The following PIABA Comment Letter regarding the *File No. SR-FINRA-2015-056 – "Pay to Play" Rule* was submitted to the Securities and Exchange Commission by Hugh D. Berkson on January 20, 2016 (prepared with the assistance of Benjamin Edwards).

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

Re: File No. SR-FINRA-2015-056 – "Pay to Play" Rule

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"). While PIABA generally supports the proposal to establish a rule to address "pay-to-play" issues, we have three primary concerns: (i) the proposal does not apply to state-registered investment advisers; (ii) the cooling-off period is too short and should be extended to four years; and (iii) disgorgement should be the minimum penalty.

I. The Proposal Should Apply To State-Registered Investment Advisers

PIABA believes that the proposal should also apply to state-registered investment advisers because solicitation of a government entity by a FINRA-member firm on behalf of state-registered investment adviser should be prohibited in the same manner as it would be with an SEC-registered adviser if the soliciting FINRA-member firm made qualifying contributions to the government entity. While the Commission and FINRA have noted that relatively few state-registered investment advisers manage public pension plans, this alone does not justify permitting those FINRA-member firms that do manage public pension plans, but happen to work with smaller investment advisers, to engage in pay-to-play activities with no repercussions from FINRA. Moreover, successful solicitations of public pension funds by FINRA-member firms may actually result in more assets being under management of the state-registered investment advisers with which they are working, requiring those advisers to register with the SEC, which would render the proposed rule applicable to them anyway. PIABA does not believe that any good reason compels the exclusion of state-registered investment advisers from the reach of the rule.

II. The Cooling-Off Period Should Be At Least Four Years

PIABA believes that the current two-year cooling-off period does not adequately reduce the incentive for FINRA member firms to make political contributions in order to obtain pay-to-play advantages. Even though a two-year cooling-off period does provide some benefit, many political terms last substantially longer than two years. For example, if the government official serves a six-year term, a two-year cooling-off period would not adequately protect against the corrupting influence of donations from FINRA member firms. It also bears noting that FINRA has already built into the proposal potential exceptions to the two-year cooling off period such that FINRA could probably limit any unfair or unnecessary application of a four-year cooling off period through its ability to approve exceptions in certain circumstances. PIABA believes FINRA should start with the most comprehensive rule and that FINRA's rationale for limiting the cooling off period is not persuasive given the extent that "pay-to-play" schemes can undermine the confidence of the investing public. Further, PIABA would welcome the deterrent effect of a four-year cooling off period.

III. Disgorgement Should Be the Minimum Penalty

PIABA is concerned about FINRA's decision to weaken the possible penalty its member firms might suffer for violating the "pay-to-play" rule. The original regulatory notice made clear that FINRA-member firms violating the "pay-to-play" rule would be forced to disgorge any ill-gotten profits. The final proposal substantially weakens the "pay-to-play" rule by making it possible for FINRA member firms to violate the rule and then keep a substantial portion of the profits derived from the violation.

By making the possibility of disgorgement discretionary, FINRA has substantially reduced the deterrent power of the rule and the incentive of its member firms to take steps to comply with the rule. Consider, for example, the most likely defense to an enforcement action arising out of a breach of the rule. The FINRA member firm will likely contend that the breach occurred because of some flaw in the firm's internal oversight procedures. The significant profits to be realized, and potentially kept, promote a less-than-robust compliance and supervision system. When the inevitable violation occurs, the FINRA member firm will ask FINRA for a light penalty because the member-firm's failure was innocent, not intentional. There is no good reason to impose a penalty of anything less than full disgorgement of the ill-gotten gains.

PIABA thanks you for the opportunity to comment on this important topic.

Sincerely yours,
Hugh D. Berkson
PIABA President

Notes & Observations