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Public Investors Arbitration Bar Association Report
BROKERCHECK – THE INEQUALITY OF INVESTOR ACCESS TO INFORMATION REMAINS UNABATED – AN UPDATE TO PIABA'S MARCH 2014 REPORT

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Acknowledgements[2]

Introduction

On March 6, 2014, the Public Investors Arbitration Bar Association ("PIABA") issued a report titled "Inequality of Investor Access To Information," written by then-PIABA president Jason Doss, and law school clinic directors Christine Lazaro and Ben Edwards (the "Report"). The Report

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Marnie Lambert is the founding member of Lambert Law Firm, LLC, with offices in Ohio and California. Since 2005, Marnie has primarily represented investors across the country against brokerage firms in FINRA arbitrations (and in court), handling hundreds of such cases. She is also an active advocate for the investing public, generally, through her service on the Board of Directors of the Public Investors Arbitration Bar Association ("PIABA"). She is currently Executive Vice President and will take over as President for 2016-2017 at the end of the month when Mr. Berkson's term is over.

2. The authors would like to thank the authors of PIABA's original report: Jason Doss, Christine Lazaro, and Ben Edwards, for their hard work in bringing the issues underlying BrokerCheck to light in 2014. They would also like to thank Christine Lazaro for her valuable input on this update. Finally, they would like to thank PIABA's executive director, Robin Ringo, for her continued and significant assistance in pursuing PIABA's mission of protecting investors.

was critical of the discrepancy of information available regarding stockbrokers in reports offered to the public by the Financial Industry Regulatory Authority ("FINRA") and those offered by states given that both rely on the same source for information in the reports – the Central Registration Depository ("CRD"). The CRD system is a database maintained as a joint venture between FINRA and the states. FINRA's reports, branded "BrokerCheck reports" are often far less complete than reports available from the states. PIABA called upon FINRA to harmonize its disclosures with those already being made by the states, thereby promoting investor protection.

Not only has FINRA failed to make meaningful changes to the BrokerCheck system, the problem has only grown worse since the Report was published in early 2014. We explore below what few changes have been made, describe how the problems continue to grow worse, and renew our call on FINRA to enhance the BrokerCheck system to provide as much background data on brokers as the least restrictive states already provide, thus increasing investor protection by providing a one-stop shop for stockbroker background research.

A Summary Of The Landscape in March 2014

Summary of Report

A single database provides the information reported by FINRA in its BrokerCheck reports and the various state reports. The CRD system, formed in 1981 as a joint venture between FINRA and the North American Securities Administrators Association ("NASAA"), is fueled by regular disclosures from brokers and firms under their ongoing obligation to keep registration information current.[3] The Securities and Exchange Commission ("SEC") mandates that the information maintained in the CRD system be made public upon inquiry.[4] The SEC, however, also directs FINRA to adopt rules regarding the type, scope, and presentation of information to be provided in response to the inquiries.[5]

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3. *See* Doss, Lazaro, and Edwards, *Inequality of Investor Access To Information* at 2 & 6 (March 6, 2014).

4. Specifically, Section 14 of the Securities and Exchange act of 1934 mandates that FINRA shall make its members registration information readily available by phone and by electronic (or other) access.

5. 15 U.S.C.A. §78o-3(i).

FINRA advertises the BrokerCheck reports as being "complete" and helpful to investors wanting to learn more about specific brokerage firms and financial advisors. The Report discussed the fact that, in reality, BrokerCheck reports often omit information about brokers that is highly relevant and necessary for investors to make informed decisions about who they may want to hire.[6] By way of illustration, the PIABA report presented a number of examples of discrepancies between the information available from states' reports and the BrokerCheck reports.

Summary of suggestions

The PIABA Report called for FINRA to enhance BrokerCheck and, at a minimum, harmonize it with whatever information was already available in the public domain through the reports the States provide in response to investor requests for broker background information. The PIABA Report was not, however, the first to call upon FINRA to improve the BrokerCheck system. The Report explored in great detail the continuing demands for improvements made by the SEC, NASAA, and various commentators through the years. Notably, in 2010, the SEC *urged* FINRA to consider the commentators' comments and provide information already available from the states.[7] A year later, the SEC renewed its recommendation to improve BrokerCheck by, among other things, including U5 notes regarding the reasons for broker employment termination, as well as historical filings going back more than 10 years.[8]

Given the fact that FINRA had not made any meaningful improvements to the information in BrokerCheck reports, and had largely ignored the chorus of public comments urging such improvements, the Report called for Congress to step in and legislate the necessary changes. Specifically, PIABA called for an amendment to §15A of the Exchange Act to further define the type and scope of information FINRA would be required to make available through BrokerCheck.

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6. *Inequality of Investor Access To Information* at 4.

7. SEC Release No. 34-62476; File No. SR-FINRA-2010-012, at 15.

8. SEC, *Study and Recommendations on Improved Investor Access to Registration Information About Investment Advisers and Broker-Dealers*, January 2011.

FINRA's Response

FINRA largely ignored PIABA's calls for reform, just as it had ignored such calls in the past from NASAA, the SEC, and other commentators. The closest thing to a response from FINRA came in the form of an amendment to Rule 2210, "Communications with the Public." The amendment, which went into effect on June 6, 2016, requires that links to the BrokerCheck homepage be readily apparent on: (1) the initial Web page the member firm intends the public to see; and, (2) any other Web page that includes registered persons' professional profiles.[9]

Thus, although FINRA's revision to Rule 2210 does serve to reinforce the importance of a broker's background and qualifications, FINRA's conduct in promoting the BrokerCheck system as the only way to check those backgrounds and qualifications has imposed a disservice upon those investors using the system. The reality is that investors who may have once researched their brokers by contacting their state securities regulators have been led to believe they can simply rely on an online BrokerCheck report, which they can access themselves on the internet or through brokerage firm website links. Unless an investor is employed in, or otherwise familiar with the securities industry, the chances are negligible that they know that the BrokerCheck report may well be hiding relevant information.

PIABA's Report highlighted a perfect example of a BrokerCheck report's omission of relevant information. In that example, the state disclosed information from the national CRD system regarding the circumstances related to the broker's termination. The state's report revealed the following comment from the terminating brokerage firm, "We were preparing to terminate Mr. [REDACTED] after his May 21, 2003 audit. Mr. [REDACTED] submitted his letter of resignation on May 27, 2003 before his notice of termination letter was delivered on May 28, 2003." Such information would likely be relevant and important to an investor's analysis of the qualifications of a broker with whom the investor plans to invest. Yet, the BrokerCheck report for that same broker, based on the same national CRD system that produced the state's report, noted simply that the broker's employment had ended. Conspicuously absent from the BrokerCheck report was any mention of the firm's audit or its intent to fire the broker. While it may be technically true that the broker was not fired, the real truth is that something found in the firm's audit caused enough concern that the firm decided to terminate him and did not do so only

9. FINRA Regulatory Notice 15-50 (December 2015). The required link is only to the BrokerCheck homepage meaning that investors still have to search for specific brokers by name in order to view a BrokerCheck report.

because he quit one day before he would have received notice of his termination (and just six days after the bad audit result). FINRA, fully on notice of meaningful discrepancies between its BrokerCheck reports and state-produced CRD reports, has chosen to do nothing to improve the disclosure of information.

On October 18, 2016, the authors came across a near exact duplicate of the example set forth above. While investigating a potential client's claims against a broker and his firm, a review of the broker's BrokerCheck report revealed that he was the subject of five customer complaints, including three pending arbitrations. There was, however, no indication the broker left any of his employers under any adverse (or even questionable) circumstances. Rather, his BrokerCheck report simply indicated the broker left one of the firms with which he was employed in April 2015. The lack of any other information leaves the reader with the impression that the departure was voluntary. A review of the CRD information obtained from Florida, however, reveals a very different picture. The state CRD report notes that the broker was discharged from that employer and includes the comment: "Multiple violations of industry standards and firm policy relating to outgoing correspondence."

While it was true that the broker left his employer in April 2015, the Florida CRD also notes that, on May 20, 2015, the firm reported that it had started an investigation into the broker's conduct in April 2015 and concluded the investigation in May 2015. The firm reported:

> A review was conducted in regards to the RR's outgoing email correspondence from January 2, 2015 to April 3, 2015. Approximately 415 messages to external email addresses were examined. The majority of the messages were sent to prospective and existing clients. Only one outgoing message, dated February 18, 2015, evidenced principal review and approval form the RR's supervisor. There were 14 messages that included non-approved sales material specific to mutual funds and 7 messages included attachments that were generated exclusively by the RR without the knowledge of a supervising principal. It was also discovered that the RR neglected to report 2 non-sales practice complaints (dated January 9, 2015 and April 1, 2015) to his supervisor/compliance department. None of the unapproved emails resulted in any customer loss.

The broker left the investigating firm and joined a new one while the former firm's investigation was underway. Obviously, the broker left under a cloud of suspicion of misconduct, but an investor relying on a BrokerCheck report alone would have no idea of the broker's propensity to ignore policies and procedures, which should at least be considered before hiring that broker.

There are now three pending arbitrations related to the broker's conduct at the new firm, and more claims are being investigated.

Even though FINRA has not improved the quality of the BrokerCheck reports, it has spent significant resources promoting the system. It issued a press release on June 1, 2015, trumpeting its new promotion of the system:

> The ads, created by Ogilvy & Mather, feature humorous examples of people taking action without conducting any background research, including:
>
> > a bride surprised by her organist's song choice;
> >
> > a man too late in reading the listed side effects of the medication he has taken; and
> >
> > a truck driver blissfully ignorant of a road's clearance restrictions.
>
> Viewers are urged not to make the same type of leap-before-you-look mistakes when choosing a broker—they should use BrokerCheck.[10]

It is no coincidence that one of FINRA's public governors, Shelly Lazarus, has been the Chairman Emeritus of Ogilvy & Mather – the firm that created the BrokerCheck ads – since July 2012.

FINRA boasted that the 15 second pro-BrokerCheck spots would run for 5 weeks across a number of outlets, including: CNBC, Bloomberg, CNN, MSNBC, Fox Business, Fox News, ESPN, Discovery, The History Channel, and HGTV. FINRA also said that pro-BrokerCheck print ads would run in the Wall Street Journal and appear digitally on sites including Bloomberg, CNBC, Fortune, Reuters, TubeMogul, the Undertoen Network, and the Wall Street Journal. For good measure, FINRA also advocated for the use of BrokerCheck via Google, Bing/Yahoo, and YouTube.[11]

The exact amount FINRA spent on the media blitz is impossible to state with certainty. It was first reported that FINRA spent $3.5 million on the initial campaign.[12] It seems, however, that the total sum spent is greater than that.

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10. FINRA, *FINRA Launches National Ad Campaign Promoting BrokerCheck*, (June 1, 2015); available at https://www.finra.org/newsroom/2015/finra-launches-national-ad-campaign-promoting-brokercheck.

11. A summary of the video and print ads can be found: http://jeffleaf.com/brokercheck/.

12. Mark Schoeff Jr., *FINRA lauches ad campaign for BrokerCheck*, (June 1, 2015), available at http://www.investmentnews.com/article/20150601/FREE/150609993/finra-launches-ad-campaign-for-brokercheck.

FINRA's 2015 annual report indicates an increase of $27.4 million dollars in its annual professional and contract services, which it explained as follows:

> Professional and contract services increased due to enhancement efforts and our advertising campaigns in 2015. Enhancement efforts were driven by FINRA's use of outside contractors to implement market regulation applications using cloud technologies in order to contain escalating platform costs and improve operational efficiency. Additionally, FINRA launched two five-week advertising campaigns designed to promote BrokerCheck as a useful free tool to obtain information about brokers and firms.[13]

It is impossible to determine how much of the $27.4 million was spent with outside contractors to implement market regulation applications and how much was spent on the advertising campaign.

Regardless, it seems apparent that FINRA spent considerable resources to promote the flawed BrokerCheck system and that the marketing has been successful in driving more traffic to the BrokerCheck site. FINRA reported 71 million reviews of broker or firm records in 2015, up from 29 million the year before.[14]

The Problems With BrokerCheck Have Become More Evident

FINRA Continues To Mislead Investors Regarding the Utility of BrokerCheck

While the fact that more people are turning to BrokerCheck to investigate their brokers is a good thing in the abstract, the fact that the reports upon which the investors are relying are often deficient is problematic. FINRA's new marketing push for BrokerCheck makes it appear to an unwitting investor that the system is the proverbial "one stop shop." Conspicuously absent from the heavily-promoted BrokerCheck homepage is any reference to the value of

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13. FINRA 2015 Year in Review and Annual Financial Report, 20, available at https://www.finra.org/sites/default/files/2015_YIR_AFR.pdf.

14. See Hammad Qureshi & Jonathan Sokobin, *Do Investors Have Valuable Information About Brokers*, FINRA Office of the Chief Economist, August 2015, 2 (available at https://www.finra.org/sites/default/files/OCE-Working-Paper.pdf); Alessandra Malito, *Finra's BrokerCheck link mandate for adviser websites effective today* (June 6, 2016), available at http://www.investmentnews.com/article/20160606/FREE/160609951/finras-brokercheck-link-mandate-for-adviser-websites-effective-today.

contacting state securities regulators for CRD reports. FINRA describes BrokerCheck's scope:

BrokerCheck by FINRA

Check out your broker with BrokerCheck

FINRA oversees the people and firms that sell stocks, bonds, mutual funds and other securities. Simply type in your current or prospective broker's name to see employment history, certifications, and licenses —as well as regulatory actions, violations or complaints you might want to know about. You also can get information about your broker's firm. There's no reason not to check.

BrokerCheck can tell you...

...if a broker or brokerage firm is registered.

Individuals and firms can be registered as brokers or investment advisers—or both. Individuals with these designations have particular knowledge and take on legal responsibilities. Individuals and firms must be registered with FINRA (for brokers), the SEC (for certain investment advisers), and in those states where required by law.

...what has been disclosed to regulators.

From the time they register—and throughout their careers in the securities industry—individuals and firms must inform FINRA if certain events occur; these events include regulatory actions, criminal convictions, and for brokers, customer complaints.

...about a broker's experience.

BrokerCheck provides an overview of a broker's work history, as well as brokerage firm history.

...about what a broker or brokerage firm is able to do.

Brokers and investment advisers are qualified to perform certain tasks for clients, based on the exams they have passed and state licenses they hold. Individuals and firms must register in each state where they have customers.

There is nothing on the BrokerCheck homepage that tells an investor looking at it for the first time that they should also contact their state securities regulator for more information.

This lack of sufficient disclosure about the limited scope, detail and/or time frames included in BrokerCheck reports is made worse by the additional language contained on the homepage under the heading, "BrokerCheck cannot tell you . . .." For example, even where FINRA does inform an investor about something that may not be in a broker's report (*e.g.*, due to the removal of some information from BrokerCheck after a certain amount of time), there is no explanation for what is omitted or removed from a broker's report at any given time. This could leave an investor assuming that certain omitted or removed information is neither relevant, nor available, from other sources. Instead, BrokerCheck merely states the following:

BrokerCheck cannot tell you...

...FINRA's opinion of a broker or brokerage firm.

No opinions, no recommendations, just facts. FINRA can't tell you if someone is a "good" broker—but BrokerCheck gives you information about that person's experience, credentials, and history so you can make an informed decision.

...how well your money will be managed.

FINRA can't guarantee that a broker or firm will perform well for you. Do your homework and make sure you're actively involved with managing your money.

...info that's older or from other financial industries.

Some information is removed after a certain time period, such as bankruptcies over 10 years old. It's also possible that a broker has worked in other parts of the financial services industry (for example, insurance or banking). BrokerCheck may not have information about those industries.

...information that FINRA has not received.

Brokers and brokerage firms are required to update their professional and disciplinary information, generally within 30 days. BrokerCheck does not have information until it is reported. Under most circumstances, information reported to FINRA is available in BrokerCheck by the next business day. If you are aware of missing or incorrect information in BrokerCheck, please contact us.

FINRA 's BrokerCheck homepage misleads investors when it fails to put them on notice that there is additional relevant information, not identified, that is missing from BrokerCheck reports.

Exacerbating FINRA's omissions is other language on the BrokerCheck homepage (under "Data") that gives the illusion that BrokerCheck's information is drawn from multiple sources and includes all manner of information if it exists (without any meaningful limitation):

More about BrokerCheck

BrokerCheck is a free tool which is part of FINRA's ongoing efforts to help investors make informed choices about brokers and brokerage firms. BrokerCheck also provides information about formerly registered brokers who, although no longer registered in the securities industry, may work in other financial services industries. These individuals could still seek to gain the trust of potential investors, so we feel it's important to include them here.

The Data

The information contained in BrokerCheck is collected through FINRA's registration process. The information is drawn from filings by regulators, firms and investment professionals. It includes current licensing status and history, employment history and, if any, reported regulatory, customer dispute, criminal and other matters.

Learn more about BrokerCheck

PIABA agrees with FINRA that it is important that investors educate themselves about their brokers and brokerage firms. But it is crucial that FINRA be straightforward with investors regarding BrokerCheck's limitations and the manner in which investors can and should try to fill the gaps.

To be fair, PIABA acknowledges that FINRA's website does state that investors should learn as much as possible about their investment professionals and that "[i]n addition to using BrokerCheck, FINRA encourages investors to also consult their state securities regulator."[15] The problem is that this important caveat of the need to supplement a BrokerCheck report is not stated any place on the most recent version of the BrokerCheck homepage. Instead, it is buried on a page about state securities regulators that investors may never find. Notably, the reference to the importance of checking with state securities regulators isn't found through any direct link from any BrokerCheck-related web page. Rather, an investor would have to start with the FINRA homepage, click on the "Protect your money" link, then select the "Ask and Check" link, and read the page to see what to do if a salesperson says they are a broker:

Ask and Check

Check Out the Seller

If a salesperson is trying to sell you an investment, check them out by following these steps.

Step 1: Ask "Are you licensed to sell me this investment?"

Legitimate investment professionals—including brokers, investment advisers and insurance agents—must be licensed with the Financial Industry Regulatory Authority (FINRA), the Securities and Exchange Commission (SEC) or your state securities or insurance regulator before they can sell you anything. If they say they *aren't* licensed, say good bye—and don't buy.

Step 2: Check.

If they say they *are* licensed, check them out as follows:

If They Say They Are a ...	Look Here	Helpful Hints
Broker	» Visit FINRA BrokerCheck or call FINRA at (888) 295-7422. » Also contact your state securities regulator.	» If you find the individual on BrokerCheck, click the "Get Details" button to the right of their name to view their summary report. Get Details The summary report provides information on the individual's employment history, qualifications, disclosure events and more. You can also download a detailed report on the individual. » To interpret what you find, see FINRA BrokerCheck Tips below. » Use both FINRA BrokerCheck **and** contact your state. There's helpful information in both places.

Share Tweet Share Email

SEE ALSO

SaveAndInvest.org

TOOLS & CALCULATORS

FINRA BrokerCheck

Securities Helpline for Seniors

Fund Analyzer

Market Data Center

529 Expense Analyzer

Required Minimum Distribution Calculator

The Alert Investor

ALL TOOLS AND CALCULATORS »

(*See* http://www.finra.org/investors/ask-and-check). According to FINRA, if an investor is solicited to invest money, the investor should first ensure the broker is licensed.

To find out if the broker is licensed, investors are told to first look at BrokerCheck or call FINRA. Investors are then told "Also contact your state securities regulator." The "state securities regulator" is a hyperlink. Only if the investor happens to follow the pages and links all the way to the "state securities regulators" page would they have a chance of seeing the statement,

15. *See* http://www.finra.org/investors/state-securities-regulators.

"In addition to using BrokerCheck, FINRA encourages investors to also consult their state securities regulator."

In the continued spirit of full disclosure, PIABA also notes that the last item in the "helpful hint" column on the "Ask and Check" page states, "Use both FINRA BrokerCheck and contact your state. There's helpful information in both places." Notably absent from FINRA's "helpful hints" though is an explanation of the difference between the "helpful information" available from BrokerCheck and the state. There is also no clear warning to investors that there may be some "helpful information" that investors can *only* obtain from the states (because FINRA declines to provide it in BrokerCheck).

Notably, in direct contrast to what seems like FINRA's effort to bury notice of and/or access to relevant information, the SEC's website clearly describes the best way to investigate a broker or brokerage firm.[16] The SEC states in unequivocal terms:

> You can ask your state securities regulator or the Financial Industry Regulatory Authority (FINRA) to provide you with information from the CRD. Because your state securities regulator may provide more comprehensive information from the CRD than FINRA, especially when it comes to investor complaints, you may want to check with your state securities regulator first.

As discussed above, the need for FINRA to mimic the SEC's clear and definitive language is particularly critical given FINRA's success in driving more investors to the BrokerCheck site over the past few years.

In 2014, 29 million broker searches were conducted, with 18.9 million summary records viewed, and 7 million downloads of detailed broker reports.[17] In 2015, FINRA reported that the number of investors viewing BrokerCheck more than doubled to 71 million.[18] While the increased use of BrokerCheck is positive and means that the public is now beginning to understand the need to investigate their brokers, it also heightens PIABA's concern that those people who account for the 50 million *additional* views of broker (and firm) records may not be looking anywhere else for supplemental information concerning their broker.

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16. *See* https://www.sec.gov/investor/brokers.htm.

17. *See* Qureshi & Sokobin, *Do Investors Have Valuable Information About Brokers* at 2.

18. *See, Finra's BrokerCheck link mandate for adviser websites effective today.*

Academics and Economists Have Also Highlighted Problems With BrokerCheck

Although FINRA has made no meaningful progress on the issue of further expanding the scope, detail, and time frames of disclosures in the BrokerCheck system, there has been significant interest generated elsewhere. Studies and analyses conducted since PIABA's Report was published have provided ample evidence of relevant disclosures missing from BrokerCheck reports including, but not limited to, a number that may be indicative of a broker's propensity to cause harm to investors in the future.

- **Findings of FINRA's Office of the Chief Economist**

FINRA's Office of the Chief Economist[19] (the "OCE") published a working paper entitled "Do Investors Have Valuable Information About Brokers?" in August 2015.[20] The co-authors of the working paper were Jonathan S. Sokobin, Chief Economist and Senior Vice President, who oversees the OCE,[21] and Hammad Qureshi, Economist.[22] FINRA's Office of

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19. According to FINRA's website, the Office of the Chief Economist was created in 2013 "to conduct research and analysis in support of FINRA's rulemaking and policy agendas." *See* http://www.finra.org/industry/chief-economist (last visited October 8, 2016). The Chief Economist's duties include "conducting sophisticated economic and statistical analyses related to FINRA's mission, working with outside experts in academia and industry to enhance FINRA's foundation of knowledge, [and] conducting special studies and evaluations, …" *Id*.

20. A copy of a non-technical summary of the OCE working paper is available at: http://www.finra.org/sites/default/files/OCE-Non-technical-Summary.pdf, and a copy of the OCE working paper itself is available at http://www.finra.org/sites/default/files/OCE-Working-Paper.pdf. We refer to the two as "OCE Summary" and "OCE Working Paper" in the citations that follow.

21. Dr. Sokobin came to the OCE from the U.S. Treasury Department where he had been since 2011 and most recently was the Acting Deputy Director, leading the Research Center in the Office of Financial Research. *See* http://www.finra.org/about/jonathan-s-sokobin (last visited October 8, 2016). Before that, Dr. Sokobin had worked for the SEC since 2000 (he was also a Senior Research Fellow there from 1998 to 2000). *Id*. Dr. Sokobin received his doctorate in Finance from the Graduate School of Business at the University of Chicago. *Id*.

22. Dr. Qureshi received his doctorate in Economics from the Ohio State University in 2009. *See* https://www.linkedin.com/in/hammad-qureshi-5aa89013 (last visited

the Chief Economist plays a unique role within FINRA and, although it conducts "sophisticated economic and statistical analyses related to FINRA's mission, …" the papers that result from such analyses are represented as not necessarily representing the "views and positions of FINRA."[23]

The OCE's working paper was born of a premise with which PIABA and other commentators do not necessarily agree – that "… BrokerCheck is considered to be the most comprehensive source of information available to investors about brokers' professional histories, …"[24] Notwithstanding what some view as an inaccurate premise, which is acknowledged in footnote 5 of the Non-Technical Summary,[25] the working paper correctly reasons that "… it is important to examine the value of BrokerCheck information to investors and to assess whether BrokerCheck would be enhanced by the inclusion of additional non-public information. [Fn omitted]"[26]

The records reviewed by OCE for its working paper consisted of a subset of data from the CRD system from 2000-2013.[27] The sample included 181,133 brokers who registered with FINRA in 2000 or later.[28]

The OCE's working paper focused on two primary questions: (1) "[d]o investors already have access to valuable information about brokers through BrokerCheck?" and (2) "[w]ould including additional non-public CRD information enhance the value of BrokerCheck to investors?"[29] To assess

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October 8, 2016). He worked for a Washington D.C. management consulting firm from 2009 until he joined FINRA in January 2014. *Id.*

23. *See* http://www.finra.org/industry/chief-economist (last visited October 8, 2016).

24. See OCE Working Paper at 1 & 3 and OCE Summary at 1.

25. See OCE Summary at 1. We must note at the outset that PIABA and the OCE may not agree on what information in the national CRD system is "non-public" versus "public." States often vary, depending on their respective sunshine laws, on what may (and may not) be disclosed publicly from the national CRD system when an investor makes a request for information about a broker (*i.e.*, what is "public" or "non-public"). In this Update, PIABA's use of the term "non-public" in the discussion of the OCE's working paper is meant only to be consistent with the verbiage of that working paper and should not be taken as being determinative of PIABA's position on the issue of whether any given data or information is or should be truly "non-public."

26. OCE Summary at 3.

27. *See* OCE Summary at 2 and OCE Working Paper at 7.

28. *Id*.

29. *See* OCE Summary at 1 and OCE Working Paper at 3.

whether BrokerCheck provides useful information to investors at present in terms of helping them "to evaluate a broker's propensity for investor harm," OCE tested the "predictability of investor harm based on BrokerCheck information."[30]

The OCE's key findings were as follows:

- Information available to investors now on BrokerCheck (*i.e.*, disciplinary records, financial and other disclosures, and the employment history) "has significant power to predict investor harm."[31]
- Release of additional non-public CRD information on BrokerCheck regarding harm associated with a broker's co-workers at the firm where the broker is registered may benefit investors because it increases the power to predict investor harm.
- Release of additional non-public CRD information about qualification exams[32] (specifically the Series 6, 7, 63 and 65, and including scores and proportion of exams failed), undisclosed financial events (such as satisfied liens and bankruptcies more than 10 years old), disciplinary events (such as internal reviews), closed/dismissed regulatory actions, investigations or judicial actions do not increase the ability to predict investor harm.

Ultimately, the OCE concluded that the information already disclosed in BrokerCheck reports is valuable to investors because it can help investors "… discriminate between brokers associated with investor harm events and other brokers." Importantly, the OCE did not recommend narrowing the scope of BrokerCheck reports – a conclusion with which PIABA agrees whole-heartedly. Additionally, while commenting on whether certain non-public CRD information increases the ability to predict investor harm, the OCE notably avoided saying that such non-public CRD information was neither

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30. OCE Working Paper at 21.

31. The OCE found that "[t]at the 20% of brokers with the highest *ex-ante* predicted probability of investor harm are associated with more than 55% of investor harm events and the total dollar harm in [their] sample." *See* OCE Working Paper at 21.

32. The OCE did find that average exam scores were "negatively associated with investor harm," but also found that there was "no statistically significant association between the number of times a broker failed the exams and investor harm." *See* OCE Working Paper at 19. Interestingly, the OCE also found that exam performance led to a decrease in the ability to predict investor harm. *Id.*; *see also* OCE Summary at 3.

relevant nor useful when determining whether or not to do business with a broker.

PIABA also notes with interest that the OCE found that the release of additional information - specifically that related to a broker's coworkers' misconduct – would be useful. PIABA's members regularly experience situations in which brokers will engage in wrongdoing at Firm A, then leave *en masse,* and join Firm B where they continue their abusive sales practices. This unwelcome trend of brokers filtering down to ever-lower-quality firms was addressed by a report issued by the University of Chicago Booth School of Business, which is discussed next.

- Findings of Chicago Booth School of Business

The Stigler Center for the Study of the Economy and the State, University of Chicago Booth School of Business, published a working paper in February 2016 entitled, "The Market for Financial Adviser Misconduct."[33] The co-authors of the working paper were Mark Egan,[34] Gregor Matvos[35] and Amit Seru.[36]

While the topic addressed in the Chicago Booth working paper is similar to the OCE's working paper, it is not exactly the same. Additionally, while the data reviewed and analyzed in the OCE's working paper was similar to what was studied by Chicago Booth for its working paper, it was not identical.

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33. *See* http://www.chicagobooth.edu/~/media/B76C81EFE39B4EDB9A4B4D8B 34D0B0F7.pdf ("Chicago Booth working paper")(there was a March 2016 revision to the working paper, which can be accessed at http://dx.doi.org/10.2139/ssrn. 2739170).

34. Dr. Egan received his doctorate in Economics from the University of Chicago in 2015 and is currently an Assistant Professor of Finance at University of Minnesota. *See* https://drive.google.com/file/d/0B_jujkslhaXPM0dWQVpOVEVlZ2s/view (last visited October 9. 2016).

35. Dr. Matvos received his doctorate in Business Economics in 2007 from Harvard (from where he also graduated Phi Beta Kappa with honors in economics in 2002). *See* https://sites.google.com/site/gmatvos/cv (last visited October 9, 2016). He is currently an Associate Professor of Finance at University of Chicago Booth School of Business. *Id*.

36. Dr. Seru received his doctorate in Finance from the University of Michigan in 2007 and became a Professor of Finance at the University of Chicago in 2013. *See* http://faculty.chicagobooth.edu/amit.seru/vitae/CV.pdf.

For example, unlike the data reviewed by the OCE, Chicago Booth constructed "a novel database containing the universe of financial advisers in the United Stated from 2005 to 2015 . . .."[37] The breadth of the Chicago Booth's "novel database" is considerable. Chicago Booth analyzed certain disclosure records of *over one million more* brokers than the 181,133 brokers that OCE had reviewed.[38]

Another difference between the data analyzed in the studies is that the OCE, being part of FINRA, had access to information from the actual national CRD system, whereas Chicago Booth culled its data concerning brokers' employment history, qualifications, and disclosure information only from the more publicly available BrokerCheck system. Chicago Booth then supplemented the BrokerCheck information about brokers and their firms with certain "firm-level data."[39]

The Chicago Booth working paper is an "attempt to provide the first large scale study that documents the economy-wide extent of misconduct among" brokers and brokerage firms.[40] Chicago Booth's findings of particular were as follows:

- More than twelve percent of brokers' records contain a disclosure (not all of which are indicative of fraud or wrongdoing).[41]
- Misconduct varies considerably across brokers and firms, but there is evidence to suggest that some firms are more tolerant of

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37. *See* Chicago Booth working paper, 1. For its working paper, the OCE only reviewed records consisting of a subset of data from the CRD system for brokers that registered with FINRA from 2000-2013, which was 181,133 brokers. *See* OCE Summary, 2 and OCE Working Paper at 7.

38. *See* Chicago Booth working paper at 2 & 6-7.

39. That "firm-level data" included, for a small group of firms, the firm assets, revenues, and compensation structure obtained from a private survey. *See* Chicago Booth working paper at 6. The data analyzed also included curriculum vitae from a "leading social networking website for professionals" to gain data on the popularity of firms; "county-level" data from the 2010-2013 timeframe for "employment and demographic information," and data from Form ADVs for information on "firms' customer base and fee structure." *Id*.

40. Chicago Booth working paper at 2.

41. *Id*.at 7.

misconduct, hiring brokers with bad records and then firing those brokers less often if they engage in misconduct.[42]

• One in thirteen brokers has a misconduct-related disclosure on their BrokerCheck record;

• The median settlement paid to investors related to broker misconduct is $40,000 (and 25% of the settlements exceed $120,000);[43]

• One-third of brokers with misconduct in their BrokerCheck records are "repeat offenders."[44]

• "Past offender" brokers are five times more likely to participate in misconduct again than the average broker (including brokers in the same firm at the same time).[45]

• Brokers working for firms run by "executives and officers with records of misconduct are more than twice as likely to engage in misconduct."[46]

• Despite the presence of so many repeat offenders, firms can be strict in disciplining brokers for misconduct, *e.g.*, nearly one-half of brokers that engaged in misconduct in any given year do not have their job the following year.[47]

• Forty-four percent of brokers who lose their job after misconduct find new employment within the securities industry within a year.[48]

• Although some brokers with misconduct in their BrokerCheck records are able to find new employment within the securities

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42. Id.at 26.

43. *Id*.at 10. The true "cost" of those settlements associated with broker misconduct is better understood when one considers that the median household net worth in the U.S. in 2011 was only $68,828, meaning that the median settlement amount is over one-half of the median household net worth. *Id*.

44. *Id*. at 3.

45. *Id*. This finding, along with the "repeat offender" statistic of one-third, suggests that investors could avoid being the victim of misconduct by avoiding brokers misconduct records in BrokerCheck. *Id*. Such findings highlight the importance of brokers, firms and regulators making timely, accurate and complete disclosures regarding broker misconduct so that it appears on in the BrokerCheck records.

46. *Id*.

47. *Id*.

48. *Id*. at 4.

> industry, those brokers often take longer to find new employment and when they do, they are often hired at smaller, less desirable firms where they are paid ten percent less than they were making at their former firm.[49]
>
> • Brokers with misconduct in their BrokerCheck records switch to firms where more brokers with past misconduct records work (compared to other brokers looking for employment).[50]
>
> • Those firms that hire more brokers with misconduct records are not as likely to fire brokers for new misconduct.[51]
>
> • Broker misconduct is more prevalent among firms that work with retail investors (as opposed to institutional investors).[52]
>
> • The results suggested that broker misconduct is more common in areas with "relatively high incomes, low education, and elderly populations."[53]

At the end of its conclusion, the Chicago Booth working paper stated that "a natural policy response to lowering misconduct is an increase in market transparency and in policies helping unsophisticated consumers access more information."

Notwithstanding the importance of some of the findings in this particular study, PIABA was most intrigued by, and interested in, the discussion under Section 6 of the working paper: "Robustness and Extensions." There, the authors began by explaining that they had "conservatively categorized" six of twenty-three categories of disclosure as "misconduct disclosures."[54] It was also in Section 6 that the authors specifically explored "whether other [*i.e.*, non-misconduct] disclosures predict advisers' future misconduct." Table 16 shows that several "other disclosure" categories (of which there were seventeen) can also predict "future misconduct to some extent . . .." In other words, the Chicago Booth authors also found a correlation between "non-misconduct" disclosures and the predictability of misconduct, "suggesting that disclosing these categories may be valuable to potential consumers trying to avoid misconduct [by their broker]." PIABA accordingly supports the continued disclosure of the "non-misconduct" disclosure information.

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49. *Id*. at 4 & 26.

50. *Id*.

51. *Id*.

52. *Id*.

53. *Id*. at 27.

54. *Id*. at 25.

The Chicago Booth working paper only focused on information which is presently disclosed in BrokerCheck. Because the authors did not analyze any of the additional disclosures that may be made available to the public by various states drawing from the national CRD system, they could not offer any opinion on whether any of the potential additional disclosures may predict future misconduct or otherwise be of value to investors.

- **Additional Analysis Finds The OCE and Chicago Booth Studies Under-Report The Problems With BrokerCheck**

The OCE's and Chicago Booth's work was analyzed and critiqued in June 2016 report titled *How Widespread and Predictable is Stock Broker Misconduct?*, written by Craig McCann, PhD, CFA, Chuan Qin, PhD, and Mike Yan, PhD, CFA, FRM.[55] The SLCG Report confirmed the findings of OCE and Chicago Booth that "the risk a broker will commit misconduct is significantly increased if he or she works with co-workers who have previously committed misconduct."[56] Additionally, the SLCG Report also showed what OCE's and Chicago Booth's reports showed – "that association with past customer complaints and disciplinary events is a good indicator of higher propensity for future investor harm."[57]

However, SLCG ultimately determined that the information that is provided by BrokerCheck is not useful to retail investors for two reasons: (1) investors are still not getting all of the information that could be made available on BrokerCheck (*i.e.*, all of the information from the national CRD system); and, (2) investors do not have the analytical capabilities to truly use whatever information they are able to get from BrokerCheck to determine whether any given broker is likely (or more likely than another) to engage in broker misconduct.[58] Not mincing words, SLCG stated that "BrokerCheck is worthless in its current hobbled form, but could easily be modified so that investors could protect themselves and market forces would substantially

55. Hereinafter the "SLCG Report." McCann and Yan are principals with Securities Litigation & Consulting Group ("SLCG"), with Qin serving as a senior financial economist for SLCG. The report is available at http://www.slcg.com/pdf/working papers/McCann%20Qin%20and%20Yan%20on%20BrokerCheck%20Final.pdf.

56. *Id*. at 31.

57. *Id*.

58. *Id*. at 28-29.

reduce broker misconduct."[59] The modification advocated by SLCG is for FINRA to make *all* the "public facing data" that is made available in individual BrokerCheck reports available to the public for analysis, testing, rating and ranking instead of only providing what is now available through BrokerCheck on a broker-by-broker or firm-by-firm basis.

The SLCG report was critical of the OCE working paper for, among other reasons, excluding a large number of brokers – 85% of the 1.2 million brokers on BrokerCheck. It then assessed the Chicago Booth working paper and was largely able to replicate its findings, specifically agreeing that the "regulatory environment and labor market sifts bad brokers down the quality ladder over time into brokerage firms with loose hiring practices and compliance ethics."[60]

Significantly, the SLCG report found that the brokers excluded from the OCE study were between six and nine times more likely to have a claim reported than those included in the SLCG study.[61] Viewed differently, SLCG found that the brokers excluded from the OCE analysis were associated with 75% of all investor harm events between 2000 and 2014.[62] SLCG also found that the factors most commonly associated with investor harm events included higher average number of past customer complaints that led to an award or settlement, general customer disputes, judgments and liens, disciplinary events, and criminal events. As noted above, however, SLCG concluded that the key indicator of potential future broker misconduct was the extent to which a particular broker's co-workers had been involved in previous investor harm events.

The SLCG authors analyzed 10,009,600 broker-year observations for 1,200,673 unique brokers by conducting deep and sophisticated statistical analyses of the data, and concluded:

> The effectiveness of the regression models shows that the coworker disclosure and employment history contains valuable information for predicting the *first incidence* of investor harm event in a broker's career, and this information, if carefully compiled and explained, may protect investors from potential misconduct by brokers with clean disclosure record.[63]

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59. *Id.* at 1.

60. *Id.* at 5-6.

61. *Id.* at 7-8.

62. *Id.* at 21.

63. *Id.* at 30.

They then noted that, as currently constituted, FINRA's BrokerCheck system makes it impossible for an investor to glean this sort of information, in part, because reports are only available one at a time:

> Our analysis, and the analyses conducted by [Chicago Booth] and [OCE] show that association with past customer complaints and disciplinary events is a good indicator of higher propensity for future investor harm. While avoiding brokers with disclosure events may be a good rule of thumb for unsophisticated investors who have access to nothing more than public BrokerCheck information, it is not sufficient. Even at the highest risk firms, 80% of brokers don't have customer complaints. The 20% of brokers at these firms with a history of customer complaints do, though, increase the likelihood that other brokers at the same firm with a clean record will cause investor harm in the future. Investors need to know the disciplinary history of a broker's co-workers.[64]

The authors then called upon FINRA to release *all* of the BrokerCheck database so that anyone interested in analyzing the data could do so. While FINRA subsequently acknowledged that third parties analyzing BrokerCheck data could offer value to investors, it has not actually made the data available.[65]

What SLCG meant by "all" of the BrokerCheck database is "the public facing BrokerCheck data."[66] SLCG reasoned that making such information available should not be problematic because "FINRA and the SEC have already determined that this information is not confidential and should be disseminated to the public."[67] Yet, SLCG seems to be aware that FINRA *has* had a problem with making additional information from the national CRD system publicly available through BrokerCheck.[68]

And so, PIABA finds itself still asking FINRA to make more information available on BrokerCheck. Only now, PIABA is making this request of FINRA (the same as it made in March 2014) with even more support from

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64. *Id.* at 29.

65. *See* Jason Zweig, *Is Your Broker Good or Bad*, Wall Street Journal (April 22, 2016) (available at: http://www.wsj.com/articles/is-your-broker-good-or-bad-1461342875).

66. *Id*. at 31.

67. *Id*.

68. *Id*. ("FINRA has so thoroughly throttled the distribution of this important data as to make it virtually useless.").

others who have studied the issue and agree that the current BrokerCheck system is deficient and could be improved to better serve investors.

Taken on the Whole, The Academics and Experts Find That BrokerCheck Must Be Expanded If FINRA Is To Promote Investors' Well Being

Regardless of whether one considers the OCE, the Chicago Booth, or the SLCG study, the authors considered hundreds of thousands of broker records, and in some cases, millions. They analyzed those broker records to discover predictors of misconduct. They all concluded that prior instances of misconduct often served as indicators of likely future harm to investors. They also all found, to varying degrees, that the "quality" of a broker's co-workers served as an indicator of the likelihood of future wrongdoing.

All three reports also implicitly acknowledged a fundamental premise: that a one-off review of a particular broker's report is better than nothing. While that may be true, those analyses failed to challenge the quality of the BrokerCheck reports themselves. The Chicago Booth working paper and the SLGC study did not examine the potential value of the information which FINRA presently excludes from BrokerCheck because this information was not readily available. Given the differences in state disclosure, it is generally not possible for outsiders to obtain complete state CRD reports for every broker. Accordingly, the reports and their conclusions have their limitations. Notwithstanding the limitations, the conclusion that non-misconduct related disclosures are still relevant and may be predictors of future misconduct lend support to the premise that the disclosure of information presently excluded by BrokerCheck would have some value to investors.

FINRA Must Be The Principal Provider of Broker History Information

As discussed above, FINRA's BrokerCheck as presently constituted does not present a full and fair background regarding brokers and firms. And, as discussed above, an investor must consult his or her state securities regulator in an effort to try to fill the gaps in the BrokerCheck report. Unfortunately, there are differences in what data in the national CRD system can be made publicly available by the various states (due to their respective sunshine laws). Thus, in order for investors across the United States to obtain uniform information about brokers (regardless of the state(s) in which brokers are

registered), FINRA should be the principal provider of *full and complete* BrokerCheck reports.

There are two principal reasons that investors should not have to rely on states for historical data about brokers: (1) differing state laws on what may be made publicly available, combined with the states' obligations to protect (and not produce) personal identifying information ("PII"), have made it more difficult and expensive for investors to obtain relevant information from some state regulators; and, (2) FINRA stands in the best position to ensure that the national CRD system is complete and up-to-date, as well as ensure that investors are all receiving uniform information about brokers regardless of where the brokers are registered.

States Operate Under Different Constraints Than FINRA, Which Hinders Their Ability To Adequately Fill The Gaps In BrokerCheck Reports

When states make CRD reports available upon request of investors, the data in the CRD reports is provided under the public records, or sunshine, laws. States vary in terms of what information they are able to make available under these laws. Accordingly, an investor making such a request from Florida will receive different information than an investor making such a request from New York, even if the request is for background information about the same broker. The result is that an investor in one state (New York, here) may not receive key historical information about his or her broker simply because that investor did not know to find out if the broker is registered in other states and then request information about the broker from any other state(s) too.

Because an investor's request for a state regulator's CRD report on a broker seeks the revelation of information in public records, many states treat such requests as Freedom of Information Act Requests ("FOIA requests"). As a result, those states charge a fee to collect the information, as they would for any other FOIA request. Other states, cognizant of the need to avoid the inadvertent disclosure of a broker's PII, may require investors to pay a fee for the time required for staff to review the information in the state's CRD reports and redact PII. In those states, investors cannot get the CRD report for a broker until they have paid the fee and the staff has reviewed and redacted any PII that was found in the broker's report. Additionally, even the process by which a CRD report is requested can vary by state. In some states, an investor can simply call or email the securities regulator and they will receive the broker's state CRD report without any appreciable delay. On the other hand, some states require the request for a CRD report to be made in writing, and a fee to

be paid (sometimes by a specific method such as cashier's check or money order mailed to a certain address), before the report will be provided to the investor.

Contrary to the variances in content, cost, and time at the state level, BrokerCheck is electronically accessible, immediately available, and has already been vetted to ensure it reveals no personal identifying information. FINRA has the ability to include in its BrokerCheck reports any information it wants from the more complete data that resides in the national CRD system.[69] Thus, FINRA can, and should, make more fields and data available to investors through expanded BrokerCheck reports that investors can access in the same manner as they do for current BrokerCheck reports. Dissemination of more complete background information about brokers through the existing BrokerCheck system will ensure that investors across the country have access to the same information about a broker at the same time and at the same cost.

FINRA is best situated to ensure an accurate CRD system

FINRA is, and has been, the regulator with the ability to correct all of the issues with BrokerCheck. While states often provide investors with more thorough reports (*i.e.*, containing additional important data from the national CRD system) than BrokerCheck reports, that is not always the case. Additionally, it has become apparent that the national CRD database itself is missing critical information because brokers and firms have not always reported what is required.

FINRA must act *now* to ensure the information available to investors through BrokerCheck is comprehensive and accurate. A Wall Street Journal article published on March 14, 2014, just a week after PIABA's Report was released, reported that more than "1,600 stockbrokers . . . records failed to disclose bankruptcy filings, criminal charges or other red flags in violation of regulations, without regulators noticing."[70] Roughly nine months later, FINRA amended its supervision rule to add a requirement that firms adopt procedures to verify the accuracy and completeness of information contained on a broker's Form U4 (one of the primary forms used to funnel information

69. The data in the CRD reports provided by the states actually comes from the national CRD system.

70. Eaglesham, Jean and Rob Barry, "Stockbrokers Fail to Disclose Red Flags," Wall Street Journal, March 5, 2014, available at http://www.wsj.com/news/articles/SB10001424052702304026804579411171593358690.

into the CRD system).[71] FINRA also adopted a temporary program to address the underreporting of information on Form U4. FINRA permitted firms to update missing information between 2014 and 2015, and refunded late reporting fees.[72]

Notwithstanding the two-year-old Wall Street Journal article and FINRA's subsequent efforts to remedy the situation, the problem persists today. SLGC has compared BrokerCheck information with FINRA's arbitration award database, finding at least 75 examples of brokers not reporting arbitration award information.[73]

The fact that SLCG found 75 examples of brokers not reporting arbitration award information is shocking, given the fact that FINRA itself publishes the information regarding arbitration awards. In other words, despite having the arbitration award data in its possession, FINRA has somehow failed to ensure that the data makes it into the CRD system. If the CRD system is incomplete, the BrokerCheck reports and state CRD reports drawn from that system will also be incomplete – leading state regulators and investors, alike, without the information needed to fully assess brokers.[74] Simply put, FINRA must ensure that accurate and complete information is being disclosed to the CRD system, or else BrokerCheck will always be broken.

CONCLUSION

PIABA's March 2014 report called on FINRA to step forward and ensure that BrokerCheck provided investors with sufficient information to allow them to fully vet, to the extent possible, potential stockbrokers with whom they

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71. See "Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1 Thereto, Relating to the Adoption of FINRA Rule 3110(e) (Responsibility of Member to Investigate Applicants for Registration) in the Consolidated FINRA Rulebook," File No. SR-FINRA-2014-038 (December 30, 2014), available at https://www.sec.gov/rules/sro/finra/2014/34-73966.pdf.

72. See Id., see also FINRA Rule 3110.15.

73. McCann, Craig, Mike Yan and Chuan Qin, "Things Go From Bad to Worse for BrokerCheck" (July 7, 2016), available at http://blog.slcg.com/2016/07/things-go-from-bad-to-worse-for.html.

74. The problems related to expungement of customer complaints from CRD records is beyond the scope of this Update. PIABA has addressed issues with the current expungement process in previous reports and updates, and will continue to push for expungement reform in the future.

would entrust their life savings. The closest thing to a response from FINRA came in the form of an amendment to Rule 2210, "Communications with the Public," which required the inclusion of links to the BrokerCheck website in specified circumstances. Otherwise, the only other noticeable actions taken by FINRA with respect to BrokerCheck was limited to some tweaks to the BrokerCheck website and homepage, and an advertising campaign touting the broken BrokerCheck system as the best (and seemingly only) source of broker background information.

In other words, it appears as though FINRA has made little, if any, progress in enhancing or otherwise improving the BrokerCheck system. While its own Office of the Chief Economist found value in offering additional information within BrokerCheck reports, FINRA has not publicly endorsed the working paper and certainly has not taken steps to enhance BrokerCheck disclosures. FINRA's lack of progress is particularly frustrating given FINRA's Chief Legal Officer's April 2016 statement that FINRA recognized that third parties may be able to provide valuable information to investors and that FINRA was "carefully considering the issue."[75] FINRA has been silent regarding its consideration, much less implementation, of efforts to make more information publicly available as suggested by SLCG.

Moreover, it has become increasingly apparent that the data contained in the national CRD system, and thus BrokerCheck reports, is incomplete, unreliable or even false. These issues threaten to render even what broker background information is disclosed in BrokerCheck reports useless to an investor trying to research his or her broker.

Since PIABA's Report was published in early 2014, academics have spent countless hours gathering data from the BrokerCheck system, as well as (in some instances) the CRD system and limited publicly available information, in an effort to assess the utility of the BrokerCheck system to investors trying to learn about their brokers' history. Their primary conclusion was unambiguous: a broker's co-workers have a large impact on whether that broker is more likely than another broker at another firm to commit sales abuses in the future. Accordingly, the history of those who work with and around a broker is important in predicting how likely a particular broker is to engage in future wrongdoing. Unfortunately, the current BrokerCheck system does not provide any data on others that work at a broker's firm or in a broker's office.

Based on the studies, articles and reports that have been published by a variety of sources over the last two and a half years since PIABA's report was

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75. *See* Zweig, *Is Your Broker Good or Bad* (available at: http://www.wsj.com/articles/is-your-broker-good-or-bad-1461342875).

published, it is clear that FINRA needs to take action to improve the national CRD system and BrokerCheck reports. Indeed, if FINRA is serious about protecting investors and truly believes, as it has professed, that researching a broker is a meaningful part of an investor's broker selection process, PIABA calls upon FINRA to:

1. Ensure that *all* complaints, arbitration awards, and settlements are promptly and accurately recorded in a broker's and/or firm's CRD record(s);
2. Ensure that the data disclosed *via* BrokerCheck is, at a minimum, congruous with the most liberal state sunshine law;
3. Include in BrokerCheck reports data concerning whether arbitration awards or settlements were actually paid;[76]
4. Add statistical information on the BrokerCheck home page to allow an investor to put an individual BrokerCheck report into context (*e.g.*, include statistics showing the total number of registered brokers in the industry and the total number in the industry with one, two, three, four, or more investor complaints on their record);
5. Open the entire BrokerCheck database to the public (*e.g.*, academics and other third parties) to allow deep data analysis and development of quantitative and qualitative reports concerning brokers and brokers' co-workers.

Should FINRA continue to ignore PIABA's, the SEC's, NASAA's, academics,' and the public's calls for improvements in the BrokerCheck system, PIABA calls upon Congress to amend §15A of the Exchange Act to define the type and scope of information FINRA would be required to make

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76. PIABA issued a report concerning the scourge of unpaid arbitration awards in February 2016. *See Unpaid Arbitration Awards, A Problem The Industry Created – A Problem The Industry Must Fix,* Hugh Berkson (Feb 2016)(available at 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) Given that FINRA does not publish data concerning unpaid awards, PIABA tried to determine for itself whether arbitration awards were paid. This proved to be impossible because there is nothing in BrokerCheck reports concerning whether any particular award against a broker or brokerage firm went unpaid. Investors deciding whether to do business with a firm (or a broker) should have the benefit of knowing whether that firm (or broker) has been unable to pay awards awarded to aggrieved investors in the past. With respect to the ability to pay awards, we also note that PIABA is in favor of BrokerCheck reports including data on whether a firm (or a broker) maintains liability insurance and, if so, the limits of such insurance.

available through BrokerCheck so that, similar to Florida and other states with broad public records laws, the only data that would be excluded would be personal information such as social security numbers, home addresses, and other personal identifying information.

The current incomplete and/or inaccurate BrokerCheck reports are of limited value, and may be of no value depending on how incomplete or inaccurate a given broker's information is. Investors should not be subject to the vagaries of their local public records laws to ensure that they gain the information necessary to fully and fairly assess their potential financial advisor. Investors also should not be subject to brokers' whims with respect to what, when, and how much they will disclose to FINRA when the information to be disclosed is otherwise available and/or known to FINRA.

As things stand now, FINRA claims to offer information "You might want to know about"[77] but fails to offer information you definitely want to know about. The solution to the BrokerCheck problems is so simple and the resulting potential benefit to investors so meaningful that FINRA cannot be allowed to continue promoting the current broken BrokerCheck system. FINRA is fully aware of BrokerCheck's limitations and it must be required to eliminate those that it can.

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77. *See* FINRA's BrokerCheck home page, available at: http://brokercheck.finra.org.

STATES WITH A CIVIL PRIVATE RIGHT OF ACTION FOR FINANCIAL ELDER ABUSE AND EXPLOITATION

Jeff Aidikoff, Esq. and Ashley Rivkin

INTRODUCTION

Financial elder abuse and exploitation costs victims up to an estimated $2.6 billion annually.[1] Although the number of reported cases is on the rise, financial abuse is often more difficult to detect and less widely reported than physical abuse because a person of trust such as a family member, or a fiduciary such as an investment advisor, is more likely to perpetrate the abuse.[2] These factors create unique challenges in preventing, detecting, and responding to cases of financial exploitation and abuse. Some states have addressed the difficulties associated with financial elder abuse and exploitation by enacting statutes with a civil private right of action, and heightened remedies and penalties to encourage enforcement and deter abuse; other states have failed to specifically address the growing epidemic of financial elder abuse and exploitation by statute and thus rely on laws that prohibit unlawful conduct generally, in addition to criminal penalties for people who abuse the elderly population.

This article is a survey of financial elder abuse laws in the U.S. It is divided into two tiers, the first presents each state that has enacted a statute (or statutes) creating a civil private right of action for financial elder abuse or exploitation and provides the available legal remedies for private civil litigants. The second tier presents the states that do not create a civil private right of action for financial elder abuse or exploitation, but which do have general elder abuse

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1. Kevin E. Hansen, et al., *Criminal and Adult Protection Financial Exploitation Laws In the United States: How Do the Statutes Measure Up To Existing Research?*, 42 MITCHELL HAMLINE L. REV. 897, 899 (2016).

2. Ron Acierno, et al., *Prevalence and Correlates of Emotional, Physical, Sexual and Financial Abuse and Potential Neglect in the United States: The National Elder Mistreatment Study*, 100 AM. J. PUB. HEALTH 292-97 (Feb. 2010), *available at* http://doi.org/10.2105/AJPH.2009.163089; Lifespan of Greater Rochester, Inc., et al., *Under the Radar: New York State Elder Abuse Prevalence Study–Self-Reported Prevalence and Documented Case Surveys–Final Report*, 50 (May 2011), *available at* http://www.nyselder abuse.org/documents/ElderAbusePrevalenceStudy2011.pdf. This study estimated that only 1 in 44 cases of financial abuse came to the attention of agencies that provide services to victims of elder abuse in New York State.

prevention laws, or which criminalize abusive and/or deceptive practices against elders.

A. TIER 1:

Tier 1 represents states with statutes creating a civil private right of action for financial elder abuse and/or exploitation.

Arizona:

Arizona's financial abuse statute applies specifically to "Vulnerable Adults" and creates a private right of action for civil litigants for claims of financial exploitation.[3] The law requires a person who is in a position of trust and confidence to a vulnerable adult to "use the vulnerable adult's assets solely for the benefit of the vulnerable adult and not for the benefit of the person who is in the position of trust and confidence to the vulnerable adult or the person's relatives."[4] The court may award actual damages, reasonable costs, and attorney fees in a civil action brought by, or on behalf of, a vulnerable adult, including damages in an amount up to two times the amount of the actual damages; actual damages for financial exploitation are also not limited by the victim's survival.[5]

However, Arizona defines "Vulnerable Adult" as "an individual who is eighteen years of age or older and who is unable to protect himself from abuse, neglect, or exploitation by others because of a physical or mental impairment," and also includes an incapacitated person as defined in section 14-510 of Arizona's Revised Statute Annotated.[6]

California:

California's Elder Abuse and Dependent Adult Civil Protection Act (EADACPA) creates a private right of action for civil litigants for claims of

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3. ARIZ. REV. STAT. ANN. §46-451 (2017).

4. ARIZ. REV. STAT. ANN. §46-456.A (2017).

5. *Id*.

6. ARIZ. REV. STAT. ANN. §46-451A.9 (2017).

elder financial abuse, which occurs "when a person takes, secretes, appropriates, obtains or retains real or personal property of an elder or dependent adult for wrongful use or with intent to defraud or both," or "when someone *assists* in taking secreting, appropriating, obtaining, or retaining real or personal property of an elder or dependent adult for a wrongful use or with intent to defraud, or both."[7] An elder is a person sixty-five years of age or older.[8] The statute further provides that "[a] person or entity shall be deemed to have taken, secreted, appropriated, obtained, or retained property for a wrongful use if, among other things, the person or entity takes, secretes, appropriates, obtains, or retains the property and the person or entity *knew or should have known that this conduct is likely to be harmful* to the elder or dependent adult."[9]

Further, under the EADACPA, "[w]here it is proven by a preponderance of the evidence that a defendant is liable for financial abuse … in addition to compensatory damages and all other remedies otherwise provided by law, the court shall award to the plaintiff reasonable attorneys fees and costs."[10] Furthermore, "where it is proven by clear and convincing evidence that the defendant has been guilty of recklessness, oppression, fraud, or malice in the commission of the abuse," the Plaintiff may recover punitive damages, in addition to compensatory damages, all other remedies otherwise provided by law, and reasonable attorney fees and costs.[11] There is a four-year statute of limitations in elder and dependent adult financial abuse cases.[12]

However, an employer shall not be liable for damages "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."[13] For a corporate employer, "the advance

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7. CAL. WELF. & INST. CODE § 15610.30 (West 2017) (emphasis added).

8. *Id.*

9. CAL. WELF. & INST. CODE § 15657.5; CAL. WELF. & INST. CODE § 15610.3(b) (West 2017) (emphasis added).

10. CAL. WELF. & INST. CODE § 15657.5(a) (West 2017).

11. CAL. WELF. & INST. CODE § 15657.5 (West 2017). CAL. CIV CODE § 3294(a) (West 2017).

12. CAL. WELF. & INST. CODE § 15657.5 (West 2017).

13. CAL. CIV CODE § 3294(b) (West 2017).

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."[14]

A civil litigant in California may also make a claim on behalf of a financially aggrieved elder under its Consumer Legal Remedies Act (CLRA).[15] Specifically, the CLRA prohibits specified unfair and deceptive acts and practices in a transaction intended to result or which results in the sale or lease of goods or services to any consumer.[16] It also authorizes the recovery of punitive damages, three times actual damages, five-thousand dollars ($5,000), as well as reasonable attorney fees, when the victim is a senior citizen (defined as 65 years or older).[17]

And last, California prohibits unfair competition and deceptive trade practices,[18] providing seniors victimized under the law to recover treble damages if it is found that the defendant "knew or should have known that his or her conduct was directed to one or more senior citizens or disabled persons."[19]

Connecticut:

Connecticut's elder abuse statute creates a civil private right of action for an elder who has been victimized and/or exploited, and provides recovery of actual and punitive damages for the exploitation, plus costs, and reasonable attorney fees.[20] An "elderly person" is anyone sixty-years or older, and "exploitation" is defined as "the act or process of taking advantage of an elderly person by another person or caregiver whether for monetary, personal or other benefit, gain, or profit."[21]

An action under the statute "may be brought by the elderly person, or the elderly person's guardian or conservator, by a person or organization acting

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14. *Id.*

15. CAL. CIV. CODE § 1750, *et seq.*

16. CAL. CIV. CODE § 1770(a) (West 2017).

17. CAL. CIV. CODE § 1780, *et seq.*

18. CAL. BUS. & PROF. CODE § 17200, *et seq.*

19. CAL. CIV. CODE § 3345(b)(1) (West 2017).

20. CONN. GEN. STAT. § 17b-462 (2015).

21. CONN. GEN. STAT. § 17b-450(7) (FORMERLY SEC.17A-430) (2015).

on behalf of the elderly person with the consent of such elderly person or the elderly person's guardian or conservator, or by the personal representative of the estate of a deceased elderly victim."[22] The court may also prohibit "the defendant from transferring, depleting, or otherwise alienating or diminishing any funds, assets or property."[23]

Delaware

Although Delaware has not enacted a specific statute addressing financial elder abuse, it does prohibit damages to an elder person (defined as 65 years of age or older) as a result of unfair or deceptive practices, including but not limited to misrepresentation and/or material omission.[24] Elderly civil litigants may seek injunctive relief and may also recover three times their actual damages, as well as costs and reasonable attorney fees for violations under the statute.[25]

Florida:

Florida provides a private right of action for financial exploitation of a vulnerable adult.[26] A "vulnerable adult" is "a person 18 years of age or older whose ability to perform the normal activities of daily living or to provide for his or her own care or protection is impaired due to a mental, emotional, sensory, long-term physical, or developmental disability or dysfunction, or brain damage, *or the infirmities of aging*."[27]
Exploitation is defined as where:

> a person who … [s]tands in a position of trust and confidence[28] with a vulnerable adult and knowingly, by deception or intimidation, obtains

22. CONN. GEN. STAT. § 17b-462(a) (2015).

23. CONN. GEN. STAT. § 17b-462(b) (2015).

24. DEL. CODE ANN. tit. 6, § 2532, § 2580(a) (2017).

25. DEL. CODE ANN. tit. 6, § 2583(a), § 2533(a) (2017).

26. FLA. STAT. § 415.1111 (2017).

27. FLA. STAT. § 415.102(28) (2017) (emphasis added).

28. This includes, among other relationships including child or spouse, someone who has a fiduciary relationship with the elderly person or disabled adult, including but not

> or uses, or endeavors to obtain or use, a vulnerable adult's funds, assets, or property with the intent to temporarily or permanently deprive a vulnerable adult of the use, benefit, or possession of the funds, assets, or property for the benefit of someone other than the vulnerable adult; or [k]nows or should know that the vulnerable adult lacks the capacity to consent, and obtains or uses, or endeavors to obtain or use, the vulnerable adult's funds, assets, or property with the intent to temporarily or permanently deprive the vulnerable adult of the use, benefit, or possession of the funds, assets, or property for the benefit of someone other than the vulnerable adult.[29]

Exploitation may also include, but is not limited to, breaches of fiduciary relationship, misappropriation, misuse, or transfer of moneys belonging to a vulnerable adult from a personal or joint account; or "negligent failure to effectively failure to effectively use a vulnerable adult's income and assets for the necessities required for that person's support and maintenance."[30]

A successful civil litigant may recover actual and punitive damages, reasonable attorney fees and costs.[31] Any such "action may be brought by the vulnerable adult, or that person's guardian, by a person or organization acting on behalf of the vulnerable adult with the consent of that person or that person's guardian, or by the personal representative of the estate of a deceased victim without regard to whether the cause of death resulted from the abuse, neglect, or exploitation."[32] The remedies provided under the statute "are in addition to and cumulative with other legal and administrative remedies available to a vulnerable adult."[33] Florida also provides that where a party is over the age of 65, the court may advance the trial date.[34]

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limited to, "a court-appointed or voluntary guardian, trustee, attorney or conservator." FLA. STAT. § 415.102(11) (2017).

29. FLA. STAT. § 415.102(8)(a) (2017).

30. FLA. STAT. § 415.102(8)(b) (2017).

31. FLA. STAT. § 415.1111 (2012).

32. *Id.*

33. *Id*.

34. FLA. STAT. § 415.1115 (2012).

Georgia:

Although Georgia has not enacted a specific statute addressing financial elder abuse, it does provide enhanced remedies to an elderly as a result of unfair or deceptive practices.[35] Specifically, a civil litigant may recover "actual damages, punitive damages, if appropriate, and reasonable attorney fees."[36]

Illinois:

Illinois provides a civil private right of action for an elder or anyone suing on their behalf for financial exploitation, and defines elderly persons as 60 years of age or older.[37] A person commits financial exploitation of an elderly person when "he or she stands in a position of trust or confidence with the elderly person … and he or she knowingly and by deception or intimidation obtains control over the property of an elderly person … or illegally uses the assets or resources of an elderly person."[38] A person who stands in a position of trust includes anyone with a legal or fiduciary relationship with the elderly person, in addition to financial planning or investment professionals.[39] "Deception" includes misrepresentation and false pretense, and false promise in order to induce, encourage or solicit, the elderly person to enter into a contract or agreement.[40] In addition, "[t]he illegal use of the assets or resources of an elderly person or a person with a disability includes, but is not limited to, the misappropriation of those assets or resources by undue influence, breach of a fiduciary relationship, fraud, deception, extortion, or use of the assets or resources contrary to law."[41]

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35. GA. CODE ANN. § 10-1-850, *et seq*.

36. GA. CODE ANN. § 10-1-853 (2017).

37. 720 ILL. COMP. STAT. 5/17-56 (2014).

38. 720 ILL. COMP. STAT. 5/17-56(A) (2014).

39. *Id.*

40. *Id.*

41. 720 ILL. COMP. STAT. 5/17-56(B) (2014).

The statute provides damages of treble the amount of the value of the property obtained, plus reasonable attorney fees and costs.[42] The standard of proof under the statute is a preponderance of the evidence.[43]

Iowa:

Under Iowa law, elder financial exploitation occurs when a person in a position of trust or confidence of a vulnerable elder knowingly, either" by undue influence, deception, coercion, fraud, or extortion, obtains control over or otherwise uses or diverts the benefits, property, resources, belongings, or assets of the vulnerable elder."[44] "Vulnerable elder" ia defined as "a person sixty years of age or older who is unable to protect himself or herself from elder abuse as a result of age or a mental or physical condition."[45] In a successful claim under the act, the court may order any relief the court considers necessary, including but not limited to the recovery of attorney fees and costs.[46]

Minnesota:

In Minnesota, a vulnerable adult[47] who is a victim of financial exploitation has a cause of action against a person who committed the financial exploitation.[48] In an action under this subdivision, "the vulnerable adult is entitled to recover damages equal to three times the amount of compensatory damages or $10,000, whichever is greater."[49] In addition to those damages, "the vulnerable adult is entitled to recover reasonable attorney fees and costs,

42. 720 ILL. COMP. STAT. 5/17-56(G) (2014).

43. *Id.*

44. IOWA CODE § 235F.1(8) (2017).

45. IOWA CODE § 235F.1(17) (2017).

46. IOWA CODE § 235F.6.2(a-d), § 235F.6.7 (2017).

47. "Vulnerable adult" is defined in MINN. STAT. § 626.5572.21 (2017).

48. MINN. STAT. § 626.557.20 (2017).

49. *Id.*

including reasonable fees for the services of a guardian or conservator or guardian ad litem incurred in connection with a claim."[50]

However, "vulnerable adult" only includes persons 18 years of age or older with physical impairments and certain medical issues, including but not limited to, an impaired ability to provide adequately for one's "own care without assistance, including the provision of food, shelter, clothing, health care, or supervision."[51]

Oregon:

In Oregon, a civil private right of action may be brought for financial abuse in the following circumstances: "when a person wrongfully takes or appropriates money or property of a vulnerable person, without regard to whether the person taking or appropriating the money or property has a fiduciary relationship with the vulnerable person."[52] A vulnerable person under the statute includes an elderly person, which is defined as a person who is 65 years of age or older.[53]

In addition, the court shall provide an amount equal to three times all economic damages resulting from the abuse or $500 to a prevailing plaintiff (whichever is greater), as well as three times all noneconomic damages resulting from the financial abuse.[54] The court shall also provide reasonable attorney fees, and reasonable fees for the services of a conservator or guardian *ad litem*.[55] There is a seven-year statute of limitations for financial abuse under the statute.[56] *However, this statute* ***does not apply*** *liability to financial institutions and broker-dealers.*[57]

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50. *Id.*

51. MINN. STAT. § 626.5572.21(a) (2017).

52. OR. REV. STAT. § 124.110(1)(a) (2017).

53. OR. REV. STAT. § 124.100 (1)(a) (2017).

54. OR. REV. STAT. § 124.100(2)(a-d) (2017).

55. *Id.*

56. OR. REV. STAT. §124.130 (2017).

57. OR. REV. STAT. §124.115(1)(a),(d) (2017).

South Dakota:

In 2016, South Dakota created a private right of action for civil litigants for claims of financial exploitation, although the court must find that the exploitation first occurred before an "elder has a cause of action against the perpetrator and may recover actual and punitive damages for the exploitation."[58] Exploitation is defined as "the wrongful taking or exercising of control over property of an elder or adult with a disability with intent to defraud the elder or adult with a disability."[59]

If the elder financial exploitation victim dies, their guardian/conservator, a person or organization acting on their behalf (with consent), or a personal representative of a deceased elder victim may bring the action.[60]

The court may also order a variety of remedies or preventative measures in a claim for financial exploitation. These include but are not limited to:

> (1) Directing the respondent to refrain from exercising control over the funds, benefits, property, resources, belongings, or assets of the vulnerable adult; (2) Requiring the respondent to return custody or control of the funds, benefits, property, resources, belongings, or assets to the vulnerable adult; (3) Requiring the respondent to follow the instructions of the guardian, conservator, or attorney in fact of the vulnerable adult; and (4) Prohibiting the respondent from transferring the funds, benefits, property, resources, belongings, or assets of the vulnerable adult to any person other than the vulnerable adult.[61]

Tennessee:

Tennessee provides civil litigants with a private right of action for financial exploitation of an elder.[62] Exploitation is defined as "the improper use by a caretaker of funds that have been paid by a governmental agency to

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58. S.D. CODIFIED LAWS §22-46-13 (2017).

59. S.D. CODIFIED LAWS §22-46-1(5) (2017).

60. S.D. CODIFIED LAWS §22-46-13 (2017).

61. S.D. CODIFIED LAWS §22-46-13 (2017), as stated in S.D. CODIFIED LAWS §22-46-17 (2017).

62. "Elderly person or elder means a person who is sixty (60) years of age or older who has some mental or physical dysfunctioning, including any resulting from age." TENN. CODE ANN. §71-6-120 (a)(3) (2017).

an adult or to the caretaker for the use or care of the adult."[63] However, "a financial institution is not a caretaker of funds or other assets unless such financial institution has entered into an agreement to act as a trustee of such property or has been appointed by a court of competent jurisdiction to act as a trustee with regard to the property of the adult."[64] Available remedies for successful litigants under the statute "include compensatory damages and costs, where it is proven that a defendant is liable for abuse or exploitation, or for theft of such elderly person's or disabled adult's money or property whether by fraud, deceit, coercion, or otherwise;" costs shall include reasonable expenses.[65]

Additionally, "if it is proven upon clear and convincing evidence that abuse or exploitation or theft resulted from intentional, fraudulent, or malicious conduct by the defendant, a claimant shall be entitled to recover reasonable attorneys' fees."[66] A right of action against a wrongdoer will not extinguish upon the death of the elder, but shall pass as provided in the Abatement and Survival of Actions chapter of the Tennessee Code.[67] However, if the alleged wrongdoer is a family member, "the cause of action shall pass to the victim's personal representative."[68]

Utah:

Utah provides civil litigants with a private right of action for financial exploitation of a vulnerable adult, and provides for the recovery of compensatory damages, as well as costs and reasonable attorney fees to a prevailing plaintiff under the statute.[69] The statute further provides that upon the death of a vulnerable adult, any cause of action shall constitute an asset of

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63. TENN. CODE ANN. §71-6-102(8) (2017).

64. TENN. CODE ANN. §71-6-102(5)(B) (2017).

65. TENN. CODE ANN. §71-6-120(d)(2017).

66. *Id*.

67. TENN. CODE ANN. § 20-5-120(b) (2017).

68. *Id*.

69. UTAH CODE ANN. § 62A-3-314(1),(3) (2016). The statute also provides that "If the defendant prevails in an action brought under this section, the court may order that the plaintiff pay the costs and reasonable attorney fees of the defendant, if the court finds that the action was frivolous, unreasonable, or taken in bad faith." UTAH CODE ANN. § 62A-3-314(4) (2016).

the vulnerable adult's estate.[70] A vulnerable adult is defined as a person sixty-five (65) years of age or older or an adult who has a mental or physical impairment which substantially affects that person's ability manage their own financial resources, along with their ability to provide themselves with basic living needs.[71]

Further, Utah defines financial exploitation as where, by deception or intimidation, "a person who is either in a position of trust and confidence or business relationship or has undue influence over the vulnerable adult and knowingly … obtains or uses, or endeavors to obtain or use, a vulnerable adults funds, credit, assets or other property with the intent to temporarily or permanently deprive" the elder of her assets and property.[72] Undue influence "occurs when a person uses the person's role, relationship, or power to gain control deceptively over the decision making of the vulnerable adult."[73]

West Virginia:

West Virginia_provides civil litigants with a private right of action for financial abuse as follows: in an action brought against a person for financial abuse, and upon finding that an elderly or protected adult has in fact been financially exploited, the court may order the return of property or assets which were improperly obtained, controlled, or used.[74] Financial Exploitation is defined as "the intentional misappropriation or misuse of funds or assets of an elderly person, protected person or incapacitated adult, but shall not apply to a transaction or disposition of funds or assets where the defendant made a good-faith effort to assist the elderly person, protected person or incapacitated adult with the management of his or her money or other things of value."[75]

Further, in a successful action under the statute, the court may order "[a]n award of actual damages to the person who brought the action … or for the value of the property or assets lost as a result of the violations."[76] For

70. UTAH CODE ANN. § 62A-3-314(2) (2016).

71. UTAH CODE ANN. § 62A-3-301(29) (2016).

72. UTAH CODE ANN § 76-5-111(4) (2016).

73. UTAH CODE ANN § 76-5-111(1)(r) (2016).

74. W. VA. CODE §55-7J-3(a)(1) (2016).

75. W. VA. CODE §55-7J-1(b)(3) (2016).

76. W. VA. CODE §55-7J-3(a)(2) (2016).

violations committed by a person who is not in a position of trust and confidence, a court may order (in addition to the remedies provided above) "payment of two times the amount of damages incurred or for the value of property or assets lost."[77] Additionally, "[f]or violations committed by a person in a position of trust and confidence," a court may order payment of treble damages.[78] Moreover, the court may award reasonable attorneys fees and costs to the prevailing party.[79]

In addition, the standard of proof for showing that an individual committed financial exploitation is by a preponderance of the evidence.[80] An elderly, protected, or incapacitated adult "may bring an action to enjoin the alleged commission of financial exploitation and may petition the court to freeze the assets of the person who allegedly committed the financial exploitation."[81]

A. TIER 2:

Tier 2 lists each state that fails to provide a civil private right of action for financial elder abuse and/or exploitation. Nonetheless, these states do have reporting requirements and/or criminal statutes:

General Elder Abuse Prevention Statutes	
State	**Statutes**
Alaska	ALASKA STAT. § 47.24.010 *et seq.;* ALASKA STAT. § 13.27.010 *et seq.*
Arkansas	ARK. STAT. ANN. § 5-37-227; ARK. STAT. ANN. § 28-74-101 *et seq.*
Colorado	COLO. REV. STAT. § 26-3.1-101 *et seq*.; COLO. REV. STAT. § 18-6.5-108

77. W. VA. CODE §55-7J-3(b)(1) (2016).

78. W. VA. CODE §55-7J-3(b)(2) (2016).

79. W. VA. CODE §55-7J-4(a) (2016).

80. W. VA. CODE §55-7J-4(b) (2016).

81. W. VA. CODE §55-7J-5(a) (2016).

Delaware	DEL. CODE ANN. tit. 31, § 3901 *et seq*; DEL. CODE ANN. tit. 11, § 1105; DEL. CODE ANN. tit. 6, § 2580 *et seq.*
District of Columbia	D.C. CODE ANN. § 7-1901 *et seq*.; D.C. CODE ANN. § 22-3227.03; D.C. CODE ANN. § 21-2401.01 *et seq.*
Georgia	GA. CODE § 30-5-1 *et seq*.; GA. CODE §16-5-100 *et seq*.; GA. CODE § 10-1 850 *et seq*.; GA. CODE § 29-11-1 *et seq.*
Indiana	IND. CODE § 12-10-3-1 *et seq*.; IND. CODE § 35-46-1-12; IND. CODE § 24-5-0.5-0.1 *et seq.*
Kansas	KAN. STAT. ANN. § 39-1401 *et seq.*; KAN. STAT. ANN. § 17-1776; KAN. STAT. ANN. § 59-3050 *et seq.*
Kentucky	KY. REV. STAT. § 41.305; KY. REV. STAT. § 209.005 *et seq.*; KY. REV. STAT. § 387.810 *et seq.*
Louisiana	LA. REV. STAT. ANN. § 15:1501 *et seq*.; LA. REV. STAT. ANN. § 14:67.16; LA. REV. STAT. ANN. § 13:4251.101 *et seq.*
Maryland	MD. CODE ANN., FAM. LAW § 14-101 *et seq.*; MD. CODE ANN., FIN. INST. § 1-306; MD. CODE ANN., CRIM. LAW § 8-801; MD. CODE ANN., COM. LAW § 13-204; MD. CODE ANN., EST. & TRUSTS § 13.5-101 *et seq.*
Massachusetts	MASS. GEN. LAWS. ANN. ch. 19A, § 14 *et seq.*; MASS. GEN. LAWS ANN. ch. 190B, § 5A-101 *et seq.*
Michigan	MICH. COMP. LAWS § 400.581*et seq*.; MICH. COMP. LAWS § 750.174a; MICH. COMP. LAWS § 700.5301 *et seq.*

Mississippi	MISS. CODE ANN. § 43-47-1*et seq.;* MISS. CODE ANN. § 93-14-101 *et seq.*
Missouri	MO. REV. STAT. § 192.2400 *et seq*; MO. REV. STAT. § 565.184 *et seq.*; MO. REV. STAT. § 475.501 *et seq.*
Montana	MONT. CODE ANN. § 52-3-801 *et seq*.; MONT. CODE ANN. § 30-10-306; MONT. CODE ANN. § 45-6-333; MONT. CODE ANN. § 72-5-601 *et seq.*
New Hampshire	N.H. REV. STAT. ANN. § 161-F:43 *et seq*; N.H. REV. STAT. ANN. § 464-C:1 *et seq.*
New Mexico	N.M. STAT. ANN. § 27-7-14 *et seq*.; N.M. STAT. ANN. § 45-5A-101 *et seq.*
Nevada	NEV. REV. STAT. § 200.5091 *et seq.*; NEV. REV. STAT. § 90.611 *et seq.*; Nev. § 200.5093; NEV. REV. STAT. § 159.1991 *et seq.*
North Carolina	N.C. GEN. STAT. §108A-99 *et seq*.; N.C. GEN. STAT. §14-112.2; N.C. GEN. STAT. §35B-1 *et seq*.
North Dakota	N.D. CENT. CODE § 50-25.2-01 *et seq*.; N.D. CENT. CODE § 12.1-31-07.1; N.D. CENT. CODE § 28-35-01 *et seq.*
Ohio	OHIO REV. CODE ANN. § 5101.60 *et seq.*; OHIO REV. CODE ANN. § 2101.26; OHIO REV. CODE ANN. § 2913.02; OHIO REV. STAT. ANN. § 2112.011 *et seq.*
Vermont	VT. STAT. ANN. tit. 33, § 6901 *et seq.*; VT. STAT. ANN. tit. 13, § 1380; VT. STAT. ANN. tit. 14, § 3151 *et seq*.

Washington[82]	WASH. REV. CODE § 74.34.005 *et seq.*; WASH. REV. CODE § 11.90.010 *et seq.*
Idaho	IDAHO CODE § 39-5301 *et seq.*; IDAHO CODE § 18-1505; IDAHO CODE § 15-13-101 *et seq.*
Oklahoma	OKLA. STAT. tit. 43A, § 10-101 *et seq.;* OKLA. STAT. tit. 21, § 843.1 *et seq*.; OKLA. STAT. tit. 30, § 3-301 *et seq.*
New York	N.Y. SOC. SERV. LAW § 473 *et seq*; N.Y. MENTAL HYG. LAW § 83.10 *et seq*.
New Jersey	N.J. REV. STAT. § 52:27D-406 *et seq.;* N.J. REV. STAT. § 3B-12B-1 *et seq*.
Pennsylvania	35 PA. CONST. STAT. § 10225.101 *et seq*; 18 PA. CONS. STAT. § 4120; 20 PA. CONS. STAT. § 5901 *et seq.*
Rhode Island	R.I. GEN. LAWS § 33-19.1-1 *et seq.*; R.I. GEN. LAWS § 42-66-1 *et seq;* R.I. GEN. LAWS § 42-9.2-1 *et seq*.; R.I. GEN. LAWS § 11-41-5; R.I. GEN. LAWS § 33-15.2-101 *et seq.*
South Carolina	S.C. CODE ANN. § 43-35-5 *et seq.*; S.C. CODE ANN. § 62-5-700 *et seq.*

82. Washington provides that when a vulnerable adult has been subjected to financial exploitation either while residing in a facility or in the case of a person residing at home who receives care from a home health, hospice, or home care agency, or an individual provider, shall have a cause of action for damages on account of his or her injuries, pain and suffering, and loss of property sustained thereby. Further, in an action brought under this section, a prevailing plaintiff shall be awarded his or her actual damages, together with the costs of the suit, including a reasonable attorneys' fee. The term "costs" includes, but is not limited to, the reasonable fees for a guardian, guardian ad litem, and experts, if any, that may be necessary to the litigation of a claim brought under this section. WASH. REV. CODE § 74.34.200

Texas	TEX. HUM. RES. CODE ANN. § 48.001 *et seq*.; TEX. PENAL CODE ANN. § 31.03; TEX. EST. CODE ANN. § 1001.001 *et seq.*
Virginia	VA. CODE ANN. § 63.2-1600 *et seq*.; VA. CODE ANN. § 18.2-178.1; VA. CODE ANN. § 64.2-2100 *et seq*.
Wyoming	WYO. STAT. ANN. § 35-20-101 *et seq*.; WYO. STAT. ANN. § 6-2-507; WYO. STAT. § 3-8-101*et seq*.

CONCLUSION

Too many states have failed to provide abused elderly victims with a civil private right of action, as well as heightened remedies to attempt to address the growing epidemic of financial elder abuse and exploitation, as evidenced by Tier 2. In response, the Consumer Financial Protection Bureau ("CFPB") and North American Securities Administration Association ("NASAA") have issued recommend-ations and a model statute, respectively, attempting to address some of the unique challenges specific to financial institutions, as well as the shortcomings in statutory protections for seniors. Specifically, CFPB's key recommendations are a) train management and staff to prevent, detect and respond to suspected exploitation; b) use technology to monitor for signs of elder financial exploitation; c) report all cases of suspected exploitation to relevant federal, state and local authorities; d) file suspicious activity reports (SARS); e) expedite document requests for Adult Protective Services (APS), law enforcement and other government entities; f) comply with the Electronic Fund Transfer Act (EFTA) and Regulation E.[83]

The recommendations are intended to provide specific provisions for legislators addressing financial exploitation in their respective states, including holding financial institutions and their employees to higher standards of conduct and reporting. For added protections, NASAA recommends that Broker-dealers and Investment Advisors use more technology to monitor signs

83. CONSUMER FIN. PROT. BUREAU, RECOMMENDATIONS AND REPORT FOR FINANCIAL INSTITUTIONS ON PREVENTING AND RESPONDING TO ELDER FINANCIAL EXPLOITATION (2016), *at* http://s3.amazonaws.com/files.consumerfinance.gov/f/documents/082016_cfpb_Networks_Study_Report.pdf.

of elder financial exploitation, including but not limited to, suspicious activity reports (SAR's) and digital information sharing with account-holder-approved third parties.[84]

Many states across the country have failed to implement these recommendations and thus have fallen short in protecting one of the most vulnerable sections of our population, the elderly.

84. *Id*.

SENIOR INVESTOR CASES: LEVERAGING THE FINRA REGULATORY FRAMEWORK[1]

Jack Duval[2]

The United States is a rapidly aging society. As our population lives longer, the numbers of those who will suffer from declining mental capacities and dementia will increase. Since most investors are older, if not retired, broker-dealers and their Registered Representatives are on the front line of facing the rising levels of dementia.

Training, vigilance and close supervision are required to address these trends and to protect senior investors and the broker-dealers themselves. Both general FINRA rules and recently-adopted FINRA rules specific to senior investors address the steps that broker dealers must take in handling accounts of senior investors.

Undoubtedly, issues around dementia and diminished mental capacities will appear in securities litigation and arbitration. Indeed, they already are. Even in cases where the claimant's mental acuity is a secondary issue, attorneys need to familiarize themselves with the FINRA rules, and supervisory procedures required, to protect senior investors.

Furthermore, as the population ages, there are likely to be new products and investment schemes offered to seniors. Some of those may be fraudulent or abusive. For instance, over the past few years, some firms have been purchasing pension income streams from retirees. As FINRA highlighted in RN 16-12 Pension Income Stream Products, these transactions are complex and expensive.[3]

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1. This article is adapted from course materials for the New York State Bar Association CLE Program "Securities Arbitration and Mediation 2017: The Courage to Simplify," Apr. 6, 2017. Parts of the paper appeared as blog posts on the Accelerant blog: blog.accelerant.biz/blog.

2. Jack Duval is the managing partner and an expert witness at Accelerant, a securities litigation consulting boutique. For further information see www.accelerant.biz.

3. FINRA, NOTICE TO MEMBERS 16-12: PENSION INCOME STREAM PRODUCTS (Apr. 2016), *available at*: http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-16-12.pdf (last visited June 9, 2017).

By understanding the basics of dementia, FINRA rules, standard industry practices to protect investors, and investments targeted at seniors, litigators will be well equipped to evaluate and prosecute claims.

Background

A recent article in *Nature* entitled "The Dementia Time Bomb" estimated that by 2050 over 130 million people worldwide could be affected by dementia.[4] The article estimated the costs in the U.S. alone to reach $1 trillion in today's dollars.[5]

However, a more immediate financial threat exists from dementia: financial fraud and abuse. Investors 50 years and older hold 77% of all U.S. financial assets.[6] Of course, they are also the most at risk of dementia. This makes them easy targets for financial abuse.

Apparently, the criminally inclined have figured this out. Some statistics summarized by the Securities Industry and Financial Markets Association ("SIFMA") are sobering:

> Senior financial exploitation is a problem that costs senior investors an estimated $2.9 billion annually – funds that many were relying on to support them in retirement. Moreover, with 10,000 Americans turning 65 every day and an estimated 1 in 5 Americans aged 65 or older being victimized by financial fraud, this problem will continue to grow. Complicating these protection efforts is the fact that only an estimated 1 in 44 cases of financial elder abuse is reported and the fact that 55% of financial abuse in the United States is committed by family members, caregivers and friends.[7]

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4. Elie Dolgin, *The Dementia Time Bomb*, NATURE, 156 (Nov. 10, 2016).

5. *Id*.

6. Yuka Hayaski, *FINRA Proposes Steps to Prevent Abuse of Senior Investors*, WALL ST. J. (Oct. 20, 2016), *available at*: http://www.wsj.com/articles/finra-proposes-protections-for-seniors-against-exploitation-1476977937 (last visited Jan. 4, 2017).

7. Lisa Bleier, SIFMA, Comments letter on FINRA Regulatory Notice 15-37, Financial Exploitation of Seniors and Other Vulnerable Adults (Dec. 1, 2015) (notes omitted).

Defining a "Senior Investor"

Most states and regulators define "senior" or "vulnerable" adult as one who is age 60 or 65 and older. I have summarized some state and regulatory definitions in the table below.

Table 1: Age of a "Senior"

Entity	Document	Senior Age	Notes
FINRA	NTM 07-43 - Senior Investors	65	Age referred to but not defined.
FINRA	RN 15-37	65	
SEC	National Senior Investor Initiative	65	
NASAA	Model Legislation	65	
Missouri	Sweep Report Findings	60	Age of "elderly persons".
Washington State	Title 74, Chapter 74.34	60	Age of "vulnerable adult".
Delaware	Title 11, Section 222	62	Age of "elderly person".
Illinois	720 ILCS 5/17-56	60	Age of "elderly person".
Alabama	Title 38, Capter 9E, Section 38-9E-2	60	Age of "elderly person".
Louisiana	Elder Law Task Force 2014 Update	60	
Congress	Senior$afe Act, S.2216	65	Age of "senior citizen".
Senate	The Elder Protection and Abuse Prevention Act, S.3270	60	Age of "elder".

General FINRA Rules Applicable to Senior Investors

Registered Representatives are tasked to "know your customer." FINRA Rule 2090 states:

> Every member shall use reasonable diligence, in regard to the **opening and maintenance** of every account, to know (and retain) the essential facts concerning every customer and concerning the

> authority of each person acting on behalf of such customer. (Emphasis added) [8]

Of particular importance is the phrase "opening and maintenance." This means the duty to know the customer is not a one-time obligation to be met at the beginning of a financial relationship. Instead, it is an ongoing duty that must be maintained throughout the relationship. It is a diligence-based rule, as opposed to FINRA Rule 2111 – Suitability, which is a recommendation-based rule.

In industry parlance, FINRA Rule 2090 imposes a duty upon financial advisors to continually inquire (or "profile") clients to be up to date on any changes in their "essential facts." Not only is this common sense, but it is standard industry practice.

Furthermore, it is a long-standing rule with antecedence in NYSE Rule 405 – Diligence as to Accounts:[9]

> Every member organization is required through a principal executive or a person or persons designated under the provisions of Rule 342(b) (1) to
>
> (1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account **accepted or carried** by such organization and every person holding power of attorney over any account accepted or carried by such organization. (Emphasis added)

Like the "opening and maintenance" language above, the phase "accepted or carried" is critical. It means that the obligation to know the client is ongoing.

New FINRA Rules, the Report and Hold Framework

On February 3, 2017, the SEC approved the proposed change to FINRA Rule 4512 and the adoption of FINRA Rule 2165 that were set forth in FINRA Regulatory Notice 15-37 – Financial Exploitation of Seniors and Other

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8. FINRA, RULE 2090 (2012), *available at*: http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=13389&element_id=9858&highlight=2090#r13389 (last visited Jan. 26, 2017).

9. FINRA, RULE 405 (2010). Rule 405 is no longer in force, having been replaced by FINRA Rule 2111 – Suitability and FINRA Rule 2090 – Know Your Customer. NYSE rules were subsumed into FINRA rules on November 11, 2008. *See* FINRA, NOTICE TO MEMBERS 08-64 (2008), *available at* http://finra.complinet.com/net_file_store/new_rulebooks/f/i/finra_08-64.pdf (last visited Aug. 14, 2017).

Vulnerable Adults.[10] These rule changes are designed to protect senior investors from financial fraud and abuse, and are built on what is known as a "report and hold" framework.

The changes to, and amendment of, the rules will become effective on February 5, 2018. Each of the rules are examined below.

FINRA Rule 4512 – Customer Account Information

The additions to Rule 4512 add a pre-identified trusted contact person for broker-dealers to reach out to in the event of suspicious activity. While contacting the authorities has been and remains an option, this adds another contact to "report" to - the first part of the report and hold framework.

The rule currently requires Registered Representatives to gather information about any person or entity opening an account. Gathering information is part of the profiling process and one of the ways in which the broker-dealer can demonstrate that it knows the client. While new account forms used to be one or two page documents in the 1980s and 90s, under the heightened requirements of The Patriot Act, OFAC, and FinCEN, many new account forms extend to four or five pages.

The new parts of FINRA Rule 4512 – Customer Account Information, state:[11]

> (a)(1)(F) subject to Supplementary Material .06, name of and contact information for a trusted contact person age 18 or older who may be contacted about the customer's account; provided, however, that this requirement shall not apply to an institutional account.
>
> **.06 Trusted Contact Person**
>
> (a) With respect to paragraph (a)(1)(F) of this Rule, **at the time of account opening a member shall disclose in writing, which may be electronic, to the customer that the member or an associated person of the member is authorized to contact the trusted contact person and disclose information about the**

10. Adoption of FINRA Rule 2165, Exchange Act Release No. 34-79964 (Feb. 9, 2017), *available at* https://www.gpo.gov/fdsys/pkg/FR-2017-02-09/pdf/2017-02645.pdf (last visited Feb. 25, 2017).

11. FINRA, RULE 4512 (2011), *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=17537&element_id=9958&highlight=4512#r17537 (last visited Feb. 25, 2017).

> **customer's account to address possible financial exploitation, to confirm the specifics of the customer's current contact information, health status, or the identity of any legal guardian, executor, trustee or holder of a power of attorney, or as otherwise permitted by Rule 2165.** With respect to any account that was opened pursuant to a prior FINRA rule, a member shall provide this disclosure in writing, which may be electronic, when updating the information for the account pursuant to paragraph (b) of this Rule either in the course of the member's routine and customary business or as otherwise required by applicable laws or rules.
>
> (b) **The absence of the name of or contact information for a trusted contact person shall not prevent a member from opening or maintaining an account for a customer, provided that the member makes reasonable efforts to obtain the name of and contact information for a trusted contact person.**
>
> (c) With respect to any account subject to the requirements of SEA Rule 17a-3(a)(17) to periodically update customer records**, a member shall make reasonable efforts to obtain or, if previously obtained, to update where appropriate the name of and contact information for a trusted contact person** consistent with the requirements of SEA Rule 17a-3(a)(17). (Emphasis added)

FINRA Rule 2165 – Financial Exploitation of Specified Adults

This new rule addresses the "hold" part of the report and hold framework. It works in tandem with the amendments to Rule 4512. Rule 2165 states, in part:[12]

> (a)(1) **For purposes of this Rule, the term "Specified Adult" shall mean: (A) a natural person age 65 and older**; or (B) a natural person age 18 and older who the member reasonably believes has a mental or physical impairment that renders the individual unable to protect his or her own interests.
>
> (b)(1) A member may place a temporary hold on a disbursement of funds or securities from the Account of a Specified Adult if:

12. FINRA, RULE 2165 (2018), *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=17538&element_id=12784&highlight=2165#r17538 (last visited Feb. 25, 2017).

> (A) The member reasonably believes that financial exploitation of the Specified Adult has occurred, is occurring, has been attempted, or will be attempted; and
> (b)(2) The temporary hold authorized by this Rule will expire not later than 15 business days after the date that the member first placed the temporary hold on the disbursement of funds or securities, unless otherwise terminated or extended by a state regulator or agency of competent jurisdiction or a court of competent jurisdiction, or extended pursuant to paragraph (b)(3) of this Rule. (Emphasis added)

Together, FINRA Rules 4512 and 2165 will provide a non-authority to report to and a safe harbor for member firms to temporarily hold distributions of cash and/or securities.

Supervision

As with all FINRA rules, each firm must design and implement supervisory policies and procedures that are tailored to their business and reasonably designed to achieve compliance. While the changes to Rule 4512 do not specifically address supervision, Rule 2165 states:[13]

> (c)(1) In addition to the general supervisory and recordkeeping requirements of Rules *3110, 3120, 3130, 3150*, and *Rule 4510* Series, **a member relying on this Rule shall establish and maintain written supervisory procedures reasonably designed to achieve compliance with this Rule**, including, but not limited to, procedures related to the identification, escalation and reporting of matters related to the financial exploitation of Specified Adults.
> (2) **A member's written supervisory procedures also shall identify the title of each person authorized to place, terminate or extend a temporary hold on behalf of the member pursuant to this Rule**. Any such person shall be an associated person of the member who serves in a supervisory, compliance or legal capacity for the member. (Emphasis added)

13. *Id*.

Red Flags

In fulfilling their responsibilities under Rule 2165, supervisors should be vigilant to potential abuses by relatives and others around senior investors, as well as their own Registered Representatives possibly exerting undue influence or other forms of fraud and abuse.

Some obvious red flags include (but are not limited to):

- A change in a long-standing investment strategy, especially one that has adverse tax consequences and/or increased costs;
- Increases in the size and/or frequency of withdrawals, especially those incurring penalties and/or taxes;
- Changes to the titling of accounts and/or other assets;
- Securities and/or cash transfers from an individual to a joint account (or vice versa), especially when there is a second transfer or withdrawal from the receiving account; and,
- Changing communications patterns, such as:
    - A client who used to come into the office changes to only phone calls;
    - A client who used to deal with the Registered Representative by herself changes to always being accompanied by someone else.

Best Practices

There are a number of best practices that broker-dealers can implement to protect senior investors and the firm. Some of them include:

- Getting the trusted contact person involved as early as possible with any signs of dementia or suspected fraud or abuse;
- Escalating early: for Registered Representatives to their supervisors and supervisors to their legal department;
- If the senior investor is always accompanied by someone, get them one-on-one to confirm that their true instructions are being followed;
- Videotaping of meetings with senior investors (and their trusted advisor, if possible) that appear to have, or are confirmed to have diminished capacities;
- Printing the age of clients on trade reviews, exception reports and other supervisory documents;
- Implementing heightened supervision for any clients who have been flagged for possible or actual dementia; and,

- Creating red flag triggers that generate exception reports for suspicious activity in senior investors' accounts.

Conclusion

Both longstanding general FINRA rules and newly-adopted FINRA Rules 2165 and 4512 combine to form a regulatory framework designed to protect senior investors. Claimants counsel should review the facts of their cases to determine whether violations of these rules may bear on liability.

FINRA ARBITRATION CUSTOMER WIN-RATES: *A SURVEY BY JURISDICTION*

Ryan Cook[1]

The Financial Industry Regulatory Authority ("FINRA") publishes statistics about the overall success rate of customer claimants in FINRA arbitration.[2] Setting aside for the moment concerns about how these statistics are generated, some of which will be addressed later in this article, not all jurisdictions are created equal. There are different laws that apply with different standards and statutory remedies, different arbitrator pools, and any number of other intangible differences that can culminate to different results. This survey tracks the results of claims by state, both by tracking how often claimants were successful in recovering anything, as well as tracking how much claimants were recovering compared to their requested damages.

Awards Considered

This survey includes awards returned by FINRA's online repository of arbitration awards, http://www.finra.org/arbitration-and-mediation/arbitration-awards. Any award which was returned with for a search term of "customer" between the dates of January 1, 2014 and December 31, 2016 was included.[3]

These results were further refined by only including claims where a customer is the original claimant (not respondent or counter-claimant). These filters resulted in approximately 1,500 awards for the three years being

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1. Mr. Cook is a member of the Public Investors Arbitration Bar Association (PIABA) and is currently the managing editor of the PIABA Bar Journal. He is also a member of the Texas State Bar Association. David Miller, Esq. aided in the data collection and analysis done for this article.

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

3. The purpose of the search was to reduce the volume of awards that had to be screened to avoid industry only disputes, as there is no specific filter currently available for that purpose. An unintended possible effect of doing so is that some awards with poor resolution could have been excluded from the results, which otherwise would have qualified to be included, as described below.

reviewed where the arbitrators terminated the case by involuntary dismissal, by ruling on the merits, by adopting a stipulated award, or by holding a hearing and making a ruling on an expungement request after a settlement agreement was reached with the claimant(s).[4]

After filtering out the stipulated awards and awards generated solely to rule on an expungement request, there are approximately 1,000 awards over these three years where the arbitration panel made a ruling as to whether or not the customer would recover and, if so, how much. Beyond determining which awards to include, parameters also had to be created to determine how to handle the data that is available. A full list of methodology issues is presented in Table 1 at the end of the article.

The Results

One of the most difficult parts of this process was trying to determine what segments of the data set illustrate the most meaningful results for the practitioner, particularly considering that the more finely filtered the awards considered are, the less data there is to work with. For those reasons, multiple presentations of the survey results are presented below, with the decisions of which is the most practically useful and what inferences should be drawn largely left to the reader.

Claimant's counsel, when evaluating potential arbitrators, would likely exclude several kinds of awards for the most apples to apples comparison for arbitrators who would be most favorable for his or her case:

- cases where the initial damages sought were $50,000 or less (small cases and simplified arbitrations);
- *pro se* claimant cases;
- cases where the claimant was represented by non-attorney counsel; and
- default judgments.

Unfortunately, by filtering out this many types of awards, the total amount of data shrinks down considerably to approximately 450 awards. Setting aside this limitation, this data set shows a nationwide win rate[5] of approximately

4. Many claims do not result in an award ever being generated; no public award is ever generated unless the arbitrators are asked to make a finding to conclude a case.

5. Defining what "winning" a claim means is described in more detail in the methodology section in Table 1. In short, it was defined to mean that the claimant

42%, an average award size of approximately 65%,[6] and an average recovery[7] of 27%. States with at least five awards meeting these criteria (ranked from highest to lowest average recovery) are as follows:[8]

State	# of Awards	Win Rate (A)	Avg. Award Size (B)	Avg. Recovery (A x B)
PR	19	68%	86%	59%
GA	12	50%	92%	46%
OH	5	100%	43%	43%
MA	8	38%	115%	43%
CO	11	45%	87%	39%
AZ	6	50%	79%	39%
VA	6	33%	117%	39%
NC	7	86%	43%	37%
MO	15	47%	76%	35%
CA	66	44%	79%	35%
TX	21	33%	100%	33%
NJ	15	60%	55%	33%
PA	23	30%	91%	28%
FL	41	51%	47%	24%
MI	20	45%	41%	18%
D.C.	6	50%	34%	17%

was awarded some amount of compensatory damages, not including an award solely of costs, sanctions, or similar, non-compensatory money.

6. The factors included in calculating the percentage of a recovery size for an award is described in more detail in the methodology section in Table 1. In short, it is calculated to include all sums of money awarded to the claimant, regardless of how it was described, divided by the most recent amount requested for ***compensatory damages only***. The denominator ***does not include*** any requested money for attorney's fees, punitive damages, costs, etc.

7. Average recovery is calculated by multiplying the win rate (A) by the average award size (B). The product of these two numbers is used to roughly approximate the value of a case in cents on the dollar of compensatory damages, as of the time of filing.

8. A table including all states is included as Table 2 at the end of the article.

IN	8	38%	45%	17%
NY	64	31%	49%	15%
IL	25	28%	54%	15%
WA	9	22%	47%	10%
AL	6	17%	60%	10%
MN	7	14%	27%	4%

Obviously, many of these cases are concentrated in a handful of states, with roughly half the awards for the entire country (including those not listed here with less than five awards per state) coming out of just five states: California, Pennsylvania, Florida, New York, and Illinois. This means that there are many states with a limited number of awards which are far more susceptible to having their average award size influenced by outlier data points. Alternatively, one can look at the entire data set for these same states, including cases regardless of size, whether they were defaults, whether they were *pro se*, etc. This changes the nationwide statistics to a win rate of 36%, an average award size of 78%, and an average recovery rate of 29%. This changes the results of the same states given above as follows:[9]

State	# of Awards	Win Rate (A)	Avg. Award Size (B)	Avg. Recovery (A x B)
PR	22	59%	86%	51%
PA	55	33%	151%	50%
GA	20	50%	89%	45%
AZ	20	35%	118%	41%
OH	26	50%	79%	40%
TX	44	36%	91%	33%
CA	131	38%	81%	31%
MO	21	43%	66%	28%
D.C.	12	42%	67%	28%
IN	14	36%	76%	27%
CO	21	29%	94%	27%
NJ	40	45%	59%	26%

9. A table including all states is included as Table 5 at the end of the article. A data set showing awards state by state, but excluding claims under $50,000 is included as Table 3. Another table excluding only *pro se* claims is included as Table 4.

FL	95	42%	60%	25%
MI	35	43%	58%	25%
NC	17	47%	50%	24%
NY	140	31%	71%	22%
IL	49	27%	84%	22%
MA	22	27%	81%	22%
VA	19	21%	88%	18%
MN	20	25%	69%	17%
AL	14	29%	60%	17%
WA	21	19%	54%	10%

Many of the statistics for these states stay fairly close. Texas, for instance, is almost identical in both data sets. Others change a great deal. Virginia's average recovery, for instance, is cut in half, falling from 39% to 18%.

Nationwide Statistics

Aside from venue considerations, the data provides some insight into FINRA arbitrations nationwide. The nationwide data, including calculations of several different subsets of the data, is as follows:

All Awards	
Overall Win Rate	36.46%
Average Amount Won	78.39%
Average Recovery	28.58%

Excluding Default Awards	
Overall Win Rate	32.83%
Average Amount Won	75.56%
Average Recovery	24.81%

Excluding Pro Se	
Overall Win Rate	40.62%
Average Amount Won	70.48%
Average Recovery	28.63%

Pro Se Only	
Overall Win Rate	30.88%
Average Amount Won	97.31%
Average Recovery	30.05%

Pro Se Excluding Defaults	
Overall Win Rate	17.56%
Average Amount Won	99.91%
Average Recovery	17.55%

Excluding Pro Se & <$50k	
Overall Win Rate	42%
Average Amount Won	65%
Average Recovery	27%

Nationwide, customer claimants won their claim 36.5% of the time, and were awarded 73% of their compensatory damages, between 2014-16. Excluding default awards, the results fall to a win rate of 32.8% and an average award of 70.9% of compensatory damages. Excluding both default awards and *pro se* claimants, the win rates go up to 40.6% with an average award of 65.4%.

Looking at only the *pro se* claimants, they won 30.9% of the time with an average award of 90.9% of the claimed damages. Excluding claims where the respondent(s) defaulted, the win rate falls to 17.6%, but the amount awarded actually increases to an average 97.9% of the claimed compensatory damages.

Similarly, the data allows a glimpse into the different results claimants see based upon the size of the claim:

$1,000,000+ Cases	
Overall Win Rate	45.71%
Average Amount Won	45.62%
Average Recovery	20.85%

$100,000-$999,999 Cases	
Overall Win Rate	40.73%
Average Amount Won	73.56%
Average Recovery	29.96%

<$100,000 Cases	
Overall Win Rate	29.73%
Average Amount Won	97.32%
Average Recovery	28.93%

So, in large, seven-figure cases, claimants actually have the highest chances of getting an award in their favor, while at the same time having the lowest average recovery due to the average size of the awards.[10] Mid-sized cases, between $100,000 and $1 million, and small cases, below $100,000, have almost identical average recoveries, but they come in different forms. Customers have a high chance to recover in the medium sized cases, but have the highest average recovery when they do get a favorable award in the smallest cases.

Practitioners know that respondents in FINRA arbitration often request an award of attorneys' fees, costs, or other remuneration from claimants, if not outright filing a counterclaim under some theory of liability. The data provides an opportunity to evaluate how serious of a threat these tactics really are.

Claimants Ordered to Pay Respondents	# of Awards	Average Amt.	% of Awards
All Awards	17	$ (124,290.08)	1.71%
Pro Se Only	7	$ (38,272.70)	2.06%
Represented Only	7	$ (211,412.81)	1.14%
Non-Attorney Counsel Only	3	$ (121,710.90)	7.14%

The data shows that respondents were successful in getting an award requiring the claimant(s) to pay ***them*** some amount in less than 2% of the cases

10. Note that 12 of 140 cases in the data pool for $1M+ cases are Puerto Rico bond cases, which will affect the outcome to some degree. Many, if not all, of those cases involve a request for damages for transactional losses, which in many instances is a number considerably larger than a net-out-of-pocket ("NOP") calculation.

decided.[11] If you only look at cases where the claimants were represented by counsel that number falls to less than 1.15% of the cases. Claimants who were represented by a third party, including companies like Cold Springs Advisory, were over six times more likely to be ordered to pay the respondent(s) than those represented by an attorney.

Discrepancies with FINRA's Reported Statistics

FINRA also publishes various nationwide statistics regarding its arbitration forum. Several discrepancies exist between those reported statistics and the nationwide statistics given above. First, FINRA reports approximately 1,300 customer cases were decided during the same period as was analyzed for this article.[12] This is a difference of approximately 300 cases.[13] There are at least three possible sources for this discrepancy. First, there may be a limitation with the search function for FINRA's arbitration portal. As noted above, the cases included in this survey were limited to those awards returned by FINRA's arbitration award system with a search for the keyword "customer" within the given date range. So, it is possible some cases FINRA counted in its statistics were not returned with that search. Second, this survey only includes claims where the customer claimant initiated the case. FINRA may be including in its statistics claims where an associated person or FINRA member initiated a claim, but where the customer filed a counter-claim. Third, FINRA may be counting stipulated awards in the data set, which are counted as settlements for this article and therefore excluded from the data pool.

Similarly, FINRA reports a different average win rate for customer claimants for this time period.[14] FINRA reports a win-rate of 41%, 42%, and 38%, respectively, for 2016, 2015, and 2014. The simple average of those

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11. To look at it another way, in approximately 3.2% of cases where the panel found against the claimant in a case initiated by the claimant, the panel also ordered to claimant pay out of pocket to a respondent some amount.

12. *See* FINRA, DISPUTE RESOLUTION STATISTICS, *available at* https://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics.

13. As noted above, the research for this article found approximately 1,000 customer cases which ended in an award decision on the merits, out of approximately 1,500 customer claim awards generated during this period of time. The remaining roughly 500 awards generated only addressed expungement requests or were stipulated awards.

14. *Id.*

win-rates is 40.3%.[15] As noted above, this survey found the average win-rate during this time period, including all customer awards, to be approximately 36%. There are two likely sources of this discrepancy. First, the difference in data points described above. FINRA's average includes cases which this survey did not. Second, FINRA may be including as a "win" claims where a customer is awarded nothing for compensatory damages, but where the respondent(s) are ordered to pay the claimant some other type of compensation, including costs, sanctions, etc. This survey counts those types of awards as losses.

Major Research Limitations

In addition to the issues already mentioned, there are a number of limitations to the data available to draw from that should be highlighted. First and foremost is the data source itself: FINRA arbitration awards. Although determining a winner and a loser from the awards is fairly straightforward, trying to determine how "good" a win was is tricky, at best. These awards commonly include vague statements about what the requested damages were, if, in fact, they include that information at all. Even if the claimant provided a clear and specific request for damages at hearing, as presumably almost every claimant does, very few awards actually include a note as to what that updated damage request was. For that reason, many of the statistics given above are reliant upon a claimant's initial damages request, which is by no means the most desirable data to use. However, in the absence of better *publically available* data, this survey uses what is available.

Another issue is simply the limited number of awards that exist. While 1,000 awards is certainly not a small number, due to the concentration of most of those awards coming out of a handful of states, it is very difficult to draw meaningful conclusions for states that generate fewer awards. Even looking at the full data set, there are approximately 25 states, or almost half the country (since D.C. and Puerto Rico are included separately) that have less than 10 awards generated over those three years. A possible solution could have been expanded to include more years. However, the longer the time period surveyed, they greater amount of change there would be within that time period of the arbitrator pool, both with new arbitrators joining and older arbitrators leaving the pool. So, this creates its own problems with the

15. The weighted average is 40.1%.

potential usefulness of the data. For that reason (along with the additional time cost of analyzing more years), only three years were surveyed here.

Another challenge is that many cases may include out-of-district arbitrators. Practitioners are certainly familiar that FINRA often includes arbitrators from a state other than the selected venue to be put into a panel ranking, and potentially hear and decide a case. This issue was not included in this survey for two reasons: 1) awards themselves do not indicate where the arbitrators are from, and the burden to track down each of the hundreds or thousands of arbitrators is practically prohibitive; and 2) there is nothing a practitioner can do about it anyway. Sometimes claimant's counsel may have a choice to make about what state to choose for a hearing venue; claimant's counsel never gets a similar choice for what states' arbitrators FINRA will include in the ranking pool. So, from a practical standpoint, this issue can't affect the decision counsel is presented with, so attempting to track the data, while interesting, is unlikely to be practically useful.

Other Notes When Considering Data Results

A few major common issues which have a disproportionate effect on the results should also be noted. First, the results for Puerto Rico as a venue are likely inflated for this time period. Almost every, if not every, claim analyzed related to the collapse of Puerto Rico bonds in 2015. These specific product claims are stronger on average than most other claims. As a result, the desirability of Puerto Rico as a venue for other types of claims is likely not as high as is shown here.

Second, *pro se* cases carry somewhat inflated results for average award sizes. As described in more detail in Table 1, the award amount used includes every type of compensation, including any requirement by the panel that the respondent(s) reimburse a claimant for all or part of the FINRA filing fee. In *pro se* cases during this time period, it appears that in most cases, arbitrators included in any favorable award a taxing of all or some of the filing fee cost against the respondent. In a dispute of about $1,000, being awarded an additional $300-$600 is a very large percent increase for the award. The combination of these two factors makes the average award size for small *pro se* cases appear more favorable than it really is.

Conclusion

Despite limitations in both quality and quantity of data available, there appear to be meaningful differences in the strength of customer cases in FINRA arbitration based upon the venue the claim is filed in. It is up to the practitioner to determine how much weight to give these statistics, given the limitations described, as well as what specific conclusions should be drawn from the results.

TABLE 1
Methodology Notes

This table includes a list of the data that was tracked, as well as any decisions, which had to be made from a methodology standpoint to determine how to treat or calculate certain data.

1. Case number.
2. State hearing location.
    a. Awards indicating there was a change of venue after the sitting of a panel are tracked in the original state.
3. Is the claimant *pro se*?
    a. *Pro se* is limited to mean the customer representing himself or herself, primarily relying upon whether the award described the claimant as *pro se.*
    b. The determination of *pro se* is as of the date the case was disposed of, however the case was disposed. For example, Claimants that filed *pro se*, but retained counsel prior to hearing, are not counted as *pro se*. Claimants that filed with counsel, but who went to hearing without counsel, are counted as *pro se*.
    c. *Pro se* also does not include people who had counsel, even where that counsel is not an attorney. Those statistics were tracked separately (see below).
    d. Claimants represented by law school clinics are not counted as *pro se*.
4. Did the claimant have non-attorney counsel?
    a. In light of the numerous awards with "counsel" like Stock Market Recovery Consultants, Cold Spring Advisory, etc., these cases were tracked separately.
    b. Law school clinics are not counted as "non-attorney" counsel, as the clinic directors are licensed attorneys.

5. What damages did the claimant request?
    a. The latest damage request made by the claimant is used. Damages requested at hearing were used over amended claim damages, which were used over original claim damages, wherever possible.
    b. Awards that do not specify any damage request amount are tracked only for win/loss purposes, but excluded for average award size.
    c. The number used includes ***only*** the compensatory damages. Requests for attorney's fees, interest, costs, punitive damages, or damage multipliers ***are not included***.
    d. Damage requests given in a range are included as an average of the highest number and lowest number requested. This is true even in instances where three or more alternative damage measures were identified in the award.
    e. Damage requests given as "in excess of" a particular number are included as the number stated.
6. Was the case dismissed pre-hearing?
    a. A case is only tracked as dismissed if the totality of the claim was dismissed pre-hearing against the wishes of the claimant.
        i. Claims that were withdrawn are not counted as dismissed.
        ii. Claims where only a portion of the damages/claims were dismissed are not counted as dismissed.
        iii. Claims where only a portion of the respondents were dismissed are not counted as dismissed.
    b. No distinction is made between dismissal with prejudice or without prejudice to refile (such as dismissal pursuant to FINRA Rule 12200).
7. If a hearing occurred, did a respondent appear and defend it?
    a. A case is tracked as a default if:
        i. No respondent ever appeared to defend, including simplified arbitrations where no written response was submitted by the respondent(s); or
        ii. One or more respondent(s) defended the claim, but the arbitration panel only issued an award against the respondent(s) who did <u>not</u> defend.
            1. For example, a claim with three respondents where two failed to defend but one did defend, and the panel issued an award against all three respondents, is not listed as a default.

2. In the same case, but where the award is issued only against the two that failed to appear, it is listed as a default.

8. How much was the customer awarded?
    a. This number includes every amount awarded ***regardless of how denominated***. The purpose is to be able to compare how much of the customers' losses they recovered, however the panel may have titled the various dollar amounts. As a result, there are many awards where the statistics show an award greater than 100%. This does **not** indicate the customers got more than they asked for; it simply means they recovered more than they lost through some combination of an award of compensatory damages, punitive damages, attorneys' fees, interest, costs, or some other amounts. While this may create the appearance claimants recovered closer to what the law says they are entitled to than they actually did, it is the author's belief it is still a more reliable data set than including requests for punitive damages and other non-compensatory damages that are, in many cases, frankly unreasonable.
    b. Damage amounts do not include any amount for awards of attorneys' fees that are required to be determined in amount by a court or post-award interest. In both cases, the awards do not include a determined amount, so for the purposes of this survey, those amounts are treated as zero.
    c. The average calculated in the results is a simple average of the percent award for each award in the data set.
    d. Some states are carried as "N/A" for average award size, even where there were "winning" awards for the state. That indicates that there were awards in that state where the customer won, but that none of the winning awards included data for how much in damages were requested by the claimant(s), so no comparison could be drawn.
9. Did the claimant "win?"
    a. Any award ordering one or more respondent to pay the claimant any amount of compensatory damages (net of any money the claimant is ordered to pay the respondent(s), if any) is considered a win. Otherwise, it is a loss.
    b. Awards where the panel gave the claimant nothing in compensatory damages, but awarded the claimant some amount in reimbursed costs, sanctions, or some other form of procedural recovery are considered a loss.

TABLE 2

Arbitration Decisions by State: Excluding Cases <$50,000 in Damages, *pro se* claimants, Default Judgments, and Non-Attorney Counsel

State	# of Awards	Win Rate (A)	Avg. Award Size (B)	Avg. Recovery (Ax B)
AL	6	17%	60%	10%
AR	0	n/a	n/a	n/a
AZ	6	50%	79%	39%
CA	66	44%	79%	35%
CO	11	45%	87%	39%
CT	5	0%	0%	0%
D.C.	6	50%	34%	17%
DE	0	n/a	n/a	n/a
FL	41	51%	47%	24%
GA	12	50%	92%	46%
HI	0	n/a	n/a	n/a
IA	1	100%	26%	26%
ID	0	n/a	n/a	n/a
IL	25	28%	54%	15%
IN	8	38%	45%	17%
KS	1	0%	0%	0%
KY	3	67%	113%	75%
LA	4	50%	104%	52%
MA	8	38%	115%	43%
MD	5	60%	48%	29%
ME	0	n/a	n/a	n/a
MI	20	45%	41%	18%
MN	7	14%	27%	4%
MO	15	47%	76%	35%
MS	2	50%	32%	16%
MT	0	n/a	n/a	n/a
NC	7	86%	43%	37%
NE	0	n/a	n/a	n/a

NH	1	100%	n/a	n/a
NJ	15	60%	55%	33%
NM	2	100%	4%	4%
NV	5	40%	43%	17%
NY	64	31%	49%	15%
OH	5	100%	43%	43%
OK	2	100%	29%	29%
OR	1	100%	45%	45%
PA	23	30%	91%	28%
PR	19	68%	86%	59%
RI	3	33%	57%	19%
SC	4	25%	n/a	n/a
SD	0	n/a	n/a	n/a
TN	0	n/a	n/a	n/a
TX	21	33%	100%	33%
UT	3	33%	4%	1%
VA	6	33%	117%	39%
VT	0	n/a	n/a	n/a
WA	9	22%	47%	10%
WI	4	0%	0%	0%
WV	1	0%	0%	0%

TABLE 3

Arbitration Decisions by State: Excluding Claims < $50,000

State	# of Awards	Win Rate (A)	Avg. Award Size (B)	Avg. Recovery (A x B)
AL	8	25%	48%	12%
AR	1	0%	0%	0%
AZ	9	50%	83%	41%
CA	83	41%	78%	32%
CO	12	42%	87%	36%
CT	8	13%	98%	12%

D.C.	10	50%	67%	33%
DE	0	n/a	n/a	N/a
FL	49	49%	51%	25%
GA	15	47%	101%	47%
HI	0	n/a	n/a	N/a
IA	3	100%	76%	76%
ID	0	n/a	n/a	N/a
IL	28	25%	54%	14%
IN	8	38%	45%	17%
KS	1	0%	0%	0%
KY	4	50%	113%	56%
LA	4	50%	104%	52%
MA	12	33%	108%	36%
MD	7	57%	57%	32%
ME	1	0%	0%	0%
MI	21	48%	42%	20%
MN	9	33%	69%	23%
MO	15	47%	76%	35%
MS	3	33%	32%	11%
MT	0	n/a	n/a	N/a
NC	7	86%	43%	37%
NE	1	100%	52%	52%
NH	2	50%	n/a	N/a
NJ	18	61%	48%	30%
NM	4	100%	101%	101%
NV	7	29%	43%	12%
NY	83	33%	56%	18%
OH	8	63%	43%	27%
OK	2	100%	29%	29%
OR	4	25%	45%	11%
PA	35	34%	84%	29%
PR	21	62%	86%	53%
RI	3	33%	57%	19%

SC	4	25%	n/a	N/a
SD	0	n/a	n/a	N/a
TN	1	100%	n/a	N/a
TX	30	43%	89%	39%
UT	3	33%	4%	1%
VA	11	36%	88%	32%
VT	1	0%	0%	0%
WA	12	33%	54%	18%
WI	8	38%	137%	51%
WV	2	0%	0%	0%

TABLE 4

Arbitration Decisions by State: Excluding *pro se* claimants

State	# of Awards	Win Rate (A)	Avg. Award Size (B)	Avg. Recovery (A x B)
AL	10	30%	70%	21%
AR	0	N/a	N/a	N/a
AZ	14	29%	48%	14%
CA	88	45%	84%	38%
CO	15	40%	94%	38%
CT	7	2%	100%	2%
D.C.	11	45%	67%	30%
DE	2	0%	0%	0%
FL	68	51%	58%	30%
GA	17	53%	90%	48%
HI	2	50%	103%	51%
IA	5	100%	79%	79%
ID	0	N/a	N/a	N/a
IL	38	34%	84%	29%
IN	10	40%	68%	27%
KS	1	0%	0%	0%
KY	5	40%	113%	45%

LA	5	40%	104%	42%
MA	12	33%	108%	36%
MD	8	63%	59%	37%
ME	1	100%	9%	9%
MI	28	50%	54%	27%
MN	16	31%	69%	22%
MO	17	41%	76%	31%
MS	4	50%	63%	32%
MT	0	n/a	N/a	N/a
NC	13	62%	50%	31%
NE	3	100%	84%	84%
NH	3	33%	N/a	N/a
NJ	26	42%	55%	23%
NM	7	57%	101%	58%
NV	5	40%	71%	28%
NY	104	34%	67%	22%
OH	15	73%	75%	55%
OK	2	100%	29%	29%
OR	1	100%	45%	45%
PA	36	39%	87%	34%
PR	19	68%	86%	59%
RI	3	33%	57%	19%
SC	5	40%	41%	16%
SD	1	0%	0%	0%
TN	1	100%	N/a	N/a
TX	35	40%	100%	40%
UT	4	50%	52%	26%
VA	13	23%	84%	19%
VT	0	N/a	N/a	N/a
WA	14	29%	54%	15%
WI	11	45%	99%	45%
WV	1	0%	0%	0%

TABLE 5

Arbitration Decisions by State: Including all Data

State	# of Awards	Win Rate (A)	Avg. Award Size (B)	Avg. Recovery (A x B)
AL	14	29%	60%	17%
AR	1	0%	N/A	N/A
AZ	20	35%	118%	41%
CA	131	38%	81%	31%
CO	21	29%	94%	27%
CT	13	23%	102%	23%
D.C.	12	42%	67%	28%
DE	3	0%	N/A	N/A
FL	95	42%	60%	25%
GA	20	50%	89%	45%
HI	5	20%	103%	21%
IA	5	100%	79%	79%
ID	2	0%	N/A	N/A
IL	49	27%	84%	22%
IN	14	36%	76%	27%
KS	2	50%	107%	53%
KY	7	29%	113%	32%
LA	5	40%	104%	42%
MA	22	27%	81%	22%
MD	10	50%	59%	29%
ME	7	29%	56%	16%
MI	35	43%	58%	25%
MN	20	25%	69%	17%
MO	21	43%	66%	28%
MS	6	33%	63%	21%
MT	1	0%	N/A	N/A
NC	17	47%	50%	24%
NE	3	100%	84%	84%

NH	4	25%	N/A	N/A
NJ	40	45%	59%	26%
NM	7	57%	101%	58%
NV	8	25%	43%	11%
NY	140	31%	71%	22%
OH	26	50%	79%	40%
OK	2	100%	29%	29%
OR	7	29%	61%	17%
PA	55	33%	151%	50%
PR	22	59%	86%	51%
RI	5	20%	57%	11%
SC	6	50%	70%	35%
SD	3	0%	N/A	N/A
TN	3	33%	N/A	N/A
TX	44	36%	91%	33%
UT	5	40%	52%	21%
VA	19	21%	88%	18%
VT	1	0%	N/A	N/A
WA	21	19%	54%	10%
WI	12	42%	99%	41%
WV	2	0%	N/A	N/A

THE DEVELOPMENT OF REAL ESTATE CROWDFUNDING: WILL IT SURPASS TRADITIONAL REAL ESTATE FINANCING?

*Arooj Z. Nazir**

Jelliene Helman, the 27-year-old CEO and Co-Founder of Realty Mogul, took the right step at the right time: after paying attention to the political arena and the SEC's growing interest in crowdfunding, she launched an online platform in March of 2013 allowing accredited investors to collectively invest in the real estate project of their interest and receive an equity interest in that project.[1] Realty Mogul is now ringing in its second anniversary with investments of $470 million in commercial real estate properties.[2]

Traditionally, real estate investors have used real estate investment trusts (REIT) to purchase commercial and residential properties.[3] Helman's brilliant idea stemmed from the passage of the Jumpstart Our Business Startups Act ("JOBS Act") by Congress on March 27, 2012, as well as the subsequent signing of the JOBS Act by President Barack Obama on April 05, 2012.[4] The JOBS Act aims to encourage non-traditional investing by improving the public's access to emerging growth companies and also attempts to decrease regulatory hurdles for investors and companies seeking investment.[5] The JOBS Act has changed the scope of the investment arena through its crowdfunding exemption under Title III, which allows issuers to raise up to $1

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1. Geri Stengel, *Real Estate Investing Is No Longer A Private Club*, FORBES (Apr. 2, 2014), http://www.forbes.com/sites/geristengel/2014/04/02/real-estate-investing-is-no-longer-a-private-club/.

2. REALTY MOGUL, https://www.realtymogul.com/ (last visited Apr. 5, 2015).

3. Andrew R. Berman, *Once a Mortgage, Always a Mortgage – The Use (and Misuse of) Mezzanine Loans and Preferred Equity Investments*, 11 STAN. J.L. BUS. & FIN. 76, 76 (2005) (discussing the mortgage market and its growth over the years).

4. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

5. *Id.*

million in a 12-month period through crowdfunding offers with the use of a funding portal.[6]

Section 5 of the Securities Act of 1933 ("33 Act") prohibits the offering and selling of securities in interstate commerce unless the securities are registered with the SEC[7] or meet an exemption.[8] Title III of the JOBS Act sets forth a crowdfunding exemption, allowing investors to participate in the potential profits of a crowdfunded project by issuing stock or limited partnership interest in the project, or by loaning money to the project at interest[9] Crowdfunding is a method for raising capital by obtaining small amounts of money from a large group of people, generally over the internet.[10]

The crowdfunding exemption allows developers and project managers to raise up to $1 million in a 12-month period through crowdfunding offerings controlled by an intermediary, such as a funding portal.[11] Currently, crowdfunding firms are allowed to market their products only to accredited investors based on limitations placed by the SEC.[12] Realty Mogul, discussed above, is a crowdfunding firm that offers crowdfunding opportunities only to accredited investors. Accredited investors are, among other things, those people with a net worth of $1 million or more (excluding personal residence) or an annual income of at least $200,000 for a single person and $300,000 for a married couple filing jointly.[13] At the time this article was written, the SEC had not promulgated rules regarding the ability of unaccredited investors to

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6. C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 29 (2012).

7. Securities Act of 1933 § 5, 15 U.S.C. § 77e(a) (2010).

8. *Id.*

9. *See supra* note 1.

10. Alysha Schertz, *Crowd funding helps businesses raise capital*, BIZTIMES.COM (Apr. 2, 2010), http://www.biztimes.com/apps/pbcs.dll/article?AID=/20100402/MAGAZINE03/304169970/0/MAGAZINE02/Crowd-funding-helps-businesses-raise-capital/&template=printart.

11. Securities Act §4(6), 15 U.S.C. § 77d(a)(6) (2014).

12. 17 C.F.R. §230.501(a)(5) and (6) (defining "accredited investor" as "any natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000" and "[A]ny natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year").

13. *Id.*

participate in equity crowdfunding. Certain states, however, allow unaccredited investors to participate in real estate crowdfunding.[14] States that allow unaccredited investors to participate in real estate crowdfunding generally use the intrastate offering exemption discussed below in further detail.

Crowdsourcing, and the History and Development of Traditional and Equity Crowdfunding

Prior to the passage of the JOBS Act[15], investors were barred from participating in equity crowdfunded offerings. The JOBS Act, whose stated purpose is to "increase American job creation and the economic growth by improving access to the public capital markets for emerging growth companies" has made it easier for the everyday person to be a partial owner of large crowdfunded investments.[16] Title III of the JOBS Act allows developers to raise capital for their projects through crowdfunding.

A. History of Traditional Crowdfunding

Crowdfunding came about as a byproduct of crowdsourcing, which is defined as "the practice of obtaining needed services, ideas, or content by soliciting contributions from a large group of people and especially from the

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14. *See* Deborah Gage, *Groundfloor Raises $1M, Moves to Georgia to Crowdfund Real Estate*, THE WALL ST. J. (Aug. 19, 2014, 7:14 PM), http://blogs.wsj.com/venturecapital/2014/08/19/groundfloor-raises-1m-moves-to-georgia-to-crowdfund-real-estate/ (discussing the ability of unaccredited investors to participate in real estate crowdfunding in Georgia). Other states that allow unaccredited investors to invest in equity based offerings include Alabama, Colorado, Georgia, Idaho, Indiana, Kansas, Maine, Maryland, Massachusetts, Michigan, Oregon, Tennessee, Texas, Washington, and Wisconsin. WHERE NON ACCREDITED INVESTORS CAN INVEST NOW, https://fundwisdom.com/crowdfunding-investors/types/retail-unaccredited-non-accredited (last visited Apr. 5, 2015).

15. JOBS Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

16. Nickolas C. Jensen, *Fundraising on The Internet: Crowdfunding, Kickstarter and the JOBS Act*, 49 AZ ATTORNEY 22, 22 (2013) (introducing crowdfunding, its development and effects on securities-based investments) (quoting P.L. 112-106, 126 Stat. 306, 306 (2012)).

online community rather than from traditional employees or suppliers."[17] Generally, crowdsourcing involves a large group of people attempting to accomplish a goal and receiving a small token in return. Over the last decade, crowdsourcing has evolved into an online phenomenon, with websites like Wikipedia and Facebook rising to the challenge. Crowdsourcing starts with a call broadcast over the internet, where the crowdsourcer describes the problem.[18] An online crowd then gives input to the crowdsourcer, who collects the best solutions and decides how to implement it.[19]

In the United States, the earliest example of crowdsourcing was seen in 2003, when Brian Camelio, a musician and programmer from Boston, launched ArtistShare.[20] Through Camelio's website, musicians could ask for donations from their fans to produce digital recordings.[21] Maria Schneider, a jazz musician, used ArtistShare's platform to offer a tiered system of rewards to help produce her jazz album "Concert in a Garden."[22] Fans received gifts ranging from a booklet to the honor of being listed as an executive producer in exchange for their donation.[23] Schneider managed to raise about $130,000 via her ArtistShare campaign.[24] Websites like ArtistShare started the first wave of rewards-based crowdfunding, which took many paths that skirted on the edge of legality under federal security laws.

Where crowdsourcing allows a group of people to help someone with a project, crowdfunding involves the issuer asking a crowd to invest a small amount of money in their project. In 2006, entrepreneur Michael Sullivan coined the term "crowdfunding," which he used to explain his brainchild

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17. Merriam-Webster Online Dictionary ("crowdsourcing"), available at http://www.merriam-webster.com/dictionary/crowdsourcing (last visited Jan. 24, 2015).

18. Erin R. Frankone, *Free Agents: Should Crowdsourcing Lead to Agency Liability for Firms?*, 15 VAND. J. ENT. & TECH. L. 883, 886-87 (2013).

19. *Id.*

20. David M. Freedman and Matthew R. Nutting, *A Brief History of Crowdfunding Including Rewards, Donation, Debt and Equity Platforms in the USA*, FREEDMAN CHI. (Jan. 19, 2015), http://www.freedman-chicago.com/ec4i/History-of-Crowdfunding.pdf.

21. *Id.*

22. *Id.*

23. *Id.*

24. *Id.*

named fundvlog, which aimed to create an incubator for video blogs.[25] Generally, there are five models for internet crowdfunding: (1) donation-based crowdfunding, (2) reward-based crowdfunding, (3) pre-purchase based crowdfunding, (5) peer-to-peer lending, and (5) equity-based crowdfunding.[26] Because most of the crowdfunding activities are conducted on the internet, and therefore could be conducted on foreign portals, an analysis must be done on whether crowdfunded offerings are subject to United States federal securities laws. Generally, the majority of the models of crowdfunding is exempt from federal securities law because of its inherent characteristics and is therefore exempt from registration.

The donation-based model allows crowdfunders to invest in a project without receiving anything in return.[27] Generally, if the crowdfunding project requests "donations without any express or implied possibility of a return to the donor, there is no offering of securities, and thus, the securities laws are not implicated."[28] If the project is purely donation-based, the receiver of funds is not required to have a business purpose behind his or her request for monetary contributions.[29] This type of crowdfunding is rare because of the lack of return for investors and is therefore used typically by non-profit organizations and charities.[30] GlobalGiving uses donation-based crowd-funding by connecting donors with grassroots projects around the world, allowing them to contribute to development projects all over the world.[31]

The reward-based model, as seen above in the ArtistShare campaign, allows crowdfunders to receive a tangible benefit in exchange for their

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25. Mark Koba, *You Hear Lots About Crowdfunding, But What Is It?*, CNBC (Oct. 23, 2013), http://www.cnbc.com/id/101136608.

26. John S. (Jack) Wroldsen, *The Social Network and the Crowdfund Act: Zuckerburg, Saverin, and Venture Capitalists' Dilution of the Crowd*, 15 VAND. J. ENT. & TECH. L. 583, 588 (2013).

27. *Id.*

28. Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws – Why the Specially Tailored Exemption Must Be Condition on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1739 (2012).

29. Bradford, *supra* note 6, at 15 (quoting Frequently Asked Question: Kickstarter Basics, Kickstarter. https://www.kickstarter.com/help/faq/kickstarter%20basics (last visited Feb. 2, 2015)).

30. *See* Wroldsen, *supra* note 26, at 588.

31. Bradford, *supra* note 6, at 15.

donation.[32] However, the "reward" cannot be an "interest, dividends, or part of the earnings of the business[33]" or else it runs the risk of being classified as a security, in which case registration with the SEC might be required. Generally, the reward takes the form of a thank you card, t-shirt, key chain, the investor's name on the credits of the movie, or any other memento symbolizing the completion of the project.[34] For example, Facebook recently purchased Oculus Rift, which was formed by a $2 million donation campaign on Kickstarter.[35] Because Oculus Rift was formed via the reward-based model, backers of the project did not receive anything in return when Facebook purchased it because they did not qualify as actual investors and shareholders.[36] Instead, they were "simply product owners and supporters", raising a question of how reward-based crowdfunding could be replaced by equity-based crowdfunding.[37] One of the largest rewards-based crowdfunding campaigns involved 62,642 backers pledging $13 million to finance Coolest Cooler[38], which is a portable cooler that allows users to blend drinks and play music.[39]

The pre-purchase model, the most common type of crowdfunding, limits the crowdfunders' rewards to items produced as a result of the crowdfunders' contributions.[40] Similar to the reward-based model discussed above, investors are not allowed to receive interest, dividends, or distributions of earnings from the venture they have funded.[41] Essentially, the contributor pays a sum of money, generally less than the amount the product will sell for, in exchange

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32. *See* Wroldsen, *supra* note 26, at 588.

33. Bradford, *supra* note 6, at 16.

34. *See id.*

35. Chance Barnett, *Crowdfunding Sites in 2014*, FORBES (Aug. 29, 2014), http://www.forbes.com/sites/chancebarnett/2014/08/29/crowdfunding-sites-in-2014/.

36. *Id.*

37. *Id.*

38. *Id.*

39. *Coolest Cooler: 21st Century Cooler that's Actually Cooler*, KICKSTARTER (last visited Apr. 5, 2015), https://www.kickstarter.com/projects/ryangrepper/coolest-cooler-21st-century-cooler-thats-actually.

40. *See* Wroldsen, *supra* note 26, at 588.

41. Bradford, *supra* note 6, at 17.

for receiving the reward in advance.[42] Along with employing the rewards-based model, Kickstarter also uses the pre-purchase model to give rewards to backers of their projects.[43] A reward, according to Kickstarter, is an item "produced by the project itself – a copy of the CD, a print from the show, a limited edition of the comic."[44]

The peer-to-peer lending model allows crowdfunders to make loans and receive a small amount of interest in exchange.[45] In 2005, with the launch of Kiva, peer-to-peer lending became the primary micro-lending platform.[46] Kiva, which allows people with imperfect credit to qualify for traditional low-interest loans from internet users, has basically been used to fund projects in developing countries.[47] Another website using the peer-to-peer lending model is Prosper.com, which launched in 2006.[48] Prosper.com brought the micro-lending concept to the United States.[49] Like Kiva, Prosper also charged a lesser interest compared to a traditional banks.[50]

The equity model, discussed below in detail, has evolved out of the JOBS Act. Although it has been used in other countries for years, it gained more traction in the US following President Obama's initiative with the passage of the JOBS Act.[51] The JOBS Act allows contributors (also known as investors)

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42. *Id*. ("Typically, the 'donation' required to receive the product is below the planned retail price. For example, Dan Provost and Tom Gerhardt, who designed a tripod mount for the iPhone, offered one of the mounts to anyone who donated $20. They planned to sell the mount [to the general public] for a retail price of $34.95.").

43. *Id.*

44. *Id.* at 15.

45. *See* Wroldsen, *supra* note 26, at 588-89.

46. Mohana Ravindranath, *Kiva's Evolving Microlending Model*, WASH. POST (Aug. 12, 2013), http://www.washingtonpost.com/business/on-small-business/kivas-evolving-microlending-model/2013/08/12/e6d95528-fa1f-11e2-a369-d1954abcb7e3_story.html.

47. *Id.*

48. Bill Clark, *Crowdfunding History*, MASHABLE (Sept. 15, 2011), http://mashable.com/2011/09/15/crowdfunding-history/.

49. *Id.*

50. *Id.*

51. Wil Schroter, *Crowdfunding Around the World*, FORBES (July 9, 2014), http://www.forbes.com/sites/wilschroter/2014/07/09/crowdfunding-around-the-world/.

to get an ownership stake and financial reward based on their donations.[52] Alternatively stated:

> "[T]he equity model differs from all types of crowdfunding because crowdfunders invest money in order to receive ownership interest in a company. This unique characteristic of the equity model has had far-reaching implications because, while securities laws have allowed other types of crowdfunding to flourish, they have impeded the development of the crowdfunding investment model."[53]

Essentially, the investor receives a security in the form of "stock" or "investment contract" which implicates federal securities law.[54] The unequal treatment of equity-based crowdfunding under federal law led, in part, to early legislative drafts asking for an exemption for equity crowdfunding.[55] Prior to the passage of the JOBS Act, certain issuers of equity crowdfunded offerings had to register with the SEC under the '33 Act or rely on another exemption.[56] At the same time, the websites facilitating these investments had to register as broker-dealers under the '34 Act.[57] Although the donation-based, pre-purchase, and reward-based models of crowdfunding do not classify as securities and have no requirement to register with the SEC, the peer-to-peer lending and equity models discussed above likely qualify as securities and will have to register with the SEC unless they qualify for an exemption under federal securities law.

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52. *See* Wroldsen, *supra* note 26, at 589.

53. *Id.*

54. Bradford, *supra* note 6. at 33 ("Even if crowdfunding investors are offered some . . . [security] that does not involve corporate stock, their investments would still be securities . . . [and those interests] offered to investors on equity-model sites would clearly be investment contracts under Howey."); *see also* SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946).

55. Wroldsen, *supra* note 26, at 589-90 (noting that securities laws before the JOBS Act allowed organization to raise unlimited amounts of money while preventing for-profits from doing the same).

56. Securities Act of 1933 § 5(a)(1), 15 U.S.C. § 77e(a)(1) (2010).

57. *Id.*

B. Crowdfunding in the rest of the world

Although crowdfunding is a relatively new concept in the US, it has been employed all over the world for years. Initially, crowdfunding was used to finance books in 17th century Europe, where the purchasers would pre-order printed publication ahead of time.[58] It was also used to finance music projects in the 1700s. For example, when Mozart did not have enough money to host concerts, over the course of two years, he employed crowdfunding to raise money for his events at Viennese concert hall.[59] In return, he offered manuscripts of his concertos to backers of his fundraising scheme.[60]

Most recently, when a family-run soy sauce factory was demolished during the 2011 tsunami in Japan, crowdfunding became a popular way for people to provide assistance to those who were suffering.[61] Other countries like Canada and Italy allow rewards-based crowdfunding with minimal regulation but have more stringent requirements for equity-based crowdfunding.[62] On the other hand, Sweden and New Zealand have more liberal rules regarding equity-based crowdfunding, and have been using it for years now.[63] The U.K. has been far ahead of other countries in allowing non-accredited investors to participate in equity-based crowdfunding offerings.[64] In the U.K., non-accredited investors are allowed to invest up to 10 percent of their net assets to start ups.[65] The hope is that one day, U.S. crowdfunding laws can follow in the footsteps of their predecessors in allowing non-accredited investors to invest in crowdfunding offerings of their choice.

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58. Schroter, *supra* note 51.

59. *Id.*

60. *Id.*

61. Tesun Oh, *Crowdfunding Revives Quake-Hit Small Businesses in Japan*, BLOOMBERG BUS. (Jan. 26, 2015), http://www.bloomberg.com/news/articles/2015-01-26/crowdfunding-revives-quake-hit-japan-companies-avoiding-red-tape.

62. Schroter, *supra* note 51.

63. *Id.*

64. *Id.*

65. *Id.*

C. Crowdfunding under the Securities Act of 1933 and 1934

To fully understand the impact of the JOBS Act on federal securities law, we must first determine whether the crowdfunded offering qualifies as a security. The term security is defined broadly in the '33 Act as "any note, stock, treasury stock . . . investment contract. . . or in general, any interest or instrument commonly known as a security, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."[66] Generally, in an equity-based crowdfunding transaction, the investor receives monetary compensation in exchange for his or her investment, which may qualify as an investment contract under the *Howey* test.[67]

An equity crowdfunded transaction involves an offering to an investor who seeks returns in the form of future profits or ownership in the venture. In *Howey,* the Supreme Court established a method for determining whether an instrument qualifies as an investment contract.[68] Per *Howey*, an investment contract is "a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or third party."[69] An equity-based crowdfunding transaction will likely qualify as an investment contract, and therefore a security under the '33 Act, under the *Howey* test, because it involves an investment from a backer in a big project that others are involved in where the backer expects profits from the efforts of the crowdfunding portals. Equity crowdfunding interest can be classified "not only as investment contracts but also as securities under Section 2(a)(1) of the Securities Act as interpreted by *Howey* and its progeny."[70] There are four prongs to the *Howey* test: (1) investment of money, (2) common enterprise, (3) an expectation of profits and (4) profits derived solely from the efforts of others.[71]

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66. Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2010).

67. SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

68. *Id.* at 298-99.

69. *Id.*

70. Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and The Securities Act of 1933*, 78 TENN. L. REV. 879, 891 (2011) (citing 15 U.S.C. § 77b(a)(1)).

71. *Howey*, 328 U.S. at 301.

The first requirement under *Howey* is the investment of money.[72] Investors participating in an equity crowdfunding purchase their interest with cash, which easily qualifies as an investment of money. There are two main approaches to determining whether an investment has been made. The first approach looks at "whether the primary, rather than exclusive, purpose of the arrangement is to provide for a return to funders."[73] In a typical crowdfunded offering, the investor receives either profit from the investment or an ownership stake, fulfilling the requirements of the first approach. The second approach looks at "whether the arrangement subjects the [crowdfunder] to a loss."[74] The requirement of an investment of money would be fulfilled under this approach because regardless of the type of investment, the investor is always under a risk of the investment not producing a return. Regardless of what approach is examined, most equity-based crowdfunded offerings will fulfill the first prong under *Howey.*

Secondly, the *Howey* test requires the investment to be in a "common enterprise" existing between the investors.[75] There are two methods to examine commonality: vertical and horizontal.[76] Vertical commonality exists when the success of the venture depends on the success of the entrepreneur and portal promoting the investment.[77] On the other hand, horizontal commonality exists when the investors' return depends on the success of the overall venture.[78] Generally, horizontal commonality will always be present in a crowdfunded offering because of the very nature of the scheme. Equity-based crowdfunding involves a pooling of funds by many investors, which means that if the venture fails, it affects the success of not just one investor but of everybody invested in the scheme. Because horizontal commonality is always present in an equity-based crowdfunded investment, "the crowdfunding business models constitute a common enterprise for the purposes of the *Howey* test."[79]

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72. *Id.*

73. Hemingway & Hoffman, *supra* note 70, at 899.

74. *Id.* at 900-01.

75. *Howey,* 328 U.S. at 293.

76. Hemingway & Hoffman, *supra* note 70, at 901.

77. *Id.* at 901-02.

78. *Id*. at 901.

79. *Id.* at 902.

The third prong of *Howey* requires an "expectation of profits" by the investors.[80] Generally, an investor's motive for participating in an equity-based transaction is the expectation of future earnings or an ownership stake in the venture.[81] Although this prong would never be satisfied in a donation-based model, the equity-based crowdfunded offering is based on the very concept of receiving profit in exchange for the investment, and therefore the third prong of *Howey* is satisfied in an equity-based transaction.

The fourth and final prong of *Howey* requires the profits to come "solely from the efforts of others."[82] In a traditional equity-based crowdfunded transaction, the investor is not directly involved in the management of the venture and instead "serves as a passive patron while the principals of the crowdfunded venture, with some marketing or logistical support from the crowdfunding website, are responsible for the venture's success or failure."[83] Although the companies offering crowdfunding investments differ in their individual definition of who classifies as "others," a true equity-crowdfunding transaction will almost always involve a transaction where the investor is not directly involved in the management of the venture.

Because most traditional equity-based crowdfunding transactions meet the various prongs of the *Howey* test and therefore qualify as an investment contract, they will be subject to federal securities law unless they fall within an exemption. The offer and sale of securities is regulated by section 5 of the '33 Act, which prohibits the offer or sale of securities via interstate commerce unless an applicable exemption is available.[84]

Section 3(b) of the '33 Act includes Regulations A and D, both of which may be used to claim an exemption for registration.[85] These regulations, when paired with crowdfunding offerings, yield low benefits with high costs. Regulation A initially imposed limits of $5 million in any 12-month period.[86] It also allows the general solicitation of investors.[87] On March 25, 2015, the SEC voted to expand Regulation A (calling it Regulation A+) to allow smaller

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80. *Howey*, 328 U.S. at 300.

81. Hemingway & Hoffman, *supra* note 70, at 902-03.

82. *Howey*, 328 U.S. at 300.

83. Hemingway & Hoffman, *supra* note 70, at 903.

84. Securities Act of 1933 § 5, 15 U.S.C. §77e(c) (2010).

85. Securities Act of 1933 § 3(b), 15 U.S.C. §77c(b) (2010).

86. *Id.* These limits recently changed on March 25, 2015.

87. *Id.*

companies to sell up to $50 million of securities in a 12-month period.[88] Regulation A+ implements a two-tier system of offerings. Tier 1 allows securities offerings up to $20 million in a 12-month period, with a $6 million limit on offers by selling security-holders that are affiliates of the issuer.[89] Tier 2 allows offerings up to $50 million in a 12-month period with a limit of $15 million on offers by selling security-holders that are affiliates.[90] Companies that choose to offer securities under Tier 1 have to issue reviewed financial statements, but not audited, which makes the cost of disclosures lower.[91] To qualify for a Regulation A exemption, the issuer must produce a limited registration statement (Form 1-A) and an offering circular to all investors, which adds extra cost to the use of the exemption, making it expensive for small businesses.[92]

Regulation D contains a number of exemptions, including Rules 504, 505, and 506. Rule 504, which applies to private companies, limits the size of the offering to $1 million but does not allow general solicitation.[93] Rule 505 allows non-registration of offerings less than $5 million in a twelve-month period[94], but does not allow solicitation and advertising.[95] It allows an issuer to make the offering available to a maximum of 35 non-accredited investors.[96] Although this is a viable option for crowdfunding, the limitation on the amount of investors is too low for a large scale crowdfunded offering. Finally, rule 506 allows the company to sell its securities to an unlimited number of accredited investors and up to 35 non-accredited investors, who must be sophisticated.[97] Rule 506 also imposes a ban on solicitation and advertising.[98]

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88. *SEC Adopts Rules to Facilitate Smaller Companies' Access to Capital*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/news/pressrelease/2015-49.html#.VSGW6vnF-So (last visited Apr. 5, 2015).

89. *Id.*

90. *Id.*

91. *Id.*

92. Regulation A, 17 C.F.R. §§230.251-.263; Hazen, *supra* note 28 at 1746.

93. 17 C.F.R. §230.504(b)(2)(i).

94. *Id.*

95. 17 C.F.R. 230.502(c).

96. 17 C.F.R. §230.505(b)(2)(ii).

97. 17 C.F.R. §230.506(b)(2)(i).

98. *Id.*

If an entrepreneur chooses not to file under Regulation A or A+, Section 3(a)(11) of the '33 act provides an exemption for an entrepreneur who sells securities in a single state and the business is incorporated in the same state.[99] Kansas, for example, allows companies formed in Kansas "to raise up to $1 million from non-accredited investors, so long as they're state residents."[100] Section 4(2) is limited to transactions that do not involve a public offering.[101] It also only applies to sophisticated investors.[102] The definition of public offering has been heavily litigated, but over time "the exemption question turns on the knowledge of the offerees" and "whether the particular class of person affected needs the protection of the act."[103] According to *SEC v. Ralston Purina Co.,* the private offering exemption is available when the offerees can be shown to "fend for themselves".[104] Similarly, an exemption under section 4(5) applies to private offerings with a limitation of $ 5 million in a twelve-month period and is limited to accredited investors only.[105] Both of these exemptions are not suitable for crowdfunding offerings because they "are conditioned on the absence of general solicitation of investors."[106] Crowd-funded offerings depend on the solicitation of investors by funding portals and therefore, make these offerings impractical. Due to the complexity and high costs of complying with the exemptions discussed above, small businesses pushed for the passage of the JOBS Act which allows for an exemption from

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99. Nikki D. Pope, *Crowdfunding Microstartups: It's time for the Securities and Exchange Commission to Approve a Small Offering Exemption*, 13 U. PA. J. BUS. L. 973, 989 (2011).

100. *Crowdfunding Update: some states aren't waiting for the SEC to act*, CLEANTECH FIN., http://cleantechfinance.net/crowdfunding-2/state-crowdfunding/ (last visited Apr. 5, 2015).

101. Securities Act of 1933 § 4(2), 15 U.S.C. §77d(2) (2006).

102. 17 C.F.R. §230.501(a)(5) and (6) (defining "accredited investor" as applied to individuals: "any natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000" and Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year"l).

103. SEC v. Ralston Purina Co., 346 U.S. 119, 126 (8th Cir. 1953).

104. *Id.* at 125.

105. Securities Act of 1933 § 4(5), 15 U.S.C. §77d(5) (2006).

106. Hazen, *supra* note 28, at 1745.

registration. The JOBS Act opened the doors for equity-based crowdfunding for accredited investors.

D. Development of Equity-based Crowdfunding

Crowdfunding has become an incredibly successful fundraising method for music and technology. Because of federal securities laws, this form of crowdfunding was historically reward-driven, where donors received a prize like they did in Schneider's ArtistShare campaign[107], or purely donative, where donors received nothing in exchange for their donation. Equity crowdfunding has come about as the result of the CROWDFUND Act of 2012, which stands for Capital Raising Online While Deterring Fraud and Unethical Non-Disclose Act.[108] Vanessa Grout of Forbes magazine defines equity crowdfunding as "the sale of corporate equity stakes through online platforms."[109] The CROWDFUND Act, or Title III of the JOBS Act, creates a new exemption from registration under the Securities Act of 1933 for small offerings of securities to the public over the internet with the use of a funding portal.[110] Under the CROWDFUND Act, the offer or sale of securities through crowdfunding is allowed without registration and limitations on the number of investors as long as the aggregate amount of securities sold in the preceding 12-month period does not exceed $1 million.[111]

Since its beginning, equity crowdfunding has garnered a lot of attention and concern. Part of the concern comes as a result of the substantial limitations and disclosure requirement under Title III of the JOBS Act. First, the amount of money contributed by an investor is capped based on the investor's annual income or net worth.[112] Investors with an annual income or net worth of less than $100,000 can only buy crowdfunded securities equal to the greater of (1) $2,000 or (2) 5 percent of the investor's annual income or net worth in a 12-

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107. Freedman & Nutting, *supra* note 20.

108. CROWDFUND Act, S. 2190, 112th Cong. (2012).

109. Vanessa Grout, *Move Over, Kickstarter: Real Estate Equity Crowdfunding Is Catching On With Investors*, FORBES (Sept. 10, 2014), http://www.forbes.com/sites/vanessagrout/2014/09/10/move-over-kickstarter-real-estate-equity-crowdfunding-is-catching-on-with-investors/.

110. CROWDFUND Act, S. 2190, 112th Cong. (2012).

111. JOBS Act § 302, 126 Stat. 302 (2012).

112. *Id.*

month period.[113] An investor with a net worth or annual income of greater than $100,000 can invest up to 10 percent of his or her annual income or net worth (not to exceed $100,000 in a twelve month period).[114] Second, the amount of money issuers can raise through crowdfunded offerings is limited to $ 1 million in a 12-month period as long as the offering is conducted through a registered broker or funding portal that complies with certain requirements.[115] Third, the exemption requires certain disclosures by the issuer and the crowdfunding intermediary.[116] An issuer's disclosure obligations vary based on the size of the offering. Generally, the issuer must include the purpose of the offering, the amount of capital to be raised, an offering price for the investment, risks to investors, company information and statements regarding capital structure and the venture's financial standing.[117] If the offering is less than $100,000, the issuer is only required to produce income tax returns for the most recent year and certified financial statements.[118] A crowdfunded offering between $100,000 and $500,000 requires the issuer to provide audited financial statements.[119] In addition to these requirements, the investor must file annually with the SEC the results of its operations and financial conditions.[120] Fourth, the crowdfunding intermediary is also subject to significant disclosure requirements. The intermediary must be registered as broker-dealer or "funding portal" under the '34 Act.[121] Funding portals must register with the SEC or an applicable self-regulatory organization (SRO).[122] Currently, the only applicable self-regulatory organization is the Financial Industrial Regulatory Authority (FINRA).[123] After registering with the SEC or an SRO, the funding portal must provide relevant educational materials to investors,

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113. *Id.*

114. *Id.*

115. *Id.*

116. JOBS Act § 304, 126 Stat. at 321-22.

117. JOBS Act § 302, 126 Stat. 317 (2012).

118. *Id.*

119. *Id.*

120. *Id.*

121. 15 U.S.C. §77d(b)).

122. JOBS Act, § 302(b).

123. DAVID SIROTA, ESSENTIALS OF REAL ESTATE FINANCE, 23 (10th ed. 2006).

disclose any potential risks, ensure review of the disclosures, perform background checks and ensure that the individual investors do not exceed the annual cap.[124] Civil liability may be imposed on the issuer for material misstatements and omissions under Section 12(b) and 13 of the '33 Act.[125]

The limitations on income and disclosure prohibit scammers from gaining a significant amount of capital from non-accredited investors. Before the passage of the JOBS Act, a new business could not sell equity or a share of its future profits legally over the internet without registering the sale under federal securities laws.[126] Per Section 5 of the '33 Act, the "means or instruments of transportation or communication in interstate commerce or of the mail" may not be used to sell an unregistered security.[127]

The Current State and Future of Real Estate Crowdfunding

Real-estate crowdfunding allows investors to purchase commercial or residential real estate investments by pooling resources together with other investors.[128] The investor then receives income from the project and shares of the proceeds when the project is sold.[129] One of the earliest examples of real-estate crowdfunding was seen when the owners of Hard Rock Hotel in Palm Springs sold a 15 percent stake for $ 1.5 million to a group of 85 investors[130] in an offering conducted by Realty Mogul.[131] In return, the investors received financial benefits from ownership, as well as VIP benefits "including free use of the hotel owner poolside cabana, 25% discounts off the best available room

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124. Bradford, *supra* note 6, at 45-46.

125. *See generally* Harry Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227 (1933).

126. Michael B. Dorff, *The Siren Call of Equity Crowdfunding*, 39 IOWA. J. CORP. L. 492, 500 (2014).

127. *Id.*

128. NerdWallet, *Is Real Estate Crowdfunding Right For Me?*, NASDAQ (May 12, 2014), http://www.nasdaq.com/article/is-real-estate-crowdfunding-right-for-me-cm352224.

129. *Id.*

130. Grout, *supra* note 109.

131. Stengel, *supra* note 1.

rate, free room upgrades and much more."[132] Since 2013, Realty Mogul has helped fund over 225 properties worth over $470 million.[133]

Groundfloor, another startup that crowdfunds real estate investments, has raised over $ 1 million in funding to move its headquarters to an area with less-restrictive crowdfunding rules.[134] Groundfloor's move came as a result of lax laws in Georgia that allow money to be raised from accredited as well as unaccredited investors.[135] The reason real estate crowdfunding has flourished in recent years may have to do with the housing crash of 2008, after which some traditional sources of financing were reluctant to grant loans to landlords and developers.

In 2015, the real estate crowdfunding industry is expected to grow to more than $2.5 billion.[136] Although it is becoming incredibly popular, real estate crowdfunding has its own set of advantages and disadvantages. One of the primary reasons an investor may choose to invest in a crowdfunded offering instead of participating in a traditional loan is the ability to be directly involved in the process. For example, iFunding, a real estate crowdfunding platform, allows investors to "review projects, fund investments and track them via computer, smartphone, or ipad (via their own app)".[137] This ability to be directly involved will likely attract investors who appreciate quick access to information and decision making power. At the same time, the ability to pick and choose projects might also result in investors making emotional decisions that may not be wise investments in the long term. It is unlikely that crowdfunding will replace traditional avenues of obtaining financing to

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132. JD Alois, *Realty Mogul Announces Hard Rock Hotel Offer has Sold Out*, CROWDFUND INSIDER (July 22, 2014), http://www.crowdfundinsider.com/2014/07/44744-realty-mogul-announces-hard-rock-hotel-offer-sold/.

133. REALTY MOGUL, https://www.realtymogul.com/ (last visited Apr. 5, 2015).

134. Deborah Gage, *Groundfloor Raises $1M, Moves to Georgia to Crowdfund Real Estate*, WALL ST. J. (Aug. 19, 2014, 7:14 PM), http://blogs.wsj.com/venturecapital/2014/08/19/groundfloor-raises-1m-moves-to-georgia-to-crowdfund-real-estate/.

135. *Id.*

136. Catherine Clifford, *Real Estate Crowdfunding Set to Top $2.5 Billion This Year*, ENTREPRENEUR (Mar. 3, 2015), http://www.entrepreneur.com/article/243526.

137. JD Alois, *iFunding Real Estate Crowdfunding Allows Direct Investments for Accredited Investors*, CROWDFUND INSIDER (July 3, 2013), http://www.crowdfundinsider.com/2013/07/18425-crowdfunding-real-estate-ifunding/.

purchase real estate. It will, however, likely become a staple for investors looking for more direct involvement in their investments.

The cost of crowdfunding may be off-putting for some investors. The SEC estimates that an offering over $500,000 would cost up to $152,000, with the compensation to the intermediary being $112,500, the disclosure documents costing $11,000 and the audited financial statement costing $28,700.[138] The high costs may deter some potential issuers from taking the path of going through a crowdfunded offering. Along with the high disclosure related costs, there may be administrative costs that go along with having numerous shareholders, including but not limited to notifications, meetings, obtaining consent, and providing tax information to each shareholder.[139]

One of the biggest hurdles the crowdfunding industry might face is the lack of experience of some small investors. Small investors generally have limited investment experience, and are more likely to invest a larger portion of their net worth than large investors, making their losses more meaningful.[140] In this case, the funding portal might have an obligation to provide additional help that is generally not warranted in a crowdfunding transaction.

Additionally, although there is a risk of the investment going sour, the stringent limitations and disclosure requirements should provide a safe harbor for inexperienced investors. At the same time, an argument could be made that the stringent requirements create burdens for issuers who may want to keep their financials private. Until the final rules for Title III are issued in 2015, we will not know if the requirements will become more stringent or lax.

Conclusion

Although equity-based crowdfunding has been in existence all over the world for many years, it is a relatively new concept in the United States. This article discusses traditional methods of financing real estate, as well as their advantages and disadvantages. Although traditional methods of real estate financing are less risky, the costs associated with them are very different from those associated with crowdfunding offerings. Where the majority of the costs

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138. Benjamin G. Lombard, *SEC Proposes Crowdfunding Rules*, REINHART – HEADLINES IN SECURITIES LAW E-ALERT (Nov. 14, 2013), http://www.reinhartlaw.com/Publications/Documents/ea20131114SL.pdf.

139. Jeffrey Marks, *Feature: The Practical Challenges of the Crowdfunding Law*, 56 ORANGE CNTY LAW. 38, 38 (2014).

140. *Id.*

of traditional real estate financing lie in the actual financing i.e. interest, loans, etc., the costs of crowdfunding offerings comes from more stringent disclosure requirements.

Real estate crowdfunding is booming at the moment, but it has the potential of remaining in existence on a fairly limited scale because of the high risk and costs associated with it. Crowdfunding offerings require public disclosures, which are disliked by many in the real estate industry. Furthermore, although real estate crowdfunding allows for more direct involvement in the investment, it can be difficult for non-accredited investors who may make bad investments because of their lack of knowledge. At the same time, although the disclosure requirements raise the cost of crowdfunding offerings significantly, they protect investors from fraud by scammers who might get away from the scrutiny of the funding portals. Unless the SEC promulgates rules that have less stringent disclosure requirements and lower costs associated with the disclosures, it is likely that real estate crowdfunding will co-exist with traditional financing methods, but not surpass them.

FROM THE PROFESSOR:
ASSESSING DAMAGES IN BOND CASES

Seth E. Lipner

Cases involving bond losses are different from stock loss cases because bonds are fundamentally different from stocks. From the viewpoint of the law, bonds are promissory instruments, while stock and equity investments have no promissory element.[1] From an investment standpoint, the two also have very different risk/reward characteristics.

Not only are there legal differences and risk/reward differences between the categories of investors, there are differences in the objectives of investors in these different types of securities. Bond investors seek the promise of current income and the issuer's promise to pay "par value" at maturity – a fixed amount at a fixed time. There is no hope for a meaningful capital gain, and that is fine with bond investors. Stock investors have more lofty expectations. They hope to make a capital gain at some undetermined date and, although they may even expect some dividends along the way, there are no guarantees.

In arbitrations involving bond losses, these differences present challenges, especially when assessing the damages the investor suffered. The battleground issue is usually whether to deduct interest the bond paid from capital losses the investor suffered. Respondents want interest to be deducted from the principal loss because doing so will often wipe out a large capital loss on the bonds. Claimants resist such netting, but must be prepared to explain their reasons for resisting. The impact of discovery dates and prices, and whether the investor must sell the bonds in order to maintain an action, are also important issues for advocates. This Article explores each of these issues.

ASSESSING DAMAGES:
THE DIFFERENCES BETWEEN STOCKS AND BONDS

From the legal and corporate perspective, the differences between stocks and bonds are well-known. Bonds represent corporate promises with *priority* but no *equity*; stocks are all equity, without promises of any kind. Put simply,

1. *See* RESTATEMENT (2D) CONTRACTS § 1 ("A contract is a promise or set of promises….").

bonds are contracts and stocks are not.[2]

This difference is critical, and it carries over to the way we assess damages in these two types of cases:

> (1) **Expectations -** The bondholder's contract creates what the law terms an "expectation" and contract law gives the promisee an "expectationary" remedy from the promisor.[3] Those who own stock, on the other hand, have no such expectation, right, or remedy.
>
> (2) **Promises -** The bondholder's contract – his legally enforceable "expectation" – contains two separately created and separately enforceable (i.e., severable) promises. The first promise is to pay interest. The second promise is to repay principal.[4]

These legal differences are not so technical that investors do not understand the difference. Quite the contrary: bond investors either expressly or intuitively divide the right to receive periodic interest from the right to the payment of principal at maturity. They see the bond (and its return components) as comprised of these distinct issuer promises. And unless they have suffered a bond default or near-default, this understanding is likely to be reinforced by their own experience.

Since these two distinct issuer promises constitute the basis for the bargain, mixing interest and principal together at the damages stage of a bond case, in the form of a "net-out-of-pocket loss" calculation, is contrary to the investor's understanding and the basis upon which the investor agreed to invest.

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2. This Article focuses on the difference between stocks and bonds; the article is not about the differences between bond investors (who, for example, may be older and retired, and thus more risk-averse) and stock investors. Individual risk tolerance is, of course, an important aspect of most securities arbitrations.

3. *See* RESTATEMENT (2D) CONTRACTS § 1, cmt. g (AM. LAW INST. 1981). ("A promise that is a contract is 'binding'…."); § 347 (…the injured party has a right to damages based on his expectationary interest….").

4. These promises, of course, come from the issuer, not the financial advisor. The point to be stressed is that the underlying investment expectations themselves are contractual. Thus, damages that flow from, *e.g.*, due diligence failures by the advisor, trace directly to an identifiable, contractual expectation of the customer.

Along with these legal and investor-mindset distinctions, the economic characteristics of bonds are different from those of stocks:

1. **Non-Linear Upside -** Unlike stock investment outcomes, the outcomes of bond investments are not linear. That is, stock prices start at zero and follow a straight line to infinity. But bonds selling at or near par or at premium do not appreciate as much when interest rates go down as they do when rates go up, because they will always, some day, accrete to 100.[5] Stated differently, stocks can keep going up as profits are made or economic changes take place, but potential gains on bonds top out and bond investors who buy near, at or above par have limited upside. Unlike stock investors, bond investors are not investing for capital gains.
2. **Outcome Distributions -** On the downside, stocks and bonds again face different characteristics. If a bond investor is willing and able to hold the investment to maturity, and there is no default, the bond investor realizes all of his expectation. On the other hand, if the bond defaults, the bond investor's loss tends to be catastrophic – all or nearly all the principal.[6] Stock investors, by contrast, face a much wider spectrum of downside outcomes, with catastrophic loss only one of many possible results.
3. **Investor Mindset: Loss v. Gain** -- Hold-to-maturity bond investors need to focus hard on what can go wrong; their upside is limited, but their potential loss is catastrophic. Managing risk is the key element. While stock investors may also be concerned with loss, their goal is to find companies whose stock price will rise.[7] Risk management is less important to them. Stock investors

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5. Call features, early redemption features, sinking funds, etc., combined with the fact that at prices over par, bonds accrete as they advance toward maturity, all contribute to the non-linearity of bond investment outcomes.

6. Of course, bond defaults do not necessarily result in a complete wipe-out; there may be residual assets flowing (some day) from a bankruptcy or reorganization.

7. A consequence of these economics is that bond managers seek to provide value to their clients by avoiding having any losers, thus achieving the returns of their management benchmarks. With limited upside and a potentially catastrophic downside, most bond managers avoid bad outcomes by being very diversified. By contrast, active equity managers must try to add value to their clients by "beating" their benchmark indexes – usually by being less widely diversified than those benchmarks. Put differently, equity investors can afford a few losers if they find some big winners. Bond investors can't find big winners – they don't exist. In such

want to be rewarded (at the end of their holding period) because the stock went up. Bond investors are not looking for profit upon final sale.

Because stock investors are seeking potentially unlimited capital gains, and the ending value is a key component, a stock investor's outcome is appropriately measured by "total return" (i.e., an accounting outcome that nets dividends paid and capital gains/losses). There is no rational basis for separating dividends from capital losses; both reflect the issuer's success, and success is what the stock investor bargained for.[8]

For the bond investor, especially one who divides the promise to pay interest from the promise to return principal – usually by spending the periodic amounts earned on living expenses – total return was not the object of the exercise.[9] Dollars received today are not fungible with the principal dollars promised – and not paid – at maturity. Indeed, often the interest was spent *in reliance on* the issuer's promise to return principal. Measuring total return (i.e., assessing damages based on net-out-of-pocket loss on a bond that paid interest for some years and then declined with a default or threat of default) may satisfy an accounting professional's urge to add columns and balance debits with credits, but it ignores the basis for (and nature of) the investment. Most of all it ignores real losses to the investor's principal.[10]

For all these reasons, assessing damages in a bond case is different from assessing damages in a stock case. Netting of dividends and capital losses –

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an environment, bond investors especially need to watch their downside.

8. Both the dividends and the gain/loss are a product of the profitability of the corporation. An unprofitable corporation typically does not pay dividends; its stock price tends not to rise. But that same company's ability to make its contractual payments is subject to a very different set of factors, including its ability to obtain re-financing.

9. Damages in cases involving unsuitable asset allocations (as opposed to unsuitable bonds within the allocation) may properly be measured by total return (and netting stock outcomes with bond outcomes), because the object was to produce a diversified total portfolio. But when the alleged wrong relates to the makeup of individual parts of an otherwise well-allocated portfolio, assessing damages based on the total return of the whole portfolio is wrong because it has the potential of excusing wrongdoing or carelessness by netting it against gains from proper or careful behavior.

10. Thus, the out-of-pocket loss calculation of damages – appropriate to a stock case or other investment where total return is the object and cash flows are fungible – is inappropriate to a bond or other income-oriented investment (especially bonds).

the so-called "net-out-of-pocket" method – is useful in many securities cases. But that measurement fails to capture the essence of bonds, bond investors, and bond investing. A different assessment is thus needed – one in which there is no netting, so that the bond investor's justified expectations are actually realized.[11]

DETERMINING THE DATE ON WHICH TO MEASURE DAMAGES; OF PURCHASE DATES AND POST-PURCHASE EVENTS

Even before there were securities, there was a law of fraud. At common law, the typical measure of damages for fraud-in-the-inducement in the sale of a chattel is the (inflated) price paid for the object minus the actual value of that object on the date of the purchase.[12]

In chattel cases, damages are, under the formula, measured as of the date of the fraud.[13] The same rule applies in many investment cases. Damages, the cases say, are the "pecuniary losses" that are the "direct result" of the defendant's fraud.[14] But what does "pecuniary loss" mean? How does the law measure it? And as of what date is such a loss measured in a securities case? Is it the same as a chattel case?

The date-of-the-fraud measure, courts often say, follows from the observation that a seller's fraud is "complete and its effect exhausted at the time of the sale and transfer."[15] Under this approach, damages based on subsequent events are not compensable, because of the lack of causation associated with later occurrences. For example, in cases involving misreported earnings, courts require the plaintiff to prove (through economic analysis) the value of the stock – absent the fraud (i.e., the intrinsic value on

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11. A "benefit of the bargain" calculation in a bond case might involve netting (depending on circumstances) the "risk free" rate (comparable maturity Treasuries) or some other surrogate, assuming a reliable one can be found and employed.

12. *See* Hotaling v. A.B.Leach & Co., Inc., 247 N.Y. 84, 87-88 (1928) ("Ordinarily the actual pecuniary loss as a direct result of the fraud which induces a chattel is the difference between the amount paid and the value of the article received.")

13. *Id.*

14. *See* Reno v Bull, 226 N.Y. 546, 553 (1919) ("The true measure of damages is indemnity for the actual pecuniary loss sustained as a direct result of the wrong."); *Hotaling,* 247 N.Y. at 87.

15. *Hotaling*, 247 N.Y. at 88.

the date of purchase). That calculation is designed to exclude from damages the effect of events subsequent to the purchase that caused the price to decline.[16]

Courts recognized early on, however, that in investment cases, the circumstance can be different. For example, in cases alleging issuer fraud – where the buyer could not discover the fraud until later – courts have looked to the post-discovery price of the security as a surrogate for the intrinsic purchase-date value, especially if the fraudulent conduct caused an artificial inflation of price for a long duration.[17] But still, if other events unrelated to the fraud intervene, the price movements associated with those subsequent events must be accounted for and removed when assessing damages based on this discovery-date surrogate.

In cases calling for a discovery-date assessment, courts have sometimes split on whether to use the date on which the public discovered the fraud, or the date on which the investor discovered the fraud.[18] In many cases, of course, the investor discovers the truth at the same time as the general public. In cases where the investor discovers before the public does, damages are assessed as of the (earlier) date of the investor's discovery; if the investor discovers the fraud after the public (and can explain why the investor failed to learn the truth at that time), damages are assessed as of the time of actual discovery.[19]

Broker cases present yet another situation, and a different exception to the date-of-purchase rule exists for these cases. When a risk is omitted or misrepresented by a broker, events subsequent to the sale can trigger price declines and losses. In such cases, the causal chain is not necessarily broken by these post-purchase events, and one thus cannot simply exclude the effects of subsequent events that turn undisclosed or misrepresented risks into investment losses.

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16. *See Hotaling*, 247 N.Y. at 87. (Defendants should not be held liable for any part of plaintiff's loss caused by subsequent events not connected with [the] fraud.").

17. *See Harris v. American Inv. Co.,* 523 F.2d 220, 226 (8th Cir. 1975) (citing RESTATEMENT OF TORTS § 549 cmt. c).

18. *Compare* Richardson v. MacArthur, 451 F.2d 35, 43-44 (10th Cir. 1971) (using the date of public discovery) *with* Harris v. American Inv. Co., 523 F.2d 220 (using the date of investor discovery).

19. *See Harris*, 523 F. 2d at 226-27.

Hotaling v. Leach & Co.,[20] a seminal broker case, is a classic and powerful example – and it involved bonds. In *Hotaling*, the defendant broker misrepresented the issuer's financial wherewithal to withstand adverse market events. When those events occurred (subsequent to the purchase), the New York Court of Appeals awarded damages for losses caused by *post-purchase* events.[21]

The New York Court of Appeals in *Hotaling* began by observing (as we did) that, in a case involving fraud in the sale of chattels, damages are ordinarily measured by the difference between the price paid and the real (intrinsic) value *on the date of purchase*.[22] The Defendant thus argued that the bond-buyer's damages should be measured by the liquidation value of the company on the date of the fraud; since the company had sufficient assets to meet its obligations on that date, the company argued there was no loss.

The Court of Appeals rejected that argument and any date-of-purchase measure of damages. Pointing to the long-term investment purpose of the bonds the buyer bought, the Court ruled that damages must be assessed in light of the fact that the company was an ongoing concern; after all, the Court said, the bonds were bought "for investment, not speculation."[23] Damages in such a case, said the Court, "must represent the loss which the plaintiff sustained through the purchase *and continued ownership* of the bond."[24] The Court is telling us – investment cases are different from chattel cases, and bond cases are different from stock cases.

The Court explained that the buyer's loss in *Hotaling* occurred when the company's ability to meet its obligations under the bond was impaired by subsequent events in the oil business. The Court, upholding the buyer's claim

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20. *See Hotaling,* 247 N.Y. at 84.

21. *Id.* at 87.

22. *Citing* Smith v. Duffy, 57 N.J.L. 679 (Court of Errors & Appeals 1895).

23. While the Court does not so state, one can observe, as Part I of this Article observed, that, in a legal sense, all stocks are held for "speculation" because, by definition, there are no promises involved.

24. *Hotaling*, 247 N.Y. at 87. Addressing the causation issue associated with using subsequent prices to assess damages, the *Hotaling* Court determined that the change in conditions in the oil business as a "subsidiary cause," rather than an "independent" one. *Cf.* Nye v. Blythe Eastman Dillon & Co. Inc., 588 F.2d 1189 (8th Cir. 1978) ("the appellees had a reasonable time in which to make a 'second investment decision' to either hold the shares or sell them and reinvest the proceeds elsewhere. (*citing* Harris v. American Investment Company, 523 F.2d at 228)). The second investment decision doctrine is analyzed in Part III of this Article.

to these (subsequent) losses, explained that "the[] disturbed conditions [in the oil business] would not have caused the company's failure if the enthusiastic statements ... contained in the circular had been true....[A]n expectant investor might have hesitated and drawn back...."[25] As long as the fraud "continued to operate and induce the continued holding of the bond, all losses flowing naturally from that fraud may be regarded as its proximate result," the Court held.[26]

Claimants who can satisfy *Hotaling* and show that the subsequent events triggered a bond loss that was tied to a risk that was misrepresented at the moment of purchase can recover damages for the misrepresentation even if the events leading to the decline occurred after the purchase. In such situations, the price of the date of discovery is the price to use in assessing damages.

DISCOVERY AND THE INVESTOR WHO WON'T SELL

Once discovery of the fraud occurs, the investor who decides to hold securities cannot later assert a claim for the declines that occurred after that discovery because such an investor made a "second investment decision" – one that is free from the original fraud. But that does not mean that an investor who discovered the fraud is under a duty to sell the securities and cannot maintain any action if he fails to do so.

Although arbitration respondents sometimes try using the argument, it has long been held that the decision to hold a security after the discovery of a broker fraud is not "ratification."

The leading case is *Harris v. American Inv. Co*.[27] That federal district court decision involved a stockholder's derivative suit alleging common law fraud and the violation of federal Rule 10b-5. The defendants sought dismissal, alleging that the named plaintiffs, who held the stock after discovery of the fraud, suffered no damages because the stock price rose after the action was commenced, and their loss was thus wiped out.[28]

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25. *Id.* at 90.

26. *Id.* at 93.

27. Harris v. American Inv. Co., 523 F.2d 220, 227 (8th Cir. 1975). *See also* Pfeffer v. Cressaty, 223 F.Supp 756, 758 (S.D.N.Y. 1963); Hindman v. First National Bank, 112 F. 931, 935-36 (6th Cir.), cert denied, 186 U.S. 483 (1902); Hotaling v A.B. Leach & Co., 247 N.Y. 84 (1928).

28. *Harris v. American Inv. Co.*, 523 F.2d at 224.

The Eighth Circuit disagreed with the defendants, explaining that "it would be inappropriate to apply a rule requiring [plaintiff] to sell [the securities] prematurely for the benefit of the defrauding defendant."[29] Any other rule, the Court said, would give the plaintiff all the risk of further price decreases, while still giving the defendant all the benefit of any price increases. Since the plaintiffs "second investment decision" was independent of the original fraud, said the Court, "what[ever] happens after this second investment decision has no bearing whatsoever on the measure of the plaintiff's damages."[30]

The *Harris* rule is not just equitable; it's logical. The rule fixes a claimant's damages at the moment of discovery; it aligns risks and rewards from that point out in an equitable manner; and, it allows the law to compute damages with certainty. Any other rule would, as the *Harris* Court explained, give the wrongdoer the benefit of a heads-I-win-tails-you-lose scenario.[31]

The *Harris v. American* rule produces not just economic fairness; it offers a consistent measure of damages. As another court explained when applying the rule:

> The plaintiff will not be able to avail himself of any further decrease in the value of the security after [the discovery] date. So also the defendant should not be able to avail itself of any increase in the value of the stock after that date. This is the only method in which a consistent measure of damages can be obtained. If the defendant's

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29. *Id.* at 228.

30. *Id. See also* Acticon v. China North East Petroleum Holdings Ltd, 692 F.3d 34, 41 (2d Cir. 20 12); NYE v. Blyth Eastman Dillon and Co., Inc., 588 Fed. 1189 (1978); Alexander v. Evans, No. 88-CV-5309, 1993 WL 427409 (S.D.N.Y. 1993).

31. *See also* Pfeffer v. Cressaty, 223 F.Supp. 756, 758 (S.D.N.Y. 1963) (court held that the common law rule permitting an aggrieved buyer to maintain an action even though he continued to hold the securities after discovery of the fraud also applied to actions for damages claims under Section 17 of the 33 Act and Section 10b of the 34 Act).

With respect to the state securities statutes, the rule is different. Uniform Securities Act Section 410 measures the aggrieved buyer's recovery as "the consideration paid for the security, together with interest at (x) percent per year from the date of payment, costs, and reasonable attorneys' fees, less the amount of any income received on the security, upon the tender of the security and any income received on it, or for damages if he no longer owns the security." The statute assumes either a tender or a sale. If there is neither a tender nor a sale, the statute appears to offer no remedy.

> contention was accepted the scale of damages would be prejudicially tipped in favor of the defendant.[32]

Hindman v. First Nat'l Bank of Louisville[33] is similar. The case was an action for deceit. The plaintiff alleged he was induced to buy stock which he claimed was worthless at the time of his purchase. The defendants argued that even if the shares lacked any intrinsic value on the date of purchase, the shares subsequently acquired "market value" and the plaintiff's recovery should be limited thereby. The Court disagreed with the defendants, holding that "if the shares had ... afterwards a market value is of no importance....[T]he plaintiff was under no obligation to sell, and might hold for an investment, if he saw fit."[34]

Subsequent cases show that the second investment decision rule offers even further instruction about how to measure damages in bond cases. In *Harris v. Union Electric Company*,[35] a securities fraud defendant argued that a bond buyer's damages for fraud should be reduced by interest paid on the bond after discovery of the fraud. The trial court refused to so instruct the jury, and the 8th Circuit Court of Appeals agreed. The Court wrote: "the [lower] court properly refused to instruct the jury to reduce the award by the value of any benefits received by the plaintiffs .... the recovery of the bonds two months later, and the continued receipt of interest payments have no bearing on the measure of damages ...."[36]

Harris v. Union Electric demonstrates that the second investment decision doctrine not only applies to subsequent increases and decreases in the price of the securities, but also to interest earned on bonds after discovery of a securities fraud. Interest earned after discovery is part of the "benefit" assigned to the plaintiff who, having decided not to sell, took the "risk" of decline.

Thus, even if one were to compute damages by netting interest and capital losses, the netting must end with discovery of the fraud. All subsequent coupon payments must be excluded from the damage calculation.

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32. Cant v. Becker & Co., 379 F.Supp. 972, 975 (N.D. Ill. 1974).

33. Hindman v. First National Bank, 112 F. 931 (6th Cir.), cert denied, 186 U.S. 483 (1902).

34. *Id.* at 935-36 (*citing* Smith v. Bolles, 132 U.S. 125 (1889)). The Supreme Court held that damages for common law securities fraud do not include "the expected fruits of an unrealized speculation." *Smith*, 132 U.S. at 130.

35. Harris v. Union Electric Co., 787 F.2d 355 (8th Cir. 1986).

36. *Id.* at 372.

Those payments belong to the investor who made a "second investment decision" and took the risk they would not be made.

CONCLUSION

Bond cases [37] present special issues of damage assessment. Parties to a securities arbitration involving bonds that went bad after several years of ownership and coupon payments are likely to be far apart in their damage assessments. The investors will be looking for the return of lost principal, while the respondent will be looking to net the interest payments against that capital loss.

Bonds are different from stocks in all their attributes and investors who buy bonds with the intention of holding them to maturity have different expectations from those who buy equities. The measure of damages that applies to stock cases does not fit bad-bond cases. *Hotaling* shows that discovery-date prices are the right prices to use in assessing bond-case damages.

The second investment decision doctrine is another important issue to be addressed in many cases. Aggrieved bond investors face a difficult choice when they discover that the bond they were sold was misrepresented to them by their broker. The investor does not know whether the bond will recover, but he does know that selling it and replacing it will (unless he can win his arbitration) forever diminish his income and his wealth. He must make a choice. But the choice is not one-sided because of the second investment decision doctrine. If the bond continues to pay interest and/or revenue, those facts do not diminish the compensable damages. But if the bond's value goes down further, or stops it paying interest, the loss is on the investor for the same reason.

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37. And, for many of the reasons offered in this article, other cases involving fixed income products and interest-spending investors.

REGULATORY UPDATES: FINRA AND SEC RULE CHANGES AND GUIDANCE OF INTEREST

Christine Lazaro

Over the past year, FINRA has proposed and approved new rules and amendments to its existing rules. FINRA has also issued supplemental guidance on existing rules. This article highlights those rule changes and guidance governing sales practice obligations of brokers, as well as the arbitration process. Additionally, this article will cover certain recently adopted SEC and CFTC rules.

I. FINRA Rules and Guidance

A. Rules Governing the Arbitration Process

Arbitration Award Offsets: Occasionally, counterclaims will be filed in an arbitration, and the arbitrator may end up ordering both the Claimant and the Respondent to pay the other. This often occurs in industry disputes, where, for example, the broker may be ordered to pay a portion of an outstanding promissory note and the firm may be ordered to pay compensation for wrongful discharge. FINRA rules did not address whether the two awards might be offset, and arbitrators did not always address that issue in the award. Accordingly, FINRA has amended Rules 12904 and 13904 to address the payment of awards when an arbitrator orders both Claimant and Respondent to make some payment.[1] Rules 12904(j) and 13904(j) both state in relevant part:

> Absent specification to the contrary in the award, when arbitrators order opposing parties to make payments to one another, the monetary awards shall offset, and the party assessed the larger amount shall pay the net difference.[2]

1. *See* FINRA, REGULATORY NOTICE 16-36, ARBITRATION AWARD OFFSETS; SEC APPROVES AMENDMENTS TO THE CODES OF ARBITRATION PROCEDURE REGARDING AWARD OFFSETS (Sep. 2016), *at* http://www.finra.org/sites/default/files/Regulatory-Notice-16-36.pdf.

2. FINRA Rules 12904(j) and 13904(j) both became effective October 24, 2016.

Arbitration Panel Selection: When customer cases call for three arbitrators, parties receive three lists: a chair-qualified public list, a public list, and a non-public list. Parties had received 10 names on each list that they could rank or strike. Under Rule 12403, parties had been permitted to strike up to four names on both the chair-qualified public list and the public list; and parties were permitted to strike all of the names on the non-public list. If all of the names were stricken from the non-public list, FINRA would attempt to fill the third seat from the remaining names on the public list first, and then the chair-qualified public list. However, given the number of strikes each party has, there may have been no names left on either list able to serve. If there were no names remaining, FINRA may simply have appointed an arbitrator. To minimize the need for FINRA to appoint arbitrators in this fashion, FINRA amended Rules 12403(a)(1)(B) and (c)(2)(A) to increase the number of names initially on the public list and concurrently increase the number of strikes available to each party.[3] Now, parties will receive 15 names on the public list, and are able to strike up to 6 of the names. The amendments became effective on January 3, 2017.

Motions to Dismiss in Arbitration: Parties have very few grounds upon which they may have a motion to dismiss considered prior to the non-moving party having presented their case in chief. An arbitration panel may only act upon a motion to dismiss if: (a) the non-moving party previously released the claim in dispute, either by a signed settlement agreement or a written release;[4] (b) the moving party was not associated with the account, security, or conduct at issue;[5] or (c) the claim was ineligible for arbitration because six years have elapsed from the occurrence or event giving rise to the claim.[6] FINRA has amended Rules 12504 and 13504 to add an additional ground for dismissal.[7]

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3. *See* FINRA, REGULATORY NOTICE 16-44, ARBITRATION PANEL SELECTION; SEC APPROVES AMENDMENTS TO THE CUSTOMER CODE OF ARBITRATION PROCEDURE REGARDING PANEL SELECTION IN CASES WITH THREE ARBITRATORS (Dec. 2016), *at* http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-16-44.pdf.

4. *See* FINRA, RULE 12504(a)(6)(A), 13504(a)(6)(A) (2017).

5. *See* FINRA, RULE 12504(a)(6)(B), 13504(a)(6)(B) (2017).

6. *See* FINRA, RULE 12206, 13206 (2011).

7. *See* FINRA, REGULATORY NOTICE 17-02, MOTIONS TO DISMISS IN ARBITRATION; SEC APPROVES AMENDMENTS TO THE CODES OF ARBITRATION PROCEDURE REGARDING MOTIONS TO DISMISS (Jan. 2017), *at* http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-02.pdf.

Rules 12504(a)(6)(C) and 13504(a)(6)(C) now permit the panel to consider a motion to dismiss on the following ground:

> The non-moving party previously brought a claim regarding the same dispute against the same party that was fully and finally adjudicated on the merits and memorialized in an order, judgment, award, or decision.

Now, claims that have been settled *or* adjudicated may be dismissed. The amendments to the rules were effective for motions filed after January 23, 2017.

Dispute Resolution Party Portal: Several years ago, FINRA developed a Party Portal to allow claim filings and interactions to occur through a secure, online location. Initially, the portal was rolled out through a pilot program, with brokerage firms consenting to participation. The portal was then expanded and made available for all cases on a voluntary basis. FINRA has now amended the Arbitration Code to require all parties, except *pro se* customers, to use the Party Portal.[8] FINRA has amended the Mediation Code to permit parties to use the Party Portal for mediations. A number of the rules were amended, including Rules 12100 (Definitions) and 12300 (Filing and Serving Documents).[9]

Generally, all documents must be filed through the Party Portal; however, there are several exceptions. Documents produced in connection with the Discovery Guide or in response to a discovery request should not be filed through the Party Portal;[10] however, correspondence related to discovery must be filed with the Party Portal.[11] Answers containing third party claims may not be served on the third party through the Party Portal.[12] If a pleading is amended to add a party, both the pleading and any motion to amend may not be served on the new party through the Party Portal.[13] Subpoenas may not be served on

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8. *See* FINRA, REGULATORY NOTICE 17-03, DISPUTE RESOLUTION PARTY PORTAL; SEC APPROVES AMENDMENTS TO THE CUSTOMER AND INDUSTRY CODES OF ARBITRATION PROCEDURE REGARDING REQUIRED USE OF THE DISPUTE RESOLUTION PARTY PORTAL (Jan. 2017), *at* http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-03.pdf.

9. *See* FINRA, REGULATORY NOTICE 17-03, Attachment A, *at* http://www.finra.org/sites/default/files/notice_other_file_ref/Regulatory-Notice-17-03-Attachement-A.pdf.

10. *See* FINRA, RULE 12300(a)(3) (2017).

11. *See* FINRA, RULE 12300(b)(1) (2017).

12. *See* FINRA, RULE 12303(b) (2017).

13. *See* FINRA, RULE 12309(a)(2), (c) (2017).

non-parties through the Party Portal.[14] For documents not served through the Party Portal, service may be accomplished by first-class mail, overnight mail service, overnight delivery service, hand delivery, email or facsimile.[15] The new requirements are effective for all cases filed on or after April 3, 2017. FINRA has also issued a User Guide to help parties with the portal.[16]

Arbitrator Chairperson Eligibility: Chairpersons must have some experience in arbitration, as well as specific training. On customer cases, chairpersons must meet the definition of "public arbitrator." Previously, if an arbitrator had completed the chairperson training, he or she was eligible to chair a panel if he or she had served as an arbitrator through award on two (if the arbitrator is also an attorney) or three cases. Following the amendments to the definitions of public and non-public arbitrators, a number of public arbitrators were reclassified as non-public, making them ineligible for the chairperson list in customer cases. The chairperson roster was reduced by approximately 14%.[17] Because of this decline in numbers, FINRA has asked chair-qualified arbitrators to travel to nearby locations to ensure there are a sufficient number of arbitrators available to the parties.[18] This has raised concerns with parties because the out-of-town arbitrators may be unwilling to travel during inclement weather, and may not be familiar with local venue customs and procedures.[19] To address these concerns, FINRA amended Rule 12400 and 13400 to provide that if an arbitrator is an attorney, they need only to have served on one case through to award to qualify for the chair roster (provided they have also completed the chairperson training).[20] The amendments became effective on January 9, 2017.

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14. *See* FINRA, RULE 12512(d) (2017).

15. *See*, *e.g.*, FINRA, RULE 12300(a)(2)(C), (a)(3) (2017)

16. FINRA, FINRA DR PORTAL: USER GUIDE FOR ARBITRATION AND MEDIATION CASE PARTICIPANTS (Apr. 2017), *available at* http://www.finra.org/sites/default/files/dr-portal-user-guide-parties.pdf.

17. *See* FINRA, REGULATORY NOTICE 17-04, ARBITRATOR CHAIRPERSON ELIGIBILITY; SEC APPROVES AMENDMENTS TO THE CUSTOMER AND INDUSTRY CODES OF ARBITRATION PROCEDURE BROADENING CHAIRPERSON ELIGIBILITY IN ARBITRATION (Jan. 2017), *at* http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-04.pdf.

18. *Id.*

19. *Id.*

20. *Id.*

B. Rules Governing Sales Practices of Brokers

Communications with the Public: FINRA has comprehensive rules governing firm and broker communications with the public. FINRA has amended portions of the rules governing correspondence concerning investment companies (mutual funds) and investment analysis tools. FINRA had required that firms file the management's discussion of fund performance portion of a registered investment company shareholder report if that report was provided to prospective investors. Because these reports are already filed with the SEC and do not present the same concerns that other marketing pieces may present, FINRA has eliminated this requirement from Rule 2210.[21] FINRA has also eliminated the requirement to file registered investment company ranking and comparison backup material, but still requires the firm to maintain the materials as part of its records.[22] FINRA has amended the requirement that communications concerning registered investment companies be filed. The rule had covered both generic communications and communications that promote a specific registered investment company or family of registered investment companies. Now, firms are only required to file those communications that promote a fund or fund family.[23]

FINRA has amended Rule 2213, which deals with communications containing bond fund volatility ratings. These communications were required to be accompanied or preceded by the bond fund's prospectus as well as contain specific disclosures. FINRA also required that the communications be filed before they were used. Again, FINRA determined that these communications were not causing the sorts of issues that were expected. FINRA has amended Rule 2213 to remove the requirement that communications containing bond fund volatility ratings be accompanied or preceded by a prospectus and eliminated many of the disclosure requirements.[24] Additionally, firms are no longer required to pre-file these

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21. *See* FINRA, REGULATORY NOTICE 16-41, COMMUNICATIONS WITH THE PUBLIC; SEC APPROVES AMENDMENTS TO RULES GOVERNING COMMUNICATIONS WITH THE PUBLIC (Oct. 2016), *at* http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-16-41.pdf.

22. *Id.*

23. *Id.*; *see also*, FINRA, RULE 2210(c)(3)(A) (2017).

24. *See* FINRA, REGULATORY NOTICE 16-41.

communications, and may file them after they have begun to use the communications.[25]

FINRA Rules 2210(c)(3)(C) and 2214(a) required that firms that utilize investment analysis tools file templates for reports produced by the tool as well any written communications concerning the tool. FINRA has amended these rules to eliminate the filing requirements. Now, firms must only provide FINRA staff with access to the tool upon request.[26] FINRA has also amended its rules governing the use of templates. Firms are not required to file retail communications that are based on templates, and are permitted to update statistical or other non-narrative information without refiling the template. FINRA had required any updates to the narrative information to be refiled. However, FINRA found that the narrative information did not present significant investor risk, and has expanded the exclusion from filing to also cover updates to narrative information.[27]

The amendments to the rules were effective January 9, 2017.

Pricing Disclosure in the Fixed Income Markets: Pursuant to SEC Rule, firms are required to provide transaction cost information when the firm acts as a principal in connection with an equity trade. Neither FINRA nor the SEC had any comparable requirement if the transaction involved a bond. FINRA coordinated its rulemaking efforts with those of the MSRB to develop similar disclosure obligations for corporate, agency and municipal debt trades.[28] The new disclosure requirements of FINRA Rule 2232 mirror those of MSRB Rule G-15. A firm is now required to disclose the mark-up or mark-down that a non-institutional customer has paid for a bond trade, if the firm also executes one or more offsetting principal transactions in the same bond on the same day which in the aggregate meet or exceed the size of the customer trade.[29] Both

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25. *Id.*

26. *Id.*

27. *Id.*

28. *See* FINRA, REGULATORY NOTICE 17-08, PRICING DISCLOSURE IN THE FIXED INCOME MARKETS SEC; APPROVES AMENDMENTS TO REQUIRE MARK-UP/ MARK-DOWN DISCLOSURE ON CONFIRMATIONS FOR TRADES WITH RETAIL INVESTORS IN CORPORATE AND AGENCY BONDS (Feb. 2017), *at* http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-08.pdf; MSRB, REGULATORY NOTICE 2016-28, NEW DISCLOSURE REQUIREMENTS UNDER MSRB RULE G-15 AND PREVAILING MARKET PRICE GUIDANCE PURSUANT TO RULE G-30 EFFECTIVE MAY 14, 2018 (Nov. 2016), *at* http://www.msrb.org/~/media/Files/Regulatory-Notices/Announcements/2016-28.ashx?n=1.

29. *Id.*

rules provide exceptions to the disclosure requirement, if, for example, the firm executes principal trades on a trading desk functionally separate from the trading desk that handles customer trades.[30] FINRA has provided guidance for firms as to what would be considered an "off-setting" transaction:

> If a member purchases 100 bonds at 9:30 a.m., and then sells to three customers, who each buy 50 bonds in the same security on the same day, without purchasing any more of the bonds, the rule requires mark-up disclosure on two of the three trades, since one of the trades would need to be satisfied out of the member's prior inventory, or its short position, rather than offset by the member's same-day principal transaction.[31]

Firms are required to determine the prevailing market price for the security when determining the mark-up or mark-down.[32] The mark-up or mark-down must be disclosed in a dollar amount and as a percentage of the prevailing market price.[33] The MSRB rule contains similar requirements.[34]

For all bond transactions, FINRA requires that firms disclose a reference or link to security specific trade data, which is available through a FINRA hosted web page containing TRACE trade data.[35] Firms are also required to provide investors with the time of their trade, so that they may more easily identify their transactions in the TRACE data.[36] The MSRB requires similar disclosures; however, the link must be to EMMA instead of TRACE.[37] The amendments and new requirements will go into effect on May 14, 2018.

Financial Exploitation of Seniors: Financial exploitation of senior investors has been a concern of FINRA's for many years. In January 2016, NASAA adopted the Model Act to Protect Vulnerable Adults from Financial Exploitation.[38] FINRA followed close behind, and has amended Rule 4512

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30. *Id.*

31. FINRA, REGULATORY NOTICE 17-08.

32. *Id.*

33. *Id.*

34. *See* MSRB, REGULATORY NOTICE 2016-28.

35. *See* FINRA, REGULATORY NOTICE 17-08.

36. *Id.*

37. *See* MSRB, REGULATORY NOTICE 2016-28.

38. *See* NASAA, NASAA MODEL LEGISLATION OR REGULATION TO PROTECT VULNERABLE ADULTS FROM FINANCIAL EXPLOITATION (Jan. 22, 2016), *available at* http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/07/NASAA-Model-Seniors-Act-adopted-Jan-22-2016.pdf.

(Customer Account Information) and adopted Rule 2165 (Financial Exploitation of Specified Adults).[39]

Rule 4512 will now require firms to make reasonable efforts to obtain the name of and contact information for a trusted contact person.[40] This must be done either at account opening or when account information is being updated.[41] Asking for the information from a customer will be considered reasonable efforts to obtain the information. The firm must also disclose that it may contact the trusted contact and:

> disclose information about the customer's account to address possible financial exploitation, to confirm the specifics of the customer's current contact information, health status, or the identity of any legal guardian, executor, trustee or holder of a power of attorney, or as otherwise permitted by Rule 2165.[42]

In addition to amending Rule 4512, FINRA adopted Rule 2165, which permits a firm to place a temporary hold on disbursement of funds or securities.[43] If a firm reasonably believes that financial exploitation has occurred, is occurring, has been attempted or will be attempted, the firm is permitted to place a hold on the disbursement of funds or securities from the customer's account.[44] There is no obligation to do so, the rule is entirely permissive. The rule defines the various terms included within it, including who is a specified adult, and what is considered financial exploitation.[45]

Once a firm places a hold, it is required to initiate an internal review of the facts and circumstances that led the firm to believe there may be financial exploitation.[46] A firm must notify the customer and the trusted contact of the hold within two days.[47] The firm is not required to notify the trusted contact if it believes the person is involved in the suspected financial exploitation. The

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39. *See* FINRA, REGULATORY NOTICE 17-11, FINANCIAL EXPLOITATION OF SENIORS; SEC APPROVES RULES RELATING TO FINANCIAL EXPLOITATION OF SENIORS (Mar. 2017), *at* http://www.finra.org/sites/default/files/Regulatory-Notice-17-11.pdf.

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.*

47. *Id.*

firm may discuss the suspected financial exploitation with the customer's broker, unless the firm believes the broker may be involved.[48] The temporary hold should expire within 15 business days, but may be extended for an additional 10 days.[49] The amendment and the new rule will become effective on February 5, 2018.

C. FINRA Guidance

Forum Selection Provisions: In July 2016, FINRA issued a reminder to firms that customers retain their right to request arbitration with FINRA even if the customer has signed an agreement with a forum selection clause designating another forum.[50] FINRA Rule 12200 requires parties to arbitrate under the Code if requested by the customer.[51] FINRA Rule 2268(d) prohibits any predispute arbitration agreement from including any condition that limits or contradicts the rules of any SRO, including Rule 12200.[52] In the notice, FINRA discusses recent federal court opinions which have enforced forum selection clauses which are contrary to FINRA rules:

> The holdings of these courts rest on the assumption that the duty to arbitrate under FINRA rules, or to arbitrate in FINRA's arbitral forum, is merely "contractual" and can be superseded or waived. This assumption is inconsistent with the fact that the Exchange Act requires most broker-dealers to be members of FINRA and that FINRA's rules are approved by the Securities and Exchange Commission (SEC), binding on FINRA member firms and associated persons, and have the force of federal law. FINRA rules are not mere contracts that member firms and associated persons can modify.[53]

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48. *Id.*

49. *Id.*

50. *See* FINRA, REGULATORY NOTICE 16-25, "FORUM SELECTION PROVISIONS; FORUM SELECTION PROVISIONS INVOLVING CUSTOMERS, ASSOCIATED PERSONS AND MEMBER FIRMS (July 2016), *at* http://www.finra.org/sites/default/files/notice_other_file_ref/Regulatory-Notice-16-25.pdf.

51. *Id.*

52. *Id.*

53. *Id.*

In outlining a firm's obligations under Rules 2268 and 12200, FINRA provides the firms with guidance as to what potential consequences may result if a firm uses a predispute agreement that is inconsistent with these rules:

> FINRA rules set forth specific requirements relating to predispute arbitration agreements and when a customer dispute must be arbitrated at FINRA. They are not default rules that may be overridden by more specific or separate contractual terms without consequences under FINRA rules. Thus, any member firm's denial, limitation or attempt to deny or limit a customer's right to request FINRA arbitration, even if the customer seeks to exercise that right after having agreed to a forum selection clause specifying a venue other than a FINRA arbitration forum, would violate FINRA Rules 2268 and 12200. In addition, in FINRA's view, the failure to submit a dispute to arbitration under the Customer Code as required by the Code would violate FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade).[54]

If a firm chooses to utilize a forum selection provision that provides for a forum other than FINRA, FINRA suggests appropriate language to include to ensure compliance with Rule 2286:

> This agreement does not prohibit or restrict you from requesting arbitration of a dispute in the FINRA arbitration forum as specified in FINRA rules.[55]

In the notice, FINRA has also reminded firms that brokers have the same right to request arbitration with FINRA under Rule 13200.[56] This rule may not be waived through the use of a forum selection clause specifying a forum other than FINRA. FINRA will deem it "conduct inconsistent with just and equitable principles of trade and a violation of FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade)" if a firm attempts to require a broker to waive his or her rights to arbitrate before FINRA under Rule 13200.[57] FINRA has suggested that firms use the same language suggested for customer agreements if it will utilize a forum selection clause with brokers that specifies a forum other than FINRA.[58]

Social Media and Digital Communications: In April 2017, FINRA issued additional guidance with respect to the recordkeeping, suitability, supervision,

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54. *Id.*

55. *Id.*

56. *Id.*

57. *Id.*

58. *Id.*

and content requirements when communicating with the public while using social media or personal devices.[59] FINRA has provided a series of questions and answers to provide guidance to firms and brokers as to what they may and may not do.

A firm is required to retain communications related to its business that occur through text messaging apps or chat services.[60] FINRA has provided examples of communications that would not need to be retained under Rule 2210: information about the firm's sponsorship of a charitable event, a human interest article, an employment opportunity, or employer information covered by state and federal fair employment laws.[61] If a firm shares or links to content, the firm has adopted that content, although, generally, the firm will not adopt the content of any information that is contained through links in the shared content.[62] Firms are permitted to use native advertising – advertising that bears a similarity to the news, feature articles, product reviews, entertainment and other materials that surrounds it online, so long as the firm complies with the requirements of Rule 2210.[63] FINRA does not consider unsolicited third-party opinions or comments to be testimonials under Rule 2210.[64] However, if a broker likes or shares comments that have been posted, the broker has adopted the comments.[65]

Sanction Guidelines: In April 2017, FINRA updated its sanction guidelines to include one new principal consideration when assessing sanctions, three new guidelines, and one new general principal.[66] The new principal consideration examines whether a respondent has exercised undue

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59. *See* FINRA, REGULATORY NOTICE 17-18, SOCIAL MEDIA AND DIGITAL COMMUNICATIONS; GUIDANCE ON SOCIAL NETWORKING WEBSITES AND BUSINESS COMMUNICATIONS (Apr. 2017), *at* http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-18.pdf.

60. *Id.*

61. *Id.*

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.*

66. *See* FINRA REGULATORY NOTICE 17-13, "SANCTION GUIDELINES; FINRA'S NAC REVISES THE SANCTION GUIDELINES (Apr. 2017), *at* http://www.finra.org/sites/default/files/Regulatory-Notice-17-13.pdf.

influence over a customer.[67] FINRA is formalizing its practice of considering this principal when determining whether there are aggravating circumstances present.[68] FINRA has also expanded its guidelines by including new sanction guidelines related to: (1) Systemic Supervisory Failures; (2) Borrowing From or Lending to Customers; and (3) Short Interest Reporting.[69] Last, FINRA has codified a new general principal which "addresses the potential mitigative effect of regulator or firm-imposed sanctions and corrective action."[70]

In addition to the new guidance, FINRA has also increased the monetary and non-monetary sanction guidelines for certain misconduct: (1) sales of unregistered securities that involve a high number of penny stock transactions; (2) churning; and (3) unauthorized trading.[71]

II. SEC Rules

Exemptions to Facilitate Intrastate and Regional Securities Offerings: The SEC has reviewed its rules governing exemptions from registration for intrastate and small offerings.[72] With respect to intrastate offerings, the SEC has amended Rule 147 and adopted Rule 147A.

Manner of Offering: Through prior guidance, the SEC had recognized that certain offering methods may be imperfect in terms of being limited solely to the residents of a state. For example, newspaper advertisements may encompass other states through circulation. However, the SEC has not considered that advertisement over the internet to be similarly targeted to the individuals of a state the way a newspaper might be targeted. Accordingly, the SEC has adopted a new exception to permit this form of solicitation, pursuant to its authority under Section 28 of the Securities Act of 1933, rather than under

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67. *Id.*

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.*

72. *See* Exemptions to Facilitate Intrastate and Regional Securities Offerings, Exchange Act Release 33-10238, 34-79161, 81 Fed. Reg. 83494 (Nov. 21, 2016), *available at* https://www.federalregister.gov/documents/2016/11/21/2016-26348/exemptions-to-facilitate-intrastate-and-regional-securities-offerings.

Section 3(a)(11).[73] Rule 147A will permit general solicitation and advertising, so long as the sale of securities are only made to residents of the issuer's residence.[74]

Residency of the Issuers: Rule 147 has limited the availability of the rule to issuers incorporated in or organized in the state where the securities were offered. The issuer was also required to have its principal office in the state. Pursuant to the amendments to Rule 147, the SEC has replaced the requirement that an issuer have its principal office located in the state, with a requirement that its principal place of business be located within the state.[75] Rule 147A does not require that the issuer be incorporated in or organized in the state. It only requires that an issuer's principal place of business be within the state.[76]

Resale of Securities: Both Rules 147 and 147A will require that for six months from the date of sale of the security, re-sales may only be made to other residents of the state.[77]

Offerings Under Rules 504 and 505: The SEC is increasing the aggregate amount of securities an issuer may offer and sell under Rule 504 from $1 million to $5 million.[78] Rule 505 similarly permits offerings and sales of up to $5 million in securities. In conjunction with the increase in Rule 504, the SEC is repealing Rule 505.[79]

The changes to Rules 147 and 504, the repeal of Rule 505, and the adoption of Rule 147A became effective May 22, 2017.

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73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.*

78. *Id.*

79. *Id.*

III. CFTC Rules

Whistleblower Award Process: The CFTC has reviewed its rules governing whistleblowers and has made amendments and additions where needed.[80]

Eligibility Requirements: The CFTC has clarified that a claimant may receive an award in a Covered Action, in a Related Action, or both.[81] Additionally, the CFTC has eliminated the requirement that the claimant be the "original source" of the information.[82]

Retaliation Against Whistleblowers: The CFTC has reconsidered is prior interpretation of the Commodity Exchange Act that it had lacked authority to bring an enforcement action against an employer who violates the anti-retaliation provision of Section 23(h)(1)(A). The CFTC has now made it clear that violations of the Act may be pursued by the CFTC.[83]

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80. *See*, CFTC, Whistleblowers Award Process, 82 Fed. Reg. 24487 (May 30, 2017), *available at* http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2017-10801a.pdf.

81. *Id.*

82. *Id.*

83. *Id.*

RECENT ARBITRATION AWARDS

Jason M. Kueser

In this volume, we will be highlighting a few "noteworthy" awards. There is nothing these awards necessarily share in common. However, upon a review of the awards database, they seemed to be awards that readers of the Journal may be interested in learning more about.

Jan E. Tullis and Scott K. Tullis, Claimants v. Ameriprise Financial Services, Inc. and Andrew Joseph Hall, Respondents
Case No. 16-01261[1]
Portland, Oregon

Claimants' Counsel: Joshua L. Ross, Esq., Stoll Stoll Berne Lokting & Shlachter PC, Portland, Oregon.

Respondents' Counsel: Howard M. Klausmeier, Esq., Ameriprise Financial Services, Inc.

Arbitrators: Stephany Adriene Watson, Public Chairperson; Rick D. Hampton, Public Arbitrator; Paul R. Meyer, Public Arbitrator.

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1. Claimants asserted the following causes of action: breach of duties owed to Claimants; mishandled accounts; negligence; breach of fiduciary duty; violation of the Oregon securities laws and applicable regulation laws, unsuitability, and failure to supervise. The causes of action relate to, among other things, Claimants' investments in First Trust Unit Investment Trusts ("UITs").

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

In the Statement of Claim, as amended, Claimants requested: compensatory damages of $195,044.41; recovery of all commissions, fees, and profits realized by the Respondents in an amount to be proven at hearing; interest at the rate of 9% per annum; and attorneys' fees and costs. At the close of the hearing, Claimants requested damages in the amount of $191,772.00.

In the Statement of Answer, Respondents requested dismissal of Claimants' Statement of Claim with prejudice; An Award of Forum costs and fees; and expungement from Respondent Hall's Central Registration Depository ("CRD") record.

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

1. Respondents Ameriprise Financial Services, Inc. and Hall are jointly and severally liable and shall pay to Claimants the sum of $191,772.00 in compensatory damages.
2. Respondents are jointly and severally liable and shall pay to Claimants interest on $191,772.00 at the rate of 9% per annum from the date of the award through the date of payment of the award.
3. Respondents' request for expungement is denied.
4. Any and all relief not specifically addressed herein, including Claimants' request for attorneys' fees, is denied.

The Panel issued provided an explanation of their decision. In their findings, the arbitrators noted that the broker's overall strategy was unsuitable, noting that he "took Claimants' asset allocation to 100% equities, from 70%" and that after "[a]ccounting for expected margin leverage, this amounted to 133% equity exposure." The broker "compounded leverage by investing in UITs comprised of closed-end funds ("CEF"), many of which used leverage as a component of their strategy." The Panel also noted that this investment strategy was less liquid due to high costs and more volatile than comparable investments in similar asset classes. The Panel also noted that the broker "compounded the unsuitability in February 2015, by selling the original UITs and placing fully 50% of Claimants' portfolio in a single sector, which was tightly linked to oil prices – UITs of CEFs of master limited partnerships" and that "[t]he balance of the portfolio was invested in an unsuitable UIT, which was not well diversified because it held only 12-13 individual stocks." The award was also noteworthy in that there was a reasoned Dissenting Decision provided by one of the arbitrators (Meyer). The dissenting decision covered 6 ½ pages of the award and included discussion relating to the arbitrator's opinion that Respondents should have taken steps to prevent Claimants from committing financial suicide.

The award is noteworthy for the reasoned decision, and, in particular the length to which the dissenting arbitrator detailed his findings and concerns. Furthermore, the award represented recovery of 100% of Claimant's claimed damages.

Agatha Dancy, individually and on behalf of her husband John Dancy, Claimants v. Wedbush Securities Inc. and Mark Fred Augusta, Respondents
Case No. 16-00847[2]
Los Angeles, California

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2. Claimants asserted the following causes of action: violations of state and federal securities laws and FINRA/SEC Rules; breach of fiduciary duty; unsuitable recommendations; failure to supervise; constructive fraud, common law fraud and fraud by material misrepresentations/omissions; unjust enrichment; and elder financial abuse. In the Amended Statement of Claim, Claimants added a cause of action for unauthorized trading. During the evidentiary hearing, Claimants moved to amend the Statement of Claim to add a cause of action for "unauthorized trading." Wedbush and Augusta opposed the motion. The Panel granted the motion.

The causes of action relate to Claimants' investment in long-term municipal bonds and structured certificate of deposits, including Citigroup FDG Medium Term due 5/30/2033, Lloyds TSB Bank Steepner Note due 2/22/2033, SG Structured Prods Medium Term due 11/30/2032, Citibank NA Prin Prot MLCD Quarterly due 3/27/2033, JP Morgan Chase Bank NA Columbus Oh CD due 1/18/2028, JP Morgan Chase Bank NA Columbus Oh CD due 11/20/2028, JP Morgan Chase Bank NA 30 YR US Dollar due 3/24/2029, JP Morgan Chase Bank NA Columbus Oh CD due 1/23/2029, United CMNTY Bank Blairsville Ga CD due 6/28/2033, and United CMNTY Blairsville GA CD due 8/23/2033.

Unless specifically admitted in their Statements of Answer, Wedbush and Augusta denied the allegations made in the Statement of Claim and asserted various defenses and affirmative defenses. Respondent Augusta also asserted cross-claims against Respondent Wedbush.

In the Statement of Claim, Claimants requested: 1. General and compensatory damages according to proof, in the amount of $247,000.00; 2. Lost opportunity costs in an amount according to proof; 3. Disgorgement of all commissions and fees paid to Wedbush and Augusta for the life of the accounts; 4. Costs of proceedings; 5. Punitive damages; 6. Interest at the legal rate on all sums recovered; 7. Reimbursement of all attorneys' fees and costs; and 8. Such other and further relief as this Panel deems just and appropriate.

In the Statement of Answer, Wedbush requested: 1. Dismissal of Claimants' claims in their entirety; and 2. An award of costs in its favor for having to defend against this claim. In the Statement of Answer to the Cross-Claim, Wedbush requested denial of Augusta's claims in their entirety.

In the Statement of Answer and Cross-Claim, Augusta requested: 1. Claimants take nothing by reason of their Statement of Claim; 2. Wedbush be ordered to indemnify Augusta for all legal fees and costs incurred with this matter; 3. In the event liability

Claimant's Counsel: Robert J. Girard, II, Esq., Girard Bengali, APC, Los Angeles, California.

Respondents' Counsel: For Respondent/Cross-Respondent Wedbush Securities Inc. ("Wedbush"): Charles LaChaussee, Esq., Wedbush Securities Inc., Los Angeles, California. For Respondent/Cross-Claimant Mark Fred Augusta, ("Augusta"): David S. Harrison, Esq., Law Offices of David Harrison, Beverly Hills, California.

Arbitrators: A. Joel Klein, Public Chairperson; Owen J. Thomsen, Public Arbitrator; Carolyn Renee Payne, Public Arbitrator.

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

1. The Panel finds that Wedbush and Augusta both engaged in improper conduct. The Panel also grants Augusta's Cross-Claim for indemnification. Accordingly, Wedbush is solely liable for and shall pay to Claimants the following amounts:
    a. $250,000.00 in compensatory damages;
    b. $110,000.00 in commission disgorgement;
    c. Interest in the amounts of $35,069.00 for compensatory damages and $15,430.00 for commission disgorgement. The Panel calculated interest at a rate of 10% per annum from December 31, 2015 through and including May 26, 2017;
    d. $1,080,000.00 in punitive damages pursuant to CA Elder Abuse and Adult Civil Protective Act, Welfare and Institutions Code Section 15600 et seq.;
    e. $277,691.00 in attorneys' fees pursuant to CA Welfare & Institutions Code Section 15657.1; and
    f. $28,864.00 in costs.
2. The Panel awards Augusta the sum of $110,000.00 in attorneys' fees and costs. However, as a result of Augusta's improper conduct, the Panel subtracts the commissions that he received, plus interest, in the amount of $50,172.00. Therefore, Wedbush is liable for and shall pay Augusta the net sum of $59,828.00 in attorneys' fees and costs pursuant to Lab. Code Section 2802.
3. The Panel finds that Wedbush and Augusta subjected Claimants to elder abuse and that they permitted unauthorized trading in the Claimants' account.

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is attributed to Augusta, Wedbush be ordered to indemnify him for any award paid to Claimants; and 4. Such further relief as the Panel deems appropriate.

4. Any and all claims for relief not specifically addressed herein are denied.

This award is noteworthy in that it represented a full recovery of Claimant's alleged losses, plus disgorgement of commissions, interest, attorneys' fees, costs, and more than $1 million in punitive damages. The Panel issued a finding that Respondents subjected Claimants to elder abuse and permitted unauthorized trading. The Panel also awarded the broker attorneys' fees and costs for his cross-claim, which were offset by commissions he received.

John T. Keck and Kathleen A. Keck, Claimants v. Jacqueline Sarette Georgia a/k/a Jacqueline Sarette Georgio Westover, Paul Samuel Howard, Bryan Kristian Pedersen, RBC Capital Markets, LLC, and The Pedersen Investment Group, Respondents.
Case No. 16-00512[3]
Cheyenne, Wyoming

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3. Claimants asserted the following causes of action: breach of fiduciary duty; omission of facts; failure to supervise; negligence; and errors/charges. The causes of action relate to Claimants allegations that Respondents transferred funds from Claimant John T. Keck's Wyoming Retirement System's defined benefit plan which forfeited Claimants' right to receive monthly benefits from the plan.

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

In the Statement of Claim, Claimants requested: 1. Money damages to replace the approximately $3,200.00 per month that the Claimants were entitled to receive from the Wyoming Retirement System for the balance of their lives in the amount of $750,000.00 to $1,000,000.00; 2. Costs in the amount of $12,635.84, including reasonable attorneys' fees in the amount of $27,315.00, expended by Claimants in pursuing the appeal before the Wyoming Retirement Board and this arbitration; 3. Forum fees in the amount of $2,000.00; 4. Interest in the amount of $80,000.00; 5. Purchase of an annuity to replace retirement benefits lost; and 6. Any and all additional relief to which they are entitled.

At the close of the hearing, Claimants requested damages in the amount of $662,625.00.

In the Statement of Answer, Respondents requested: 1. Dismissal of Claimants' claims with prejudice in their entirety; 2. Expungement of the Central Registration Depository ("CRD") records of the individual Respondents; and 3. Such other relief as is just and proper.

Claimants' Counsel: Patrick J. Crank, Esq., Crank Legal Group, P.C., Cheyenne, Wyoming

Respondent's Counsel: For Respondents RBC Capital Markets, LLC ("RBC"), Jacqueline Sarette Georgia a/k/a Jacqueline Sarette Georgia Westover ("Georgia"), Paul Samuel Howard ("Howard), and Bryan Kristian Pedersen ("Pedersen"), hereinafter collectively referred to as "Respondents": Adrian P. Castro, Esq. and John S. Lutz, Esq., Fairfield and Woods, P.C., Denver, Colorado. Respondent The Pedersen Investment Group did not enter an appearance in this matter.[4]

Arbitrators: Richard Djokic, Public Chairperson; Thomas R. Bromberg, Public Arbitrator; Larry D. Hayden, Non-Public Arbitrator.

Award: After considering the pleadings, the testimony and evidence presented at the hearing, the Panel 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 Claimants the sum of $559,612.00, as a result of Respondents' negligent conduct.
2. Respondents are jointly and severally liable for and shall pay to Claimants interest at the rate of 10% per annum on the amount of $559,612.00, pursuant to Minnesota Statutes §549.09. Interest shall begin accruing 30 days from the date of entry of the Award and continue until the amount of $559,612.00 is paid in full.
3. Respondents' request for expungement of the individual Respondents' CRD records is denied.
4. Any and all claims for relief not specifically addressed herein, including attorneys' fees, are denied.

This award represents another example of a sizeable award relative to relief requested, plus an award of post-judgment interest pursuant to Minnesota Statute.

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4. The Panel noted that Respondent The Pedersen Investment Group is not a member or associated person of FINRA and did not voluntarily submit to arbitration.
Therefore, the Panel made no determination with respect to Claimants' claims against Respondent The Pedersen Investment Group.

CASES & MATERIALS

Joseph Wojciechowski

Illinois Court Denies Market Manipulation Claim

CP Stone Fort Holdings, LLC v. John Doe(s), 2016 U.S. Dist. LEXIS 141078 (N.D. Ill. October 11, 2016)

This case involves an unusual situation where a plaintiff brought an assigned claim against anonymous defendants for trading manipulation in the United States Treasury Market. The defendants are anonymous because of the nature of secondary market trading in US Treasuries. The allegations entailed a market manipulation scheme involving numerous participants. The complaint alleged that the defendants manipulated the market by submitting orders to the various trading platforms they never intended to execute, which lured other market participants into entering sell orders below, or buy orders above, the prevailing market price because of the impact the "deceptive orders" had on the impression of supply and demand. The defendants then allegedly "flashed" the market by cancelling their bogus orders and simultaneously entering new "aggressor orders" in the opposite direction for the same security at the same price. Those orders were then filled by legitimate market participants at allegedly artificially high or low prices. These deceptive orders were alleged to be significant enough in size to move the market. Further, deceptive orders and flashes occurred within milliseconds of each other.

Defendants moved to dismiss the complaint on three primary grounds. First the Plaintiff lacked standing to pursue an assigned claim under Rule 10b-5 which are specifically restricted to persons who are either purchasers or sellers of securities. Plaintiff was neither. Plaintiff argued it was the legal assignee of the claims and the court agreed. The second ground for dismissal was based on the statute of repose which must be brought "not later than the earlier of 1) two years after discovery of the facts constituting the violation or 2) five years after such violation. All of the allegedly manipulative trading activity took place in 2013 and 2014, with the vast majority of the trades taking place more than two years prior to the date the complaint was filed. Plaintiff argued successfully that nothing pleaded in the complaint indicates Plaintiff was aware that defendants were purposefully engaging in a trading scheme. The court noted that Plaintiff was aware it suffered losses in 2013, but that incurring losses does not mean Plaintiff should have discovered then that those losses were the result of a market manipulation scheme. The final ground for

dismissal proffered by Defendants was that the claim failed to plead facts sufficient to state a claim for a Rule 10b-5 violation. Because of the heightened pleading requirements required for a fraud claim and further heightened pleading standards of the PSLRA, the court found in favor of Defendants. The court went so far as to state that the complaint essentially failed to plead that Defendants even did anything wrong, only that they seemed to legally manipulate a market because the activity engaged in was not expressly prohibited.

Plaintiff filed an amended complaint limiting the causes of action to a one count manipulation claim under Rule 10(b)-5. The court once again dismissed the case. *See CP Stone Fort Holdings, LLC v. Does,* 2017 U.S. Dist. LEXIS 42069 (N.D. Ill. March 22, 2017).

Sixth Circuit Dismisses ARS Case

William Beaumont Hosp. Sys. v. Morgan Stanley & Co., LLC., 2017 U.S. App. LEXIS 1549 (6th Cir. January 26, 2017)

Plaintiff Hospital entered into an ARS agreement with Morgan Stanley and Goldman Sachs in 2006 in order to finance a hospital renovation project. Defendants were underwriters of the debt and agreed to purchase and make a public offering of the ARS. The ARS market deteriorated and collapsed in 2007 and 2008. None of the auctions involving Plaintiff's debt securities failed, but the lack of demand resulted in it having to pay higher interest rates. In January 2014, Beaumont Hospital filed a FINRA claim, which was dismissed as ineligible for arbitration under the six year Eligibility Rule. Plaintiff pursued the case in federal district court which dismissed the case based on Michigan's six year statute of limitations for fraud claims. The district court also dismissed the case for failure to state a claim. The court of appeals affirmed the district court's ruling dismissing the case for failure to state a claim under Rule 10b-5. The core of Plaintiff's complaint was 1) that Defendants intentionally withheld information about the structure of the ARS market and their support-bidding practices; 2) that defendants misrepresented the availability of fixed versus formulaic rate structures in order to achieve higher fees; and 3) failed to warn Plaintiff about the deteriorating ARS market in 2007 and 2008. The court determined the complaint simply contained vague accusations of fraud, not the particularized facts necessary to plead fraud under rule 9(b).

Ohio Court Rules Commodities Futures Contracts Are Not Securities

Stevens v. S.W.LH.S. Investment Partners, 2017 Ohio App. LEXIS 415 (Ohio Ct. App. February 3, 2017)

A family entrusted several hundred thousand dollars to Stevens, a disabled retiree who day-traded commodities futures through an online broker. They entered into a formal written agreement where Stevens would be entitled to 40% of any gains and in the event there were no gains, would receive no compensation. The first year, 2007, did not go well and Stevens lost almost all of the $500,000 the family entrusted to him. The following year however, Stevens earned over a million dollars for the family and generated a return of almost $200,000 in 2009 before the family decided to close the accounts.

The Family paid Stevens, but he contended he was underpaid. The Family believed Stevens had to first make up the losses incurred in 2007, before being paid on any profits in 2008 and 2009. After a trial, the jury awarded Stevens all compensation he was allegedly owed. The Family appealed on multiple grounds, two of which were that Stevens was operating as an unregistered commodities pool operator in violation of Federal law and as an unlicensed investment advisor in violation of Ohio law.

First, the court determined that commodities futures contracts are not securities. The court concluded that because Stevens dealt strictly in commodities futures contracts, which were not securities, he was not bound by any registration requirements of an investment advisor.

With respect to Steven's failure to register as a commodities pool operator, the court determined that he fell under the registration exception for "small pool" operators, which consist of less than fifteen participants and less than $400,000 in capital contributions. The court would not reverse the trial court's denial of summary judgment on this point ruling that there was an issue of material fact about whether Stevens solicited, accepted or received funds and whether therefore the overall operation could even be considered a "small pool". The case is currently pending further appeal to the Ohio Supreme Court.

Definition of "Whistleblower" Under Dodd-Frank Probably Headed To Supreme Court Showdown

Somers v. Digital Realty Trust, Inc., 2017 U.S. App. LEXIS 4079 (9th Cir. March 8, 2017)

This case is about the interpretation of "whistleblower" in the Dodd-Frank Act's anti-retaliation provision, 15 U.S.C. Section 78u-6(h)(1)(A)(iii), which literally only applies to those who disclose information to the Securities and Exchange Commission. The Court determined other laws, including the anti-retaliation provision in the Sarbanes-Oxley Act, protected those who were fired after making internal disclosures of alleged unlawful activities. The court also deferred to the regulations of the SEC promulgated under Dodd-Frank which interpreted the word "whistleblower" more broadly and thus resolved the issue.

Somers reported several alleged securities law violations by his company to senior management. He was fired before he was able to report his findings to the SEC. He sued his former company for unlawful retaliation, amongst other causes of action, and the district court denied the company's motion to dismiss. The Court of Appeals agreed with the district court. The court reasoned the narrow interpretation argued by defendant and readily accepted by the Fifth Circuit made "little practical sense and undercut congressional intent." In siding with the Second Circuit's interpretation of the statute, *Berman* 801 F.3d at 151-52, the Ninth Circuit added to the "intercircuit disagreement" regarding the interpretation of "whistleblower" under Dodd-Frank. In so holding, the court ruled that Dodd-Frank whistleblower protections extend to those who report internally as well as to those who report to the SEC. Even if the statute is ambiguous, the court applied the *Chevron* doctrine and deferred to the SEC's regulations promulgated thereunder which broadened the interpretation.

Nevada Court Overturns FINRA Award

Sanchez v. Elizondo, 2016 U.S. Dist. LEXIS 171438 (Dist. Nev. December 12, 2016)

The district court granted a motion to vacate an arbitration award because the arbitrator committed reversible error by proceeding with a single arbitrator over the Respondent/Plaintiff's objection. The objection was based on the fact that Claimant/Defendant sought damages in excess of $100,000 at the arbitration hearing. Proceeding with one arbitrator therefore violated FINRA Rule 12401(c) which provides "if the amount of the claim is over $100,000…the

panel will consist of three arbitrators" absent agreement by of the parties. The Claimant/Defendant alleged damages in his prehearing brief, which was cited in the award, of $125,000 and Respondent/Plaintiff refused to consent to a single arbitrator. The FAA, 9 U.S.C Section 5, mandates adherence to the method for appointing arbitrators agreed to by the parties. Because the refusal of one party to consent to the method of selection of one arbitrator only, "it was error for an award to be made by an arbitrator not appointed under the method agreed upon by the parties. In such a case, the arbitrator exceeds his powers…" The court determined there was no issue of waiver by Respondent/Plaintiff because he had no reason, at least as far as the record reflected, to believe the Claimant/Respondent claimed an amount in damages that would entitle him to a panel of three arbitrators.

Eight Circuit Court Denies Claim against Bank in Sigillito Ponzi Case

Aguilar v. PNC Bank, N.A., 2017 U.S. App. LEXIS 2150 (8th Cir. February 7, 2017)

Ninety-two plaintiffs filed suit against PNC Bank in connection with the Ponzi scheme in British Lending Program (BLP) run by former pastor and attorney Martin Sigillito. BLP originated as a loan program for a British law firm to fund "black lung" claims brought on behalf of British coal miners in the late 1990s. The loans then began to fund real estate developments in England a few years later. Sigillito would solicit American investors and had them open self-directed IRAs or fund the investments by depositing money into his IOLTA account.

Allegiant, which was later purchased by National City Bank, which was then acquired by PNC Bank, served as the IRA custodian for many of these purported loans or investments. Sigillito's IOLTA account was also held at Allegiant. Each plaintiff assigned Sigillito as their "authorized representative" for their self-directed account. The self-directed IRAs were handled through the Allegiant trust department, whereas the IOLTA account operated through the retail banking department. In October 2001, Sigillito transferred funds from his IOLTA account to "buy out" one of the investors, with the funds being transferred to the Allegiant Self Directed IRA.

In September 2001, an Allegiant trust officer became suspicious and called certain red flags to the attention of the bank, including the fact that Sigillito received 32% of the loan proceeds as a fee, calling this "another red flag in a series of red flags" in an unsworn declaration. Further investigation revealed that Sigillito used investor money deposited into his IOLTA account to pay

interest and principal on some of the loans. In November 2001, Allegiant resigned as IRA custodian and facilitated the transfer of the accounts to Millennium Trust Company. No one from Allegiant communicated in any to any account owner the reason behind the resignation and in fact, kept quite at Sigillito and his team's request, to allow for a smooth transition to Millennium Trust.

BLP and Sigillito's scam continued for another eight years. Sigillito was convicted of multiple counts of wire fraud and money laundering, and the investors sued. The district court dismissed claims for aiding and abetting fraud, breach of fiduciary duty, and negligence. PNC then moved for summary judgment on the remaining claims under Missouri's Uniform Fiduciaries Laws, aiding and abetting breach of fiduciary duty, and conspiracy. The district court granted summary judgment for PNC and the court of appeals affirmed that decision.

The Plaintiffs, the court determined, simply did not have evidence to establish more than a mere association with Sigillito, which was insufficient to establish RICO liability. Further, the court determined there was insufficient evidence to establish at what point Sigillito's loans program became criminal in nature. Civil conspiracy requires more than mere association. It requires evidence that the defendants "met, negotiated, and more importantly, achieved a meeting of the minds to carry out some unlawful purpose." (citations omitted). Further, establishing a claim for aiding and abetting requires evidence of knowledge and "substantial assistance or encouragement to the other so to conduct himself." (citation omitted).

Similarly, the court determined there was insufficient evidence to hold the bank liable under the Uniform Fiduciaries Act, which requires "actual knowledge" of a breach or "knowledge of sufficient facts to constitute bad faith."

Signed Documents Prove Fatal to Investor Claims Involving Margin Blowouts in Connecticut and California

Batchelar v. Interactive Brokers, LLC, 2016 U.S. Dist. LEXIS 133719 (Dist. Conn. September 28, 2016)

Plaintiff, an online stock trader, brought a putative class action against Interactive Brokers for improperly liquidating positions in margin trading accounts when the accounts failed to meet Interactive's margin requirements. When a customer opens a margin account with Interactive, the firm engages software which monitors the Net-Liquidating Value ("NLV") of the customer's account. If the NLV drops below that customer's margin requirement,

a margin deficiency occurs, with results in the software engaging in an auto-liquidation function then liquidates positions using a "liquidation algorithm".

Plaintiff signed numerous documents, contracts and disclosures about auto-liquidation and margin requirements. But Plaintiff alleged the algorithm contained a "programming error." The complaint failed to specify this error or identify how it damaged his accounts. Interactive moved to dismiss which the court granted. The court ruled that Plaintiff's allegations of a breach of the margin agreement were unfounded and based on selective interpretation of the otherwise unambiguous language of the agreement, which provides Interactive with broad discretion to "liquidate all or any part of Customer's positions at any time and in any manner" in the event of an NLV deficiency. Further, the complaint did not allege Interactive did anything in "bad faith" and as such, could not sustain a claim for violation of a commercial reasonableness standard. In fact, the complaint was based on an alleged "programming error" not intentional misconduct or bad faith.

Court Denies Auto-Liquidation is Discretionary Trading Creating Fiduciary Duties

*Patterson v. E*Trade Clearing, LLC,* 2016 U.S. Dist. LEXIS 155748 (N.D. Cal. November 9, 2016)

Plaintiff brought a multiple count complaint against E*Trade in connection with auto-liquidation of securities in his account to cover margin calls. E*Trade moved to dismiss the breach of the implied covenant of good faith and fair dealing and breach of fiduciary duty claims. Applying New York law, the court granted the motion.

Plaintiff was an account owner at E*Trade for several years, opening his most recent account in 2014. Before opening this new account, Plaintiff spoke to an E*Trade representative about a previous loss he sustained with another broker as a result of a liquidation to cover margin deficiency without first giving him the opportunity to deposit cash into the account to cover the margin call. Before opening the account, Plaintiff sought assurances from the E*Trade representative that he would be informed and provided an opportunity to remedy any shortfall prior to a liquidation taking place. Plaintiff alleged that he received an unequivocal confirmation that E*Trade would afford him that opportunity. Plaintiff signed documents which contradicted this oral representation.

About a year later, E*Trade liquidated the only position in Plaintiff's account to cover a margin deficiency causing him to realize a $400,000 loss. E*Trade never contacted Plaintiff to provide him that opportunity to remedy the margin deficiency. The futures account margin agreement between the parties contained

a New York choice of law provision which meant the court considered cases like *De Kwiatkowski v. Bear Stearns,* 306 F.3d 1293 (2d. Cir. 2002), in determining E*Trade owed Plaintiff no fiduciary duties because the account was non-discretionary. Plaintiff argued unsuccessfully that the automatic margin liquidation event was in fact a discretionary transaction, thereby vesting E*Trade with fiduciary responsibilities. Although Plaintiff pleaded facts establishing he "trusted E*Trade's assurances" regarding the liquidation events which caused him to deposit funds in the account in the first place, the court ruled the facts as alleged were not sufficient to establish a fiduciary duty existed. Lastly, the court dismissed Plaintiff's breach of the implied covenant of good faith and fair dealing claim because it was essentially a breach of contract claim. The written contract between the parties clearly vested E*Trade with the contractual right to liquidate positions to satisfy a margin deficiency without adequate notice to cure.

California Denies LPL's Motion to Compel Arbitration

Dagostino v. LPL Financial, LLC, 2016 Cal. App. Unpub. LEXIS 8794 (Cal. Ct. App. December 6, 2016)

LPL clients loaned their financial advisor $375,000 to develop property in Hawaii. The advisor defaulted on the loans and the clients sued LPL and the advisor in California state court. After nine months, LPL sought to compel arbitration through FINRA and the court denied the motion. LPL argued the amended complaint did not contain allegations that fell within the scope of the arbitration clause and that plaintiffs were not prejudiced by the delay.

Plaintiffs pleaded causes of action for breach of fiduciary duty, constructive fraud, tort of another, professional negligence, breach of duty to supervise, and violations of the California Corporate Securities Law. Plaintiffs alleged that Schmidt, the financial advisor, was a management-level agent of LPL with authority to bind the company, such that his actions were those of LPLs. In an attempt to plead around the arbitration clause, the Plaintiffs cited to language of the loan agreements which provided for an action at law in the event of default.

In its initial pleading, LPL did not even mention the arbitration provision, nor did it file a motion to compel arbitration. Instead, LPL filed an answer and affirmative defenses, none of which included a reference to an arbitration clause. During the case management conference, LPL expressly requested a jury trial, even though arbitration was an option. The parties conducted fairly extensive discovery, including depositions. Each party then filed motions for summary judgment, which were stayed pending the resolution of discovery disputes. Then, Plaintiffs sought leave to file a second amended complaint,

which was granted. The second amended complaint added allegations in connection with an extensive supervisory issue at LPL including that discovery revealed that Schmidt had in fact been borrowing millions of dollars from clients for years. The new allegations also included details about which securities were liquidated in Plaintiff's accounts in order to fund the loans. LPL then sought to compel arbitration.

The court denied the motion stating "you can't use the court system and take up our time in discovery and counsel's time in discovery and try - almost completely try this case in the state court and then request, by way of motion to compel arbitration, arbitration…It's a waiver, and is abuse of the system. You committed to state court by your actions, you're going to try it in the state court and it's not going to go by way of arbitration." The court determined the allegations of the first amended complaint were arbitrable and that by litigating the case, aggressively, for nine months, LPL waived its right to invoke the clause. The court also ordered LPL to pay the Plaintiffs for costs of the appeal.

Puerto Rico Overrules Client's Attempt to Avoid Arbitration

Perez v. UBS Financial Services, Inc., 2016 U.S. App. LEXIS 136397 (Dist. P.R. September 29, 2016)

Perez became a client of Paine Webber prior to 1990. Over the years his accounts migrated to UBS-PR and invested in several UBS-PR closed end funds. He executed numerous documents over the years containing mandatory arbitration clauses, the first in 1996. In 2008, Perez executed another document, the UBS "Client Relationship Agreement" which also contained a mandatory arbitration clause. But this agreement also contained something called a "change-in-terms" provision and a choice of law clause identifying New York as the governing law.

Perez filed suit against UBS-PR in the district court in connection with investment losses in the UBS-PR closed end funds. UBS moved to compel arbitration. In response, Perez argued that the "change-in-terms" clause - which vested UBS with the right to change any term of the contract unilaterally rendered the contract illusory. Essentially, Perez argued the contract lacked mutuality because it authorized UBS to amend the agreement at any time and at its sole discretion. Perez also argued the New York choice of law provision was invalid under Puerto Rico law.

The court rejected the Plaintiff's arguments and granted the motion to compel arbitration. In order to find a choice of law provision unenforceable, it must be deemed unreasonable. The court determined there was nothing unreasonable about the New York choice of law provision considering that

UBS is incorporated in that state. The court further ruled there was nothing unconscionable about the contract as a whole or the arbitration provision. It was a creative attack on the arbitration provision, but the court determined it was without merit.

11th Circuit Sides With Morgan Keegan on *Erie* Doctrine Case

Mandel v. Morgan Keegan & Co., Inc., 654 Fed. Appx. 1001 (11th Cir. March 23, 2016)

Morgan Keegan appealed a decision to vacate an arbitration award based on the evident partiality of one of the arbitrators. *Mendel v. Morgan Keegan*, 110 F. Supp. 3d 1203 (N.D. Ala. 2015). Morgan Keegan argued that the lower court improperly relied on the Alabama Supreme Court's interpretation of the relevant Federal Arbitration Act provision instead of the Court's binding precedent. According to Morgan Keegan, had the court applied the correct standard, it could not have granted the motion to vacate. The Eleventh Circuit agreed.

Mendel was awarded $279,500 after an arbitration hearing, which was about one-tenth of his damages. After the award, it became evident that one of the arbitrator's former law firms used to represent Morgan Keegan. This was not disclosed. At oral argument, Morgan Keegan's lawyers argued Alabama substantive law controlled the interpretation of the grounds for vacatur. The district court treated *Mun. Workers Comp. Fund, Inc. v. Morgan Keegan* 190 So. 3d 895 (Ala. 2015) as controlling, which holds that the arbitrator need not actually know of a conflict and fail to disclose it in order to meet the evident partiality standard. This holding conflicts with Eleventh Circuit precedent as set forth in *Gianelli Money Purchase Plan & Trust v. ADM Investor Servs., Inc.* 146 F.3d 1309 (11th Cir. 1998) which requires a showing of actual knowledge.

Notwithstanding Morgan Keegan's erroneous comments at oral argument, the court ruled that the district court's reliance on the *Erie* doctrine to adopt state substantive law was misguided because the law to be interpreted was a federal statute. Just because jurisdiction was based on diversity did not automatically mean state substantive law applied to everything. This is a well-known exception to the *Erie* doctrine. Once the court applied the "actual knowledge" standard to the facts before it, it reversed the decision vacating the arbitration award. Mendel sought review by the United States Supreme Court, but the writ was denied by *Mendel v Morgan Keegan*, 137 S. Ct. 407 (2016).

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 Marnie Lambert at mlambert@mclinvestlaw.com, Andrew Stoltmann at andrew@stoltlaw.com or Robin S. Ringo at rsringo@piaba.org for assistance.

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The following PIABA Comment Letter regarding *AB 1517 (Muratsuchi/Chiu) – SUPPORT* was submitted to the Assembly Judiciary Committee Chair by Marnie C. Lambert on April 20, 2017 (prepared with the assistance of Scot Bernstein).

Honorable Assembly Member Mark Stone Chair, Assembly Judiciary Committee
P.O. Box 942849
Sacramento, California 94249-0029

Re: AB 1517 (Muratsuchi/Chiu) – SUPPORT

Dear Assembly Member Stone:

The Public Investors Arbitration Bar Association (PIABA) supports AB 1517 as amended effective April 5, 2017. PIABA believes that AB 1517, as amended on April 5, 2017, would provide meaningful protections to the investing public. In view of those meaningful protections, PIABA looks forward to working with Small Business California in moving this bill forward.

Sincerely,
Marnie C. Lambert, PIABA President
mlambert@mclinvestlaw.com

cc: Members, Assembly Judiciary Committee

Alison Merrilees,
Chief Counsel, Assembly Judiciary Committee
Alison.merrilees@asm.ca.gov

Paul Dress, Republican Caucus Consultant, Assembly Judiciary Committee
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Scot Bernstein
Via Email Only to swampadero@sbernsteinlaw.com

Lori Kammerer
Via Email Only to lck@midtown.net

The following PIABA Comment Letter regarding the *RIN 1210-AB79; Definition of the Term "Fiduciary"; Updated Economic and Legal Analysis* was submitted to the U.S. Department of Labor by Marnie C. Lambert on April 17, 2017 (prepared with the assistance of Mindy Steuer and Lisa Bragnca).

Office of Regulations and Interpretations
Employee Benefits Security Administration
Attn: Fiduciary Rule Examination
Room N-5655
U.S. Department of Labor
200 Constitution Avenue, N.W.
Washington, D.C. 20210

Re: RIN 1210-AB79; Definition of the Term "Fiduciary"; Updated Economic and Legal Analysis

To Whom It May Concern:

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

PIABA strongly opposes any revision or revocation to the Department of Labor's Conflict of Interest Rule (the "Rule") and accompanying exemptions (collectively, the "PTEs"). On February 3, 2017, the President, by Memorandum to the Secretary of Labor, directed the Department to prepare an updated economic and legal analysis and to "examine the Fiduciary Duty Rule to determine whether it may adversely affect the ability of Americans to gain access to retirement information and financial advice."

PIABA urges the Department to move forward with implementation of the Rule and PTEs as initially adopted over a year ago. The Rule is necessary to protect investors like Steve, a 69 year old Vietnam War veteran. He lives in Sycamore, Illinois with his wife, Constance, who has a pacemaker and other serious health problems. Steve had been a supervisor for Ideal Industries, a manufacturer of electrical connectors, testers, and other electrical components. In 1999, Steve went through a corporate downsizing after the company began

moving some of its manufacturing to China. After being laid off, he worked several jobs. He worked on the assembly line at Caterpillar and as a real estate appraiser. He is now receiving social security and does not work.

In about 2007, Steve's broker invited him to a "free lunch" seminar. At the seminar, and in later meetings, the broker said he recommended taking a cautious, conservative approach to investing. He also offered his clients the services of an attorney to set up trusts at reduced rates. Steve was convinced that his broker was an advisor he could trust with his life savings and he rolled over his pension. The broker recommended that Steve invest in Inland American and Behringer Harvard REITs because they were safe, secure investments that would pay him supplemental retirement income. He invested over 80% of Steve's life savings in these two speculative, non-traded REITs, which made no sense for someone who was 60 years old at the time, retired, had no pension, and needed to preserve his savings. Steve ended up losing $144,000, or approximately half of his initial investment. The losses were devastating to him.

The Department engaged in a lengthy rulemaking process before it adopted the Rule and accompanying PTEs. The Department has already considered the concerns raised in the Presidential Memo, and determined that associated costs were outweighed by the benefits to retirement investors. Nothing has changed since the Rule and PTEs were adopted, and they should be permitted to be fully enacted.

I. The Rule and PTEs were adopted after significant study and analysis

The Department adopted the Rule and the PTE's after it engaged in the rulemaking process over at least a six year period. The Department filed its initial proposal to amend the definition of "investment advice fiduciary" in October 2010.[1] The Department received over 300 comment letters on the 2010 proposal, held a public hearing at which 38 speakers testified, and then received an additional 60 comments following the public hearing.[2] The Department then met with various stakeholders over the next several years.[3]

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1. *See*, Dep't of Labor, *Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice; Final Rule*, 81 Fed. Reg. 20946, 20956 (April 8, 2016) ("DOL Final Rule"), available at http://webapps.DOL.gov/FederalRegister/PdfDisplay.aspx?DocId=28806.

2. *Id.* at 20957.

3. *Id.*

This process resulted in the Department's withdrawal of the 2010 proposal and submission of a new proposal in April 2015.[4] Throughout 2015, the Department received over 3,000 comment letters and over 300,000 submissions made as part of 30 separate petitions submitted on the new proposal.[5] The Department held four days of public hearings at which over 75 speakers testified.[6] On April 8, 2016, the Department filed its final rule in the Federal Register.[7] It provided for an applicability date of April 10, 2017.[8] The Department delayed the applicability date for full compliance with the terms of the various PTEs to allow firms to continue to benefit from the relevant exemptions without having to meet all of the exemptions' requirements for a number of months.[9] In support of the final rule, the Department prepared a 395 page Regulatory Impact Analysis.[10]

When issuing the Rule, the Department determined that "in light of the importance of the final rule's consumer protections and the significance of the continuing monetary harm to retirement investors without the rule's changes, an applicability date of April 10, 2017, is adequate time for [retirement] plans and their affected financial services and other service providers to adjust to the basic change from non-fiduciary to fiduciary status."[11]

It is important that the Rule and the PTEs move forward and begin the intended protection of retirement investors. Currently, brokers, often called financial advisors by themselves and others, are governed primarily by FINRA rules and state law (which is inconsistent across the country). For example, the FINRA suitability rule requires that a broker only have a "reasonable basis" for making an investment recommendation, and that the recommendation be "suitable" for the investor. Under this suitability standard, a broker can sell a

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4. *Id.*

5. *Id.* at 20958.

6. *Id.*

7. *Id.* at 20946.

8. *Id.*

9. *Id.*

10. *See*, "Regulating Advice Markets; Definition Of The Term "Fiduciary"; Conflicts Of Interest - Retirement Investment Advice; Regulatory Impact Analysis for Final Rule and Exemptions" (April 2016) ("RIA"), available at https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/completed-rulemaking/1210-AB32-2/conflict-of-interest-ria.pdf.

11. DOL Final Rule at 20946.

high-priced fund to an investor rather than a lower cost S&P 500 Index fund as long as the broker determines that the higher priced fund is "suitable" for the investor. The broker is not required to disclose to the investor that there were other lower cost options available that were also suitable or that there were conflicts of interest which may have influenced the broker's recommendation. This conflicted advice costs investors **$17 billion each year**.[12]

Under the Rule, financial advisors are obligated to eliminate conflicts of interest which permeate the financial services industry. Financial advisors are given the ability to manage certain conflicts, so long as they comply with an exemption to the Rule which provides transparency to the investor. No longer will the financial advisor be permitted to recommend an imprudent investment product or one based on the amount of commissions paid, even if it they are suitable, without disclosing the potential conflicts of interest that may be affecting the advice the investor receives.

The Department created the Best Interest Contract Exemption (the "BICE"), which would allow firms to continue receiving commissions and other forms of compensation that are common to retail transactions involving retirement plans, which would otherwise be prohibited under the Rule.[13] However, the BICE also ensures that investors receive retirement investment advice that is in their best interests. Pursuant to the BICE, financial advisors and firms that provide retirement advice may continue to receive commissions, 12b-1 fees, revenue sharing payments from issuers, sales loads or other similar compensation, provided that the investment advice they give is in the investor's best interest and "that they implement safeguards against the harmful impact of conflicts of interest on investment advice."[14]

II. If the applicability date of the Rule and PTEs is delayed for 6 months, a year, or more, the costs to investors will be substantial

Any further delay in implementation of the Rule and PTEs would cause investors to incur substantial costs. While estimates of those costs vary, there

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12. *See*, White House Council of Economic Advisers, "The Effects of Conflicted Investment Advice on Retirement Savings" (Feb. 2015) ("CEA Report"); available at https://obamawhitehouse.archives.gov/sites/default/files/docs/cea_coi_report_final.pdf.

13. DOL Final Rule at 20991.

14. *Id.* at 21003, 21004.

is widespread agreement that each month of delay would cost retirement investors over one billion dollars. This confirms what the Department concluded after over six years of careful review, as set forth in the Regulatory Impact Analysis ("RIA") – that delaying the beneficial protections of the Rule will cost investors billions of dollars.

a. Delays in implementing the Rule and PTEs would cost investors billions of dollars

After six years of careful analysis, the Department reached the conclusion that the cost to investors of investing based on conflicted advice is about $1.4 billion a month.[15] The White House Council of Economic Advisors reached a similar conclusion – that investors lose about $17 billion a year – over one billion dollars a month.[16]

These estimates have been accepted not just by investor advocacy organizations, but by the CFA Institute and the Financial Planning Coalition – organizations that represent financial advisors. The CFA Institute describes itself as a global, not-for-profit professional association of nearly 146,400 investment analysts, advisers, portfolio managers, and other investment professionals in 163 countries and territories, of which more than 140,000 hold the Chartered Financial Analyst® (CFA®) designation.[17] The Financial Planning Coalition (Coalition) is comprised of the Certified Financial Planner Board of Standards (CFP Board), Financial Planning Association® (FPA®) and National Association of Personal Financial Advisors (NAPFA).

In its March 17, 2017 comment opposing delay, the CFA Institute cites the Department's analysis and estimate of investor losses. It goes on to identify other potential causes of investor losses such as "revenue sharing, or mark-ups in principal transactions, … excessive or poorly timed trading, … annuity sales to IRA investors…."[18] The CFA Institute notes that "these compensation arrangements, transactions, conflicts, activities and investment instruments all raise questions about whether the investment firms selling these types of

15. *See*, RIA, supra n. 10.

16. *See*, CEA Report at 20, supra n. 12.

17. *See* March 17, 2017 Comment of CFA Institute, available at https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB79/01045.pdf.

18. *Id.* at 2.

products and services have the best interests of their clients in mind."[19] The investor losses to which the CFA Institute refers are in addition to the losses identified in the RIA.

The Financial Planning Coalition also opposes delay because of the costs it will impose upon investors.[20] Citing the DOL's analysis of the substantial costs to investors from conflicted advice, the Financial Planning Coalition points out that "retirement investors' losses will be compounded over the life of the investment product."[21]

b. Federal courts have found the Department of Labor's estimates of investor losses to be credible

While the financial services industry has brought multiple lawsuits to block the Rule and PTEs, each court that has considered those lawsuits has upheld the rule. Those courts have rejected claims that the Department's adoption of the Rule and PTEs was arbitrary and capricious. In upholding the Rule and PTEs, those federal courts have found the Department's cost/benefit analysis was properly based upon the evidence before it. [22]

In *Chamber of Commerce*, a Texas federal court found that the Department's evaluation of the costs to investors of conflicted advice was based upon evidence – not arbitrary and capricious.[23] The court rejected the industry complaint that the Department failed to obtain more specific evidence of IRA investor losses.[24] The court noted that during the comment period, "DOL specifically requested the industry provide any and all relevant data for

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19. *Id.*

20. *See* March 15, 2017 Comment of Financial Planning Coalition, available at http://financialplanningcoalition.com/wp-content/uploads/2017/03/Financial PlanningCoalition_Comment-RIN-1210-AB79.pdf.

21. *Id.* at 7.

22. *See National Association for Fixed Annuities v. Perez*, 2016 WL 6573480 (D.D.C. Nov. 4, 2016) (granting summary judgment in favor of the Department) ("NAFA"); *Chamber of Commerce of the United States v. Hugler*, 2017 WL 514424 (N.D. Tex. Feb. 8, 2017) (granting summary judgment in favor of the Department); and *Market Synergy Group, Inc. v. Hugler*, 2017 WL 661592 (D. Kan. Feb. 17, 2017) (granting summary judgment in favor of the Department).

23. *Chamber of Commerce*, slip op. at 61-62.

24. *Id.*

IRA investments, but was told the data either did not exist or would be too expensive to collect."[25]

In *Market Synergy*, a Kansas federal court concluded that "[a]ny injunction will produce a public harm that outweighs any harm that plaintiff may sustain from a rule change."[26] The court noted there was no basis in the administrative record to question the Department's conclusion that the Rule would produce valuable net benefits:

> The Department has determined that the Rule changes will benefit retirement investors throughout the United States by requiring investment advisers to act in the best interest of those investors. Congress authorized the Department to evaluate these competing interests and it has concluded that significant public interests favor the proposed regulatory changes. As already explained, evidence in the administrative record supports the Department's determination and the court finds no basis for contradicting those findings.[27]

In *NAFA*, the D.C. federal district court rejected all of the plaintiff's claims that the Rule was invalid. The court granted summary judgment to the Department. In rejecting the plaintiff's request for a stay pending appeal, the court emphasized the need to ensure that the "core protections" in the Rule go into effect no later than April of 2017: "this [is] not a case in which other interested parties or the public will suffer "little if any harm" if the new rules are enjoined pending appeal."[28]

III. The anticipation of the Rule has not caused brokerage firms to cease to offer commission based products, or to otherwise abandon or de-emphasize the needs of small investors

Virtually every major brokerage firm has announced that they intend to continue to offer commission based accounts and products to their clients, after the Rule goes into effect. These brokerage firms include: Morgan Stanley, Ameriprise, Raymond James, LPL Financial, Edward Jones, Cambridge Investment Research, Cetera Financial Group, Wells Fargo Advisors, and the

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25. *Id.* at 62.

26. *Market Synergy* at *30.

27. *Id.*

28. *Nat'l Ass'n for Fixed Annuities v. Perez*, No. CV 16-1035 (RDM), 2016 WL 6902113, at *3 (D.D.C. Nov. 23, 2016).

brokerage firms affiliated with insurance companies Massachusetts Mutual Life Ins. Co., Lincoln National Corporation, and Primerica.[29] Similarly, Merrill Lynch has recently stated that it may not eliminate commission based accounts for all of its retirement customers, as it had originally planned.[30] Indeed, a recent study of representatives affiliated with 14 of the largest independent brokerage firms reflects that 74% of such advisors/firms will continue to allow commission based transactions in retirement accounts after the fiduciary rule goes into effect.[31] These representatives reported that they believe that they can operate in the best interest of their clients, while still offering commission based products.[32] In fact, the only brokerage firm that has affirmatively stated that it will no longer offer commission based accounts in response to the Rule is Commonwealth Financial Network.[33] Commonwealth's shift away from commission based accounts is unlikely to have any significant impact on customers because Commonwealth only employs 1,600 advisors, and derives less than 10% of its revenues from commissions on retirement accounts.[34]

The vast majority of brokerage firms and financial advisors have also stated, without equivocation, that they will continue to offer the full panoply of financial products to small investors, once the fiduciary role goes into effect. For example, Morgan Stanley announced that its transaction based retirement brokerage accounts will continue to offer a broad array of products after the Rule goes into effect, including, but not limited to, mutual funds and exchange

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29. Greg Iacurci, "Insurance – based Broker-dealers Plan Use BICE Under DOL Fiduciary Rule", investment news.com (July 7, 2016); Greg Iacurci & Christine Idzelis, "Broker-dealer Split on Commissions in Wake of DOL Fiduciary Rule", investment news.com, (October 30, 2016); Bruce Kelly, "Cambridge, Cetera Will Continue to Pay Commissions on IRAs Under DOL Fiduciary Rule", investment news.com (November 1, 2016); Greg Iacurci, "Wells Fargo to Keep Commission Retirement Accounts Under DOL Fiduciary Rule", investment news.com (December 2, 2016).

30. Diana Britton, "Delay or not IBDs Moving Toward a Fiduciary Future", wealth management.com, (April 5, 2017).

31. *Id.*

32. *Id.*

33. Greg Iacurci & Christine Idzelis, Broker-dealer Split on Commissions in Wake of DOL Fiduciary Rule", investment news.com, (October 30, 2016).

34. *Id.*; Andrew Welsch, "Raymond James Follows Morgan's Lead in Keeping Commissions Under Fiduciary Rule", on Wall Street.com, (October 27, 2016).

traded products.[35] Similarly, Raymond James has announced that it fully expects to continue to offer a full range of investment options for all of its clients once the Rule goes into effect.[36] Likewise, Edward Jones customers who utilize its transaction based IRAs will be able to invest in a full range of stocks, bonds, certificates of deposits, and variable annuities.[37] Indeed, the recent survey of representatives affiliated with 14 major independent brokerage firms also found that 74% of such advisors/brokerage firms have not reduced the number of products that were available to their transaction based customers as a result of the Rule.[38] These same representatives reported that, while they are acting as fiduciaries, much of their business is still transaction based and therefore available to small investors.[39]

Several brokerage firms have also reduced their fees for small investors and/or reduced account minimums, in response to the Rule. As a result, the Rule has benefitted small investors by providing them with lower fees and access to services and accounts that they did not previously have. For example, Merrill Lynch is discounting fees for IRA accounts that are moved over to an advisory relationship in order to equalize the fee level for its low trading brokerage customers.[40] Edward Jones will be reducing the minimum on its fee-based accounts to $25,000 for clients who want to purchase stocks, mutual funds, or exchange traded funds, and to $50,000 for clients who want to purchase individual bonds.[41] In addition, Edward Jones will continue to have a minimum investment requirement of $5,000 for its Guided Solutions Fund Account.[42] Similarly, LPL Financial has announced that it will be reducing the

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35. Jim Wiggins, "Morgan Stanley to Preserve Client Choice for Retirement Accounts", Morgan Stanley.com/press releases (October 26, 2016).

36. Andrew Welsch, "Raymond James Follows Morgan's Lead in Keeping Commissions Under Fiduciary Rule", on Wall Street.com (October 27, 2016).

37. Andrew Welsch, "Fiduciary Ready: Edward Jones Unveils Compliance Plans", on Wall Street (August 19, 2016).

38. Diana Britton, "Delay or not IBDs Moving Toward a Fiduciary Future", wealth management.com, (April 5, 2017).

39. *Id.*

40. Greg Iacurci & Christine Idzelis, "Broker-dealers Split on Commissions in Wake of DOL Fiduciary Rule", investment news.com (October 30, 2016).

41. Andrew Welsch, "Fiduciary Ready: Edward Jones Unveils Compliance Plans", on Wall Street (August 19, 2016).

42. *Id.*

account minimum for its Optimum Market Portfolios from $15,000 to $10,000, in anticipation of the Rule.[43] Charles Schwab has also recently announced that it plans to launch a new advisory service in the first half of 2017 that will have an investment minimum of $25,000, but will offer comprehensive financial and investment planning, ongoing guidance from planning consultants, and fully automated and diversified portfolios comprised of low-cost, exchange traded funds from Schwab and third-party providers such as Vanguard.[44]

In short, the anticipation of the Rule has not resulted in any meaningful reduction of commission based products. It has not caused any decline in the products or services that are available for small investors. It has done exactly the opposite. As a result of the Rule, brokerage firms will be offering more services and investment products to small investors than they did prior to the enactment of the Rule.

The lack of any adverse impact to small investors from a fiduciary rule is further borne out by an extensive study that was conducted in 2012, which examined whether there were differences in the services available to investors in states that have fiduciary standards and those that do not. The study found that customers in the states that have a common law fiduciary rule applicable to broker-dealers and financial advisors [California, Georgia, Florida, Missouri, Puerto Rico, South Carolina, and South Dakota], have full access to investment advice and financial services.[45] This study found no statistical difference between the quantity and diversity of financial and investment services and products that were available in states that impose a fiduciary standard on brokers and brokerage firms, and those that do not.[46] This study further found that brokerage firms and advisors operating in states which hold brokers and brokerage firms to be fiduciaries provide the same level of service for lower wealth clients as in states without a fiduciary standard, that they provide a broad range of products to such clients, and that they allow for commission based compensation.[47]

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43. Think advisor, "LPL Cuts Prices, Account Minimums Ahead of DOL Fiduciary Rule", think advisor.com, (March 16, 2016).

44. Michael Cianfrocca, "Schwab Announces Schwab Intelligent Advisory", Charles Schwab press release (December 13, 2016).

45. Michael Finke and Thomas P. Langdon, "The Impact of the Broker-dealer Fiduciary Standard on Financial Advice" (March 9, 2012), onefPA.org/journal.

46. *Id.*

47. *Id.*

Most importantly, small investors have an equal if not greater need for the protections of a fiduciary rule than investors with larger accounts. Many small investors have less ability to withstand the risk or bear the expense that is associated with conflicted financial advice than those with greater wealth. Further, small investors are at a disadvantage if they lose money due to conflicted financial advice. It will often cost investors too much to pay an attorney hourly fees to try to recover such losses and it is often not cost-effective for an attorney to represent such an investor on a contingency fee basis (*i.e.*, where the attorney's compensation is a percentage of the amount recovered on behalf of the investor). Accordingly, it is disingenuous in the extreme to suggest that reversing and/or eliminating the Rule would somehow benefit small investors.

IV. The anticipation of the Rule has caused positive changes for investors and retirees

As discussed above, the Rule has benefitted small investors in several respects. The Rule has also led to many other positive effects for all investors, including a reduction in fees, and a pivot toward lower cost investment products.

For example, as a result of the Rule, LPL Financial has standardized the fees it charges for mutual funds, so that all of its customers now pay the same lower fee on mutual funds that are recommended by its representatives.[48] LPL has also announced that it intends to drop the pricing of its centrally managed platforms, to eliminate the research strategist fee and annual IRA maintenance fee on several of its portfolios, and to reduce the total cost to investors of accessing its financial services by nearly 30% compared to current pricing, in anticipation of the Rule.[49] Similarly, as stated above, nearly two-thirds of advisors affiliated with 14 independent brokerage firms have reported that their firms have realigned their products and services to introduce low-cost mutual funds, eliminate high-cost mutual funds, and introduce new share classes that are less expensive for the clients, in response to the Rule.[50]

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48. Bruce Kelly, "DOL Fiduciary Rule Sparks LPL to Standardize Fees on Mutual Funds", investment news.com (August 24, 2016).

49. Think advisor, "LPL Cuts Prices, Account Minimums Ahead of DOL Fiduciary Rule", think advisor.com (March 16, 2016).

50. Diana Britton, "Delay or not IBDs Moving Toward a Fiduciary Future", wealth management.com, (April 5, 2017).

The Rule has also caused several mutual fund issuers to lower the costs of mutual funds and exchange traded funds, thereby causing a substantial financial benefit to customers. Specifically, in January 2017, the Securities and Exchange Commission approved a proposal to create a new class of mutual fund shares for American Funds which would allow the brokers to determine how much to charge for the shares, thereby making it easier for brokerage firms to adopt compensation policies that pay standardized amounts across different mutual funds and different types of investments.[51] This change will eliminate many of the conflicts that are the target of the Rule without eliminating the ability of brokerage firms to offer commission based advice.[52] It is particularly beneficial and influential because American Funds is one of the largest mutual fund families. Indeed, many other mutual fund families have followed suit by issuing new types of mutual fund shares that dramatically reduce the commissions for brokers who sell those funds, and the compensation related conflicts associated with the sale of those funds, thereby resulting in substantial savings for investors.[53] Specifically, these new share classes carry a maximum sales load of 2.5%, compared with an industry standard for mutual fund Class A shares of 4.75% to 5.75%.[54] The issuance of these low-cost mutual funds is also likely to exert downward pressure on fees charged for other types of investment products, so that advisors remain cost competitive.

Not surprisingly, that has already proven to be the case. Specifically, since the Rule was enacted, several asset managers have reduced the fees charged for their products in order to be more competitive under the Rule. For example, in the fall of 2016, Blackrock eliminated commissions on eighteen of its exchange traded funds.[55] In October of 2016, Fidelity investments removed all commissions on all of its U.S. Ishares core exchange traded funds, thereby resulting in more savings for investors.[56] Shortly thereafter, Prudential

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51. Consumer Federation of America, "The Department of Labor Conflict of Interest Rule Is Already Delivering Benefits to Workers And Retirees: Delay Puts Those Benefits At Risk" (January 31, 2017).

52. *Id.*

53. *Id.*

54. *Id.*

55. Jeff Benjamin, "Fidelity Fires the Latest Salvo in ETF War", investment news.com, (October 12, 2016).

56. *Id.*

investments cut expenses on nine of its mutual funds.[57] Charles Schwab has also recently reduced the fees for its exchange traded funds.[58]

The Rule has also caused insurers to cease the sale of expensive L share variable annuities, again providing significant savings to investors.[59] Further, variable annuity sales declined sharply in 2016, in large part because of the Rule.[60] The decline in variable annuity sales is a positive development for investors because of the high costs and fees associated with variable annuities.

The most significant benefit of the enactment of the Rule, however, is the difference that it has made in the mindset of financial advisors. Specifically, a recent survey of advisors affiliated with fourteen different independent brokerage firms reflects that 78% of those advisers now consider themselves to be fiduciaries to the customers, up from 59% the previous year.[61] Seventy percent of those advisors also report that their firms have enhanced the compliance oversight of their business in response to the Rule.[62] As a result of the Rule, the vast majority of financial advisers now understand that they should act in the best interest of their customers.

As the foregoing reflects, the enactment of the Rule has already resulted in many benefits for investors and retirees. These significant and positive developments show that the Rule is doing exactly what it was intended to do, which is to preserve and protect the retirement savings of the American people. However, if the protections of the Rule are eroded through revision or revocation, these changes may be short-lived. The Rule ensures that these changes will remain in effect and continue to offer retirement investors protections.

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57. Jeff Benjamin, "Prudential Investments Joins the Fee Cuts Bandwagon", investment news.com (October 18, 2016).

58. *Id.*

59. Greg Iacurci, "DOL Fiduciary Rule Hastens Death of L – share Variable Annuities", investment news.com (January 11, 2017).

60. Barron's, "Fiduciary Rule Crushes Variable Annuities, Barron's.com, (March 29, 2017).

61. Diana Britton, "Delay or not IBDs Moving Toward a Fiduciary Future", wealth management.com, (April 5, 2017).

62. *Id.*

V. There is no realistic way to ensure compliance with the fiduciary standard if it is not an enforceable legal obligation

The Employee Retirement Income Security Act ("ERISA") was enacted in 1974. Prior to the enactment of the Rule in April of 2016, ERISA regulations regarding the duties and obligations of financial advisors had not been updated in over forty years. During the 42 years that elapsed between 1974 and 2016, brokerage firms made no meaningful changes in their treatment of their customers. Brokerage firms took no steps to adopt a fiduciary standard, or to implement policies that require all financial advisors to act in the best interests of the customers. Instead, brokerage firms routinely advertised that their customers came first, but then denied a fiduciary obligation whenever those customers were put in a position where they had to take legal action against them.[63]

In the six years of research and study which led up to the enactment of the Rule, the Department heard numerous stories from customers and retirees whose retirement savings had been decimated as a result of conflicted financial advice.[64] The Department determined that the lack of a fiduciary duty rule caused retirees to lose $17 billion each year due to conflicted financial advice, which led to them purchasing more expensive products.[65] The Department further determined, after an extensive review of independent research, that conflicted financial advice causes the average retiree to lose an estimated 12% of the value of his or her savings if drawn down over 30 years.[66]

As a result of its six years of study and research, the Department concluded that the only way to ensure that brokerage firms act in the best interests of the customer, and avoid the conflicts which cause brokers to recommend high cost investments that the customers do not need, was to enact a fiduciary requirement. That necessity, and, in particular, the need to save retirees the $17 billion or more that they lose each year due to conflicted financial advice, has not gone away. Indeed, if all financial advisors had already been providing

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63. PIABA Report, "Major Investor Losses due to Conflicted Advice: Brokerage Industry Advertising Creates the Illusion of a Fiduciary Duty; Misleading Ads Fuel Confusion, Underscore Need for Fiduciary Standard" (March 25, 2015) ("PIABA Report"), available at https://piaba.org/system/files/pdfs/PIABA%20Conflicted%20Advice%20Report.pdf.

64. *See e.g.*, PIABA Comment Letter to the Department of Labor, piaba.org (July 21, 2015).

65. CEA Report, supra n. 12.

66. Department of Labor "Faqs: Conflicts of Interest Rule Making", dol.gov.

advice based solely on the best interests of the clients prior to the enactment of the fiduciary rule, there would have been no need for a fiduciary rule in the first place.

We have had over forty years to see what happens, and the high costs that retirees bear, when brokerage firms and their representatives are not required to act in the best interests of their customers. There is no rational basis for believing that brokerage firms and their representatives would voluntarily adhere to a fiduciary standard, given their decades of inaction and resistance, and the great harm to retirees which occurred in the decades that preceded the enactment of the fiduciary rule. On the contrary, the billions of dollars that brokerage firms and financial advisors have received each year as a result of conflicted advice would be too much money for any rational business person to walk away from, in the absence of an enforceable legal mandate. It is naïve, unrealistic, and contrary to history to expect otherwise.

Further, eliminating the Rule now would only serve to hurt the financial services firms that have expended considerable resources to comply with the rule, and reward the financial services firms who have unjustifiably resisted it. Businesses that do the right thing by their customers should be rewarded, not punished.

VI. Investor education cannot address the investor confusion that currently exists

The confusion about whether a financial advisor is a fiduciary or not is not one that investor education can remedy. Research has shown over and over again that investors are confused about whether their financial advisor is acting as a fiduciary or not. This has persisted even as the issue of the Rule has been in the news. In large part this confusion persists because the industry still represents financial advisors as trusted advisors whether they are fiduciaries or not.

a. Investors remain confused

The industry is well-aware that investors are confused about whether their advisors are fiduciaries or not. In a survey open to all brokers, investment advisers, and insurance consultants and producers, 97 percent of them said "investors don't understand the differences between brokers and investment advisers." More than three out of four investors don't understand that the current laws and rules may impose different duties on brokers and investment

advisers, according to a 2010 survey conducted for the Consumer Federation of America (CFA), AARP, the Investment Adviser Association, the Financial Planning Association, the CFP Board, the North American Securities Administrators Association (NASAA), and the National Association of Personal Financial Advisors. A 2015 study confirmed that this confusion persists – most retail investors think their financial advisor is a fiduciary.

It is no accident that a financial advisor does not call himself a "broker" or a "salesperson." Firms confer upon their "brokers" a myriad of confusing and misleading titles to give the impression that they are trustworthy (fiduciary) advisors. Individual brokers serving investors have titles like "Financial Advisor" and "Wealth Management Specialist."

The confusion is compounded by the fact that a financial advisor may owe fiduciary duties in handling some of an investor's accounts but not in handling other accounts. It is not unusual for investors to have multiple investment accounts with the same financial advisor. An investor could have certain accounts for which the financial advisor is a fiduciary, such as investment advisory accounts or accounts in which the financial advisor has discretion to buy and sell securities. At the same time, the investor may have non-fiduciary commission-based brokerage accounts in which the same financial advisor may only have to recommend investments that are appropriate for the investor under the much lower suitability standard.

b. The industry advertising creates more confusion

Firms routinely advertise themselves as giving personalized, ongoing, non-conflicted advice that puts the customer first. There is a striking difference between the positions brokerage firms take when soliciting customers and those they take when those same customers file arbitrations to resolve disputes against them. At the front end, in their advertising, firms promise unconflicted, trustworthy advice – as a fiduciary would. At the back end, in arbitrations, those same firms disclaim anything more than the obligations of a used car salesman: nothing more than following customer instructions to buy and sell securities.

We provide the following statements from UBS and Morgan Stanley as examples of what firms are doing generally. At the front end, UBS holds itself out as a fiduciary in its advertising, saying:

> Until my client *knows* she comes first. Until I understand what drives her. And what slows her down. Until I know what makes her leap out of bed in the morning. And what keeps her awake at night. Until she understands that I'm always thinking about her investment. (Even if

> she isn't.) Not at the office. But at the opera. At a barbecue. In a traffic jam. Until her ambitions feel like my ambitions. Until then. We will not rest. UBS.[67]

(emphasis in original.) What UBS describes is a fiduciary duty – a continuous ongoing advisory relationship. That is not what UBS says in arbitrations with its "clients." In arbitrations, UBS says it is just a broker and "a broker does not owe a fiduciary duty to his customer in a nondiscretionary account."[68] Once an investor hires the brokerage firm, that investor becomes a "client" to whom the firm says it does not owe the duty that it advertised.

Morgan Stanley and Ameriprise do the same. At the front end in its advertising, Morgan Stanley says:

> Having an intimate knowledge of blue chips and small caps is important. But even more important is an intimate knowledge of you and your goals. Get connected to a Morgan Stanley Financial Advisor and get a more personalized plan for achieving success.[69]

Yet, in arbitration Morgan Stanley says it owes its customer a fiduciary duty ***only*** when Morgan Stanley has discretion to buy and sell securities in the account:

> There is no fiduciary duty where, as here, the client maintains a non-discretionary brokerage account.
>
> [Customer's] claim of breach of fiduciary duty fails as a matter of law and should be dismissed in its entirety. [Customer's] claim seeks to impose 'fiduciary' obligations and duties on [Morgan Stanley] that only arise in very limited circumstances that do not exist here, i.e. where [Morgan Stanley brokers] are given discretionary trading authority over Claimant's accounts.[70]

Similarly, Ameriprise tells investors:

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67. *See*, PIABA Report, supra n. 63; *see also*, Consumer Federation of America & Americans for Financial Reform, "Financial Advisor or Investment Salesperson? Brokers and Insurers Want to Have it Both Ways" (Jan. 1 8, 2017) ("CFA /AFR Report"), available at http://ourfinancialsecurity.org/wp-content/uploads/2017/01/ Financial-Advisor-or-Investment-Salesperson.pdf.

68. PIABA Report, supra n. 63.

69. *Id.*

70. *Id.*

> You can expect to hear about the options you have and any underlying factors to consider. ***Our advisors are ethically obligated to act with your best interests at heart.***[71]

Nonetheless, in arbitration Ameriprise routinely disclaims these responsibilities, saying it "owed no fiduciary duties" to its customers.[72]

It is no wonder that investors believe their financial advisors are fiduciaries -- that is what firms and brokers tell them. Investor education can be used to try to counter the multitude of confusing claims made by firms and brokers on various topics, however it is highly unlikely that it will eliminate the industry-created perception that it is acting in a fiduciary capacity on behalf of investors.

c. Options for investing retirement accounts are myriad and complex

Investor education is not sufficient to address the dizzying array of investment products that investors must choose between when investing their nest eggs.

There is a great need for protection of retirement savings because IRAs and 401(k) and 403(b) retirement plans have become the primary tool for retirement planning and savings for millions of working Americans. Pensions have become rare, making it more important for retirement investors to be responsible for ensuring they have the necessary funds to support themselves in retirement. One-time transactions like rollovers will involve trillions of dollars over the next five years and can be among the most significant financial decisions families will ever make.[73] As pensions and employer retirement accounts are rolled into IRAs, investors seek guidance and advice from financial advisors.

Retail investors now confront a myriad of choices of how and where to invest. Retirement accountholders must choose whether to invest in stocks, bonds, mutual funds, exchange traded funds, real estate investment trusts

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71. *Id.*

72. *Id.*

73. Rollovers" are expected to approach $2.4 trillion cumulatively from 2016 through 2020. *See*, Regulating Advice Markets; Definition of the Term "Fiduciary"; Conflicts of Interest – Retirement Investment Advice; Regulatory Impact Analysis for Final Rule and Exemptions (April 2016); available at https://www.DOL.gov/ sites/default/files/ebsa/laws-and-regulations/rules-and- regulations/completed rulemaking/1210-AB32-2/conflict-of-interest-ria.pdf.

(REITs), various structured debt instruments, insurance products that offer menus of direct or formulaic market exposures and guarantees from which consumers can choose, and an extensive array of derivatives and other alternative investments. These choices vary widely with respect to risk characteristics, potential return, liquidity, degree of diversification, contractual guarantees and/or restrictions, degree of transparency, regulatory oversight, and available consumer protections. These choices are complex and specialized in nature, using financial terms and formulae beyond the knowledge of most investors (and some brokers).

What investors often do not understand is that some of these products, such as oil and gas partnerships and REITs, pay substantial commissions to the broker selling them. Even the most conscientious broker can talk himself into why a product that pays him an 8% or 10% upfront commission is good for an elderly investor – Steve, the retiree discussed on the first page of this letter, is a perfect example of that. Unfortunately, even when those high commissions are "disclosed" to investors, the disclosure is buried in fine print that most investors are too overwhelmed at the time of purchase to read.

Thus, it is not surprising that after six years of study and research, the Department concluded that the only way to ensure that brokerage firms act in the best interests of the customer in handling retirement accounts was to enact a fiduciary requirement. As time goes on, the options available to investors multiply and firms find new and better ways to sell their services with fiduciary language. No amount of investor education can address this problem.

Conclusion

Delaying implementation costs investors money every day. SaveOurRetirement.com estimates that retirement savers lose between $57 million and $117 million every day due to conflicted investment advice, amounting to at least $21 billion annually.[74] The Council of Economic Advisers estimates Americans are suffering $17 billion in losses annually due to conflicted advice they receive from financial advisors.[75] It is imperative that

74. *See*, Save our Retirement Comment Letter (May 8, 2015), available at http://saveourretirement.com/cms/wp-content/uploads/2015/02/DOL-SOR-Letter-Comment-Period-Request-5-8-15.pdf.

75. *See*, White House Council of Economic Advisers, "The Effects of Conflicted Investment Advice on Retirement Savings." "Conflicted advice" refers to advice given on particular investment products where the financial advisor is compensated

the Rule become applicable as soon as possible so retirement investors can receive the protections that they deserve.

It is also worth noting that, as discussed above, the Rule and PTEs have already been reviewed by three separate federal courts following challenges by various industry members.[76] In each case, the federal judge determined that the Rule and PTEs should go forward.[77] In considering whether to issue an injunction to delay implementation of the Rule and PTEs, Judge Crabtree stated:

> an injunction will lead to confusion about the law and likely produce unwarranted delay. This is not in the public's interest. Any injunction thus will produce a public harm that outweighs any harm that plaintiff may sustain from the rule change. The DOL has determined that the rule changes will benefit retirement investors throughout the United States by requiring investment advisers to act in the best interest of those investors. Congress authorized the DOL to evaluate these competing interests and it has concluded that significant public interests favor the proposed regulatory changes. As already explained, evidence in the administrative record supports the DOL's determination and the court finds no basis for contradicting those findings.[78]

Likewise, any revision or revocation of the Rule and PTEs would similarly harm investors. The Department has previously justified the Rule and the implementation period. Nothing has changed which would justify a reconsideration at this time. As the Department itself points out,

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in fees and commissions that depend on which investment product the customers buys.

76. *National Association for Fixed Annuities v. Perez* (D.C. 2016)(No. 16-CV-01035); *Chamber of Commerce v. U.S. Dep't of Labor* (N.D. Tex. 2016)(No. 16-CV-01476-M) consolidated with *American Council of Life Insurers v. U.S. Dep't of Labor* (No. 16-CV-01530-C) and *Indexed Annuity Leadership Council v. Perez* (No. 16-CV-01537-N); *Market Synergy Group, Inc. v. U.S. Dep't of Labor* (Kan. 2016)(16-CV-04083); and *Thrivent Financial for Lutherans v. Perez* (Minn. 2016)(16-CV-03289).

77. *National Association for Fixed Annuities v. Perez,* 2016 WL 6573480 (D. D.C. 2016); *Chamber of Commerce v. U.S. Dep't of Labor,* 2017 WL 514424 (N.D. Tex. 2017); and *Market Synergy Group, Inc. v. U.S. Dep't of Labor,* 2017 WL 661592 (D. Kan. 2017).

78. *Market Synergy Group, Inc. v. U S. Dep't of Labor*, No. 16-CV-4083-DDC-KGS, 2016 WL 6948061, at *30 (D. Kan. Nov. 28, 2016).

underperformance of investments due to poor fund selection could cost IRA investors between $95 billion and $189 billion over the next 10 years, and that implementation of the rule could reduce these costs to investors by between $33 billion and $36 billion.[79] Conversely, complying with the Rule and PTEs would cost firms only $16 billion over ten years.[80] Considering the cost benefit analysis, there is no reason to delay the Rule any further, or to revise or revoke the Rule.

Accordingly, the Department should fully proceed with the applicability timeline set forth in the Rule and PTEs and ensure that investors, like Steve, are protected moving forward.

Respectfully submitted,
Marnie C. Lambert, President

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79. Dep't of Labor, *Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice; Proposed Delay of Applicability Date*, 82 Fed. Reg. 12319, 12323 (March 2, 2017), available at https://www.federalregister.gov/documents/2017/03/02/2017-04096/definition-of-the-term-fiduciary-conflict-of-interest-rule-retirement-investment-advice-best.

80. *Id.*

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The following PIABA Comment Letter regarding the *FINRA Regulatory Notice 17-06* was submitted to the Financial Industry Regulatory Authority by Marnie C. Lambert on March 27, 2017 (prepared with the assistance of Christopher Gray).

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

Re: FINRA Regulatory Notice 17-06 – Proposed Amendments to Rules Governing Communications with the Public

Dear Ms. Asquith:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitration proceedings. 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 (hereinafter "FINRA") related to investor protection.

FINRA Regulatory Notice 17-06 seeks comments on proposed amendments to FINRA Rule 2210, which currently prohibits, *inter alia*, communications with the public that predict or project performance, or imply that past performance will recur. The proposed amendments would provide a limited exception to this prohibition, permitting customized hypothetical investment planning illustrations that may project returns for a given "asset allocation or other investment strategy", but not the performance of an individual security. Under the proposed amendments, the exception would be applicable to all firms (including those with only an online platform) and may be used to provide specific current (and prospective) customers with such illustrations.

There would of course be requirements that must be met before a firm could use a customized hypothetical illustration pursuant to the exception.

First, there must be a "*reasonable basis* for all assumptions, conclusions, and recommendations" contained in the illustration (emphasis added). Second, the illustration must "clearly and prominently disclose the fact that [it] is hypothetical and that there is no assurance that any described investment performance or event will occur." Third, a registered principal must pre-approve the template to be used (such as one provided by a reliable off-the-shelf software package) to generate the illustration to be provided to the customer(s) or, if not using a template, must pre-approve each illustration before it is used or distributed.

PIABA generally supports changes to the communications rule that enhance investor education and inform customers of the need for (and potential results of) proper asset allocation, sector concentration, diversification, and other investment strategies. But PIABA is concerned with some key aspects of the proposed amendments for reasons set forth below:

First, FINRA's stated rationale that permitting registered representatives who are not dually-registered to use the same kind of illustrations investment advisers have been using with advisory clients will "better harmonize regulatory standards" just is not true. The fact remains that until FINRA, the Securities and Exchange Commission, Congress, the President or the Department of Labor establishes a uniform fiduciary standard to govern both broker-dealers and registered investment advisers, the "regulatory standards" cannot be harmonized. Only a uniform fiduciary standard can ensure that register2d representatives act in investors' best interests and alleviate the confusion and financial harm caused by the current regulatory environment. Simply changing one rule, of many, to allow a broker-dealer/registered representative to provide a customer with a hypothetical illustration that a dually-registered firm/broker can already provide does not "even the playing field" for registered representatives (or make things less complicated for investors[1]). There remains a patch work of statutory and common law across

1. Under the current regulatory structure, investors can be faced with varying standards covering the same financial advisor depending on "which hat" a dually-registered advisor may be wearing at any given point in time. Three out of four investors don't understand that the current laws and rules impose different duties on brokers and investment advisers according to a 2010 survey conducted for the Consumer Federation of America (CFA), AARP, and the North American Securities Administrators Association (NASAA), among others. *See* http://bit.ly/1Npodra (last accessed March 26, 2017). A 2015 study also confirmed that most retail investors think their financial advisor – regardless of which type of advisor he or she is – is a fiduciary. Further, according to a February, 2015 report by the Council of Economic Advisers, investors suffer $17 billion in losses annually due to conflicted advice they receive from financial advisors under the existing regulatory system. *See*

the country under which some brokers are held to fiduciary standard and others are not. Indeed, if anything, the proposed amendments will only further confuse customers as to what duty of care the person handing them the illustration projecting the performance of their investment strategy owes them. If it is an illustration for a discretionary investment advisory account, the advisor will be held to a fiduciary standard, whereas if the illustration is in a traditional brokerage account, the broker may only be held to a suitability standard (or whatever standard is applied in that particular jurisdiction). Will the "reasonable basis" factors be applied differently (using the lower suitability standard) for the registered representative's illustration than for an investment advisor's illustration? If so, a customer with more than one type of account and/or financial representative/firm will probably not know on which illustration(s) to rely in making investment decisions. PIABA believes investor confusion should be minimized rather than made worse, which is what it seems likely the proposed amendments will do.

Second, PIABA is concerned that illustrations projecting hypothetical returns for future time periods may confuse unsophisticated retail investors by creating the impression that the projected returns are more certain than they actually are. The experience of PIABA members is that a projection of future performance based on, for example, *historic returns of 8-9%* for a given asset allocation or other investment strategy, is too often viewed by the average investor as a forecast or prediction of how their investments will perform going forward (regardless of the disclaimers and limitations that may be clearly stated on the illustration). It is PIABA members' experience that boilerplate statements that the illustrations are hypothetical or that "past performance is not indicative of future results," as contemplated by the proposed amendments are not enough. Unfortunately, financial professionals too often convince customers to ignore the written warnings as "just something the company has to say" and tell them that the principal in their investment account, insurance policy or annuity will grow at the reflected historical rate for the foreseeable future. We have seen many instances of people making life-altering decisions, like taking early retirement or taking large systematic withdrawals, based on someone they trust telling them that their principal will grow at a certain rate and they can "afford" to do so. Given that some financial professionals advising customers on how to manage and grow their savings sometimes paint too rosy of a picture for customers, PIABA strongly prefers not creating a new

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"Fiduciary – Do Investors Know What It Means" accessible at http://349ab54c3b58919c6638-ff70f51d4942f2bbd11ba0e41cfec577.r51.cf2.rackcdn.com/Fiduciary%20Whitepaper.pdf (last accessed March 26, 2017).

opportunity for brokers to tell investors whatever it takes to get the assets under management or invested in a particular manner.

Third, as noted in FINRA Regulatory Notice (Request for Comment issue no. 5), PIABA is concerned about the lack of more specific guidance as to how the firm/broker should determine what assumptions or factors are appropriate to for any given illustration (beyond that a "reasonable basis" might be established by using certain factors, as long "unreasonable emphasis" is not put on any one of the factors). FINRA Regulatory Notice 17-06 provides examples of what might establish "reasonable basis" such as:

> … [R]eference to the historical performance and performance volatility of asset classes, the duration of fixed income investments, the effects of macroeconomic factors such as inflation and changes in currency valuation, the impact of fees, costs and taxes, and expected contribution and withdrawal rates by the customer.

It appears that the firm/broker would have a lot of latitude in deciding what factors are considered for any given illustration. PIABA is alarmed by that prospect because an illustration is only as good as the assumptions on which it is based. For example, if the historical performance of a given investment strategy is not taken back far enough, the resulting illustration may not include certain adverse market conditions in the past. The result is that an investor receiving such an illustration may be unprepared for volatility in returns. Thus, that investor may end up making investment decisions, like concentrating in equities for maximum growth, without regard for the potential of a significant correction in the stock market. There would simply be no realistic acknowledgement of the potential risks of such a strategy.

Fourth, as noted in FINRA's Regulatory Notice (Request for Comment issue no. 7), PIABA strongly believes FINRA must add specific language that identifies certain uniform factors that must be considered for certain types of illustrations, if the proposed amendments are going to be implemented. Moreover, FINRA needs to specify that more than one projection may be reasonable under certain circumstances. PIABA is not suggesting that customers be handed a dozen projections that only serve to confuse them, but there could be circumstances in which it may be appropriate to use more than one illustration to paint the most complete (and accurate) picture for an investor. At a minimum, the firm/broker should be required to provide a specified *range* of market conditions to demonstrate possible widely varying performance results. FINRA may also want to consider including language such as that used in FINRA Rule 2211(b)(5) (Hypothetical illustrations of rates of return in variable life insurance retail communications and correspondence) which, for example, allows combinations of assumed investment returns with some limitations, including requiring that one of the returns is a 0% gross rate.

Rule 2211(b)(5) explains the purpose of this "is to demonstrate how a lack of growth in the underlying investment accounts may affect policy values and to reinforce the hypothetical nature of the illustration."

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In summary, PIABA supports the proposed amendments to FINRA Rule 2210 set forth in Regulatory Notice 17-06 as they may benefit the investing public, but urges FINRA to consider refining the proposed language and issuing guidance to minimize investor confusion. PIABA thanks you for the opportunity to comment on this important topic.

Very truly yours,
Marnie C. Lambert
PIABA President

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The following PIABA Comment Letter regarding the *AB 1517 (Muratsuchi/Chiu) – Support as Proposed to be Amended* was submitted to Assembly Members Muratsuchi and Chiu by Marnie C. Lambert on March 27, 2017 (prepared with the assistance of Scot Bernstein).

Honorable Assembly Member Al Muratsuchi
P.O. Box 942849
Sacramento, California 94249-0066

Honorable Assembly Member David Chiu
P.O. Box 942849
Sacramento, California 94249-0017

Re: AB 1517 (Muratsuchi/Chiu) – SUPPORT AS PROPOSED TO BE AMENDED

Dear Assembly Members Muratsuchi and Chiu:

The Public Investors Arbitration Bar Association (PIABA) understands that AB 1517 will be amended so that it identical to the amended version of AB 2178 that was discussed in the attached May 25, 2016, letter to Assembly Member David Chiu. PIABA continues in its belief that AB 2178, as amended by the amendments incorporated into the attached letter and referenced below, would have provided meaningful protections to the investing public. In view of those meaningful protections, if AB 1517 is amended so that it is identical to the amended version of AB 2178 that was the subject of PIABA's attached May 25, 2016, letter, PIABA will support AB 1517.

Sincerely,
Marnie C. Lambert
PIABA President

Attachment: Letter from PIABA to Hon. Assembly Member David Chiu dated May 25, 2016, with AB 2178 Amendments to Assembly Bill No. 2178
042916 - SMFC067691160502083200.pdf

cc: Brian Duke
Office of Assembly Member Al Muratsuchi
Via Email Only to Brian.Duke@asm.ca.gov

Kevin Hefner
Office of Assembly Member David Chiu
Via Email Only to Kevin.Hefner@asm.ca.gov

Scot Bernstein
Via Email Only to swampadero@sbernsteinlaw.com

Lori Kammerer
Via Email Only to lck@midtown.net

The following PIABA Comment Letter regarding the *RIN 1210-AB79; Definition of theTerm "Fiduciary"; Delay of Applicability Date* was submitted to the U.S. Department of Labor by Marnie Lambert on March 17, 2017 (prepared with the assistance of the Fiduciary Committee).

Office of Regulations and Interpretations
Employee Benefits Security Administration
Attn: Fiduciary Rule Examination
Room N-5655
U.S. Department of Labor
200 Constitution Avenue, N.W.
Washington, D.C. 20210

Re: RIN 1210-AB79; Definition of the Term "Fiduciary"; Delay of Applicability Date

To Whom It May Concern:

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

PIABA strongly opposes the Department of Labor's proposal to delay the applicability date of the Conflict of Interest Rule (the "Rule") and its accompanying exemptions (collectively, the "PTEs"). The Department has solicited comments on its proposal to delay the Rule and the PTEs after President Trump, by Memorandum to the Secretary of Labor, directed the Department to "examine the Fiduciary Duty Rule to determine whether it may adversely affect the ability of Americans to gain access to retirement information and financial advice."

The Rule and PTEs were adopted after significant study and analysis

The Department adopted the Rule and the PTEs after it engaged in the rulemaking process over at least a six year period. The Department filed its

initial proposal to amend the definition of "investment advice fiduciary" in October 2010.[1] The Department received over 300 comment letters on the 2010 proposal, held a public hearing at which 38 speakers testified, and then received an additional 60 comments following the public hearing.[2] The Department then met with various stakeholders over the next several years.[3] This process resulted in the Department's withdrawal of the 2010 proposal and submission of a new proposal in April 2015.[4] Throughout 2015, the Department received over 3,000 comment letters and over 300,000 submissions made as part of 30 separate petitions submitted on the new proposal.[5] The Department held four days of public hearings at which over 75 speakers testified.[6] On April 8, 2016, the Department filed its final rule in the Federal Register.[7] It provided for an applicability date of April 10, 2017.[8] The Department delayed the applicability date for full compliance with the terms of the various PTEs to allow firms to continue to benefit from the relevant exemptions without having to meet all of the exemptions' requirements for a number of months.[9] In support of the final rule, the Department prepared a 395 page Regulatory Impact Analysis.[10]

When issuing the Rule, the Department determined that "in light of the importance of the final rule's consumer protections and the significance of the continuing monetary harm to retirement investors without the rule's changes,

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1. *See*, Dep't of Labor, *Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice; Final Rule*, 81 Fed. Reg. 20946, 20956 (April 8, 2016) ("DOL Final Rule"), available at http://webapps.DOL.gov/FederalRegister/PdfDisplay.aspx?DocId=28806.

2. *Id.* at 20957.

3. *Id.*

4. *Id.*

5. *Id.* at 20958.

6. *Id.*

7. *Id.* at 20946.

8. *Id.*

9. *Id.*

10. *See*, "Regulating Advice Markets; Definition Of The Term "Fiduciary"; Conflicts Of Interest - Retirement Investment Advice; Regulatory Impact Analysis for Final Rule and Exemptions" (April 2016) ("RIA"), available at https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/completed-rulemaking/1210-AB32-2/conflict-of-interest-ria.pdf.

an applicability date of April 10, 2017, is adequate time for [retirement] plans and their affected financial services and other service providers to adjust to the basic change from non-fiduciary to fiduciary status."[11]

It is important that the Rule and the PTEs move forward and begin the intended protection of retirement investors. Currently, brokers, often called financial advisors by themselves and others, are governed primarily by FINRA rules and state law (which is inconsistent across the country). For example, the FINRA suitability rule requires that a broker only have a "reasonable basis" for making an investment recommendation, and that the recommendation be "suitable" for the investor. Under this suitability standard, a broker can sell a high priced fund to an investor rather than a low cost S&P 500 Index fund if the broker determines that the higher priced fund is also "suitable." The broker is not required to disclose to the investor that there were other lower cost suitable options available or that there were conflicts of interest which may have influenced the broker's recommendation. This conflicted advice costs investors **$17 billion each year**.[12]

Under the Rule, financial advisors are obligated to eliminate conflicts of interest which permeate the financial services industry. Financial advisors are given the ability to manage certain conflicts, so long as they comply with an exemption to the Rule which provides transparency to the investor. No longer will the financial advisor be permitted to recommend an imprudent investment product or one based on the amount of commissions paid, even if it they are suitable, without disclosing the potential conflicts of interest that may be affecting the advice the investor receives.

The Department created the Best Interest Contract Exemption (the "BICE"), which would allow firms to continue receiving commissions and other forms of compensation that are common to retail transactions involving retirement plans, which would otherwise be prohibited under the Rule.[13] However, the BICE also ensures that investors receive retirement investment advice that is in their best interests. Pursuant to the BICE, financial advisors and firms that provide retirement advice may continue to receive commissions, 12b-1 fees, revenue sharing payments from issuers, sales loads or other similar compensation, provided that the investment advice they give is in the

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11. DOL Final Rule at 20946.

12. *See*, White House Council of Economic Advisers, "The Effects of Conflicted Investment Advice on Retirement Savings" (Feb. 2015); available at https://obamawhitehouse.archives.gov/sites/default/files/docs/cea_coi_report_final.pdf.

13. DOL Final Rule at 20991.

investor's best interest and "that they implement safeguards against the harmful impact of conflicts of interest on investment advice."[14]

Delay of the Rule will negatively impact investors

If the Rule and PTEs are not permitted to move forward, retirement investors will continue to be harmed by conflicts of interest. PIABA members represent investors who have been harmed under the current standards. In its prior comment letters to the Department about the rule proposal, PIABA provided numerous stories of investors who had their retirement savings compromised by improper advice; by financial advisors who were governed by the suitability standard.[15] Additionally, then-PIABA President, Joe Peiffer, testified during the Department's public hearings, and offered additional stories of the harms suffered by retirees he personally represented.[16] One set of retirees, who were solicited to cash out their pensions and turn the money over to a broker, ended up losing half their life savings and their ability to receive a steady stream of income from their pensions because of the conflicted advice they received.[17]

Every year investors file thousands of cases against brokerage firms.[18] The most frequently asserted claim in these cases is of breach of fiduciary duty primarily because investors almost uniformly believe their financial advisor is a fiduciary. Investors believe this because firms continue to mislead them, presenting brokers as trusted advisors. In reality, the brokers are usually nothing more than salesmen. It is not until the brokerage firm files its answer in the arbitration that firms finally inform investors of the true nature of their

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14. *Id.* at 21003, 21004.

15. *See*, PIABA Comment Letter to the Dep't of Labor (July 21, 2015), available at https://piaba.org/system/files/comment_letter_pdfs/DOL%20Best%20Interest%20Rule%20Comment,%20RIN%201210-AB32%20(July%2021,%202015).pdf; PIABA Comment Letter to the Dep't of Labor (Sept. 24, 2015), available at https://piaba.org/system/files/comment_letter_pdfs/DOL%20Best%20Interest%20Rule%20Comment,%20RIN%201210-AB32%20(September%2024,%202015).pdf.

16. Testimony of Joseph Peiffer (August 11, 2015), available at https://piaba.org/piaba-newsroom/congressional-testimony-statement-record-submitted-united-states-department-labor-emp.

17. *Id.*

18. *See*, FINRA Dispute Resolution Statistics, available at http://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics.

relationship with their broker. As a result, investors continue to trust their brokers, not fully understanding the relationship.

For example, consider the experience of Tom and Shari, a couple from Kansas. Tom is 71 and continues to work as a facilities engineer. Shari is 69 and works as a Program Director for their local church. Tom and Shari were introduced to their broker, Bill, by other members of the church who Bill also advised. Initially, Bill reviewed Tom and Shari's retirement accounts and told them that they were being badly mismanaged, they should sue their old broker, and they should trust his professional management. So, of course, they believed him and transferred their accounts to him. Over the next five and a half years, Bill excessively traded the accounts. Shari's IRA was worth over $700,000 when it was transferred to Bill. Five and a half years later, it was worth just over $250,000 – a loss of $450,000. Bill earned almost $230,000 in commissions during this time period which accounted for more than half the losses. Tom's IRA was worth just over $250,000 when it was transferred to Bill. At the end, his IRA was worth $40,000 – a loss of over $200,000. Bill earned $130,000 in commissions on Tom's account. In total, Tom and Shari lost over $600,000 of their retirement funds, while Bill earned $360,000. In order to just cover Bill's fees and just break even, Shari's account would have had to return 33% and Tom's accounts would have had to return 52%. Clearly, Bill placed his own interests front and center.

In order to generate higher income for themselves, brokers will sometimes put investors' retirement money in complex, non-conventional investments such as Real Estate Investment Trusts (REITs) and structured products. Losses on these investments are not readily apparent because the products are not traded on an exchange. These products often have high expenses built into—and hidden in—the product which over the years greatly impacts the value of the investment. These types of investments have a number of risks associated with them, which often make them inappropriate investments for retirement funds.

Susan was invested in such products. Susan is a cashier at Lowes. When her husband passed away in his mid-50s, Susan inherited his pension fund, which was worth half a million, and proceeds from a life insurance policy, in the amount of $450,000. Susan turned over almost $850,000 of those funds to a broker to whom she was introduced to by a co-worker. At their initial meeting, the broker presented his investment strategy, which promised income to supplement what Susan earned as a cashier, as well as growth, so Susan would be able to retire. The broker assured Susan that she would not need to worry about paying her bills or her future income if she entrusted the money to him. So, of course, she did. The broker immediately invested a third of the money in non-traded alternative investments, including three REITs, which

earned him commissions of between 9 and 14%. He put another third in an annuity, and the final third in a managed account trading leveraged energy funds and commodities funds. When Susan needed to access her funds to meet her income needs, she found that the investments were not liquid, and she would not be able to access her funds without paying substantial penalties. Certain of the investments could not be sold at all. Although she attempted to do the responsible thing by entrusting her retirement to a broker, Susan was left with investments that had really *only* benefited the broker.

When investors meet with their financial advisors to obtain advice about investing their retirement funds, because they need guidance on how to invest the funds, they expect that they are being given good advice that is for *their* benefit. They do not expect to have to double-check everything the financial advisor is telling them, or to have to investigate the incentives the financial advisor may have for recommending a particular product. Simply put, investors do not understand that their brokers may not be doing what is best for them and that it is their job to figure out what else may be motivating the broker's advice. Yet, under the suitability standard, that is precisely what an investor is expected to do.

Grant, 81, and Dorothy, 77, are retirees who turned over their hard earned retirement funds which they spent a lifetime saving to a broker, Jarrod. They invested $150,000 with Jarrod, who told them he was going to employ the "Bull-Bear Strategy." This strategy involved active trading of an investor's portfolio using primarily individual stocks and exotic Exchange Traded Funds to follow market trends. In the seven months that Jarrod employed this risky strategy, he earned for himself almost $15,000 in commissions, while Grant and Dorothy lost over $25,000 – a sixth of their portfolio.

In all of these instances, and so many more like them, it was clear after-the-fact that the financial advisors involved were primarily concerned with their own income, rather than what was in the best interest of their clients. In each of these cases, the firms disclaimed any liability for any breach of fiduciary duty. Regardless of what the firms say in arbitration or in opposition to the Rule, it cannot be doubted that each of these investors believed their financial advisor was acting in their best interest, and that they trusted the financial advisors. It must be made clear to the financial advisors and to the firms that a retirement investor's interests should be the primary concern of a financial advisor, not how much money the advisor can make from the retirement investor's account.

The Rule is essential to ensure investor protection

The Rule and PTEs are of vital importance because today, IRAs and 401(k) and 403(b) retirement plans have become the primary tool for retirement planning and savings for millions of working Americans. Pensions have become rare, making retirement investors more responsible for ensuring they have the necessary funds to support themselves in retirement. One-time transactions like rollovers will involve *trillions* of dollars over the next five years and can be among the most significant financial decisions families will ever make.[19] As funds are rolled into IRAs from workplace retirement plans, investors will seek guidance and advice from financial advisors.

Retail investors now confront a myriad of choices of how and where to invest. These include, for example: market-tracking, passively managed and so-called ''target-date'' mutual funds; exchange traded funds; real estate investment trusts; various structured debt instruments; insurance products that offer menus of direct or formulaic market exposures and guarantees from which consumers can choose; and, an extensive array of derivatives and other alternative investments. These choices vary widely with respect to risk characteristics, potential return, liquidity, degree of diversification, contractual guarantees and/or restrictions, degree of transparency, regulatory oversight, and available consumer protections. These choices are complex and specialized in nature, using financial terms and formulae beyond the knowledge of the average investor. Only a trained financial professional can sift through the mass of data to determine what is a prudent investment choice and what is not.

Financial advisors who neglect their duties subject investors' hard-earned retirement savings to risk of loss due to self-dealing and imprudent recommendations. For people victimized by their financial advisor's failure, what was meant to be the golden period of their lives often becomes a retirement nightmare. Unfortunately, this has become too common.

The brokerage firms that work with retirement investors have presented themselves in their advertisements and on their websites as trusted counselors and advisors for years.[20] Indeed, to enhance this image, the individuals

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19. "Rollovers" are expected to approach $2.4 trillion cumulatively from 2016 through 2020. *See*, RIA.

20. *See*, PIABA Report, "Major Investor Losses due to Conflicted Advice: Brokerage Industry Advertising Creates the Illusion of a Fiduciary Duty; Misleading Ads Fuel Confusion, Underscore Need for Fiduciary Standard" (March 25, 2015), available at https://piaba.org/system/files/pdfs/PIABA%20Conflicted%20Advice %20Report.pdf; *see also*, Consumer Federation of America & Americans for

working for the firms are bestowed with impressive titles such as "Financial Advisor," "Financial Consultant," "Retirement Consultant," and "Wealth Manager."[21] Based on the perception created by the firms, investors believe the individuals they are dealing with will act in their best interests.

The industry is divided in its reaction to the Rule, and there are firms ready to comply. To now delay the Rule and PTEs will punish those firms that have worked diligently over the past year to ensure they were ready to comply as of the April 10 applicability date. A delay will reward the firms that have chosen not to do what the regulations have required. The Department should not send the message that regulations it promulgates do not need to be implemented.

As stated above, there are firms ready to comply with the Rule and PTEs. Some in the industry have responded to the Rule positively. Merrill Lynch wholeheartedly embraced the Rule, with both its advertisements and in its messaging to customers, stating:

> We're committed to a higher standard for retirement accounts. We view the Department of Labor Fiduciary Rule as a positive step for the industry and great news for investors. We support it wholeheartedly.[22]

Morgan Stanley decided it would continue to offer its clients choices, stating:

> Morgan Stanley's core values of putting clients first and doing the right thing are behind our plan for implementing the Department of Labor's upcoming fiduciary rule for retirement accounts. …We believe our advisors can most effectively uphold a fiduciary standard of care and work in clients' best interests by continuing to offer choice.[23]

Financial Reform, "Financial Advisor or Investment Salesperson? Brokers and Insurers Want to Have it Both Ways" (Jan. 18, 2017) ("CFA/AFR Report"), available at http://ourfinancialsecurity.org/wp-content/uploads/2017/01/Financial-Advisor-or-Investment-Salesperson.pdf.

21. *See*, CFA/AFR Report at pp. 5-6.

22. *See*, Merrill Lynch tweet (Nov. 10, 2016), available at https://t.co/OMw73Lv R6d.

23. Morgan Stanley Press Release, "Morgan Stanley to Preserve Client Choice for Retirement Accounts" (Oct. 26, 2016), available at https://www.morganstanley.com/press-releases/morgan-stanley-to-preserve-client-choice-for-retirement-accounts; *see also*, Morgan Stanley article "Morgan Stanley Preserves Client Choice in Response to DOL Rule" (Oct. 26, 2016) ("Moving forward, our clients will continue to have access to commission-based retirement brokerage accounts with recommendations from us that will be consistent with the DOL Fiduciary Rule and Best Interest Contract Exemption…Morgan Stanley…will also offer clients the choice of fee-

Several other firms have announced their plans for complying with the Rule, including Ameriprise, LPL, Cambridge, Cetera, Raymond James, Mass Mutual, Lincoln Financial Distributors and Lincoln Financial Network and Wells Fargo.[24]

In examining the efforts made to date by the industry, a report by Consumer Federation of America determined that:

(i) the DOL rule is already eliminating the most harmful conflicts associated with commission-based advice without eliminating access to commission-based advice;
(ii) despite dire predictions to the contrary, most firms are continuing to offer commission-based retirement investment advice; and
(iii) far from driving up investors' costs, the rule is already responsible for significant cost reductions.[25]

The industry has not offered legitimate reasons for delaying applicability of the Rule and PTEs

The reasons offered for delaying the Rule are unpersuasive. When adopting the Rule, the Department considered the effect the Rule may have on small investors, and their ability to receive quality advice. In its Regulatory Impact Analysis, the Department determined:

> This analysis concludes that the final rule and exemptions will benefit small plan and IRA investors. While the exact trajectory and future shape of advisory markets is uncertain, and some frictions can be expected in the near term, the Department believes that quality, affordable advisory services will be amply available to small plans and investors under the final rule and exemptions.[26]

The Department already considered the arguments made by the industry that small investors may be priced out of the market, and responded to and ultimately rejected them.

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based retirement account arrangements."), available at http://www.morganstanley.com/articles/DOL-fiduciary-rule.

24. *See*, Consumer Federation of America, "The Department of Labor Conflict of Interest Rule is Already Delivering Benefits to Workers and Retirees: Delay Puts Those Benefits at Risk" (Jan. 31, 2017), available at http://consumerfed.org/wp-content/uploads/2017/01/1-31-17-DOL-Rule-Delivering-Benefits_Fact-Sheet.pdf.

25. *Id.*

26. RIA at 312.

If the Rule is implemented, small investors will still have the ability to receive advice. Contrary to allegations by some industry members, the adoption of a fiduciary standard does not make the provision of advice cost prohibitive. Several states (and a territory) have long considered brokers fiduciaries under state common law.[27] Investors in those jurisdictions have full access to investment advice and services. This was confirmed by a 2012 study which examined whether there were differences in the services available to investors in states that have fiduciary standards and those who do not. The study found no statistically significant difference between the two types of states when it came to servicing lower wealth clients, including the ability to provide a broad range of products including those that provide commission based compensation.[28]

Likewise, the SEC found that, even if a fiduciary standard was adopted for brokers, retail investors would "continue to have access to the various fee structures, account options, and types of advice that investment advisers and broker-dealers provide."[29]

The costs of compliance associated with a fiduciary duty standard are not meaningfully different from those associated with the existing suitability rule. The same 2012 study found that there is no statistically significant increase in compliance costs in states in which there is a clear fiduciary standard and ones in which there is no fiduciary standard.[30]

In any case, the quality of advice for small investors is riddled with conflicts of interest. The fiduciary model would act to correct this and ensure a customer's best interest is paramount to advisor compensation. While the Rule will and has already required restructuring 'business as usual' in the brokerage industry, any costs associated with the change are largely overshadowed by the benefits investors will receive by lower fees and better financial advice free from conflicts.

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27. *See*, e.g. California, Georgia, Florida, Missouri, Puerto Rico, South Carolina, and South Dakota.

28. *See*, Michael Finke and Thomas P. Langdon, "The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice" (Mar. 9, 2012), available at https://www.onefpa.org/journal/Pages/The%20Impact%20of%20the%20Broker-Dealer%20Fiduciary%20Standard%20on%20Financial%20Advice.aspx.

29. *See*, "Staff Study Recommending a Uniform Fiduciary Standard for Conduct for Broker-Dealers and Investment Advisers" (2011), available at https://www.sec.gov/news/press/2011/2011-20.htm.

30. *See*, Finke and Langdon.

Small investors have a right, and more importantly, a need, to be protected. In retirement, the vast majority of these investors need the money they have saved to fund their retirement, have little or no tolerance for risk, and cannot afford to lose money due to a broker's conflicted advice. These investors are also at a disadvantage because if they do lose money, they may not be able to obtain any meaningful recovery against the advisor or the firm. Indeed, investors in small cases do not fare as well as other investors in FINRA arbitration, averaging approximately a 10% lower win rate;[31] which is meaningful because investors generally do not fare that well overall in FINRA arbitration.

Investors will continue to have options with respect to investing their retirement funds. Firms have already embraced and adopted varying approaches in terms of implementing the Rule. Some will continue to offer commissions, others will transition to fee-based accounts. A full range of investments remain available to investors, the only change will be that the individual selling the investments will have to put the best interests of the investor ahead of their own.

Conclusion

Delaying implementation costs investors money every day. SaveOurRetirement.com estimates that retirement savers lose between $57 million and $117 million every day due to conflicted investment advice, amounting to at least $21 billion annually.[32] The Council of Economic Advisers estimate Americans are suffering $17 billion in losses annually due to conflicted advice they receive from financial advisors.[33] It is imperative that

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31. *See*, Securities Arbitration Commentator 2013 Awards Survey, available at http://www.seyfarth.com/dir_docs/publications/SecuritiesArbitrationCommentator.pdf.

32. *See*, Save our Retirement Comment Letter (May 8, 2015), available at http://saveourretirement.com/cms/wp-content/uploads/2015/02/DOL-SOR-Letter-Comment-Period-Request-5-8-15.pdf.

33. *See*, White House Council of Economic Advisers, "The Effects of Conflicted Investment Advice on Retirement Savings." "Conflicted advice" refers to advice given on particular investment products where the financial advisor is compensated in fees and commissions that depend on which investment product the customers buys.

the Rule become applicable, and retirement investors receive the protections that they deserve.

It is also worth noting that the Rule and PTEs have already been reviewed by three separate federal courts following challenges by various industry members.[34] In each case, the federal judge determined that the Rule and PTEs should go forward.[35] In considering whether to issue an injunction to delay implementation of the Rule and PTEs, Judge Crabtree stated:

> [A]n injunction will lead to confusion about the law and likely produce unwarranted delay. This is not in the public's interest. Any injunction thus will produce a public harm that outweighs any harm that plaintiff may sustain from the rule change. The DOL has determined that the rule changes will benefit retirement investors throughout the United States by requiring investment advisers to act in the best interest of those investors. Congress authorized the DOL to evaluate these competing interests and it has concluded that significant public interests favor the proposed regulatory changes. As already explained, evidence in the administrative record supports the DOL's determination and the court finds no basis for contradicting those findings.[36]

This decision should be especially relevant to the Department's consideration of delay. The Department has previously justified the Rule and the implementation period. Nothing has changed which would justify a reconsideration at this time. As the Department itself points out, under-performance of investments due to poor fund selection could cost IRA investors between $95 billion and $189 billion over the next 10 years, and that implementation of the rule could reduce these costs to investors between $33

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34. *National Association for Fixed Annuities v. Perez* (D.C. 2016) (No. 16-CV-01035); *Chamber of Commerce v. U.S. Dep't of Labor* (N.D. Tex. 2016)(No. 16-CV-01476-M) consolidated with *American Council of Life Insurers v. U.S. Dep't of Labor* (No. 16-CV-01530-C) and *Indexed Annuity Leadership Council v. Perez* (No. 16-CV-01537-N); and *Market Synergy Group, Inc. v. U.S. Dep't of Labor* (Kan. 2016)(16-CV-04083).

35. *National Association for Fixed Annuities v. Perez,* 2016 WL 6573480 (D. D.C. 2016); *Chamber of Commerce v. U.S. Dep't of Labor,* 2017 WL 514424 (N.D. Tex. 2017); and *Market Synergy Group, Inc. v. U.S. Dep't of Labor,* 2017 WL 661592 (D. Kan. 2017).

36. *Market Synergy Group, Inc. v. U S. Dep't of Labor*, No. 16-CV-4083-DDC-KGS, 2016 WL 6948061, at *30 (D. Kan. Nov. 28, 2016).

billion and $36 billion.[37] Conversely, complying with the Rule and PTEs would cost the industry $16 billion over ten years.[38] Considering the cost benefit analysis, there is no reason to delay the Rule and cost retirement investors so much of their hard earned money.

Accordingly, the Department should proceed with the applicability timeline set forth in the Rule and PTEs and ensure that investors are protected.

Very truly yours,
Marnie Lambert
PIABA, President

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37. Dep't of Labor, *Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice; Proposed Delay of Applicability Date*, 82 Fed. Reg. 12319, 12323 (March 2, 2017), available at https://www.federalregister.gov/documents/2017/03/02/2017-04096/definition-of-the-term-fiduciary-conflict-of-interest-rule-retirement-investment-advice-best.

38. *Id.*