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NATURE VERSUS NURTURE: RANKING BROKERAGE FIRMS BY THEIR BROKERS' HISTORIES OR BY THEIR HISTORY'S BROKERS

Craig McCann, Chuan Qin, and Mike Yan [1]

A. Introduction

In our previous research, we ranked brokerage firms based on the proportion of their brokers on December 31, 2015 who had been associated with at least one resolved customer complaint.[2] That approach ("Method A") assigns a higher ranking to a firm if a larger proportion of its current brokers have one or more resolved customer complaint in their career, regardless whether the complaint occurred at the current firm or at a prior employer.[3]

Our current research explores an alternative ranking of brokerage firms based on the brokerage firm where the conduct the customer complained about occurred, including both resolved and pending ("Method B"). Compared with rankings based on the entire career of brokerage firms' current cohort of brokers, the new method ranks firms based only on customer complaints over conduct occurring on the firm's watch. That is, this alternative ranking does

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2. *See* Craig McCann, et al, *How Widespread and Predictable is Stock Broker Misconduct?* (Securities Litigation & Consulting Group, Working Paper, June 2016), *available at* http://slcg.com/pdf/workingpapers/McCann%20Qin%20and%20Yan%20on%20BrokerCheck%20Final.pdf; *see also* Mark Egan, et al., The Market for Financial Advisor Misconduct (Stigler Center for the Study of the Economy and the State, Working Paper, Feb. 2016), *available at* https://www.chicagobooth.edu/~/media/b76c81efe39b4edb9a4b4d8b34d0b0f7.pdf (also ranked firms based on the quality of their brokers' lifetime of work, not just on complaints while with their current employer). For purposes of this paper, a resolved customer complaint is defined as a FINRA arbitration settlement with a dollar amount above certain thresholds or an award in favor of the customer. FINRA's BrokerCheck website also lists the pending customer complaints. It might take years for a pending case to be dismissed, settled, or finalized.

3. We use FINRA's BrokerCheck data which is incomplete because not all firms report all complaints and arbitration filings and because denied and expunged claims are removed from the public-facing BrokerCheck reports.

not penalize a firm for complaints lodged against its brokers over conduct which occurred at a prior firm, but does include in a firm's risk score complaints over conduct that occurred at the firm, even if the broker had since moved to another firm or left the industry.

Comparing the results of the two ranking methodologies provides insight into whether firms' *hiring practices* or their *compliance and supervision culture* explain their relative incidence of customer complaints. For example, a brokerage firm that is rated as high-risk using Method A (based on brokers' entire registration histories) may be ranked lower-risk based on Method B (complaints over conduct occurring at the firm) because the firm hires brokers with extensive customer complaints but supervises them closely and quickly terminates brokers who continue to elicit complaints. In this case, while the firm has hired brokers with checkered histories it nonetheless has managed to keep these brokers from causing additional complaints, perhaps by exercising strict supervision or adopting a low-risk business model.

On the other hand, a firm rated low-risk based on its brokers' entire registration histories might be rated high-risk based on the complaints over conduct at the firm. Such a firm might have hired brokers with a few or even zero complaints but placed them in a high-risk business model, supervised them laxly or tolerated productive brokers as complaints piled up.

In the remainder of this report, we first update our previous rankings based on updated BrokerCheck data. Then we present two firm rankings, both derived from the new perspective of explicitly assigning customer complaints to the brokerage firm rather than to the broker. Finally, we analyze the types of the financial products and investments involved in the recent customer complaints filed against the worst brokerage firms.

B. Ranking Firms Based on Firms' Current Brokers' Histories

Applying Method A from our prior research, the worst 30 firms with more than 200 brokers are updated in Table 1, using data available as of July 17, 2017.[4] These bad firms are familiar. In our previous publication we only reported rankings of firms with 300 or more brokers so Newbridge (#2), Financial West Investment (#6), Cantella (#16), Maxim Group (#17), Fortune Financial Services (# 19), The Investment Center (# 26), and Hilltop Securities (# 28) with between 200 and 300 brokers are new. The firms listed in Table 1

4. Based on BrokerCheck data as of July 17, 2017, there were 307 firms with more than 200 registered brokers.

are well known for employing recidivist brokers and/or for operating a risky (for investors) business model.

The worst of these firms are truly extraordinary. Only 2.6% off the brokers in our dataset of firms with more than 200 brokers have customer complaints. Aegis Capital and Newbridge employ bad brokers at nearly ten times that rate. The worst 12 firms down through Berthel Fisher employ bad brokers at more than five times the average rate.

Table 1: Worst Firms by Firms' Current Brokers' Histories of Resolved Customer Complaints

Rank	Firm Name	Firm CRD	Current Brokers	Brokers w Complaints	% Brokers w Complaints
1	AEGIS CAPITAL CORP	15007	437	107	24.49%
2	NEWBRIDGE SECURITIES CORP	104065	206	50	24.27%
3	WESTERN INTERNATIONAL SECU	39262	345	67	19.42%
4	NATIONAL SECURITIES CORP	7569	654	124	18.96%
5	SUMMIT BROKERAGE SERVICES	34643	788	133	16.88%
6	FINANCIAL WEST INVESTMENT	16668	213	32	15.02%
7	INDEPENDENT FINANCIAL GROUP	7717	619	91	14.70%
8	CALTON & ASSOCIATES, INC.	20999	309	45	14.56%
9	CENTAURUS FINANCIAL, INC.	30833	611	86	14.08%
10	WUNDERLICH SECURITIES, INC.	2543	328	45	13.72%
11	KOVACK SECURITIES INC.	44848	417	55	13.19%
12	BERTHEL, FISHER & COMPANY	13609	344	45	13.08%
13	OPPENHEIMER & CO. INC.	249	1934	229	11.84%
14	WEDBUSH SECURITIES INC.	877	555	64	11.53%
15	CROWN CAPITAL SECURITIES	6312	344	39	11.34%
16	CANTELLA & CO., INC.	13905	205	23	11.22%
17	MAXIM GROUP LLC	120708	241	25	10.37%
18	UBS FINANCIAL SERVICES INC.	8174	12237	1264	10.33%
19	FORTUNE FINANCIAL SERVICES	42150	207	21	10.14%
20	AMERICAN PORTFOLIOS FINANC	18487	811	79	9.74%
21	NEXT FINANCIAL GROUP, INC.	46214	661	58	8.77%
22	STERNE AGEE FINANCIAL SERV	18456	446	38	8.52%
23	STIFEL, NICOLAUS & COMPANY	793	4434	373	8.41%
24	SIGMA FINANCIAL CORP	14303	633	53	8.37%
25	FIRST ALLIED SECURITIES, INC.	32444	1063	89	8.37%
26	THE INVESTMENT CENTER, INC.	17839	255	21	8.24%
27	J.W. COLE FINANCIAL, INC.	124583	413	34	8.23%
28	HILLTOP SECURITIES INDEPEND	17587	256	21	8.20%
29	GENEOS WEALTH MANAGEMENT	120894	356	29	8.15%
30	WELLS FARGO ADVISORS FINANC	11025	1989	162	8.14%

C. Ranking Firms Based on Firms' Histories' Brokers – Resolved Complaints

In Table 2, we report the worst 30 firms currently employing 200 or more brokers based on a ratio of brokerage firm harmfulness in the past decade. We compute the number of unique resolved customer complaints attributable to a firm that were filed between July 1, 2007 and June 30, 2016 divided by the average number of brokers employed by the firm at the end of each year over a 10-year period of 2007-2016. We use entry labeled "Employing firm when activities occurred which led to the complaint" in BrokerCheck reports to attribute investor harm-related customer complaints reported on a broker's BrokerCheck to the firm where the conduct occurred. Table 2 is ranked by the resulting ratio, referred to hereafter as the "Event Ratio."

Table 2: 30 Worst Firms by Firms' Histories of Resolved Customer Complaints

Rank	Name	CRD	Average # of Brokers	Event Ratio	Broker Ratio
1	NEWBRIDGE SECURITIES CORP	104065	247.9	35.09%	28.24%
2	BERTHEL, FISHER & COMPANY	13609	393.3	33.05%	14.24%
3	SIGMA FINANCIAL CORPOR	14303	665	26.32%	8.27%
4	SANTANDER SECURITIES LLC	41791	438.1	25.79%	12.55%
5	NATIONAL SECURITIES CORP	7569	617.7	23.47%	17.16%
6	INDEPENDENT FINANCIAL GRP	7717	457.8	22.72%	10.05%
7	AEGIS CAPITAL CORP.	15007	254.7	21.20%	18.45%
8	UBS FINANCIAL SERVICES INC.	8174	12384	20.20%	12.83%
9	GENEOS WEALTH MANAGEMENT	120894	345.7	18.51%	9.55%
10	QUESTAR CAPITAL CORP	43100	751.1	17.84%	9.05%
11	SECURITIES AMERICA, INC.	10205	2385.9	17.73%	8.38%
12	MAXIM GROUP LLC	120708	266.3	17.27%	13.14%
13	CENTAURUS FINANCIAL, INC.	30833	590	16.27%	10.00%
14	MORGAN STANLEY & CO. LLC	8209	6179.4	16.05%	10.81%
15	COMERICA SECURITIES, INC.	17079	303.1	14.85%	7.92%
16	FIRST ALLIED SECURITIES, INC.	32444	1101.8	12.52%	6.53%
17	WEDBUSH SECURITIES INC.	877	630.4	11.90%	7.61%
18	NEXT FINANCIAL GROUP, INC.	46214	947.3	11.61%	8.02%
19	KOVACK SECURITIES INC.	44848	297.7	11.42%	7.39%
20	OPPENHEIMER & CO. INC.	249	2335.5	11.18%	7.92%
21	VOYA FINANCIAL ADVISORS	2882	2791.4	9.17%	4.37%
22	THE INVESTMENT CENTER, INC.	17839	278.7	8.97%	5.74%
23	WESTERN INTERNATIONAL SECU	39262	270.3	8.88%	5.92%
24	CROWN CAPITAL SECURITIES	6312	299.9	8.67%	6.67%
25	CITIGROUP GLOBAL MARKETS	7059	12528.2	8.59%	7.52%
26	SUMMIT BROKERAGE SERVICES	34643	415.4	8.43%	7.46%
27	CALTON & ASSOCIATES, INC.	20999	228.3	7.88%	4.82%
28	JANNEY MONTGOMERY SCOTT	463	1357.2	7.37%	5.31%

29	H. BECK, INC.	1763	833.4	7.32%	5.28%
30	CUSO FINANCIAL SERVICES, L.P.	42132	542.8	7.18%	2.21%

The "Broker Ratio" in the last column of Table 6 is the ratio of the total number of the firm's previous or current brokers associated with resolved customer complaints divided by the average number of brokers employed by the firm. The Event Ratio and Broker Ratio over all 307 firms average 2.90% and 2.05%, respectively.

The rankings in Table 1 and Table 2 overlap to a large extent. Some firms at the top of Table 1 move slightly lower in Table 2, such as Aegis Capital (from 1 to 7) and Centaurus Financial (from 9 to 13), although they still remain in the worst 5% of all firms. In contrast, some firms move up dramatically in the Table 2 rankings: Berthel, Fisher & Company moves from 12 up to 1 and Sigma Financial moves from 24 up to 3, suggesting that these firms have a lax supervision or a high-risk business model. Other firms such as Newbridge Securities (2 and 1) and National Securities (4 and 5) have similarly bad rankings in both tables, suggesting these firms play the trifecta of loose hiring, lax supervision, and a high-risk business model.

We also use the Event Ratio to identify the worst firms over the last decade. Table 3 presents the 15 firms with the highest Event Ratios among the 298 firms of average 300 or more brokers over 2007-2016. One third of these 15 firms went out of business, while the proportion of firms going out of business across all the 298 firms is about one fifth.

Table 3: Event Ratio Rank of Top 10 Firms with Average 300 or More Brokers in 2007-2016

Rank	Name	CRD	Average Brokers	Current Brokers	Event Ratio	Broker Ratio
1	VSR FINANCIAL SERVICES, INC.	14503	451.9	0	35.41%	13.06%
2	BERTHEL, FISHER & COMPANY	13609	393.3	344	33.05%	14.24%
3	INVESTORS CAPITAL CORP	30613	623.8	0	32.54%	16.51%
4	J.P. TURNER & COMPANY	43177	452.3	0	31.18%	23.00%
5	SIGMA FINANCIAL CORP	14303	665.0	633	26.32%	8.27%
6	SANTANDER SECURITIES LLC	41791	438.1	617	25.79%	12.55%
7	NATIONAL SECURITIES CORP	7569	617.7	654	23.47%	17.16%
8	INDEPENDENT FINANCIAL GRP	7717	457.8	619	22.72%	10.05%
9	MORGAN KEEGAN & COMPANY	4161	2648.3	0	21.86%	11.44%
10	UBS FINANCIAL SERVICES INC.	8174	12384.0	12237	20.20%	12.83%
11	GENEOS WEALTH MANAGEMENT	120894	345.7	356	18.51%	9.55%
12	GUNNALLEN FINANCIAL, INC	17609	683.3	0	17.85%	10.24%
13	QUESTAR CAPITAL CORP	43100	751.1	798	17.84%	9.05%
14	SECURITIES AMERICA, INC.	10205	2385.9	2768	17.73%	8.38%
15	CENTAURUS FINANCIAL, INC.	30833	590.0	611	16.27%	10.00%

VSR Financial and Investors Capital were closed in November 2016, and J.P. Turner in February 2016. All three companies were under the Cetera

Financial Group umbrella. Although Cetera claimed it closed these firms for consolidating and branding, each had an extraordinarily tarnished record of customer complaints and compliance issues.[5] Morgan Keegan was acquired by Raymond James in April 2012. It had 85 regulatory actions and 206 arbitrations. GunnAllen Financial was shut down by FINRA in March 2010 due to capital inadequacy. It had 17 regulatory actions and 13 published arbitrations resulting in customer awards.

D. Ranking Firms Based on Firms' Histories' Brokers – Pending Complaints

The rankings in Tables 1-3 are based on *resolved* complaints reflecting aged conduct. We can rank firms based on *pending* customer complaints. Pending customer complaints may be a more accurate measure of potentially harmful conduct currently occurring at brokerage firms. We calculate the ratio of the number of pending customer complaints filed against a firm divided by the number of brokers currently employed by the firm. The average Pending Ratio across firms with more than 200 brokers is 0.59%. Table 4 presents the worst 30 firms.

Table 4: Worst Firms Ranked by Pending Customer Complaints

Rank	Firm Name	Firm CRD	Current Brokers	Pending Complaints	Pending Ratio
1	SANTANDER SECURITIES LLC	41791	617	147	23.82%
2	NEWBRIDGE SECURITIES CORP	104065	206	21	10.19%
3	BERTHEL, FISHER & COMPANY	13609	344	33	9.59%
4	UBS FINANCIAL SERVICES INC.	8174	12237	837	6.84%
5	NATIONAL SECURITIES CORP	7569	654	42	6.42%
6	AEGIS CAPITAL CORP.	15007	437	24	5.49%
7	NEXT FINANCIAL GROUP, INC.	46214	661	30	4.54%
8	MID ATLANTIC CAPITAL CORP	10674	212	9	4.25%
9	DAVID LERNER ASSOCIATES, INC.	5397	216	9	4.17%
10	GENEOS WEALTH MANAGEMENT	120894	356	13	3.65%
11	INDEPENDENT FINANCIAL GRP	7717	619	22	3.55%
12	WESTERN INTERNATIONAL SECU	39262	345	12	3.48%
13	SUMMIT BROKERAGE SERVICES	34643	788	21	2.66%
14	MORGAN STANLEY & CO. LLC	8209	3477	91	2.62%
15	CENTAURUS FINANCIAL, INC.	30833	611	15	2.45%
16	OPPENHEIMER & CO. INC.	249	1934	46	2.38%

5. VSR Financial had 11 regulatory events and 6 arbitrations; Investors Capital had 21 regulatory events and 14 arbitrations; and J.P. Turner had 29 regulatory events and 12 arbitrations.

17	HARBOUR INVESTMENTS, INC.	19258	253	6	2.37%
18	CETERA ADVISORS LLC	10299	1741	35	2.01%
19	H. BECK, INC.	1763	736	14	1.90%
20	WUNDERLICH SECURITIES, INC.	2543	328	6	1.83%
21	WEDBUSH SECURITIES INC.	877	555	10	1.80%
22	STERNE AGEE FINANCIAL SERV	18456	446	8	1.79%
23	SIGMA FINANCIAL CORP	14303	633	11	1.74%
24	AUSDAL FINANCIAL PARTNERS	7995	248	4	1.61%
25	QUESTAR CAPITAL CORP	43100	798	12	1.50%
26	CADARET, GRANT & CO., INC.	10641	830	12	1.45%
27	KOVACK SECURITIES INC.	44848	417	6	1.44%
28	CFD INVESTMENTS, INC.	25427	210	3	1.43%
29	FINANCIAL WEST INVESTMENT	16668	213	3	1.41%
30	PROEQUITIES INC.	15708	1092	15	1.37%

There is a significant overlap in the worst firms listed in Table 4 (based on *pending* customer complaints) with the worst firms listed in Table 2 (ratio on *resolved* customer complaints). For example, Newbridge Securities, Berthel, Fisher & Company, and National Securities are ranked in the worst five in both tables; Aegis Capital, Independent Financial Group, and Centaurus Financial are placed in the worst 15 in both tables. This means that the worst firms over the past 10 years which are still in business remain amongst the worst firms. These firms appear to have adhered to a high-risk business model, resulted in a high continuing investor harm. In the following section, we investigate whether those worst firms specialize in problematic products as well as specializing in problematic brokers.

E. Product Type and Firm Harmfulness

Retail investors suffer billions of dollars of losses every year when their brokers, encouraged by the lure of high commissions inappropriately recommended the purchase of risky, illiquid, or unsuitable investments. To reveal the relation between products and customer complaints, we study the composition of the financial products or investments leading to resolved customer complaints filed against those worst firms in our rankings, focusing on a group of highly commissioned, illiquid investments, including non-traded real estate investment trusts ("REITs"), oil and gas products, equipment leasing, direct participation programs ("DPP"), variable and indexed annuities, tenants in common (TIC), and other private placements.

BrokerCheck reports identify the type of financial products involved in most complaints in the "Product Type" field. This field, filled out by brokerage firms or brokers, is subject to missing data, misspelling, or non-standard terminology. Roughly 1 out of 22 customer complaints has missing or

erroneous product information. However, these errors are unlikely to affect our statistical conclusions.

The product types identified in the BrokerCheck reports span a very wide range of investments. We calculate the percentage of customer complaints related to illiquid products for each firm with 200 or more brokers on July 17, 2017. The results are reported in the fifth column of Table 5. For example, 108, or 83.08%, of the 130 resolved customer complaints attributable to Berthel, Fisher and Company are linked to at least one of the illiquid products mentioned above. Customer complaints at the worst firms do not exclusively involve illiquid investments. In addition to illiquid products, we analyze two additional sets of products: (1) equity, which includes all listed and over-the-counter ("OTC") equity securities, and (2) municipal bonds and closed-end bond funds ("CEF"). These two product types are chosen due to their frequency in the BrokerCheck data.

30% of complaints related to DPPs like non-traded REITs, non-traded BDCs, oil and gas partnerships, and private placements and only 27% related to equities despite the fact that DPPs collectively are less than 0.1% of the market capitalization of US equities. The worst firms in the industry have concentrated their customers' accounts in a tiny sliver of available investments. Defining "Illiquid Ratio" as the ratio of the number of resolved complaints related to illiquid products divided by the average number of brokers over 2007-2016, the average Illiquid Ratio for the worst 30 firms ranked by Event Ratio (Table 5) is 6.46%; and the average illiquid ratio for all the 312 firms with more than 200 employees on February 9, 2017 is 1.16%. The worst firms are more than 4 times as likely to have customer complaints over illiquid investments as all firms.

Table 5: Breakdown of Resolved Complaints by Product Type (Supplementing Table 2)

Rank	Firm Name	Firm CRD	Resolved Complaints	% Illiquid	% Equity	% CEF
1	NEWBRIDGE SECURITIES CORP	104065	87	14.94%	65.52%	2.30%
2	BERTHEL, FISHER & COMPANY	13609	130	83.08%	5.38%	0.00%
3	SIGMA FINANCIAL CORP	14303	175	94.29%	5.14%	0.00%
4	SANTANDER SECURITIES LLC	41791	113	7.08%	7.08%	53.10%
5	NATIONAL SECURITIES CORP	7569	145	25.52%	64.83%	0.69%
6	INDEPENDENT FINANCIAL GRP	7717	104	90.38%	2.88%	0.00%
7	AEGIS CAPITAL CORP.	15007	54	7.41%	57.41%	0.00%
8	UBS FINANCIAL SERVICES INC.	8174	2501	2.72%	10.72%	32.47%
9	GENEOS WEALTH MANAGE	120894	64	85.94%	6.25%	0.00%
10	QUESTAR CAPITAL CORPOR	43100	134	68.66%	16.42%	0.00%
11	SECURITIES AMERICA, INC.	10205	423	88.89%	3.07%	0.24%
12	MAXIM GROUP LLC	120708	46	0.00%	91.30%	0.00%

13	CENTAURUS FINANCIAL, INC.	30833	96	78.13%	0.00%	0.00%
14	MORGAN STANLEY & CO. LLC	8209	992	4.64%	26.41%	10.89%
15	COMERICA SECURITIES, INC.	17079	45	4.44%	0.00%	0.00%
16	FIRST ALLIED SECURITIES, INC.	32444	138	66.67%	21.74%	0.72%
17	WEDBUSH SECURITIES INC.	877	75	28.00%	41.33%	5.33%
18	NEXT FINANCIAL GROUP, INC.	46214	110	68.18%	20.00%	2.73%
19	KOVACK SECURITIES INC.	44848	34	32.35%	38.24%	0.00%
20	OPPENHEIMER & CO. INC.	249	261	8.05%	45.21%	9.58%
21	VOYA FINANCIAL ADVISORS	2882	256	43.36%	17.19%	0.39%
22	THE INVESTMENT CENTER, INC.	17839	25	32.00%	44.00%	4.00%
23	WESTERN INTERNATIONAL	39262	24	4.17%	37.50%	0.00%
24	CROWN CAPITAL SECURITIES.	6312	26	69.23%	7.69%	0.00%
25	CITIGROUP GLOBAL MARKETS	7059	1076	10.22%	37.36%	5.39%
26	SUMMIT BROKERAGE SERVICES	34643	35	48.57%	34.29%	0.00%
27	CALTON & ASSOCIATES, INC.	20999	18	33.33%	33.33%	0.00%
28	JANNEY MONTGOMERY SCOTT	463	100	14.00%	48.00%	7.00%
29	H. BECK, INC.	1763	61	59.02%	8.20%	0.00%
30	CUSO FINANCIAL SERVICES	42132	39	25.64%	2.56%	0.00%

The last three columns in Table 6 present the proportion of pending complaints related to each of the three product types for each firm in Table 5. Again, the three product types together underlie a significant portion of pending complaints filed against most of the 30 firms in Table 5. Three of the ten worst firms in Table 6 have more than 60% of their pending complaints associated with illiquid products and the other three have over 45% of their pending cases linked to equity. Five of these six firms - Aegis Capital, Berthel, Fisher & Company, Geneos Wealth Management, Newbridge Securities, and National Securities - are ranked in top 10 based on resolved complaints (Table 2) and pending complaints (Table 4).

Table 6: Breakdown of Pending Complaints by Product Type (Supplementing Table 4)

Rank	Firm Name	Firm CRD	Pending Complaints	% - Illiquid	% - Equity	% - CEF
1	SANTANDER SECURITIES LLC	41791	147	0.68%	0.68%	94.56%
2	NEWBRIDGE SECURITIES CORP	104065	21	33.33%	76.19%	4.76%
3	BERTHEL, FISHER & COMPANY	13609	33	96.97%	12.12%	0.00%
4	UBS FINANCIAL SERVICES INC.	8174	837	1.43%	4.78%	86.50%
5	NATIONAL SECURITIES CORP	7569	42	2.38%	92.86%	0.00%
6	AEGIS CAPITAL CORP.	15007	24	8.33%	45.83%	0.00%
7	NEXT FINANCIAL GROUP, INC.	46214	30	36.67%	0.00%	0.00%
8	MID ATLANTIC CAPITAL CORP	10674	9	66.67%	0.00%	0.00%
9	DAVID LERNER ASSOCIATES, INC.	5397	9	44.44%	0.00%	22.22%
10	GENEOS WEALTH MANAGEMENT	120894	13	92.31%	15.38%	0.00%
11	INDEPENDENT FINANCIAL GRP	7717	22	95.45%	13.64%	0.00%
12	WESTERN INTERNATIONAL SECU	39262	12	8.33%	25.00%	0.00%
13	SUMMIT BROKERAGE SERVICES	34643	21	47.62%	33.33%	0.00%

14	MORGAN STANLEY & CO. LLC	8209	91	7.69%	50.55%	6.59%
15	CENTAURUS FINANCIAL, INC.	30833	15	73.33%	6.67%	0.00%
16	OPPENHEIMER & CO. INC.	249	46	23.91%	47.83%	10.87%
17	HARBOUR INVESTMENTS, INC.	19258	6	100.00%	0.00%	0.00%
18	CETERA ADVISORS LLC	10299	35	45.71%	60.00%	0.00%
19	H. BECK, INC.	1763	14	71.43%	0.00%	0.00%
20	WUNDERLICH SECURITIES, INC.	2543	6	50.00%	100.00%	0.00%
21	WEDBUSH SECURITIES INC.	877	10	20.00%	30.00%	10.00%
22	STERNE AGEE FINANCIAL SERV	18456	8	50.00%	37.50%	0.00%
23	SIGMA FINANCIAL CORP	14303	11	72.73%	9.09%	0.00%
24	AUSDAL FINANCIAL PARTNERS	7995	4	75.00%	25.00%	25.00%
25	QUESTAR CAPITAL CORP	43100	12	75.00%	0.00%	0.00%
26	CADARET, GRANT & CO., INC.	10641	12	66.67%	0.00%	0.00%
27	KOVACK SECURITIES INC.	44848	6	33.33%	50.00%	16.67%
28	CFD INVESTMENTS, INC.	25427	3	66.67%	0.00%	0.00%
29	FINANCIAL WEST INVESTMENT	16668	3	66.67%	33.33%	0.00%
30	PROEQUITIES INC	15708	15	80.00%	0.00%	0.00%

Some firms clearly specialize in high-cost, illiquid products. We list the worst 10 firms ranked by the ratio of the number of resolved complaints related to illiquid products divided by the average number of brokers over 2007-2016 in Table 7. All 10 firms ranked by focus on illiquid investments are also ranked in the worst 25 ranked by resolved customer complaints per broker ratio (Table 2), and five are ranked in the worst 10.

Table 7: Worst 10 Firms Ranked by Illiquid Product-Related Resolved Customer Complaints

Rank	Firm Name	Firm CRD	Total Customer Complaints	Ratio	% Complaints- Illiquid
1	BERTHEL, FISHER & COMPANY	13609	130	27.46%	83.08%
2	SIGMA FINANCIAL CORP	14303	175	24.81%	94.29%
3	INDEPENDENT FINANCIAL GROUP	7717	104	20.53%	90.38%
4	GENEOS WEALTH MANAGEMENT	120894	64	15.91%	85.94%
5	SECURITIES AMERICA, INC.	10205	52	15.76%	88.89%
6	CENTAURUS FINANCIAL, INC.	30833	96	12.71%	78.13%
7	QUESTAR CAPITAL CORP	43100	134	12.25%	68.66%
8	FIRST ALLIED SECURITIES, INC.	32444	138	8.35%	66.67%
9	NEXT FINANCIAL GROUP, INC.	46214	110	7.92%	68.18%
10	CROWN CAPITAL SECURITIES, L.P.	6312	26	6.00%	69.23%

The differing legal causes of action in cases involving illiquid products and equities can be inferred from the BrokerCheck data. We calculate the proportion of resolved customer complaints that mention each of the five misconduct types in the "Allegation" field of the BrokerCheck report: Breach of Fiduciary Duty, Misrepresentation, Fraud, Churning, and Unauthorized

Trading. For the 30 firms with the highest Event Ratio (Table 5), the correlation coefficients between the proportion of illiquid product-related complaints and each cause of action are reported in Table 8. The significantly positive correlation between proportion of illiquid products and each of the first three misconduct types suggests that the higher the concentration of a firm's complaints on illiquid products, the more likely the firm's clients have suffered from breach of fiduciary duty, misrepresentations or fraud. The significantly positive correlation between proportion of equities and each of the last two misconduct types indicates that the more heavily a firm's customer complaints are concentrated in equity products, the more likely the firm's misconduct involves excessive trading in clients' account.

Table 8: Correlation Between Product Concentration and Alleged Misconduct

	Breach of Fiduciary Duty	Misrepresentation	Fraud	Churning	Unauthorized Trading
% IH - Illiquid	0.43	0.63	0.50	-0.48	-0.59
% IH - Equity	-0.14	-0.39	-0.35	0.87	0.70

F. Conclusion

Ideally, we would assess the incidence of investor harm at brokerage firms by tallying how many times they have been sued by customers, perhaps standardized on some measure of the size of the brokerage firms. Our previous analysis, and the analysis performed by Egan, Matvos and Seru, used the complaint history of currently employed brokers to rank firms to develop a second-best measure on which to rank firms. This Herculean effort was necessary because FINRA requires that settled and pending customer complaints are reported on individual brokers' BrokerCheck reports but excluded from brokerage firms' BrokerCheck reports despite the claims typically being filed against the firm, not the brokers' BrokerCheck reports.

In this paper, we move significantly closer to a first-best ranking by using information on BrokerCheck reports which identifies the employing firm where the complained about conduct occurred. While a significant enhancement to our previous rankings, our current measure still misses cases which have been expunged. Panels have wiped these cases off brokers' CRDs and BrokerCheck reports because they found the broker was not responsible. The clear implication is that the firms were solely (not just primarily) responsible for these cases yet they vanish from the public record.

We find that the worst firms sorted by bad conduct they engaged in or supervised are pretty much the same as the worst firms sorted by the complaint history of their current brokers with a few noteworthy exceptions. For examples, Berthel Fisher, and Sigma Financial are rated as much more high-risk sorted by their entire history rather than the history of their current brokers. These firms, in particular, seem to operate a high-risk (for investors) business model with a lax compliance and supervision environment.

We also find that the worst firms in the industry specialize in illiquid niche investments which pay high commissions.

HAVE FINTECH, REGTECH AND TECHNOLOGICAL ADVANCES RENDERED LIST 1 OF THE FINRA DISCOVERY GUIDE OBSOLETE?

Timothy J. O'Connor

Technological Advances in the Financial Services Arena

In the past six years,[1] electronic communications, social media, pattern recognition software, trading programs, artificial intelligence, and even outsourcing have advanced to the point where Claimant's counsel may end up doing double duty as an information technology expert when drilling down and accessing the newly emerging categories of relevant "documents" in customer cases. During that time, there has also been a significant increase in electronic trading activity.[2] During the intervening time frame since the issuance of Regulatory Notice 11-17, we have seen the emergence of artificial intelligence programs designed to monitor trading activity, including IBM's Watson, SparkCognition, Digital Reasoning, Neurensic, and other software programs designed to monitor electronic communications in the financial services market arena. Notably, NASDAQ is already utilizing Digital Reasoning, a cognitive computing firm which has pioneered technology design to detect and monitor electronic communications.[3] Likewise, innovations in blockchain and encryption technology are

1. In 2011, FINRA issued Regulatory Notice 11-17, which revised the Discovery Guide and Document Production Lists in FINRA arbitration.

2. D.M. Levine, *A Day in the Quiet Life of an NYSE Floor Trader*, FORTUNE (May 29, 2013) (suggesting that automated trading systems comprising 75% of all trades on the NASDAQ and New York Stock Exchange as of 2014).

3. NASDAQ also utilizes SMARTS, a sophisticated natural language processing and machine intelligence-based technology to monitor and surveil communications with an eye monitoring electronic communications to detect potential market manipulation and risky conduct. *See* Press Release, NASDAQ, NASDAQ and Digital Reasoning Establish Exclusive Alliance to Deliver Holistic Next Generation Surveillance and Monitoring Technology (Feb. 23, 2016), *available at* http://Business.nasdaq.com/market-text/market-participants/SMARTS-trade-surveillance-sell-side.

technologies which both the financial services industry and FINRA have been assessing.[4]

FinTech, RegTech and Artificial Intelligence – New Terminology Defined By FINRA

In a March 16, 2017 posting on its website, FINRA defined FinTech "new technologies such as cloud storage, machine learning and blockchain" which broker-dealers are using "to enhance their overall operational infrastructure and compliance functions."[5] FINRA also included a second term, RegTech, which it defined as "…a subset of FinTech, covering new and emerging technologies that assist the Financial Services Industry in meeting its regulatory compliance obligations, in a faster and more cost effective manner including applications such as compliance monitoring and fraud prevention, data management and identification and interpretation of regulation."[6] FINRA also noted that Artificial Intelligence (AI) "… is rapidly being incorporated into various aspects of the Financial Services Industry, ranging from personalized automated advice and chatbot customer service, to trading based on social media sentiment, to highly sophisticated fraud surveillance."[7] FINRA also used a fourth term, Social Media

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4. *Are You Ready for 2017? Seven Technologies That Will Transform Your Business*, NASDAQ (Feb. 21 2017), http://www.nasdaq.com/article/are-you-ready-for-2017-seven-technologies-that-will-transform-your-business-cm750533. *See also* World Economic Forum, *The Future of Financial Infrastructure: An ambitious Look at How Blockchain Can Reshape Financial Services*, WORLD ECONOMIC FORUM (Aug. 2016), http://www3.weforum.org/docs/WEF_The_future_of_financial_ infrastructure.pdf.

5. *FinTech*, FINRA, http://www.finra.org/industry/fintech. Additionally, a word search on finra.org for "FinTech" as a supervisory, compliance, and/or regulatory tool and concept indicates no meaningful utilization of the term until 2017.

6. On November 3, 2016 the SEC announced its own agenda and panelists for a forum to address FinTech Innovation in the Financial Services Industry. Press Release, SEC, SEC Announces Agenda, Panelists for Nov. 14 FinTech Forum (Nov. 3, 2016), *available at* http://sec.gov/news/pressrelease/2016-234.html. The entire transcript of the November 14, 2016 FinTech Forum is available at https://www.sec.gov/spotlight/fintech/transcript-111416.pdf.

7. *FinTech*, *supra* note 5. *See also* Scott W. Bauguess, *The Role of Big Data, Machine Learning and AI in Assessing Risks: A Regulatory Prospective*, SEC (June 21, 2017), http:// SEC.gov/news/speech/bauguess-big-data-ai.

Sentiment Investing, which it described as "including social media data analytics companies, social media sentiment based product issuers, crowdsourced research networks and social networking platforms."[8] Given these new processes, how will the FINRA Office of Dispute Resolution and arbitration panels address discovery related requirements in the context of arbitration proceedings?

As of this writing, it is still unknown as to the extent to which emergent FinTech technology and supporting FinTech vendor firms will fully interface with, be embraced by and otherwise come under the supervisory and compliance provision of FINRA rules. Additionally, developments involving social media titans Facebook and Google; technology titan Apple, and even marketing giant Amazon, also suggest that these firms will become increasingly involved with transactions involving securities marketed to the investing public.

The FINRA Discovery Guide

The original FINRA Discovery Guide for respondents and claimants involved in FINRA arbitration proceedings was incorporated as a part of FINRA Notice to Members 99-90. The Discovery Guide was updated in April of 2011, with the issuance of Regulatory Notice 11-17, with List 1 containing 22 items deemed presumptively discoverable from firms and/or associated persons. Contemporaneous with FINRA Regulatory Notice 11-17, FINRA updated Rule 12506 (document production lists) and Rule 12508 (objecting to discovery requests; waiver of objection) in accordance with the revised provisions of the Discovery Guide.

Significantly, Regulatory Notice 11-17 placed an emphasis on "flexibility," noting that arbitrators involved in the discovery process of FINRA arbitration proceedings can "…order the production of documents not provided for by the lists," and further noting that "[e]lectronic files are 'documents' within the meaning of the Guide."[9]

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8. *FinTech*, *supra* note 5.

9. FINRA, REGULATORY NOTICE 11-17 2-3 (Apr. 2011), *available at* www.finra.org/sites/default/files/NoticeDocument/p123505.pdf.

A Sampling of Some Items From List 1 of the Discovery Guide Which Have Been Greatly Impacted By Technology Advances Since the Issuance of Regulatory Notice 11-17

Items 3, 5, 6, 7, 12, 13, 14, and 17 from List 1 of the Discovery Guide include various categories of documents that firms/associated persons are presumptively required to produce in customer cases that have been greatly impacted by technological advances since the Discovery Guide was revised in 2011.

Item 3
Trading Strategy Documentation

Documents evidencing any investment or trading strategies used or recommended in the customer parties' accounts.

Comment: The lion's share of investment and trading strategies utilized by brokerage firms are now automated, computerized, and/or involve algorithms.[10]

Item 5
Worksheets/Notes Provided to the Claimant/Proof of Broker Review

Materials the firm and/or associated persons prepared or used and/or provided to the customer parties relating to the transactions or products at issue, and worksheets or notes indicating that the associated persons reviewed or read such documents.

Comment: Hard copy, three-ring binder formatted, written notes of client conversations, cross-reference holding pages and old-school trading strategies have been almost completely replaced with customer relationship management software and other computer based programs. Further, other technology based programs now domicile the lion's share of responsive documents under this Item.

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10. Complete discovery of these trading mechanics and specifics is essential for fair discovery in a claimant's case.

Item 6
Customer Relationship Management Notes

Notes the firm/associated persons made relating to the customer parties and/or the customer parties' claims, accounts, transactions or products or types of products at issue.

Comment: As indicated above in comments to item 5, hard copy three-ring binder formatted, written notes of client conversations, cross-reference holding pages and old-school trading strategies have been almost completely replaced with customer relationship management software and other computer based programs. CRM software has become the gold standard for the prevention of client account and account related notations.

Item 7
Supervisory, Compliance or Managerial Review of Accounts, Transactions and Brokers, Including Correspondence

Notes or memoranda evidencing supervisory, compliance or managerial review of the customer parties' accounts or transactions, or of the associated persons assigned to the customer parties' accounts; and correspondence between the customer parties and firm/associated persons relating to the customer parties' claims, accounts, transactions or products or types of products at issue bearing indications of managerial, compliance or supervisory review.

Comment: Supervisory, compliance, and managerial reviews are nowadays initiated, more often than not, by reports generated by automated, computerized and/or software driven technologies. To the extent that these reviews involve notes or memoranda, these are largely computer entered and stored. Likewise, hard copy correspondence is scanned and stored and e-mails are subject to computer based storage protocols and procedures. The likelihood of any responsive documents to Item 7 being on paper as opposed digitized format has become remote.

Item 12
Analyses and Reconciliations of Client Accounts and Reviews of Account Transactions and Products

Analyses and reconciliations of the customer parties' accounts, including those relating to reviews of the customer parties' claims, accounts, transactions or the product or types of products at issue.

Comment: Periodic analyses and reconciliations are now routinely prepared by automated and computerized programs created by various software programs. The actual review of these analyses and reconciliations by the appropriate supervisory, compliance, and/or managerial personnel in line of command are also likely to be formatted in automated or computerized program. The production of these analyses, reviews, and reconciliations in their newly confirmed technology based format is essential for fair discovery.

Item 13
Exception Reports/Activity Reviews/Concentration Reports and Reviews

Exception reports, supervisory activity reviews, concentration reports, active account runs and similar documents produced to review for activity in the customer parties' accounts related to the allegations. For claims alleging failure to supervise, the firm/associated persons must produce the documents listed in this item that were produced to review for activity in customer accounts handled by associated persons and related to the allegations.

Comment: Has the term "exception report" in the first sentence of this item become obsolete or has it acquired a more expansive definition with all of the new surveillance technologies? Historically, many firms have developed their own proprietary internal mechanisms for surveilling and assessing possible client account abuses. Discovery demands not fashioned to encompass these new technologies could well resort in negative response to a simple demand for a firm's own, so nominated, exception reports when in fact a

firm has seen and observed far more expansive categories and metrics of possible customer victimization and wrongdoing that might not have been detected on an old-school earlier generation exception report.

Item 14
Internal Audit Reports for Branch, Accounts and Transactions at Issue

Portions of internal audit reports for the branch in which the customer parties maintained accounts that concern associated persons or the accounts or transactions at issue and discussed alleged improper behavior in the branch against other individuals similar to the improper conduct alleged.

Comment: Internal audit reports have become much more reliant upon technological advances which include the automated generation of reports based upon various flag parameters involving associated persons, client accounts, and securities transactions suggesting the intervention of the human element.

The same comments also pertain with respect to Item 14 as indicated in Item 13 above. Further, concerns exist with respect to the term "internal audit reports" in the first sentence of this item. Is the term obsolete or has it acquired a more expansive definition with all of the new surveillance technologies? Historically, many firms have developed their own proprietary internal mechanisms for surveilling and assessing possible client account abuses. Discovery demands not fashioned to encompass these new technologies could well resort in negative response to a simple demand for a firm's own, so nominated, internal audit reports when, in fact, a firm has seen and observed far more expansive categories and metrics of possible customer victimization and wrongdoing that might not have been detected on an old-school earlier generation exception report.

Item 17
Reports Following Regulatory Review and Inspection

Portions of examination reports or similar reports following an examination or inspection conducted by any regulator that focused on the associated persons or customer parties' claims, accounts or transactions, or the product or types of products, or that discussed alleged improper behavior in the branch against other individuals similar to the conduct alleged.

Comment: As it relates to the active time frame of the implementation and review of any program in a customer's account, there will surely also be periodic reports and cautionary critiques issued requiring human input, monitoring and correction during the lifetime of the account and such events will also require a production of documents as defined the electronic discovery definitions of FINRA Regulatory Notice 11-17. If a third-party trader, money manager, asset manager, or some other financial professional, separate and apart from the claimant's broker, has been actively involved with the selection of the asset mix and balance, their identity will also have to be made known. Discovery of these examination reports in their new technology based formats is essential.

The Hybrid BD-RIA Model

A number of firms have been moving towards the hybrid platform which tout the efficiencies of program training, while maintaining a human interface,[11] including Personal Capital, Rebalance, Blackrock, Vanguard Personal Advisors, Charles Schwab, and Betterment. Platforms such as Tradingfront and Nestegg automate routine tasks for RIA's (Betterment Institutional, Motif Institutional and Fidelity Institutional Web Services, AlgoTrades and Cloud Technology). This trend has become more pronounced with the migration of wirehouse brokers to the RIA business platform. The data generated by these predominantly paperless, technology-based modalities clearly meet the definition of "documents" under FINRA Regulatory Notice 11-17.

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11. FINRA, NOTICE TO MEMBERS 94-44 (1994); *see also* FINRA, NOTICE TO MEMBERS 96-33 (1996).

The Trend Towards Involving Non-FINRA Licensed Registered Investment Advisers

The past decade has seen an incredible transfer of assets to investment advisory platform working out of small, unsupervised offices without any compliance reviews.[12] FINRA member firms who utilize platform business models, however, must assure that they do not advance wrongful ends and discovery of these paperless, technology-based documents is essential in claims involving the activities of non-FINRA licensed advisers which interface with FINRA member firms.[13]

Cloud Technology

Cloud technology imposes its own challenges to adapting the FINRA Discovery Guide to customer claims as it relates to affording claimants and their counsel fair access to discoverable documents in arbitration proceedings. This has been accompanied by an incredible shift toward cloud technology, as opposed to in-house, on-site, proprietary, dedicated server storage, being balanced with the intellectual technology requirements of brokerage firms as set forth in the Sarbanes-Oxley Act of 2002.[14] The benefit of cloud based technology is that data is accessible anywhere – or everywhere. As such, Respondents cannot be permitted to avoid Discovery Guide production obligations by pointing to the clouds, claiming inaccessibility.

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12. *See also* Timothy J. O'Connor and Paul C. Carroll, *Trends in Supervisory and Clearing Firm Liability*, SECURITIES ARBITRATION AND MEDIATION 2017: THE COURAGE TO SIMPLY (Apr. 6, 2017).

13. Top independent broker-dealer firms include LPL Financial, AIG Advisor Group, ING Advisors Network, NFP Securities, Inc., AXA Advisors, LLC, National Planning Holdings, Inc., Securities America Inc., Commonwealth Financial Network, Northwestern Mutual Investment Services and MML Investor Services, with LPL Financial and Primevest Financial Services, Inc., a subsidiary of ING Advisors Network, Inc.

14. *The Benefits of Cloud Computing for the Banking & Financial Industry*, GLOBAL BANKING & FIN. REV. (Aug. 23, 2013).

FINRA Regulatory Notice 07-59 – Electronic Communications

FINRA Regulatory Notice 07-59 (Supervision of Electronic Communications) requires firms to have, implement, and utilize appropriate systems to monitor customer emails within their supervisory and compliance network.[15] NASDAQ's use of the SMARTS and Digital Reasoning technologies enable the monitoring of additional applications such as Customer Relationship Management software (CRM software) and other emergent technologies which have stretched the definition of "documents" under the Discovery Guide applicable to items 3, 5, 6, 7, 12, 13 and 14 from List 1.

The supervision obligations regarding electronic communications under FINRA Regulatory Notice 07-59 include the following six categories:

1. Written policies and procedures
2. Types of electronic communication review
3. The identity of the persons responsible for reviewing electronic telecommunications
4. The method of review
5. Frequency of review
6. Documentation of the actual review process[16]

All six of these categories include "documents" produced by the emerging FinTech, RegTech, and AI technologies referenced in this article.

FINRA Rule 2214 – Requirements for the Use of Investment Analysis Tools

FINRA Rule 2214 (Requirements for the Use of Investment Analysis Tools) defines the definition of investment analysis tools to include:

> "…an interactive technological tool that produces simulations and statistical analysis that present the likelihood of various investment outcomes if certain investments are made or certain investment strategies or styles are

15. Electronic Communication Networks fall under the general category of alternative trading systems and are required to register as broker dealers by the SEC. See *Electronic Communications Networks*, SEC (Sep. 25, 2013), https://www.sec.gov/fast-answers/answersecnhtm.html. *See also* FINRA, REGULATORY NOTICE 15-51 (2015).

16. FINRA, REGULATORY NOTICE 07-59 (2007).

> undertaken, thereby serving as an additional resource to investors in the evaluation of the potential risks and returns of investment choices."

These investment analysis tools will likely create electronic files. Thusly, these files are likewise "documents" pursuant to the definition of elective discovery as defined by Regulatory Notice 11-17.[17]

FINRA Rules 2165 and 4512 – Protecting the Elderly

In February 2018, FINRA will be rolling out Rule 2165 (financial exploitation of specified adults), as well as amendments to FINRA Rule 4512, which will require broker dealers to "make reasonable efforts" to acquire pertinent contact information for a trusted contact for elderly customers and will also allow firms to place temporary holds on the release of funds and securities from customer accounts "when there is a reasonable belief of financial exploitation."[18] These requirements will surely see the implementation of policies, procedures, technology formatted reports, and processes that, while not expressly contemplated expressly by the Discovery Guide, will surely meet the definition of "documents" as defined by Regulatory Notice 11-17.

Compensation Programs

Likewise, compensation models of financial professionals have been altered and are being implemented with new technologies that are innovating broker financial incentives, including indirect incentives such as client referrals, client retention, broker bonuses, account opening incentives, and assets under management based compensation (such as CallidusCloud, Synygy, Xactly, IBM's Varicent, and Orical's Siebel). This move away from traditional commission-based brokers may not afford transparency in the discovery process, unless properly pursued whether by List 1, Items 19 and 20, or separate discovery requests. Expressly incorporating these new innovations into an updated Discovery Guide makes better sense and will help avoid discovery disputes.

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17. *See also* FINRA, REGULATORY NOTICE 16-41 (Oct. 2016).

18. *See* FINRA, REGULATORY NOTICE 17-11 (Mar. 2017).

Algorithmic and Automated Trading Programs

In Regulatory Notices 15-09 and 16-21, FINRA addressed the emergence of automated and algorithmic trading systems, which in turn can be monitored and surveilled by automated and algorithmic monitoring and review.[19] In the final analysis, it will be human beings in the chain of command who will be responsible for creating, implementing, reviewing, supervising, approving, and/or correcting and engaging in problematic programs.[20] Properly formatted and articulated discovery demands will be required to afford claimants the discovery to which they are entitled under Regulatory Notice 11-17. Likewise, an updated Discovery Guide will assure transparency and a fair discovery process.[21]

Programs for Implementation of the Fiduciary Rule

Likewise, the implementation of the Fiduciary Rule will continue to see an explosion of this technology in compliance with the Fiduciary Rule, including firms such as Broadridge Financial Solutions and its DOL Fiduciary Solution product, DOL Customer Communications tool, and Red Flag Software and the Adviser Perspectives, Inc./IRA fiduciary optimizer which allows compliance officers access to various categories of information relating to a specific individual broker or brokerage firm.[22]

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19. *See* FINRA, REGULATORY NOTICE 15-09 (Mar. 2015); *see also* FINRA, REGULATORY NOTICE 16-21 (June 2016).

20. *See id.*

21. FINRA, REGULATORY NOTICE 16-21 (June 2016). Notice 16-21 addresses the SEC approval of an amendment to NASD Rule 1032(f) expanding the scope of persons required to register as a Securities Trader to include individuals who are "responsible for the day-to-day supervision or direction" of "algorithmic trading strategy relating to an equity, preferred or convertible debt securities."

22. Advicent Solution, L.P. a portfolio company of Vista Equity Partners has already teamed up with 20 broker-dealers according to its website including Allstate Financial Services, Ameritas Investment Corp., Schwab OpenView Gateway of Charles Schwab & Co., Inc., Commonwealth Financial Network, Nationwide Mutual Insurance Company, J.W. Cole Financial, Inc., and Summit Brokerage Services, Inc. *See Strategic Partners*, ADVICENT, https://www.advicentsolutions.com/en/partners/strategic-partners. These procedures would likewise be subject to discovery as "documents" as defined by Regulatory Notice 11-17 and The Discovery Guide.

Will These Innovations Give Rise to New Supervisory and Compliance Titles and Responsibilities?

Will the implementation of algorithms and FinTech innovations also see the emergence of a new FINRA Qualification Examination separate and apart from existing titles? FINRA Notice to Members 16-21 requires that individuals who are "primarily responsible for the design, development, or significant modification" of an algorithmic trading programs should be licensed with FINRA.[23] While these programs are in their infancy, as with other technological developments, discovery of their reports, processes, procedures, and reviews are essential to any claimant's case.

Additionally, the outsourcing of supervision and surveillance functions by brokerage firms to these new networks would clearly require that any such FINRA member firms have written supervisory procedures to assure compliance with FINRA rules and applicable securities law and regulations.[24]

Discovery Required of Clearing Firms Should Also Include FinTech, RegTech and Artificial Intelligence Related Documents and Information

Given detection, surveillance, and red flag-type software utilized by clearing brokerage firms, the discovery of the procedures, processes, implementation, and utilization of them as relates to customer accounts in arbitration proceedings is essential. Clearing firms also have access to technology based and algorithmic trading capabilities and are required to address qualifications associated with the human beings who monitor and assess them.[25] Anti-money laundering software and related programs also make it very difficult for clearing firms to ignore possible customer victimization. [26]

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23. FINRA, NOTICE TO MEMBERS 16-21 (June 2016).

24. FINRA, DISTRIBUTED LEDGER TECHNOLOGY: IMPLICATIONS OF BLOCKCHAIN FOR THE SECURITIES INDUSTRY 18 (Jan. 2017), *available at* http://www.finra.org/sites/default/files/FINRA_Blockhain_Report.pdf. *See also* FINRA, NOTICE TO MEMBERS 05-48 (July 2005).

25. *See also* O'Connor, *supra* note 13.

26. *See, e.g.*, FINRA, RULE 5210; FINRA, RULE 6410; 17 CFR §242.200–204; 17 CFR §240.15c3-5; 17 CFR §242.600–613.

How Will Respondents Comply in the Discovery Process With These New Technologies?

(i) How will respondents produce computer code, software, algorithms and artificial intelligence?

How will a claimant get proper discovery in a case involving algorithms, a robo-trading program, and artificial intelligence software? Particularly when these technologies continue to morph during the time frame of the maintenance of a client's account? Will the response be merely a code program, a computer chip of some sort, or would there be attendant written memoranda, instructions, commentary, and upgrades involved with the independent thought and hands-on involvement of the human being? Assuming a firm can, in fact, produce an algorithm, robo-trading program, or artificial intelligence generated trading surveillance program, how would claimant's counsel overcome a claim of proprietary protection, intellectual property protection, and confidentiality? Such obstructionist tactics are inimical to the guidelines of The Discovery Guide, which should be updated, in any event, to expressly require the production of these items.

(ii) Overcoming the "No Obligation to Create Documents" Argument/Fallacy

Further, the guidance in FINRA Regulatory Notice 11-17 entitled "No Obligation to Create Documents," which states "parties are not required to create documents in response to items on the lists," has been oft cited by obstructionist Respondent firms seeking to avoid discovery of presumptively discoverable documents. Will firms continue to be permitted to parrot this provision when faced with discovery demands encompassing these new categories of technology domiciled "documents" data and information, which they possess, but have not turned into specific, one-dimensional, paper documents?[27] The definition of "documents" in FINRA Notices 07-59 and 11-17 clearly suggest otherwise.

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27. The SEC noted the need for continued focus regarding the review of the compliance reviews of clearing firms with the Dodd-Frank Act. SEC Office of Compliance Inspections and Examinations, *Examination Priorities for 2016*, 3 (Jan. 11, 2016).

(iii) Overcoming Claims of Confidentiality and Privilege

The "confidentiality" and "privilege" definitions set forth on page three of Regulatory Notice 11-17 must also be updated to fairly address, or debunk as the case may be, Respondent Firm claims of "proprietary confidential business plans and procedures or trade secrets" and "privilege." Otherwise, how will claimant's counsel ascertain the identity of the individuals who generated and/or interfaced with these programs involved with your client's account? How could their testimony be compelled if they are not subject to FINRA jurisdiction?

WILL SECURITIES ARBITRATION BECOME OBSOLETE?

Absolutely not, as this era of commoditization of information and big data has served to only heighten and enhance the opportunity for the human element to engage in meaningful and protective supervisory and compliance reviews in the financial services industry and customer accounts. There will surely be many instances of problematic failure to properly design, implement, and supervise these new technological innovations. Given these emerging trends in technology, transactions and job titles in the securities industry, both introducing firms and clearing firms can no longer ignore wrongful conduct that they have facilitated. Some of these innovations will surely afford the securities industry and the customers they serve a more transparent and mutually beneficial and protective relationship.

The Time has come for a New, Updated FINRA Discovery Guide and Regulatory Notice to Address all of the Technological Changes Which Have Occurred Since FINRA Regulatory Notice 11-17

In closing, while the data created by these new technologies fall under FINRA's own definition of "documents," as contained in and defined by Regulatory Notice 11-17, given these recent technological advances an accompanying new paradigm in compliance and supervisory innovations over the past six years, the time has now arrived for FINRA to issue more particularized guidance in the form of a new Discovery Guide. Both claimant's and respondent's counsel will be better served with clear cut, expressly enumerated, presumptive discovery requirements. Likewise, arbitrators having to resolve discovery disputes will be better served with an updated Discovery Guide, adapted to emergent FinTech and RegTech

software programs, artificial intelligence, and technological modalities which has served to place clear *indicia* and detection of customer victimization on their radar screens.

THE USE OF ARBITRATOR *VOIR DIRE* IN FINRA ARBITRATIONS

Moshe Y. Singer, Esq.

The composition of your arbitration panel will likely be the single greatest factor in your case's outcome. It follows, then, that throughout the life of your case, ranking and selecting arbitrators (and potentially, seeking their removal or recusal) is more important than just about anything else that you do. Perhaps the best way to ensure the integrity of your arbitrators is to have them personally answer any important questions you may have relating to their ability to preside fairly over the case.

FINRA, unlike some other arbitration forums, does not permit a party to question proposed arbitrators during the ranking stage of the proceeding. Because equity plays such a large part of arbitration, and because arbitrators have such wide latitude in how they choose to administer and decide a case, it is crucial for the arbitration practitioner to try to determine a proposed arbitrator's jurisprudential proclivities before ranking him or her. That determination is made infinitely easier where arbitrators could effectively be "interviewed" before being appointed. For example, arbitrators would be able to be asked about how they handled particular discovery issues in the past, whether they tend to ask witnesses a lot of questions, and a whole host of other case-related questions it would behoove the practitioner to inquire about prior to arbitrator ranking.

FINRA previously examined the use of *voir dire* as a tool in the arbitrator selection process, but ultimately decided against it. According to its own report, a FINRA task force established in 2014 considered implementing the use of written *voir dire* of arbitrators but eventually determined that "a better way for parties to obtain relevant case-specific information about the arbitrators is [through arbitrator disclosure]."[1] Among the task force's concerns was that the use of written *voir dire* would possibly be too burdensome and act "as a disincentive on arbitrators' willingness to serve."[2]

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1. FINRA DISPUTE RESOLUTION TASK FORCE, FINAL REPORT AND RECOMMENDATIONS OF THE FINRA DISPUTE RESOLUTION TASK FORCE 14, *available at* http://www.finra.org/sites/default/files/Final-DR-task-force-report.pdf (last visited Sep. 6, 2017).

2. *Id.* at 13.

Thus, the FINRA Rules do not permit traditional *voir dire* of potential arbitrators during the ranking process. Rather, FINRA uses the framework of arbitrator disclosures in order to elicit pertinent arbitrator information for the benefit of the parties during the selection process. FINRA Rule 12405 governs arbitrator disclosure.

The disclosures required by Rule 12405 primarily concern relationships that may pose potential conflicts or biases on the part of the arbitrators, such as a financial or personal interest in the arbitration's outcome, any past or current relationship with the parties, counsel or witnesses that may affect impartiality, and the like.[3] These disclosures are contained in the "Disclosure Checklist" forwarded to the parties after appointment of the panel, pursuant to Rule 12405(c).[4]

That having been said, there are three primary points in a case during which counsel ordinarily may engage in a form of arbitrator *voir dire:* (1) after panel appointment, but before panel confirmation during the initial pre-hearing conference ("IPHC"); (2) after the IPHC, upon a party's learning additional information about the arbitrator that could not have reasonably been discovered sooner; and (3) when FINRA appoints an arbitrator who the questioning party did not previously rank, such as in instances of replacement arbitrators. This *voir dire*, however, is limited to seeking *additional* disclosures from an arbitrator to clarify potential conflicts or biases, in light of the disclosures that he or she has already made. Thus, the questions posed to an arbitrator are not so much in the form of traditional *voir dire* but, rather, should be seen (and titled) as requests for additional disclosures to the arbitrator.

I. *Voir Dire* Before the Panel has been Confirmed During the IPHC

During the IPHC, the arbitrators are asked whether they have any additional disclosures to make and the parties are then asked whether they

3. FINRA, RULE 12405.

4. The disclosure checklist should not be mistaken with the arbitrator disclosure reports provided by FINRA to the parties in advance of arbitrator rankings. The disclosure reports contain basic biographical and professional information for arbitrators. The disclosure checklist, on the other hand, contains an arbitrator's own representations as to his or her relationship (or lack thereof) with the parties, their counsel, and their witnesses. *See* FINRA, OATH OF ARBITRATOR (Apr. 2017), *available at* https://www.finra.org/sites/default/files/Oath-of-Arbitrator-Checklist.pdf (last visited Sep. 6, 2017).

consent to the composition of the arbitration panel.[5] Obviously, once consent is given, the removal of the arbitrators, either via a removal motion made to the Director of Arbitration, or a recusal motion made directly to a contested arbitrator, is increasingly difficult.[6] Therefore, before consent of the panel is given, care must be taken to avoid getting stuck with an arbitrator who may be biased against your client or partial in favor of your opponent's.

If you are suspicious about an arbitrator's loyalties, the most effective way to ensure the integrity of the panel is to directly ask the arbitrator questions designed to provide you with an accurate picture of the arbitrator. If the arbitrator answers your questions honestly, you should be able to make an informed determination as to whether the arbitrator might be impartial or biased and, if the latter, have strong legal grounds to challenge the arbitrator's appointment, either through a direct request to the arbitrator for recusal, or through a request to the Director for removal of the arbitrator. If, on the other hand, the arbitrator is untruthful in response to your follow-up questions (and you are able to subsequently challenge the veracity of the arbitrator's disclosures), the grounds for recusal and removal are even stronger.

However, when you grant consent to the composition of a panel, you are effectively waiving your right to claim that the arbitrator's initial disclosures were misleading; the reasonable assumption would be made that you granted your consent only after thoroughly researching the arbitrator's disclosures and, as such, you would effectively be estopped from subsequently challenging the arbitrator over those prior disclosures. Therefore, aside from performing regular due diligence in the arbitration ranking and selection

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5. FINRA, Initial Pre-Hearing Conference Arbitrator's Script 2 (July 14, 2017), *available at* https://www.finra.org/sites/default/files/iphc_script.pdf (last visited Sep. 6, 2017).

6. Once consent is given, the only way in which a party can seek to remove an arbitrator from a case is to file a motion for recusal or to file a request for removal of an arbitrator with the Director. See FINRA, RULE 12406; FINRA, RULE 12407. The standard for removal is "good cause" and motions for removal are decided by the arbitrator that is the subject of the motion/request. FINRA, RULE 12406. The Director is limited to removing arbitrators only for failing to disclose "information required to be disclosed under FINRA Rule 12405 that was not previously known by the parties." FINRA, RULE 12407(b).

process, practitioners should carefully examine the arbitrators' disclosure checklists provided to the parties upon appointment of the panel.[7]

Armed with the information contained in the disclosure checklists and disclosure reports, and against the backdrop of the information procured through arbitrator diligence during the ranking process, the practitioner is equipped to ask pointed questions to the proposed arbitrator in order to ascertain his or her impartiality.

The requests for additional disclosures at this juncture are generally propounded to the arbitrator during the IPHC. This occurs at the point of the arbitrator script at which the parties are asked whether they accept the composition of the panel. Depending on how an arbitrator answers (or refuses to answer) questions, the attorney may choose to: (a) consent to the arbitrator's appointment; (b) challenge the arbitrator's appointment directly to the arbitrator and ask for recusal; or (c) decline to consent to the panel's composition, pending additional research.

II. *Voir Dire* Conducted After Learning of Additional Arbitrator Information

Even after you have consented to an arbitrator's assignment to your case, you may have another chance to *voir dire* an arbitrator, in instances in which you learn information that triggers additional questions, where you would have had no way of knowing that information prior to the IPHC. Most commonly, a party learns of such information by way of an additional disclosure made voluntarily by an arbitrator. When an arbitrator's own disclosure triggers suspicion as to his or her ability to be impartial, a party may follow up with requests for additional disclosures.

It follows, therefore, that in order to be able to ask the arbitrator follow-up questions, an attorney must be conscientious to review an arbitrator's voluntary additional disclosures promptly and carefully upon receiving them. Additional disclosure reports frequently come with highlighting over the sections of the report that have changed since the previous report.

Because the answers to the follow-up questions propounded to the arbitrator at this juncture may be material in a motion to recuse, the attorney

7. Parties should receive the disclosure checklist from FINRA as a matter of course, once the panel has been appointed. Practitioners should review the disclosures and develop follow-up questions for one or more arbitrators, if necessary.

may ask FINRA to serve the questions to the arbitrator anonymously;[8] this way, in case the arbitrator denies the recusal motion, the arbitrator would not be able to hold the *voir dire* negatively against you or your client.

In order to remain truly anonymous to the arbitrator, it is vital that the propounded questions not appear to favor any party. The questions should be balanced evenly so the arbitrator could realistically think just as easily that the *voir dire* is coming from your opponent, instead of you. Keep in mind, however, that your adversary may respond and/or object to your questions in a manner that would divulge to the arbitrator that it was you who requested the additional information.

III. Additional Disclosures Propounded to Replacement Arbitrators

Voir dire made to a panel member whom you did not rank and who just replaced a prior arbitrator is somewhat unique, inasmuch as your requests for additional disclosures potentially can be broader than requests made to an arbitrator whom you ranked. After all, you may need to flesh out information contained on the general disclosure report, especially if you would have likely struck that arbitrator during the ranking stage based simply upon the report.

As in the previous case, counsel may wish to request of FINRA that the identity of the party propounding the requests for additional disclosures be kept confidential.

IV. *Voir Dire* and Motions to Remove and Recuse

Ultimately, requests made for additional disclosures by an arbitrator, whether made during the IPHC or at any point afterwards, are made for purposes of determining whether or not to request the removal or recusal of that arbitrator. Moreover, when a motion for removal or recusal is made, such motion is likely to be heavily premised on the questions propounded to, and answers received from, the arbitrator.

There are a variety of approaches as to how to structure the timing, quantity, and substance of the questions to be sent to the arbitrators. Some practitioners prefer to first seek the removal of an arbitrator by motion to the

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8. Although the FINRA rules do not specifically provide for anonymous questioning, FINRA staff will generally respect an attorney's requests to withhold the identity of the party propounding questions.

Director, before resorting to a motion to recuse. Where counsel takes this approach, he or she might choose to hold off on making the request to the arbitrator for additional disclosures until after the Director denies the removal motion. This way, the motion to remove could be renewed in light of new information received by virtue of the additional disclosures.

STATEMENTS OF CLAIM
Practice Commentary

David E. Robbins[1] *and Sam A. Silverstein*[2]

Introduction

Statements of Claim are always an intriguing subject of discussion among securities arbitration attorneys. There is no magic formula to drafting the perfect Statement of Claim and every attorney likes to add his or her own flare to the filing. While there are some aspects to drafting a Statement of Claim that most experienced securities arbitration attorneys adhere to – write in a narrative style, avoid numbered paragraphs that could be confused with a court complaint – more often than not, the particular facts and issues of that case will dictate the substance and style of a Statement of Claim. What's important for the drafter – you - is that the approach should remain the same regardless of the facts and issues.

At the beginning of every retention, we ask the new client – "What's the goal and who do we have to convince to meet that goal?" Your client's Statement of Claim has to resonate with the person or panel who will help your client achieve that goal.

Registered representatives and broker-dealers have an obligation to "know their customer" and that also applies to customer attorneys. Putting in the work early to learn all the facts you can, mapping out your claims and getting a true understanding of the damages at the outset will aid you greatly when it comes time to articulate your clients' claims before a mediator or arbitrator.

This article is based on our years of experience representing customers, brokers and firms. The subjects covered are:

1. Details vs. Short Form

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1. David E. Robbins is a founding member of PIABA and the recipient of its James Beckley Golden Bowtie Award. He is a partner of Kaufmann Gildin & Robbins LLP in New York City, is on the Board of Editors of the PIABA *Bar Journal* and is the author of the *Securities Arbitration Procedures Manual* (5th ed. 2016) and *The New York Practitioners Guide to Securities Arbitration and Mediation,* Supp. Prac. Comm., N.Y. Gen. Bus. Law Ch. 20, Art. 23-A (McKinney 2016).

2. Sam A. Silverstein is an associate at the New York City law firm Kaufmann Gildin & Robbins LLP, where he specializes in securities arbitration, mediation, litigation and disciplinary proceedings before regulatory authorities.

2. Specific Damages
3. Shotgun or Silver Bullet Claims
4. What to Say/Not Say for Insurance Carriers
5. Should I Name the Broker or Control Person?
6. FINRA Deficiency Letters
7. Motions for a More Definite Statement of Claim

1. Details vs. Short Form

Although attorneys comprise a significant percentage of FINRA arbitration panels and although most parties are represented by counsel, FINRA's former President of Dispute Resolution stated that Statements of Claim are not the same as Court Complaints. In 2004, Linda D. Fienberg said:

> In SRO NASD arbitration, unlike in court, you get an equitable result. You do not have to have a claim that is cognizable under state or federal law; it can be cognizable under NASD rules… The rules that are applied by arbitrators looking for equitable relief are much broader than if they had to strictly follow the law.[3]

Since FINRA provides practically no guidance as to the form of Statements of Claim,[4] their length and detail are primarily a matter of the drafter's style. Some customer attorneys prefer to draft incredibly detailed, voluminous Statements of Claim, replete with numerous exhibits - in an attempt to intimidate the respondent and showcase the strength of the claims to the arbitrators.

Other practitioners prefer to give as little detail as possible - oftentimes using boilerplate language to present their claims - in the belief that the details will come out at the hearing or the case will settle, thus obviating the need to the spend the time, money and effort drafting a detailed Statement of Claim. This seems to be the style of attorneys who troll the Internet for clients based on regulatory actions against particular brokers, then "drafting" Statements of Claim for alleged sales practice abuses the way you would

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3. Linda D. Feinberg, President, FINRA, Speech presented to the North American Securities Administrators Association Arbitration Forum (NAASA) (July 20, 2004). President Fienberg retired as President of FINRA Dispute Resolution in November 2014.

4. FINRA Rule 12302(a) merely requires the filing of "A statement of claim specifying the relevant facts and remedies requested."

draft Statements of Claim for product cases. In those instances, such attorneys seek to make the broker the single issue regardless of the broker's particular conduct with the customer-claimant.

While there are pros and cons to both styles, the number one priority of the drafter is to know his or her audience. Who are you trying to sway by your words, for they are your words and not your client's testimony?

The Statement of Claim represents the claimant's first impression to both the party he or she seeks relief from and the authorities empowered to grant such relief. This audience includes the respondent, defense counsel, arbitrators, insurers, regulators and, more and more commonly, mediators. Given the increasing popularity of FINRA's Mediation Program, the importance of drafting pleadings for a mediator cannot be overstated. It is this evolution of the dispute resolution process that we believe gives the edge to drafting more detail-oriented Statements of Claim.

Since a mediator will not have the benefit of a full evidentiary hearing, counsel for both parties will have to provide those details in order for the mediator to properly understand the case and then negotiate a settlement. While this is typically accomplished with the submission to the mediator of a Mediation Statement, a detailed Statement of Claim provides a strong scaffold for this submission, whereas the drafter of the boilerplate Statement of Claim will have to start from scratch – drafting a detailed Mediation Statement.

The details in our Statements of Claim and Answers are driven by the facts and the theme we want to convey. We always have themes and provide the reader with factual substantiation of those themes. When FINRA sends you the list of proposed arbitrators and you (often) see how many pending cases the arbitrators are on, this tells you that you should try to grab their interest with your Statement of Claim so that they remember your case from the many they've sat on and the many they may be sitting on at the same time as yours. To bore arbitrators with boilerplate is insulting to them and often reflective of an attorney's hubris and laziness.

Should you attach exhibits to your Statements of Claim? The default answer should be "No" except in rare circumstances where those documents speak better than you do in the body of the Statement of Claim.

2. Specific Damages

It has always been our practice to include specific monetary damages and avoid approximations in Statements of Claim. Before we take most customer cases, even before we agree on retention terms with clients, we usually

require that an outside expert undertake what we like to call the "blood test," to tell us "what happened" but not necessarily "why it shouldn't have happened."

If the damage calculation cannot be more specific without the discovery of necessary documents from your adversary (e.g., commission runs), we explain – usually as a footnote in the Claim - the possible need to amend the damage claim. While it's not uncommon to see Statements of Claim containing approximate damage amounts or wide ranges of potential damages, this is another area where it pays to put in the work in the initial filing.

As defense attorneys, we have seen customer attorneys bring sales practice abuse cases and submit Statements of Claim that focus on the broker and not the problematic activity. Such attorneys often present an identical wide range of compensatory damages, hoping – through a settlement - to forestall if not render unnecessary the expenses incurred to have a trading analysis done.

The goal of all customer claims is the return of monetary losses, either through a settlement or an Award. In either case, the amount is going to be based on a finite figure – whether it is net out-of-pocket losses, rescission, "benefit of the bargain" or any other theory of damages. The last thing a customer attorney should want to do is rely on the quantitative analysis of the brokerage firm to tell him or her "what happened." Having a quantitative expert prepare specific damage numbers before the Statement of Claim is filed shows the reader that you have a strong, accurate foundation for the damages you are seeking and that you are not just representing a disgruntled investor seeking his money back, equating *losses* with *damages*.

Another stylistic debate regarding damages stems from the different theories of damages available to a claimant. While some customer attorneys believe that it's best to present all possible calculations - offering the arbitrators a selection of different foundations on which to base an Award - this could create more problems than it offers in solutions.

Last year, while representing a claimant in a Puerto Rico bond case, the facts of the case presented us with many different damage theories. In addition to simple net out-of-pocket losses, our client insisted on presenting calculations for rescission (seeking the profit he would have received had none of the Puerto Rico bonds been purchased), "benefit of the bargain" (seeking the rate of return his broker had promised him) and "failure to follow instructions" (seeking the profits he would have received if the broker had only purchased insured Puerto Rico bonds as he was instructed to). While we had a strong argument for all of these damage theories and a superb expert to explain and support the calculations at the hearing,

presenting so many different theories appeared to confuse the arbitrators. The able defense counsel made sure to add an assertion of customer greed to the confusion of multiple damage theories.

Remember, at the end of the day, you're demanding that the respondent write a check to your client. The more clearly and concisely that you present the amount you are seeking - as early as possible - the more the integrity of your damage claim will resonate with the respondent, the mediator or the arbitrators.

3. Shotgun or Silver Bullet Claims

There's a maxim in litigation to claim everything you can think of and "let the judge sort it out." This strategy may beef up a Statement of Claim and please a client who wants to "throw the book" at his broker, but the shotgun approach[5] could backfire[6] if not properly thought out. For example, a claimant's attorney may want to avoid claims that the broker intentionally committed the wrongdoing or fraudulently concealed the illicit acts from his firm. Such claims could prevent a claimant from collecting an Award from the firm or insurance carrier, leaving nobody to pay for the damages except the individual broker – who, more than likely, may be unable to pay the full amount.

To prevent this outcome, it is our practice to make sure that all of our claims have a nexus to either the brokerage firm's supervision or the doctrine of *respondeat superior*. In most cases, it has been our practice to not even name the individual broker as a respondent (more on that below).

Another issue presented by the "shotgun" method of claims is the potential for the Statement of Claim to run on too long and lose the reader's interest. (FINRA arbitrators, unlike those at the American Arbitration Association, are not paid for their "study time.") A drafter of such a Statement of Claim runs the risk of sounding redundant, applying different claims of wrongdoing to the same set of facts. This issue is most prevalent in product cases, where the technical nature of the pleadings has a high probability of anesthetizing the reader. If the drafter truly knows the facts and understands the reasoning behind each cause of action, the proper style of pleading - to grab the reader's attention - will become self-evident.

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5. Shotgun approach, DICTIONARY.COM, http://www.dictionary.com/browse/shotgun-approach (last visited Sep. 8, 2017).

6. Pun intended.

It's been our experience that the greatest liability of the shotgun approach is that it usually permits a good defense attorney to key into the weakest argument and shift the focus of the arbitrators' attention. Frankly, when we are defending cases,that is one of *our* practice strategies.

4. What to Say/Not Say for Insurance Carriers

When drafting a Statement of Claim, insurance coverage may not top your list of considerations, but failing to address the potential insurance carrier coverage issue could create dire monetary consequences, for it doesn't matter how strong your case is if the respondent is unable to pay the damages awarded.

While it is rare for a registered representative to maintain her own insurance policy, broker-dealers often carry E&O (errors and/or omissions) coverage. The pitfall for a claimant's attorney is that these E&O policies almost always contain *exclusions* for intentional or fraudulent misconduct on behalf of an employee.[7]

This exclusion can often present a *Catch-22* for the drafter when dealing with a case of truly egregious misconduct by the registered rep.

- On the one hand, highlighting the nefarious actions with strong language like "willful," "theft" and "wanton" can really grab the reader's attention and add weight to your claims.
- On the other hand, these same words can be highlighted by an insurance carrier as reasons why its E&O policy doesn't cover such claims – leaving the claimant with a great case against a potentially judgment-proof respondent.

The solution to this problem is negligence – not on the part of the attorney but on the part of the broker. Claimant's attorneys love to include violations of securities statutes in their Statements of Claim - providing legal precedent and statutory support to the claims – but those statutes may require *scienter* as a pleading requirement. Without a claim for negligence, you may be giving the insurance carrier what it needs to deny coverage.

In a case we were involved in from the defense side, when the Award – quite favorable to the customer – referenced a state's Blue Sky statute, the insurance carrier told our clients (the brokerage firm and one of its former

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7. For a comprehensive analysis of insurance coverage and securities arbitration, see David E. Robbins, *Securities Arbitration Procedure Manual* §§8-9 (Lexis Publishing, 5th Ed. Dec. 2016).

brokers) that it would not pay the compensatory damages portion of the Award because, claimed the carrier, the arbitrators had concluded that the broker violated a statute that has intent/scienter as an element. When we explained that the Uniform Securities Act does not have intent/scienter as an element in misrepresentation cases, the carrier changed its conclusion on coverage and the customer was paid.

5. Should I Name the Broker or Control Person as Respondents?[8]

Brokers - There are a number of factors to take into consideration - on a case-by-case basis - to determine whether to name the broker as a respondent:

1. Did the broker commit the primary wrongdoing?
2. How important is the broker to the firm?
3. Is there a possibility of a conflict requiring two sets of defense counsel?
4. What is the broker's CRD history? If the broker's record is clean, naming him or her may cause a "joust to the death" as the broker vigorously protects his or her virginal reputation.
5. Is the broker still employed by the firm or still in the industry?
6. Was the broker fired for cause – related to the conduct set forth in the Statement of Claim?
7. What is the collectability of a favorable Award?

Control Persons - The factors to consider whether to name a control person (e.g., branch manager, Compliance officer) as a respondent include:

1. Do you have written evidence (or will have strong oral evidence) of his/her approval/participation of any kind in the transactions at issue?
2. Does the branch manager or Compliance person have black marks on his/her BrokerCheck Report for supervisory failings?
3. Did he/she receive a financial benefit (e.g., override) related to the transactions at issue?
4. By naming such individuals, will that put added pressure on the firm to settle?
5. Is the brokerage firm in such precarious financial condition that its potential pockets will be empty?

There is no easy answer to the question of whether to name the broker and/or control person as a Respondent – as long as, in good faith, you believe there is a *connection* between that person's conduct and your client's losses.

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8. For an in-depth analysis of this critical subject, see David E. Robbins, *Securities Arbitration Procedure Manual* §§ 6-5, 7-2 (Lexis Publishing, 5th Ed. Dec. 2016).

PIABA member Melanie S. Cherdack has suggested that customer attorneys should not underestimate the significance of determining who will become respondents in their arbitrations. In "Drafting a Securities Arbitration Claim: The Pen is (Still) Mightier Than the Market,"[9] she notes that there are several schools of thought on this issue. Some practitioners believe that the "scorched earth approach" is best. If the account executive is a "serial rogue broker" who has shuttled from firm to firm - leaving a trail of mass destruction in his wake - then naming the broker and multiple firms as respondents can help the customer's case, she says. This may cause each of the respondent brokerage firms to blame the other for the losses, causing infighting in front of the arbitrators and possibly adding more credibility to the claims. When respondents point fingers at each other, they often don't have enough fingers left to point at the customer.

A customer's attorney may also want to name the broker as a respondent if that broker is a large producer for the brokerage firm or a publicly recognizable name (and the attorney believes he or she can meet the burden of proof against the broker). In such a case, the fear of bad press could incentivize a firm to settle.

However, there are several reasons why a claimant's attorney should not name the broker. As mentioned above, in the case of substantial wrongdoing, there is the chance that the arbitration panel may allocate the losses individually among the respondents, rather than entering a joint and several Award. A customer's attorney wants to avoid the situation where the arbitrators allocate a large percentage of the Award against the broker and only a small percentage against the brokerage firm. Since brokers who engage in reckless and intentional wrongdoing are often judgment-proof, such an Award would amount to a Pyrrhic victory.[10]

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9. Melanie S. Cherdack, Drafting a Securities Arbitration Claim: The Pen Is (Still) Mightier Than the Market (2012), http://www.investorfraudlaw.com/firm-overview/articles/drafting-a-securities-arbitration-claim-the-pen-is-still-mightier-than-the-market/#q1 (last visited Sep. 8, 2017).

10. Pyrrhic victory is named after King Pyrrhus of Epirus, whose army suffered irreplaceable casualties in defeating the Romans at the Battle of Heraclea in 280 BC and the Battle of Asculum in 279 BC, during the Pyrrhic War. After the latter battle, Plutarch relates in a report by Dionysius: The armies separated; and, it is said, Pyrrhus replied to one that gave him joy of his victory that one other such victory would utterly undo him. For he had lost a great part of the forces he brought with him, and almost all his particular friends and principal commanders; there were no others there to make recruits, and he found the confederates in Italy backward. On the other hand, as from a fountain continually flowing out of the city, the Roman camp was quickly and plentifully filled up with fresh men, not at all abating in

Not naming the broker as a respondent may also make the broker more likely to cooperate with the claimant or be a friendlier witness. Don't expect too much cooperation though, since FINRA changed its reporting standards in 2009;[11] brokerage firms are required to report customer complaints and arbitrations on a broker's CRD even if that broker is not a named respondent.[12]

6. FINRA Deficiency Letters

While FINRA Rule 12302 provides nearly no guidance as to the style and format of a Statement of Claim, it does set forth requirements for its submission that, if not met, will trigger FINRA to issue the claimant a deficiency letter. At PIABA's 24th Annual Meeting in 2015, FINRA presented a checklist that its Case Administrators utilize when they receive a Statement of Claim. In order to *avoid* the receipt of a deficiency letter, a claimant's attorney must:

1. Include a Submission Agreement, signed and dated by all claimants, along with the Statement of Claim;
2. Submit the proper filing fee;
3. Redact all Personal Confidential Information ("PCI") in the claim and in the exhibits; and,
4. Make sure that the Statement of Claim itself specifies:
   - Relevant facts and remedies and
   - The claimant's city and state of residence at the time of the events giving rise to the dispute.

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courage for the loss they sustained, but even from their very anger gaining new force and resolution to go on with the war. *See Pyrrhic Victory*, WIKIPEDIA, https://en.wikipedia.org/wiki/Pyrrhic_victory (last visited Sep. 8, 2017).

11 *See* FINRA, REGULATORY NOTICE 09-23.

12 How best to deal with the issue of brokers seeking expungement after the settlement of a case in which the broker was not named as a respondent is dealt with in David E. Robbins, *Challenging Expungements After Settlements*, 23 PIABA B.J. 387 (2016).

7. Motions for a More Definite Statement of Claim

It may seem counter intuitive to a claimant's attorney, but the fact is, a respondent has a right to know what it's defending itself from. If a Statement of Claim fails to specify the relevant facts or remedies sought, a respondent may make a Motion to either the Director of Arbitration or the Case Administrator under FINRA Rule 9215(c), requesting a more definite pleading from the claimant. Defense attorneys may submit such a motion in order to gain a better understanding of the claims and to avoid having to defend a case without knowing all the pertinent details.

However, some attorneys, like now full-time mediator, James D. Yellen,[13] have a general rule against filing such a motion. During a presentation on securities arbitration hosted by PLI in 2000, he stated that a poorly presented claim is a gift to respondents, allowing them to present a detailed rebuttal in their Answer and, thus, winning "the battle of first impressions."

Conclusion

The drafter of a Statement of Claim must be thorough in presenting the main facts and central issues and, like a good chess player, anticipate the opponent's likely moves. Whether it is the amount of detail in the facts portion of the Statement of Claim, the specificity of the damages, the number of claims or the individuals and entities named as respondents, if there is sound reasoning for the way these subjects are presented, the drafter will not only avoid deficiencies and motions, but find that the reader – arbitrator, opposing counsel, mediator – understands that you are prepared to work towards a resolution. It is can be the roadmap toward meeting the goal of securing damages for your client.

In the end, this is not about us - attorneys for customers. Our desire should not be to showcase our talents but to convince three (hopefully) impartial arbitrators or one (hopefully) unjaded mediator that our clients' desire to reclaim losses is based on arguments of integrity and a clear rationale for recovery. Taking the time and using your talents to write effective Statements of Claim are critical steps to reach that goal.

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13. Mr. Yellen is a former First Vice President and Senior Attorney with Morgan Stanley, and is now a full time mediator and co-chair, with Mr. Robbins, of the New York State Bar Association program on securities arbitration.

ARBITRATION PLEADINGS: THE COURAGE TO SIMPLIFY

*James D. Yellen**

Writing is easy," said Red Smith, the premier sports journalist of his day. "You just sit at a typewriter until blood appears on your forehead."

Writing really is hard. Millions of people opened the sports pages to read what Red Smith wrote about games from the night before, but even he thought writing was hard. To read a final product that "sings"—that reads smoothly, effortlessly, and enjoyably—it belies the sweat the writer went through to get the work to such a clean state.

Introduction[1]

Arbitrators are busy people. They tend to review your pleadings—Statement of Claim and Answer—at three crucial junctures: 1) when they arrive in the mail, just to get a look at what the case is about; 2) on their way to the hearing (subway, bus, train, or car); and 3) when raised during the hearing when counsel argues that a point will be met or obliterated. The first two reviews are usually forgotten, but the third can have a big impact.

Can your writing be more effective? The answer is a surprising yes. But why bother? First, it's a question of first impression—your pleading should have the panel "lean" toward you. Second, your pleading is the first chance to tell your story. Telling your story directly, credibly, and with appropriate, but

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1. This article is an update of the author's "Arbitration Pleadings: The Courage To Simplify" published in PLI Seminar Counselbook in 2005 and edited then by co-chair David Robbins. The state of legal writing in arbitration and litigation has not advanced since then—if anything, due mostly to overuse of e-mail, electronic submission, and overworked attorneys and client desire not to pay for "training," it is probably worse.

not extreme, advocacy is the key—and that starts with the pleading. Don't get lost in lengthy build-ups or revert to pages of rote paragraphs from other matters. The three most powerful pages, and your only shot at simplicity, is your summary of facts at the beginning.

The following are my top ten Plain English tips for effective and simplified pleadings in securities arbitration. Follow these, and you just might grab one, two, or three of the panel members. Yes, you have a shot. Yes, it's worth a try.

The Ten Golden Rules for Persuasive Arbitration Pleadings

1. Omit Needless Words.[2]

Plain English, reviewed in countless books on writing,[3] comes down largely to this basic rule.[4] Justice Brandeis said it best: "There is no such thing as good writing. There is only good rewriting."[5] When you edit drafts, omit surplus words.[6] Search out compound constructions[7] and the passive voice.[8]

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2. E. B. WHITE AND WILLIAM STRUNK JR., THE ELEMENTS OF STYLE 23-24 (4th ed. 1999); *see also* RICHARD C. WYDICK, PLAIN ENGLISH FOR LAWYERS 9-24 (4th ed. 1998). When William Strunk taught at Cornell in the early 20th Century, he would shout out to his class, "Omit needless words! Omit needless words! Omit needless words!"

3. *See, e.g.*, WYDICK, *supra* note 2.

4. *See* BRYAN A. GARNER, LEGAL WRITING IN PLAIN ENGLISH 17 (2001).

5. *See* RICHARD K. NEUMANN, JR., LEGAL REASONING AND LEGAL WRITING: STRUCTURE, STRATEGY, AND STYLE 61 (4th ed. 2001).

6. WYDICK, *supra* note 2, at 9-24; STRUNK & WHITE, *supra* note 2, at 23-24. There are online sources that provide exercises to practice omitting needless words. *See, e.g.*, *Tip 2 – Omit Needless Words*, BRUSSELSLEGAL.COM, http://www.brusselslegal.com/article/display/2563/Tip_2_Omit_needless_words (last visited Aug. 11, 2017). *See also* Bryan A. Garner, *Exercises from Legal Writing in Plain English* (2001), UNIV. CHICAGO PRESS, *available at* http://press-pubs.uchicago.edu/garner/documents/section5.html.

7. WYDICK, *supra* note 2, at 13-14. Thomas Jefferson put it best when he said, "The most valuable of all talents is that of never using two words when one will do."

8. WYDICK, *supra* note 2, at 24-29; STRUNK & WHITE, *supra* note 2, at 18-19; *see also* GARNER, *supra* note 4 at 24 (discussing both nominalizations and the passive voice).

"At that point in time" becomes "then." "For the reason that" becomes "because." "In order to" becomes "to." "I personally" becomes "I."[9] And "in the instant proceeding" becomes "here." When you see these lawyer-like phrases, get rid of them. Simplify. Have no fear—the arbitrators will appreciate it.

2. Avoid Redundant Legal Phrases or Couplets.[10]

Lawyers like to use a pair or string of words that mean the same thing: null and void; last will and testament; free and clear; good and sufficient; confesses and acknowledges; deposes and says. The use has ancient roots in legal writing;[11] tradition dies slowly. Bottom line: these legal couplets are no longer necessary.[12] Avoid redundant repetition (including phrases like that).

3. Use Base Verbs, Not Nouns (Avoid Nominalizations).[13]

Lawyers for some reason like to "make statements" instead of "state." Watch for forms of the verb "to make" or "to do" followed by nouns ending in "-ment," "-tion," "-al," "-ence," and "-ity." These are nominalizations.[14] Have your cars collide, not enter into collisions. Assume, do not make assumptions, and ask panels to decide, not to make decisions. At the next hearing, I will take care to "state why I object," rather than "ask to be permitted to make a statement as to why I am interposing an objection to counsel's

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9. Or "in the case at bar..." or "in the above-captioned case ..."

10. WYDICK, *supra* note 2, at 19-24.

11. These couplets came into existence in England following the Norman Conquest about 1,000 years ago. *See Null and Void*, TRANSLEGAL.COM (Apr. 10, 2012), https://www.translegal.com/legal-english-dictionary/null-and-void (last visited Aug. 10, 2017).

12. *See* WYDICK, *supra* note 2, at 19-24.

13. *Id*. at 25-27; *see also* Garner, *supra* note 6, at 10-11.

14. *See* WYDICK, *supra* note 2, at 25-27; *see also* Matthew Salzwedel, *Eliminating Nominalizations/Buried Verbs in Legal Writing*, LAWYERIST (July 3, 2012) (noting that aside from the passive voice, the use of nominalizations is perhaps the best sign of poor legal writing).

question at this time."[15]

In the same vein, use real words, not bureaucratese. A "detonation device" is a bomb. A "home surveillance protection system" is an alarm. "To communicate orally" is to talk.

4. Use Short Sentences and Short Paragraphs.[16]

I count words in my drafts. Sentences should be fewer than 25 words.[17] Paragraphs should have an introduction, a middle, a conclusion, and should be three to five or six sentences long.[18] One thought per sentence;[19] one argument per paragraph.[20] Everything you do to help the reader helps you and your client. Attention will be paid if you pay attention to what you write.

5. Arrange Your Words With Care.[21]

Keep the subject of the sentence close to the verb.[22] Be careful in the placement of clauses and phrases. "The defendant was arrested for fornicating under a little-used state statute."[23] This may bring a smile to the reader, but vague antecedents will not advance your cause. "My client has discussed your proposal to fill the drainage ditch with his partners" is another favorite.[24] Arrange your words with care.

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15. WYDICK, *supra* note 2, at 25.

16. *See id*. at 35-41; *see also* STRUNK & WHITE, *supra* note 2, at 15-17.

17. *See* WYDICK, *supra* note 2, at 38.

18. *See* Sue Carol Rokaw, *The Essentials of Good Legal Writing*, SURVIVAL GUIDE FOR NEW ATTORNEYS IN CALIFORNIA, at 24-25 (Fall 2005), (*available at* https://www.lacba.org/docs/default-source/lal-back-issues/2005-issues/survival-guide-fall-2005.pdf).

19. *Id.*

20. *See* STRUNK & WHITE, *supra* note 2, at 15-17.

21. *See* WYDICK, *supra* note 2, at 43-56.

22. *See id.* at 43-46.

23. *Id*. at 49.

24. *Id*.

6. Use Concrete Words; Avoid Lawyerisms.[25]

Choose your words with precision; make every word tell. We often lapse into lawyerisms out of bad habit, laziness, or an ill-conceived attempt to impress.[26] Plain English in writing is often similar to plain speaking in everyday conversation.[27] You would not say at the dinner table, "Those are wonderful string beans; please pass said beans."[28] Don't write that way either. Henceforth, lose the aforesaids, heretofores, and hereinafters from your writing.[29]

Always choose the active voice over the passive voice.[30] Given the choice, use familiar words over the unfamiliar.[31] Prefer English root words to the Latin-based words (e.g., explain for elucidate; see for observe; use for utilize; free for liberate).[32] Plain English saves time and money by increasing a reader's ability to understand and retain what he has read.[33]

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25. *See id*. at 57-63; *see also* STRUNK & WHITE, *supra* note 2, at 21-23; Matthew Salzwedel, *Face It - Bad Legal Writing Wastes Money*, LAWYERIST (Feb. 20, 2013), https://lawyerist.com/face-it-bad-legal-writing-wastes-money/ (citing studies of readers' responsiveness to plain English as compared to lawyerisms).

26. As the T-shirt reads, "Eschew obfuscation."

27. *See* Garner, *supra* note 6, at 48-50; *see also* BRYAN A. GARNER, GARNER ON LANGUAGE AND WRITING 48 (2009) ("[l]f you wish to write well, you'll have to resist sounding like a machine. Or an old-fashioned pontificator. You'll have to learn to sound like the best version of yourself.").

28. Wydick, *supra* note 2, at 61.

29. *Id*. at 61-63; *see also* Gerald Lebovits, *On Terra Firma With English*, 73 N.Y. ST. B.J. 56, 64 (Sept. 2001) ("Legalese ... adds nothing of substance, gives a false sense of precision, and obscures gaps in analysis.").

30. *See* ANNE ENQUIST & LAUREL CURRIE OATES, JUST WRITING: GRAMMAR, PUNCTUATION, AND STYLE FOR THE LEGAL WRITER 76-77 (2d ed., 2005) (noting three primary benefits in preferring active voice: (1) active voice makes the sentence more concise; (2) active voice uses a more vigorous verb; and (3) active voice allows information to be processed more readily).

31. *See* Kristin K. Robbins, *The Inside Scoop: What Federal Judges Really Think About the Way Lawyers Write*, 8 LEGAL WRITING 257, 284 (2002).

32. *See* WYDICK, *supra* note 2, at 60-61.

33. *See* CHARLES R. CALLEROS, LEGAL METHOD AND WRITING 271 (6th ed. 2011) ("The readers of such [long] sentences must assimilate too much information before pausing, and they often lose track of the proper relationships of the ideas

7. Use Strong Nouns and Verbs.[34]

Legal writing should be declaratory and direct.[35] Don't dilute your points with vague, "purple-prosy" sentiments. Long sentences unnecessarily complicate legal writing.[36] "The witness intentionally testified untruthfully about the issue raised in paragraph 42 of the Claim." The witness lied. "The Claimant was very, very upset at the prognosis of the decline in value of her portfolio and her present budgetary circumstances." She was enraged. The losses were large and they hurt. Sophistication of expression should always be sacrificed if it detracts from clarity.[37]

8. Avoid Long Quotes and Legal Treatises.

Submitting a claim or answer in arbitration is the first chance you have to "tell your story." The first three to five pages are critical—they create your first impression. Most panelists wait for the hearing to absorb the finer details. Your theme should be precise and succinct, colorful and credible. Trade long passages for short sentences.[38] A claim is not a legal brief. The use of endless quotes from case law bores most arbitrators. If the panel wants a brief on a particular legal issue, it will ask for one. Long legal recitations also smack of form pleading with cookie-cutter claims or defenses.[39]

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expressed.").

34. WYDICK, *supra* note 2, at 77-78; *see also* STRUNK & WHITE, *supra* note 2, at 71-72.

35. WYDICK, *supra* note 2, at 77.

36. *See* VEDA R. CHARROW, ET AL., CLEAR & EFFECTIVE WRITING 163-64 (4th ed. 2007).

37. *See* ANTONIN SCALIA & BRYAN A. GARNER, MAKING YOUR CASE: THE ART OF PERSUADING JUDGES 107 (2008).

38. *See, e.g.*, CHARROW, *supra* note 36, at 165 (4th ed. 2007) (instructing legal writers to break long passages into shorter sentences); NEUMANN, *supra* note 5, at 229 (instructing legal writers to break long sentences "in two"); TERRILL POLLMAN ET AL., EXAMPLES AND EXPLANATIONS: LEGAL WRITING 278 (2011) (encouraging legal writers to avoid drafting sentences that exceed four typed lines).

39. It helps the defense's cause greatly when plaintiff's counsel neglects to proofread the final product carefully. You cannot blame anyone else when an old Respondent's name turns up in your new Statement of Claim against a new Respondent. Likewise for defense counsel, stating as an affirmative defense that "Claimant ratified his

The sooner you lose the reader, the sooner you lose the case. We all suffer from the tendency to believe that if words came from a published source, they must be good. Be shrewd enough to delete and revise.[40] Avoid legal jargon with no purpose and use technical language only when necessary to convey your argument clearly and concisely.[41]

9. Punctuate Carefully.[42]

The rules are too numerous for review here.[43] But remember that punctuation is a guide to meaning.[44] Sloppy punctuation doesn't only affect the meaning of your sentence,[45] but also implies, like sloppy citations, a sloppy

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trades," in response to the claim of Sally Jones does not impress.

40. *See* STRUNK & WHITE, *supra* note 2, at 72-73.

41. *See, e.g.*, BRYAN A. GARNER, THE MYTH OF PRECISION, A DICTIONARY OF MODERN LEGAL USAGE 580, 663 (2d ed. 1995).

42. WYDICK, *supra* note 2, at 85-115; *see also* STRUNK & WHITE, *supra* note 2, at 1-9.

43. *See also* JOHN C. DERNBACH ET AL., A PRACTICAL GUIDE TO LEGAL WRITING & LEGAL METHOD 200 (3d ed. 2007) (stating that errors in grammar, punctuation, and spelling suggest that the writer is sloppy and careless— qualities that people do not want in a lawyer); NEUMANN, *supra* note 5, at 224 (stating that correct punctuation and grammar make writing clearer and easier to understand); WYDICK, *supra* note 2, at 84 (noting that when you write, you should punctuate carefully, in accordance with ordinary English usage).

44. WYDICK, *supra* note 2, at 89.

45. The importance of punctuation is stressed with great style and humor in "Eats, Shoots and Leaves" by Lynn Truss (1st ed. 2004). Her thesis is that through sloppy usage and the informality of Internet writing, we have made proper punctuation an endangered species. The book title derives from the following story:

> A panda walks into a cafe. He orders a sandwich and eats it, then draws a gun and fires two shots in the air. "Why?" asks the confused waiter. As the panda exits, the panda produces a badly punctuated wildlife manual and tosses it over his shoulder. "I'm a panda," he says, at the door. "Look it up." The waiter turns to the relevant entry and, sure enough, finds an explanation. "PANDA. Large black-and-white bear-like mammal, native to China. Eats, shoots and leaves." So, punctuation really does matter, the author notes, even if it is only occasionally a matter of life and death.

and careless writer.

By inference, the grammarian panelist thinks "Sloppy writing, sloppy research, sloppy reasoning." The result again is a bias against your client rather than for your client.[46] This may strike you as minor or picayune. But small mistakes add up to an impression that you do not care enough. Assume that everything in arbitration makes a difference because anything might.[47]

10. Be Shrewd Enough to Revise. Edit, Edit, then Edit.[48]

There should be no cookie-cutter complaint or answer. Your client's story is always unique. Each arbitration is different. If you believe there is no such thing as good writing, only good rewriting, then editing is crucial.[49] Always proofread once more than you think is necessary. Make it your story. Make every word tell. Again, recall Brandeis ("Just good rewriting").

Conclusion

If you follow this recipe, the finished product will be smooth and effortless to understand. It is through your labors that clear writing will emerge. You know you have succeeded when your thoughts are so clear that the reader does not notice your choice of words or the structure of your sentences.

Keep these suggestions in mind. They are useful guidelines. You will need your voice and your style to make your story sing in the most compelling way. As an example, I offer an old (if somewhat extreme) English tax court decision. In the early days of common law, courts included the parties' positions in publications.

Defendant: "With God as my judge, I do not owe this tax."

Court: "He's not. I am. You do".

Strive to write well and be concise. It will serve everyone's interest. Be both good and short.

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46. *See* NEUMANN, *supra* note 5, at 51-53.

47. *See* DERNBACH, *supra* note 43, at 200 ("Minor errors distract the reader from the message to be conveyed. Major errors may distort the message or make it unintelligible.").

48. See STRUNK & WHITE, *supra* note 2, at 72-73.

49. *See id.*; NEUMANN, *supra* note 5, at 61-63.

MOTIONS TO DISMISS – ELIGIBILITY AND STATUTE OF LIMITATIONS

Michael S. Edmiston[1]

In January 2009, through its issuance of Regulatory Notice 09-07, FINRA announced the SEC approval of its new Motion to Dismiss rule and amendment to the Eligibility Rule in arbitration.[2] On its face, FINRA sought to limit pre-hearing dispositive motion practice and to provide more claimants with an opportunity for an evidentiary hearing.

FINRA Regulatory Notice 09-07 originally limited Motions to Dismiss to two grounds and three exceptions, including the Eligibility Rule.[3] In its amended rule, FINRA Code of Arbitration Procedure Rule 12504(a)(1) starts with the following statement: "Motions to dismiss a claim prior to the conclusion of a party's case in chief are discouraged in arbitration."[4] In FINRA's Arbitrator Guide, it restates the same position: "FINRA believes that parties have the right to a hearing in arbitration. Therefore, motions to dismiss filed prior to the conclusion of a party's case-in-chief are discouraged and granted only under limited circumstances."[5] FINRA also recognized the potential that its three exceptions might also encourage more motion filing. In Regulatory Notice 09-07, FINRA "…emphasizes that these exceptions do not constitute an invitation to parties to file motions to dismiss."[6]

As a result of Regulatory Notice 09-07 and related rule changes, pre-hearing dispositive motion practice continues, but with a greater focus on the six-year Eligibility Rule.

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1. A "thank you" is given to the PIABA members, including Christine Lazaro, Joe Wojciechowski, Randall Pulman, and David Neuman who contributed to this article.

2. FINRA, REGULATORY NOTICE 09-07 (Jan. 2009).

3. The two grounds for Motions to Dismiss was later expanded to three.

4. FINRA, RULE 12504(a)(1).

5. FINRA, FINRA OFFICE OF DISPUTE RESOLUTION ARBITRATOR'S GUIDE 49 (Feb. 2017), *available at* http://www.finra.org/sites/default/files/arbitrators-ref-guide.pdf.

6. FINRA, REGULATORY NOTICE 09-07.

I. FINRA CODE OF ARBITRATION RULE 12504

Rule 12504 governs pre-hearing Motions to Dismiss with explicit terms as to what type of pre-hearing motions to dismiss are permitted by the rule, or excepted-out and governed by another FINRA rule.

Today, Rule 12504(a)(6) permits three grounds for filing a pre-hearing motion to dismiss: (A) when the non-moving party released the claims; (B) the moving party was not associated with the account(s), security(ies), or conduct at issue; or (C) 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.[7] Otherwise, an arbitration panel "…cannot act upon a motion to dismiss a party or claim…"[8]

Rule 12504 provides exceptions for three other types of Motions to Dismiss. Motions to Dismiss based on the Eligibility Rule are governed by Rule 12206.[9] Motions to Dismiss for failure to comply with any provision in the Code of Arbitration Procedure or Order (panel or single arbitrator) are governed by Rule 12212.[10] Motions to Dismiss for Discovery Abuse are governed by Rule 12511.[11]

Missing from the permissible pre-hearing motions to dismiss and/or the exceptions to Rule 12504(a) is anything to do with the statute of limitations. It does not mean such a motion is not permitted, but that it must be brought under Rule 12504(b) which provides "[a] motion to dismiss made after the conclusion of a party's case in chief is not subject to the procedures set forth in paragraph [12504](a)."[12]

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7. FINRA, RULE 12504(a)(6). FINRA Code of Arbitration Procedure Rule 12504(a)(6)(C) was added by amendment by SR-FINRA-2016-030, effective Jan. 23, 2017.

8. *Id*.

9. FINRA, RULE 12504(c).

10. FINRA, RULE 12504(d).

11. FINRA, RULE 12504(e).

12. FINRA, RULE 12504(b).

A. Timing and Procedures for Responding to a Motion to Dismiss Under Rule 12504.

A party filing a Motion to Dismiss under Rule 12504 must do so at least 60 days before the scheduled hearing.[13] The responding party has 45 days to respond to the motion.[14] A reply in support of the motion is due 5 days after the response.[15]

Unless waived by the parties, the full panel must have an in-person or telephonic pre-hearing conference and the hearing must be recorded.[16] The decision to grant a motion to dismiss must be unanimous and must have a written explanation.[17]

B. "Penalties" for a Failed 12504(a) Motion to Dismiss

Rule 12504 provides three "penalties" and a prohibition against refiling a Motion to Dismiss. A failed Motion to Dismiss requires the arbitration panel to assess the forum fees against the moving party.[18] If the Panel deems the Motion to Dismiss was frivolous, it must award reasonable costs and attorney's fees against the moving party.[19] Sanctions are also available if the Panel determines a Motion to Dismiss was filed in bad faith.[20] Lastly, a party who loses a Motion to Dismiss under Rule 12504(a) may not re-file the denied motion.[21]

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13. FINRA, RULE 12504(a)(3).

14. *Id*.

15. *Id*.

16. FINRA, RULE 12504(a)(4), (5).

17. FINRA, RULE 12504(a)(7).

18. FINRA, RULE 12504(a)(9).

19. FINRA, RULE 12504(a)(10).

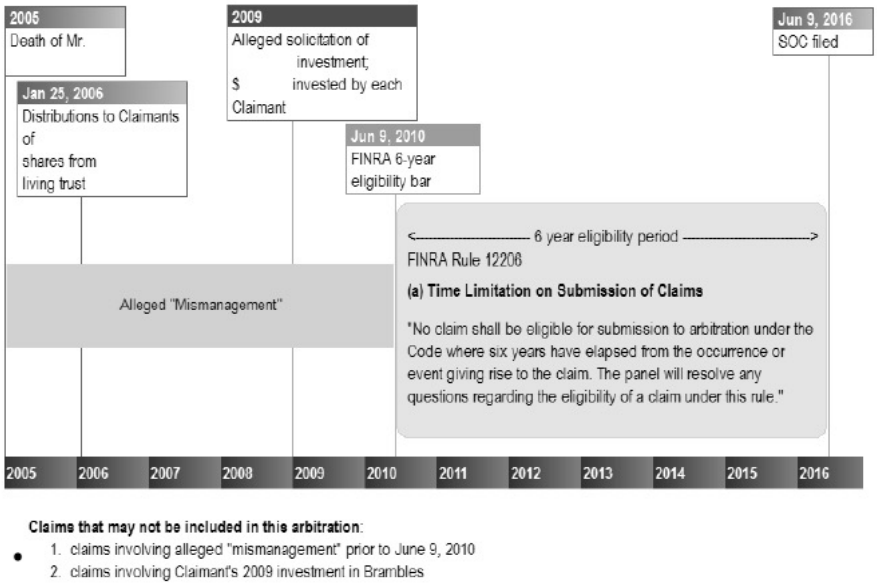
20. FINRA, RULE 12504(a)(11).

21. FINRA, RULE 12504(a)(8).

II. MOTIONS TO DISMISS FOR ELIGIBILITY – FINRA CODE OF ARBITRATION PROCEDURE RULE 12206

FINRA Rule 12206(a) provides: "No claim shall be eligible for submission to arbitration under the Code where six years have elapsed from the occurrence or event giving rise to the claim."[22]

With a separate rule detailing procedures for this specific motion practice, it is no surprise that eligibility motions are seen with increasing frequency and are getting more complex. In one recent motion faced by a PIABA member, respondents' counsel including the following graphic in the introduction of their motion:



Note how the "alleged mismanagement" stopped six years, likely to the day, before the claim was filed.

22. FINRA, RULE 12206(a).

A. What The Eligibility Rule Is and Is Not

The Eligibility Rule is a procedural gate-keeping rule for arbitrators to decide whether a claim is eligible for FINRA arbitration, with the consequence of ineligibility giving a party the right to take its claim(s) to court. The Eligibility Rule is neither a statute of limitation nor statute of repose.[23]

B. What Does Rule 12206 Require?

An eligibility motion must be filed separately and after the answer is filed.[24] The motion must be filed at least 90 days prior to "a scheduled hearing."[25] The responding party has 30 days to respond to such a motion, and the moving party has five days to reply after receipt of the response.[26]

The full panel must decide the motion.[27] An in-person or telephonic prehearing conference is required unless waived by the parties, and the hearing must be recorded.[28]

C. The Decision Making Process and Consequences for a Successful Motion to Dismiss on Eligibility

Assuming a panel is facing a Motion to Dismiss on multiple grounds (e.g., Rule 12206 and 12504(a)), the panel must decide the eligibility issue

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23. "A statute of repose 'is designed to bar actions after a specified period of time has run from the occurrence of some event other than the injury which gave rise to the claim.' *Kissel v. Rosenbaum*, 579 N.E.2d 1322, 1326 (Ind. Ct. App. 1991). In distinguishing between a statute of limitations and a statute of repose, we have stated, 'A statute of limitation extinguishes a remedy while a statute of repose may bar a cause of action even before it arises.'" *Gray v. Daimler Chrysler Corp.*, 821 N.E.2d 431 (Ind. Ct. App. 2005).

24. FINRA, RULE 12206(b)(1).

25. FINRA, RULE 12206(b)(2).

26. FINRA, RULE 12206(b)(2).

27. FINRA, RULE 12206(b)(3).

28. FINRA, RULE 12206(b)(4).

first.[29] Any decision granting the Motion to Dismiss must be unanimous and accompanied by a written decision.[30] If the panel decides to dismiss on eligibility grounds, it shall not rule on any other grounds.[31]

If a panel rules that only some of the claims are dismissed on eligibility grounds, and the non-moving party elects, the non-moving party may withdraw any remaining related claims and file all of the claims in court.[32] Once a partial eligibility ruling is made on some, but not all claims, the non-moving party has 15 days from the date of service of the panel's order to move the case to court, before the panel rules on any other ground for dismissal.[33]

If a panel dismisses any claim on eligibility grounds, the panel must record the dismissal on eligibility grounds on the face of its order and any subsequent award the panel may issue.[34]

In addition, for claims headed back to court, the statute of limitations is tolled for the time period they were on file with FINRA Dispute Resolution.[35]

D. "Penalties" for a Failed Eligibility Motion to Dismiss

If the moving party loses an eligibility Motion to Dismiss, the Panel must assess the forum fees associated with the hearing(s) on the motion against the moving party.[36] If the Panel deems the Motion to Dismiss was frivolous, it must award reasonable costs and attorney's fees against the moving party.[37]

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29. FINRA, RULE 12206(b)(7).

30. FINRA, RULE 12206(b)(5).

31. FINRA, RULE 12206(b)(7).

32. FINRA, RULE 12206(b). *See also*, FINRA, FINRA OFFICE OF DISPUTE RESOLUTION ARBITRATOR'S GUIDE 48 (Feb. 2017), "If the panel dismisses a claim on the grounds of eligibility, the non-moving party may withdraw any remaining related claims without prejudice and may pursue all claims, including the dismissed claim, in court."

33. FINRA, RULE 12206(b)(7).

34. FINRA, RULE 12206(b)(7).

35. FINRA, RULE 12206(c).

36. FINRA, RULE 12206(b)(8).

37. FINRA, RULE 12206(b)(9).

Sanctions are also available if the Panel determines a Motion to Dismiss was filed in bad faith.[38] Lastly, a party who loses a Motion to Dismiss under Rule 12206 may not re-file the denied motion unless specifically permitted by the Panel.[39]

The penalty most likely to give the ordinary respondent pause is the inability to re-file the motion absent leave from the Panel. Filed too early, before discovery, respondent hands claimant an argument to refute the motion. Filed too late, respondent may have spent a significant portion of its pre-hearing litigation budget only to see a successful Motion to Dismiss move the matter to court.

E. Six Years, Why Six Years?

Why does the Eligibility Rule use a six year time period? Would five[40] or seven years be any different?

In one Motion to Dismiss, respondents' counsel wrote the following explanation:

> …the modern six-year eligibility rule was adopted from the eligibility rule in SICA's Uniform Code of Arbitration. In drafting the UCA provision, "SICA was concerned that no stale claims be eligible for arbitration. To that end, 'SICA chose the six year eligibility period to conform with SEC regulation, now section 240.17a-4(a), which requires exchange members to retain customer records for six years.'"[41]

Accepting the argument that the Eligibility Rule is meant to work in conjunction with SEC record keeping requirements, then the issue turns on whether the records related to the dispute still exist. With modern day electronic records and storage, the likelihood documents still exist beyond the six-year SEC mandate is excellent.

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38. FINRA, RULE 12206(b)(10).

39. FINRA, RULE 12504(b)(6).

40. In 1977, the NASD Code of Arbitration Procedure's Eligibility Rule was five years. Before that, it was only two years. *See* Margaret M. Harding, *The Cause and Effect of the Eligibility Rule in Securities Arbitration: The Further Aggravation of Unequal Bargaining Power*, 46 DEPAUL L. REV. 109 (1996), n. 217.

41. *See* Pamela Jeanne Turbow Rush, Comment, *Securities Arbitration: The Six-Year Eligibility Rule*, 26 STETSON L. REV. 329, 340 (1996).

F. The "Occurrence or Event Giving Rise to the Claim"

The phrase "the occurrence or event giving rise to the claim" continues to cause more heartburn for claimants, respondents, and arbitrators and results in inconsistent and unpredictable results.

In 2002, in *Howsam v. Dean Witter Reynolds*,[42] the Supreme Court settled the question of whether eligibility of a claim within the meaning of NASD Rule 10304 (the predecessor to FINRA Rule 12206(a)) was a substantive question or a procedural question to be decided by the arbitration panel. The Supreme Court held that the determination of a claim's eligibility was a gateway procedural question to be decided by the arbitration panel and was not a question of substantive arbitrability which would be decided by the court. The Court decided "the NASD arbitrators, comparatively more expert about the meaning of their own rule, are comparatively better able to interpret and apply it."[43]

In cases where more than six years passed since the transaction(s) at issue occurred, respondents tag the date of the transaction(s) as the "event or occurrence" and cite to a series of cases from the mid-to-late 1990s, and a few into 2000. Notably, respondents rely heavily on pre-*Howsam* court decisions finding that eligibility was a substantive arbitrability issue and starting the clock at the date of purchase.[44] The very cases overturned by *Howsam* are cited by respondents for the propositions that there is no equitable tolling or accrual arguments available to claimants.

On the claimant's side, attorneys seek to define the "occurrence or event" as something after the date of transaction, usually when the claimant receives first-hand knowledge of a problem underlying the transaction(s).

Current FINRA arbitrator training materials support the claimant's argument. "The arbitrators may find that there is a continuing occurrence or event giving rise to the dispute. For example, although a customer purchased stock 10 years ago, there are allegations of ongoing fraud starting with the

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42. *Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79 (2002).

43. 537 U.S. 79 at 85.

44. *See Edward D. Jones v. Sorrells*, "Section 15…is an eligibility requirement and not a statute of limitation and thus cannot be tolled." 957 F.2d 509 at 513 (7th Cir. 1992). *See also Dean Witter Reynolds v. McCoy,* 853 F. Supp. 1023, 1031 (E.D. Tenn. 1994) (eligibility requirement was a 'substantive eligibility requirement as opposed to a statute of limitations procedural rule' subject to equitable tolling.").

purchase, but continuing to a date within six years of the date the claim was filed."[45]

In the 1990s, when the Director of Arbitration was responsible for deciding issues of eligibility, the FINRA (then-NASD) position was the same. In a series of private letter rulings, the Director stated:

> It has been determined that the purchase date is not the event or occurrence that gave rise to this dispute. Also, Section 15 does not refer specifically to the purchase date as the time that the six year limitation begins to run. Therefore it is equally appropriate that the discovery by the claimant be treated as the occurrence or event giving rise to the dispute.[46]

Another ruling by the Director of Arbitration which found its way into case law was that an occurrence or event giving rise to a claim "could just as plausibly be some other occurrence or event."[47]

1. Cases Supporting the Position that "Occurrence or Event" is Something Other Than Date of Purchase

Smith Barney, Inc. v. Vogelle, "[i]t is not a foregone conclusion ... that the purchase date is the relevant occurrence or event giving rise to [the investor's] claims, as neither § 15 nor any other provision of the NASD Code so provides."[48]

PaineWebber, Inc. v. Hofmann, found that active concealment of acts of wrongdoing could be events or occurrences under Rule 10304 (now Rule 12206):

> (1) [Broker's] advice to 'hold' [securities] – each time this advice was given being an actionable occurrence … (2) [Claimant's] discovery of [Respondents'] wrongdoing – the date of discovery being the first date on which [Claimant] could prevent further injury … (3) the continuation of an integrated pattern of wrongdoing – the fraudulent

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45. FINRA, FINRA OFFICE OF DISPUTE RESOLUTION ARBITRATOR'S GUIDE 48 (Feb. 2017).

46. *Goldberg v. Parker*, No. 94-02670, 1995 WL 396568, at *4 (N.Y. Sup. Ct., Apr. 12, 1995).

47. *FSC Secs. Corp. v. Freel*, 811 F. Supp. 439, 444 (D. Minn. 1993).

48. *Smith Barney, Inc. v. Vogelle*, 967 F. Supp. 165, 170 (E.D. Va. 1997).

> inducement to buy and hold … stock over [a] period [of time] constituting a single, ongoing wrong; and (4) the entire brokerage relationship being so tainted with fraud and mismanagement that the relationship itself constitutes a single, actionable wrong.
>
> As an example of how this analysis would work consider [Claimant's] claim that [Broker-Dealer] actively concealed [Broker's] wrongdoing, … [T]his can also be viewed as an independent cause of action based on a duty owed by [Broker-Dealer] to its customers to inform them of a broker's wrongdoing or of the unsuitably speculative nature of their investments…. In this type of situation, the court must assume for the purposes of determining arbitrability that such a duty is owed.[49]

In *FSC Secs. Corp. v. Freel*, the court found "the language of section 15 does not clearly indicate that the six-year limitations period commences on the date of purchase; rather, it measures the six-year period from 'the occurrence or event giving rise to the act or dispute, claim or controversy.' NASD § 15. The 'occurrence or event' triggering the claim could be the date of purchase; it could just as plausibly be some other occurrence or event."[50]

In *Osler v. Ware*, the Sixth Circuit Court of Appeals noted "the occurrence or event giving rise to the act or dispute, claim or controversy would not be the initial investment."[51] In *Mid-Ohio Secs. Corp. v. Estate of Burns*, a federal district court in Nevada held that the Supreme Court's decision in *Howsam*:

> [U]ndermined the basic premise upon which courts relied upon to determine eligibility rules like Rule 12206 were not subject to tolling. Those courts relied on the premise that the eligibility rule was a substantive limit on the agreement to arbitrate, not a statute of limitations. Thus, the time period was not subject to tolling. However, Howsam eviscerated that premise, finding that the eligibility time limit was not a question of arbitrability, but a gateway procedural matter for

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49. *PaineWebber, Inc. v. Hofmann*, 984 F.2d 1372, 1381 (3rd. Cir. 1993).

50. *FSC Secs. Corp.*, 811 F. Supp. at 444.

51. *Osler v. Ware*, 114 F.3d 91, 93 (6th Cir. 1997) (holding that for a claim of churning, the occurrence or event giving rise to the dispute was when the trading became excessive, not when the initial investments were made).

> the arbitrator. Thus, the entire line of cases that suggest Rule 12206 is not subject to tolling is undermined.[52]

In *Oshidary v. Purpura-Andriola*, another federal district court, this one in California, denied a motion to vacate a FINRA arbitration award where a broker was partially successful in dismissing some of the claims brought against him based on his eligibility arguments, but found liable for breaching the fiduciary duty owed to his client. In *Oshidary*, the arbitration panel used the date of discovery of the loss as the measure for determining eligibility.[53]

Ongoing misrepresentations, omissions, and even failure to supervise have been successfully argued to use dates other than the date of purchase.[54]

In one recent FINRA Arbitration case *Margaret Farwell Smith, et al. v. Centaurus Financial, Inc. and Fera Shivaee*,[55] the arbitration panel held that the date damages were sustained operated as the date the eligibility clock started. *Smith* was a claim for losses related to the purchase of various real estate-related securities, including a TIC investment. Following the conclusion of Claimants' case in chief, Respondents made a Motion to Dismiss, arguing that Claimants' claims were ineligible for arbitration as more than six years had passed between the time claimants purchased the securities and subsequently filed their arbitration claim. In its ruling finding Respondents' liable to Claimants, the Panel concluded about Respondents' motion to dismiss: "During the recorded evidentiary hearing, after the conclusion of Claimant's case-in-chief, Respondents moved to dismiss the case pursuant to FINRA Rule 12206. The Panel denied the motion finding the time limits specified by the rule do not start running until damages are sustained."[56]

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52. *Mid-Ohio Secs. Corp. v. Estate of Burns*, 790 F. Supp. 2d 1263, 1271–72 (2011) (D. Nev. 2011).

53. *Oshidary v. Purpura-Andriola*, No.3:2012cv02092, 2012 U.S. Dist. LEXIS 81367 (N.D. Cal. June 12, 2012).

54. *See Equity Securities Trading Co. v. Gillan*, 1997 U.S. Dist. LEXIS 9953 (M.D. Fla. June 23, 1997); *Cigna Securities, Inc. v. Calby*, No. 3:92CV345-P, 1993 U.S. Dist. LEXIS 19942 (W.D.N.C. June 8, 1993); (holding that conduct after the purchase of securities is still within the six-year rule and thus eligible for arbitration); and *PaineWebber, Inc. v. Landay*, 903 F. Supp. 193, 203 (D. Mass. 1995).

55. FINRA Arbitration No. 13-02924.

56. From a strategic standpoint, it is worth considering what the end result might have been had the respondents' motion to dismiss for eligibility been granted. Rule 12206 provides no guidance about the consequence of a ruling given after the

2. Tolling the Eligibility Rule: Accrual and Discovery Principles

For more than 20 years, the FINRA position regarding the six-year rule has been that discovery of wrongdoing by a claimant could be the relevant "occurrence or event". For example, in a widely circulated letter, the NASD took the position that

> "[S]ection 15 (now Rule 12206) does not refer specifically to the purchase date as the time the six year limitation begins to run. Therefore, it is equally appropriate that the discovery by the claimant be treated as the occurrence or event giving rise to the dispute." (Letter from NASD Director of Arbitration D. Masucci to R. James, dated May 24, 1991).

A New York state court quoted a phrase from a similar letter from the NASD Director of Arbitration as reflective of NASD policy that: "[a]t least in fraud cases, the 'occurrence or event' language in Section 15 is not automatically interpreted as the investment purchase date."[57] The court added: "The effect of this interpretation in fraud cases is to reward the unscrupulous broker-dealer and to penalize the unsophisticated investor who does not discover the fraud for more than six years after the investment was purchased."[58]

There remain federal appellate decisions from circuits that regarded the interpretation of Rule 10304 (now Rule 12206) to be a matter for the courts pre-*Howsam*, which are consistent with this interpretation. Those circuits adopted the view that it is the accrual of a cause of action that starts the six-year and that the purchase date is not dispositive.[59]

In *Kidder Peabody v. Brandt*,[60] the court stated: "we hold that under Section 15 [now Rule 12206] the 'occurrence or event' which 'gives rise to

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claimant's case-in-chief. It might well have been possible that the claimants would have had an opportunity to file the case in court.

57. *Goldberg v. Parker*, No. 94-02670, 1995 WL 396568, at *4 (N.Y. Sup. Ct., Apr. 12, 1995).

58. *Id*.

59. *Paine Webber, Inc. v. Hoffmann*, 984 F.2d 1372 (3d Cir. 1993); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Lauer*, 49 F.3d 393 (7th Cir. 1995); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cogswell*, 78 F.3d 474 (10th Cir. 1996); *Osler v. Ware*, 114 F.3d 91 (6th Cir. 1997); *Kidder Peabody v. Brandt*, 131 F.3d 1001 (11th Cir. 1997); and *J.E. Liss & Co. v. Levin*, 201 F.3d 848 (7th Cir. 2000).

60. 131 F.3d 1001, 1004 (11th Cir. 1997).

the … claim' is the last occurrence or event necessary to make the claim viable."[61] Therefore, when a cause of action has accrued is a claim-specific determination: "the last 'occurrence or event' necessary to make a claim viable depends on the nature of the particular claim."[62]

The relatively recent *Oshidary v. Purpura-Andriola* case gives a favorable analysis supporting the application of the discovery rule when dealing with promissory note investments.

> Indeed, the fact that the investments at issue here were loans provides support for the Panel's decision to not choose the purchase date as the triggering event. Unlike other types of investments, loans have an agreed upon return on a date certain. The investor likely will not know whether repayment will occur until that date arrives. The concern presented by the Dean Witter court, that an investor would control the running of the time limit while they "reaped the benefits of the investments about which they would later complain," is mitigated with respect to loans: the "benefit" to be reaped either will or will not occur on the payoff date. In this case, $250,000 principal and interest were due to Andriola well within the six years prior to her filing of the claim. It was within the Panel's discretion to choose such a later date—such as when it became clear that the loan would not be repaid—as the date triggering the six-year time limitation.[63]

The *Oshidary* analysis and use of the "payoff date" translates to cases involving direct participation programs and other illiquid investments as investors are often unable to "discover" their harm until events such as maturity dates, sale dates, or other known and anticipated dates come and pass without a promised event occurring.

3. The Accrual and Discovery Argument in Action

Using California cases, an accrual and discovery argument works in the following fashion: The last necessary element is the "occurrence or event"

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61. 131 F.3d at 1004.

62. *Id.*

63. *Oshidary v. Purpura-Andriola*, No.3:2012cv02092, 2012 U.S. Dist. LEXIS 81367, at *17-18 (N.D. Cal. June 12, 2012).

that gives rise to the claim.[64] "'A cause of action does not 'accrue' until the party owning it is entitled to begin and prosecute an action thereon. It accrues at the moment when he has a legal right to sue on it, and not earlier.'"[65] Under the discovery rule, the cause of action does not accrue until the plaintiff either discovers or could have discovered the injury and its cause.[66] A [Claimant] must plead: "(1) the time and manner of discovery and (2) the inability to have made earlier discovery despite reasonable diligence."[67] "In order to adequately allege facts supporting a theory of delayed discovery, the plaintiff must plead that, despite diligent investigation of the circumstances of the injury, he or she could not have reasonably discovered facts supporting the cause of action within the applicable statute of limitations period."[68]

California law holds that a fiduciary relationship reduces the burden of discovery. It is settled as a matter of California law that the relationship between a stockbroker and a customer is always fiduciary in nature.[69] The law recognizes the right of a beneficiary of a fiduciary relationship, the claimant, to rely on the truthfulness of the fiduciary's oral representations. Thus, as long as the relationship continues, the duty of inquiry is limited and accrual of the claim is postponed. In *Eisenbaum v. Western Energy Resources, Inc.*,[70] the court held:

> Where a fiduciary obligation is present, the courts have recognized a postponement of the accrual of the cause of action until the beneficiary has knowledge or notice of the act constituting a breach of fidelity. The existence of a trust relationship limits the duty of inquiry. "Thus when a

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64. *San Francisco Unified School Dist. v. W.R. Grace & Co.*, 37 Cal. App. 4th 1318, 1326 (1995)(cause of action accrues on the last necessary element). *See also* WITKIN, CAL. PROCEDURE: ACTIONS § 351 (3d ed. 1985).

65. *San Francisco Unified School Dist.,* 37 Cal. App. 4th at 1326.

66. *Id.* at 1326.

67. *WA Southwest 2, LLC v. First American Title Ins. Co.*, 240 Cal. App. 4th 148, 157 (2015).

68. *Nguyen v. W. Digital Corp.*, 229 Cal. App. 4th 1522, 1553 (2014).

69. *See Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690 (1968); and *Duffy v. Cavalier*, 215 Cal. App. 3d 1517 (1989) (stating that the relationship between a stockbroker and a customer is always fiduciary). Many other state courts have held similarly.

70. 218 Cal. App. 3d 314 (1990).

> potential plaintiff is in a fiduciary relationship with another individual, that plaintiff's burden of discovery is reduced and he is entitled to rely on the statements and advice provided by his fiduciary." (internal citations omitted).[71]

Having set the discussion, what is left is to argue the fact-specific date of discovery. Potential "discovery" events may be: the date losses are realized, the date a principal payment was missed, the date new information about an investment's market value was revealed (e.g., illiquid REIT pricing), discovery of a failure to conduct due diligence on an investment prior to selling it, or other key communications between the broker and the client. Along with presenting the date of discovery, it is important to also explain why the discovered date of the event or occurrence could not have been discovered earlier.

4. Discovering the Date of Discovery

The "discovery" event or date often turns on the production of documents in discovery. In one TIC case with a serious eligibility issue, the brokers advertised themselves as conducting outstanding due diligence for every recommended investment. In discovery, the broker signed an affirmation stating he had no documents related to due diligence performed on the investments at issue. In that case, the date of "discovery" became the date the broker signed the affirmation, and his eligibility Motion to Dismiss was denied. The key to finding the "date of discovery" is to start discovery early and pursue it aggressively before having to oppose an eligibility motion. An e-mail, exception report, internal memorandum, or even phone records may significantly alter an eligibility analysis away from the "date of purchase" argument.

Facing an early eligibility motion, there is an appealing argument (at least to some panels) to allow discovery to conclude before having to oppose and argue the motion. Similarly, the existence (or non-existence) of file destruction logs may be helpful in taking the sting out of the argument that the eligibility rule was designed to work in conjunction with the SEC's document retention rules.

Start early, and fight for every document and affirmation before having to file the opposition.

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71. 218 Cal. App. 3d at 324.

G. Arguing a Summary Judgment Standard

FINRA Rule 12206 provides no guidance into what factors the Panel is to consider or what standards it should apply when ruling on a Motion to Dismiss. Using the analytical framework courts give to motions for summary judgment may help favorably tilt the field in terms of the analysis arbitrators use to decide the motion

The issue raised by a motion to dismiss, like a motion for summary judgment, is whether the facts pleaded state a valid cause of action or claim, not whether they are true. Under such an analysis, a claimant's allegations must be accepted as true for the limited purpose of ruling on a motion to dismiss.[72] The complaint is to be liberally construed in the favor of the Plaintiff.[73] No extrinsic evidence can be considered.[74] The applicable standard of review requires all ambiguities be resolved in the light most favorable to the party opposing the motion.[75] The task in deciding such a motion "is carefully limited to discerning whether there are any issues of material fact to be tried, not to deciding them."[76]

"The [Panel] must accept all allegations of the complaint as true, construe it in a light most favorable to the [Claimant], and determine whether under any reasonable reading of the complaint, the [Claimant] might be entitled to relief."[77] "In considering a motion to dismiss under Federal Rule of Civil Procedure 12(b)(6), the averments of the complaint should be construed in the light most favorable to the plaintiff."[78]

While respondents may try to set the stage with the Motion to Dismiss, giving the arbitration panel some direction on how to analyze the issue can be both helpful and beneficial.

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72. *Del E. Webb Corp. v. Structural Materials Co.*, 123 Cal. App. 3d 593, 604 (1981).

73. *MacKethan v. Peat, Marwick, Mitchell & Co.*, 439 F. Supp. 1090 (E.D. Va. 1977).

74. *Ion Equip. Corp. v. Nelson*, 110 Cal. App. 3d 868, 881 (1990).

75. *Gallo v. Prudential Residential Servs.*, 22 F.3d 1219, 1223 (2nd Cir. 1994).

76. *LaFond v. General Physics Servs. Corp.*, 50 F.3d 29, 37 (2d Cir. 1994).

77. *Broad St. Ass'n. V. United Cos. Life Ins. Co.*, 163 Bankr. 68 (Bankr. E.D. Va. 1993).

78. *Scheuer v. Rhodes*, 416 U.S. 232, 94 S.Ct. 1683, 40 L.Ed.2d 90 (1974).

H. The Use of Prior Arbitration Awards

We all have seen the 15 page Motion to Dismiss with 150 pages of arbitration awards dismissing claims and cases on the eligibility rule.

There are two main avenues to fight the list of past awards. First, arbitration awards remain non-precedential and non-binding on subsequent cases. Second, respond with a list of cases where a Motion to Dismiss has been denied.

1. Arbitration Awards are Non-Binding and Not Precedential

"It is black letter law that arbitration awards are not entitled to the precedential effect accorded to judicial decisions. Indeed, an arbitration award is not considered conclusive or binding in subsequent cases involving the same contract language but different incidents or grievances."[79] Similarly, in *El Dorado Technical Services, Inc. v. Union General de Trabajadores de Puerto Rico*,[80] the court held, "[a]rbitration awards are not entitled to the precedential effect accorded to judicial decisions. Indeed, an arbitration award is not considered conclusive or binding in subsequent cases involving the same contract language but different incidents or grievances."[81]

2. Prior Arbitration Awards With Denied Motions to Dismiss

The FINRA rules require a written explanation whenever a Motion to Dismiss is granted under Rule 12206(b)(5). That means for every successful dismissal, there is an order, and if there is an award, a recitation of panel's decision in the award. Successfully defended Motions to Dismiss are not given the same treatment.

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79. *IBEW Local 2150 v. NextEra Energy Point Beach, LLC.*, 762 F.3d 592, 593 (7th Cir. 2008).

80. 961 F.2d 317 (1st Cir. P.R. 1992).

81. *El Dorado Technical Services, Inc.*, 961 F.2d at 318. *See also Westinghouse Elevators of Puerto Rico, Inc. v. S.I.U. de Puerto Rico*, 583 F.2d 1184, 1186-87 (1st Cir.1978). ("Courts reviewing inconsistent arbitration awards have generally concluded that arbitrators are not bound by the rationale of earlier decisions and that inconsistency with another award is not enough by itself to justify vacating an award.").

The different treatment of outcomes means there is a growing body of orders and awards with often inapplicable and distinguishable facts (assuming there is a recitation of facts) respondents may use in their motions. The following are twelve cases where an arbitration panel issued an award listing a denied Motion to Dismiss, including a few instances where the Panel provided some insight to the basis for the denial.

1. *Steven Constantino IRA and Steven Constantino Joint Account v. Ferns Baker Watts, LLC and Joseph P. Starr* (12-00340), the panel denied the Respondent's Motion to Dismiss and assessed 100% of the costs against them.
2. *C & H Properties, Inc., Calvert-Spradling Engineers, Inc., and Robert L. Calvert Consulting, Inc. vs. Morgan Keegan & Company, Inc.* (11-00263), the panel held, "A rule measured solely from the acquisition of securities makes little sense in the real world in which a customer may well be satisfied for years to hold recommend securities but regards as inappropriate or worse the advice to buy more, hold or sell after. Claimant had no viable claims during the early years of their holding and could not have claimed damages."
3. *Joseph A. Miller III Trust f/b/o Joseph A. Miller IV v. Morgan Keegan & Company, Inc.* (13-02210), the panel held, "Even though the Claimant purchased the security in question more than six years ago on March 23, 2004, which was the settlement date for the purchase, "the event giving rise to the claim" did not occur until sometime in 2008 according to Claimant's Memorandum in Opposition to Morgan Keegan's Motions to Dismiss. This when the security in question, according to claimant, began to lose value which places it well within the six year time period outlined under FINRA Rule 12206."
4. *Margaret Farwell Smith, et al. v. Centaurus Financial, Inc. and Fera Shivaee*, (13-02924), Claimant brought a claim for losses related to the purchase of various real estate-related securities including a TIC investment. Following the conclusion of Claimants' case in chief, Respondents made a Motion to Dismiss arguing that Claimants' claims were ineligible for arbitration as more than six years had passed between the time Claimants purchased the securities and subsequently filed their arbitration claim. In its ruling finding Respondents' liable to Claimants, the Panel made the following finding: "During the recorded evidentiary hearing, after the conclusion of Claimant's case-in-chief, Respondents moved to dismiss the case pursuant to FINRA Rule 12206. The Panel denied

the motion finding the time limits specified by the rule do not start running until damages are sustained."

5. *Rogers v. Summit Brokerage Services, Inc.*, (07-01262), among other claims, Claimant's alleged failure to supervise, fraud, negligence and negligent supervision, in addition to violations of NYSE and NASD rules. In considering a FINRA Rule 12206 motion, the panel held that the clock on the eligibility rule began to run on the date of the last occurrence, not the date of purchase.
6. *Pepe vs. Morgenthau &Associates, Inc.*, (07-00079), in a claim alleging fraud, fraudulent concealment and breach of contract, a New York panel denied Respondents' eligibility motion.
7. *Tanner v. Alvey*, (11-03792), Panel denied Respondents' Rule 12206 motion in a case where Claimant alleged claims for failure to supervise, negligence, misrepresentations and omissions.
8. *Alvarez-Mauras vs. Popular Securities, Inc.*, (12-00225), respondents filed an eligibility motion claiming, among other things, that the claimant filed the statement of claim almost ten years after making the investment in dispute, the panel denied the motion without prejudice to renew, ruling for the claimant who argued that the "occurrence or event giving rise to the claim" may be something other than the date of purchase, and that the claimant continued to lose money on the investments that matured within the six years prior to the filing of the claim.
9. *Larry Baum and Jane Baum v. Hantz Financial Services, Inc.*, (15-02789).
10. *Alastair Short v. UBS Financial Services Inc.*, (14-03122).
11. *Beverly Bien and David H. Wellman v. Mid-Atlantic Capital Corporation*, (15-00333);
12. *Leroy E. Carney and Barbara M. Carney v. TD Ameritrade, Inc.*, (15-01506).

One other item to look for in respondents' list of awards and orders are the counsel who won the motions. Does your opponent's name or firm appear in any of the orders or motions? If not, it may be worth calling that point to the attention of the arbitrators.

I. Arbitrator Selection is Important

Arbitrator selection is also critical to a case surviving a Motion to Dismiss for eligibility. Take a close look at your list of proposed arbitrators and research their award histories. The ones who granted an eligibility

motion will have their name in lights with orders and/or awards available on FINRA's website. The ones who denied such motions might be a little harder to find, but if found, it may change your rankings.

III. MIXED MOTIONS TO DISMISS

In some instances a "mixed" Motion to Dismiss may be filed seeking dismissal under both Rules 12504 and 12206. With a mixed motion there are conflicting filing deadlines and response deadlines. A 12504 Motion to Dismiss must be filed no less than 60 days before the hearing and the responding party has 45 days to file a response. A 12206 Motion to Dismiss for Eligibility must be filed no less than 90 days before the hearing and the responding party has 30 days to file a response. FINRA provides some guidance to arbitrators in an FAQ.[82]

According to RN 09-07 and FINRA'S "Motion to Dismiss and Eligibility Rules FAQ" guidance to arbitrators, "[t]he 90-day requirement [before the scheduled hearing] also applies to eligibility motions that include multiple other grounds (i.e., a mixed motion)."[83] The opposition deadline for a mixed motion is 45 days. "[I]f a party files a mixed motion, the party responding to the mixed motion will have 45 days to respond.[84]

IV. MOTIONS TO DISMISS FOR STATUTE OF LIMITATIONS

A Motion to Dismiss arguing the application of statute of limitations to bar a claim or claims is not permitted prior to the evidentiary by Rule 12504(a). However, after the conclusion of a party's case-in-chief, the restraints are removed by Rule 12504(b): "[a] motion to dismiss made after the conclusion of a party's case in chief is not subject to the procedures set forth in paragraph (a)." The rule is silent to the type of motion to dismiss, any filing deadlines, or even if an opposition is permitted. This is where a statute of limitations argument can be particularly dangerous. FINRA takes the position of "anything goes" in a 12504(b) Motion to Dismiss. "[A] moving

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82. *Motion to Dismiss and Eligibility Rules FAQ*, FINRA, http://www.finra.org/industry/faq-motion-dismiss-and-eligibility-rules-faq (last visited Aug. 2, 2017).

83. *Id.*

84. *Id.*

party may file a Rule 12504(b) motion based on any applicable theory of law. FINRA expects these motions to be relevant to the case and based on theories that are germane to the issues raised in the non-moving party's case. FINRA believes that by the close of the non-moving party's case, the panel will have heard enough evidence to decide whether a motion filed at this stage of the case should be considered and granted if warranted."[85]

One recent case out of California is particularly difficult for arguing the tolling of statutes of limitation where a prospectus was delivered to the client. *WA Southwest 2, LLC v. First American Title Insurance Co.* limited the use of the discovery rule when it comes to disclosures made in a prospectus or offering document. Plaintiffs purchased a roughly $5 million TIC interest in a property in 2005 and 2006. After the property was lost in foreclosure in 2012, Plaintiffs brought an action in court in California against 30 defendants. Four of the 30 defendants successfully demurred using statutes of limitation arguments. Plaintiffs countered that their claims had not accrued by virtue of the discovery rule, specifically that conflicting oral representations by various sales representatives and a prospectus containing muddied disclosures were not discovered until a bevy of experts reviewed the investment in 2012. The trial court sustained the demurrers and entered judgements of dismissal for the four defendants.

On appeal, the court held that despite Plaintiffs having to contend with the conflicting oral representations and the muddled disclosures in the prospectus, provision of the prospectus constituted sufficient notice to preclude the tolling of statute of limitations under the discovery rule.[86]

This case is troubling to the extent it calls for plaintiffs and potentially claimants to have to plead a new, wholly undisclosed issue to be able to use the discovery rule argument to toll a potentially applicable statute of limitation.

The arguments about whether statutes of limitation apply in FINRA arbitration are becoming progressively more challenging but practitioners still write about and succeed in defending against such arguments.[87]

For cases where it is likely a statute of limitations argument will be made, whether after the conclusion of the case in chief or at the end of the evidentiary hearing, having a pocket brief ready with arguments is critical.

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85. *Id.*

86. *WA Southwest 2, LLC v. First American Title Insurance Co.*, 240 Cal. App. 4th 148 (2015).

87. Jason W. Burge & Lara K. Richards, *Crafting an Argument that Statutes of Limitations Do Not Apply in Arbitration*, 22 PIABA B.J. 31 (2015).

V. CONCLUSION

The securities industry will continue to create new products with long time horizons. Investors who buy the products, are burned years later, and are brave enough to take action will face motions to dismiss prior to, at, and after their evidentiary hearing. From the claimant's side, it is critical to know the type of dismissal motion being presented and the applicable FINRA rules. Even more important is setting the stage with framing timing issues to claimant's advantage in the Statement of Claim, careful arbitrator selection, aggressive early discovery, thorough briefing, and providing the arbitration panel with a generous analytical framework to best overcome the firm's and/or broker's arguments to escape liability.

OPTIONS DAMAGES: DANGEROUS ASSIGNMENTS WITH A TWIST

Frederick W. Rosenberg[1]

An option is a derivative security whose value depends on the market price and volatility of the underlying stock and the time value until expiration. A call option gives the purchaser the right to take 100 shares of the stock from the seller at a given strike price, and a put option gives the purchaser the right to deliver 100 shares of stock to the seller at the strike price in the future. The intrinsic value of a call option is the difference between the market value of the stock and the strike price, with any excess being time value. As expiration nears, the time value of the call option steadily decreases to zero at expiration.

By selling (writing) a call option, the "Writer" receives a premium in exchange for the Purchaser's right to take the stock at the strike price prior to expiration. When the seller of the option holds the stock, the call option is referred to as a "covered" call. With a covered call, the risk to the writer is limited to being obligated to sell the shares held at the strike price between the date the option is written and the expiration date. That risk is an opportunity loss and is limited to the difference stock price at the time the option is exercised and the strike price. If the stock price increases above the strike price before expiration, the value of the call option increases and the Writer must either repurchase the option or the shares will be assigned at the strike price. When the market price of the underlying stock is below the strike price at expiration, the call option will expire worthless and the Writer keeps the premium and the stock.

Writing out-of-the-money call options frequently has been used as a portfolio strategy to generate premium income through expiration of out-of-the money calls.[2] Writing in-the-money calls increases premium but likely

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1. For additional information on covered calls, see Frederick W. Rosenberg, *Analyzing Covered Call Writing Claims*, 13 PIABA B.J. 30 (2006)

2. A call option is considered "out of the money" (OTM) when the strike price is greater than the market price of the stock. A call option is considered "in the money" when the market price of the stock is greater than the strike price.

assures the stock will be assigned (exercised) unless repurchased. Unfortunately, when misapplied, the strategy can lead to substantial and unexpected losses and tax consequences. Calculating those losses requires careful analysis as will be discussed in the following study based upon an actual case.

Covered call writing is often recommended as a low-risk means of generating premium income without loss of shares, particularly for retired executives with large positions in low-basis company stock or trusts or family accounts with large positions in low-basis stock. Commonly, an executive retires with thousands of shares of company stock that were accumulated at a very low cost. Upon retirement, the executive, who is still in love with the company, transfers those shares to a brokerage firm at a market price that is well above cost. Despite the overconcentration, the executive specifically states their objective is to hold all the shares for appreciation and to avoid having to pay taxes on the gains. The broker advises a "conservative" call option writing strategy to generate additional return (in the form of premiums on the sales of the options) without putting the shares in jeopardy. The growth the executive was hoping for occurs, but the gains in the stock were impaired by in-the-money short positions taken on the entire holdings. To preserve the position, the broker buys back the short calls at a substantial and quantifiable loss.

But, what if the options are assigned? An assignment is an exercising of the call option by the buyer who takes delivery of the shares at the strike price. Every in-the-money option will be assigned at expiration unless the short call option position is bought back and closed out. Furthermore, all in-the money options can be exercised any time prior to expiration, which often happens as here.

How are damages usually calculated? The short option is zeroed out resulting in an option profit, and the shares are delivered well below market price but still at profit when measured by cost or transfer price. Consequently, unless you know the market price of the stock on delivery and the strike price in addition to the option price at exercise you will not be able calculate the lost value caused by the short calls since both positions are profitable. I have calculated lost value as "Phantom Cost" in the attached exhibit. In summary, assignments hide options losses, intentionally or not, that would have been

identified had the position been bought back prior to exercise.

Here is an illustration of the problem based upon facts from an actual case. A husband retired from UPS with 30,000 shares of UPS stock at a cost basis of $12 per share, (total cost basis of $360,000). At retirement, the price of UPS was $73 per share, which meant that the shares of stock had a market value of $2,190,000. The brokerage firm opened separate accounts for the husband and wife and divided the shares equally between the husband and wife's separate accounts (15,000 shares each). The broker advised the husband and wife to utilize a covered call program and instituted the program in both accounts. The broker ultimately began shorting long expirations and deep in the money calls to churn the premium and ultimately shorted the call LEAPS with expirations over a year seen in the illustration. Damages ensued.

The attached exhibit simplifies the data extracted from that case into a single comparison for illustration purposes. Except for the assignment in the Wife's account, the activities were identical. Both transferred 15,000 shares valued at $1,095,000 (at $73 per share). Both wrote the identical call for 6,000 shares taking in $60,834 in Premium. The wife's account experienced an assignment of the 6,000 shares well before expiration triggering unplanned for taxes on the gain. Both accounts closed out the same time and both accounts showed virtually identical profits, $336,366 and $339,373.

The husband's account is easy to assess. He made an unrealized profit on his stock and suffered ($57,834) in losses when he bought back the call at a loss. The wife's account is not quite so easy. As you can see, traditional computations now show the option to be profitable when it was not. The option's monetary losses were netted into the profits realized from the sale of low-basis UPS stock called away on November 11, 2013 at $80, $19.28/share below market ($115,680). The husband's repurchase cost was $118,668, for a loss of ($57,834). Consequently, the wife's erroneous options profits of $60,834 must be adjusted to reflect the phantom cost of the option to properly calculate option damages, ($54,846), to equate to the husband's loss on the same closing transactions. Otherwise her analysis would show no NOP loss whatsoever on Assigned calls using normal damage calculations.

Now here is the twist I alluded to in the title. Merely asking for the money damages as with the husband, would seem to be equally appropriate for the wife, *but it is decidedly not!* Focus on the November 12, 2013 transfers-out for both the husband and the wife and it should be immediately clear. The husband

transferred out 15,000 shares worth $1,489,200, while the wife after her repurchase only transferred 13,835 shares worth $1,373,539, which is a difference of ($115,661) at closing prices attributable solely to the assigned 3,000 shares taken from her. Despite equal monetary damages and assuming a repurchase of UPS stock, the wife's account ends up with 1,165 fewer UPS shares, with a value of ($115,666) less than her husband. This equates to an additional loss more than double her adjusted option loss of ($54,840) and brings her total losses to ($170,507), which is nearly triple that of the husband ($57,834). It cannot be said that her damages equate to his. On accounts with multiple assignments the unrecognized losses in options and share loss can be substantial.

In cases with options assignments, particularly covered call cases pertaining to retired executives' company stock, the traditional profit and loss analyses are woefully deficient, and the statements of claim in such cases must incorporate demands for restitution of shares lost through assignment or liquidated to repurchase the calls as the principal claim when the facts support doing so. The husband lost a quantifiable amount. The wife also lost about the same amount after analysis, but she also lost the equivalent of 1,165 shares and arguably is entitled to their restoration regardless of price.

Over the past few years I have seen several instances where attorneys have declined options cases or advised small settlements based upon apparent minimal NOPs, but where, like the wife's account, there were multiple assignments hiding options losses and where share loss was substantial and unrecognized. When evaluating an options case where the broker allows multiple assignments mere monetary damages will be inadequate. Account analyses must not simply attribute option losses, but must also track shares lost to the strategy that would otherwise have been held but for the strategy. The wife lost more than money, she also lost 1,165 shares unnecessarily and her pleadings need to reflect that loss if restitution is to be obtained.

Assignment vs. Buy Back Options Comparison

Executive Retiree

Acct Name: Husband

UNITED PARCEL SERVICE-B

Equities **UNITED PARCEL SERVICE-B**

Plug	Date	m2m Tfr In	m2m Tfr Out	Asgn Exer	Exp	B/S	Bt	Sld	Net Pos'n	price	Amount	stk@mkt	in/out-of-money	Days to Exp	Phantom Cost	(Phantom Loss) / Adj Gain
☐	15-Apr-11	☑	☐	☐	☐	Buy	15,000	0	15,000	73.00	($1,095,000)				$0	
☐	12-Nov-13	☐	☑	☐	☐	Sell	0	15,000	0	99.28	$1,489,200				$0	
		UNITED PARCEL SERVICE-B				Buys	($1,095,000)	Sells	$1,489,200		P/L	$394,200			$0	$394,200
						Equities	Buys	($1,095,000)	Sells	$1,489,200		P/L	$394,200			$0	$394,200

Options **UNITED PARCEL SRVC CALL 15-01 $80**

Plug	Date	m2m Tfr In	m2m Tfr Out	Asgn Exer	Exp	B/S	Bt	Sld	Net Pos'n	price	Amount	stk@mkt	in/out-of-money	Days to Exp	Phantom Cost	(Phantom Loss) / Adj Gain
☐	07-May-13	☐	☐	☐	☐	Open Sell	0	6,000	-6,000	10.14	$60,834	88.66	$8.66	618	$0	
☐	11-Nov-13	☐	☐	☐	☐	Close Buy	6,000	0	0	19.78	($118,668)	99.28	$19.28	430	$0	
		UNITED PARCEL SRVC CALL 15-01 $80				Buys	($118,668)	Sells	$60,834		P/L	($57,834)			$0	($57,834)
						Options	Buys	($118,668)	Sells	$60,834		P/L	($57,834)			$0	($57,834)
Husband		*UNITED PARCEL SERVICE-B*				Buys	$1,213,668)	Sells	$1,550,034		P/L	$336,366			$0	$336,366

Assignment vs. Buy Back Options Comparison

Executive Retiree

Acct Name: Wife

UNITED PARCEL SERVICE-B

Equities **UNITED PARCEL SERVICE-B**

Plug	Date	m2m Tfr In	m2m Tfr Out	Asgn Exer	Exp	B/S	Bt	Sld	Net Pos'n	price	Amount	stk@mkt	in/out-of-money	Days to Exp	Phantom Cost	(Phantom Loss) / Adj Gain
☐	15-Apr-11	☑	☐	☐	☐	Buy	15,000	0	15,000	73.00	($1,095,000)				$0	
☐	11-Nov-13	☐	☐	☑	☐	Sell	0	6,000	9,000	80.00	$480,000	99.28	$19.28		($115,680)	
☑	12-Nov-13	☐	☐	☐	☐	Buy	4,835	0	13,835	99.28	($480,000)				$0	
☑	12-Nov-13	☐	☑	☐	☐	Sell	0	13,835	0	99.28	$1,373,539				$0	
		UNITED PARCEL SERVICE-B				Buys	($1,575,000)	Sells	$1,853,539		P/L	$278,539			($115,680)	$394,219
		Equities				Buys	($1,575,000)	Sells	$1,853,539		P/L	$278,539			($115,680)	$394,219

Options **UNITED PARCE SRVC CALL 15-01 $80**

Plug	Date	m2m Tfr In	m2m Tfr Out	Asgn Exer	Exp		B/S	Bt	Sld	Net Pos'n	price	Amount	stk@mkt	in/out-of-money	Days to Exp	Phantom Cost	(Phantom Loss) / Adj Gain
☐	07-May-13	☐	☐	☐	☐	Open	Sell	0	6,000	-6,000	10.14	$60,834	88.66	$8.66	618	$0	
☐	11-Nov-13	☐	☐	☑	☐	Close	Buy	6,000	0	0	0.00	$0	99.28	$19.28	430	($115,680)	
		UNITED PARCE SRVC CALL 15-01 $80					Buys	$0	Sells	$60,834		P/L	$60,834			($115,680)	($54,846)
		Options					Buys	$0	Sells	$60,834		P/L	$60,834			($115,680)	($54,846)
	Wife	*UNITED PARCEL SERVICE-B*					Buys	($1,575,000)	Sells	$1,914,373		P/L	$339,373			($115,680)	$223,693
		Total		**Buys**	**($2,788,668)**		**Sells**	**$3,464,407**	**Inc**			**P/L**	**$675,739**			($115,680)	$560,059

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INVESTORS, CORNERED:
FINRA UNDER FIRE, BUT FOR THE RIGHT REASONS?

Jason M. Kueser

In recent weeks, FINRA came under fire from the securities industry and congressional inquiry. Unfortunately, none of the criticism was based on FINRA'S purported mission of "investor protection." In a September 2017 article, FINRA was referred to as "a huge institution, one that generates hundreds of millions of dollars a year in revenue through membership fees and fines."[1] The article focused on two aspects: (1) the amount of money FINRA generates in membership fees and fines, and (2) the "enormous" power FINRA "wields . . . over the lives of brokers and broker-dealers."[2]

In September 2017, the Financial Services subcommittee of the U.S. House of Representatives held an oversight hearing on FINRA.[3] During the hearing, it was noted that FINRA engaged in "mission creep" and attempted to transform "itself from a traditional SRO into a quasi-governmental regulatory more akin to a fifth branch of government or . . . the deputy Securities and Exchange Commission."[4] This concern seems largely focused on issues related to transparency in how FINRA operates.[5] FINRA is

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1. Mark Schoeff, Jr. & Bruce Kelly, *FINRA: Who's Watching the Watchdog?*, INVESTMENTNEWS.COM (Sep. 2, 2017), http://www.investmentnews.com/article/20170902/FEATURE/170909996/finra-whos-watching-the-watchdog (last visited Sep. 14, 2017).

2. *Id.*

3. A recording of this hearing is available at FINANCIAL SERVICES COMMITTEE, HEARING ENTITLED OVERSIGHT OF THE FINANCIAL INDUSTRY REGULATORY AUTHORITY (hereinafter "FSC HEARING") (Sep. 7, 2017), https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=402267 (last visited Sep. 14, 2017).

4. *Id.* (specific comment is made at the 1:03:26 mark in the video).

5. *See* Schoeff & Kelly, *supra* note 1.

supposed to be under the oversight of the SEC.[6] However, given that the size – and budget – of FINRA are nearly equal to that of the SEC, there are legitimate questions as to whether the SEC is capable of its charge.[7]

Of the various issues raised, only a few focused on investor protection. Several of the comments and questions asked related to investor protection were on the other side of the issue. For example, Ann Wagner (R-MO) boisterously asserted, among her numerous interruptions of Robert Cook,[8] that she has a hard time finding many fans who liked the DOL's fiduciary rule, and that she had recently come from a meeting where "industry stakeholders, from both the public and private sector, discussed research that showed the rule is not working."[9] This anecdotal statement is almost comical given that the rule did not go into effect until June 2017 (just three months before her comment). Ms. Wagner and Bruce Polquin (R-ME) both made various statements during the hearing that the fiduciary rule was unnecessary or ineffective.[10]

Other investor protection concerns raised during the hearing were about costs related to trading, best execution, whether FINRA should return a larger percentage of fines it collects to investors, and whether FINRA's toll-

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6. David Burton, *Reforming FINRA*, THE HERITAGE FOUNDATION, http://www.heritage.org/markets-and-finance/report/reforming-finra (last visited Sep. 14, 2017).

7. *Id.* (notes that "[i]n 2015, FINRA had 3,500 employees" while "the SEC had 4,300 employees" and that "FINRA has an annual budget of $1 billion," while "[t]he SEC has an annual budget of $1.6 billion.")

8. Robert Cook is the CEO of FINRA.

9. FSC HEARING, *supra* note 3.

10. It is noteworthy that during his questions, Representative Polquin made reference to "our industry" moments after raising concerns that the fiduciary rule would make it difficult for smaller investors to get access to financial advisory services. Of note, Representative Polquin worked in the investment management industry before beginning his political career – a fact that is obviously omitted from the biography page on his website. *Compare* Biography, BRUCE POLQUIN, https://poliquin.house.gov/about/full-biography *and* Bruce Polquin, WIKIPEDIA, https://en.wikipedia.org/wiki/Bruce_Poliquin. (stating that Representative Polquin formerly worked for "Avatar Investors Associations Corporation, a fund management company" where he "helped manage nearly $5 billion in worker pension funds.") *Id*.

free line for seniors was effective.[11] Another issue that was raised was why FINRA has not freely disseminated more information related to bad brokers and bad brokerage firms.[12] There was only one mention of FINRA'S dispute resolution program, which came from Gregory W. Meeks (D-NY), who raised questions about whether the recommendations made by the Dispute Resolution Task Force regarding increased diversity of arbitrators and, in particular, FINRA mediators had been carried through.[13]

Other questions that came up related to whether FINRA was a wholly private actor or quasi-governmental agency, competition between small and mid-size broker-dealers and the reduction of the number of broker-dealers over the past several years,[14] FINRA's lack of transparency, the FINRA 360 program, consolidated audit trail and cybersecurity, and innovation outreach and FINTECH.[15]

What is the takeaway from this? When given the opportunity to ask questions of the "not-for-profit organization authorized by Congress to protect America's investors,"[16] our elected officials sought to discredit the DOL fiduciary duty rule (which requires brokers to act in the best interest of their investor customers), paid little attention to investor protection issues, and failed to discuss FINRA's dispute resolution system (which is, for most investors, the only option they have for resolving claims when their brokers do not act in their best interest). Investors are certainly cornered… by the financial services industry and by those they have elected to serve their interests in Washington.

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11. FSC HEARING, *supra* note 3.

12. *Id.*

13. *Id.*

14. Although, in response to this, Mr. Cook noted that the number of registered representatives had remained fairly consistent and that the reduction in broker-dealer firms was, in part, due to consolidation in the industry.

15. FSC HEARING, *supra* note 3.

16. *About FINRA*, FINRA, http://www.finra.org/about (last visited Sep. 14, 2017).

INVESTORS, CORNERED: THE UNOPPOSED EXPUNGEMENT – FINRA'S ABDICATION OF ITS MISSION TO PROTECT THE CRD

Michael Edmiston

Expungement, the "extraordinary" remedy to be granted only in the most deserving circumstances, has turned into cottage industry of attorneys and professionals assisting brokers in scrubbing their regulatory records.[1] As a result, FINRA's much vaunted CRD and its publicly available Brokercheck records are devoid of customer complaints and arbitration claims which would give notice to prospective clients of the potential risks of doing business with a broker.

The question is, "what role does FINRA take in the expungement process to protect its records?" The answer is: none.

The current expungement process is designed to intentionally exclude FINRA's involvement at the arbitration level, the fact-finding level. The process requires a party seeking expungement only to name FINRA in a court proceeding to confirm an arbitration award granting an order of expungement.[2] Only *after* the factual determinations are made does FINRA give itself the option to become involved in a court process which generally is limited to looking for some sort of arbitrator misconduct which resulted in the arbitration award.

If "[c]ustomer dispute information should be expunged only when it has no meaningful investor protection or regulatory value"[3] why does FINRA delegate protection of its CRD to individual investors? Especially when once expunged from the CRD system, it is permanently deleted and no longer

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1. A Google search of the terms "FINRA" and "expungement" revealed numerous paid and organic links to law firms and consultants offering expungement services, https://www.google.com/search?q=finra+expungment&ie=utf-8&oe=utf-8. (last searched Sep. 11, 2017). One entertaining highlight was a musical animated YouTube video created by the Imbesi Law Group https://www.youtube.com/ watch?v=DGEYo7_w8V4 (last visited Sept. 11, 2017).

2. FINRA, RULE 2080(b).

3. FINRA, NOTICE TO ARBITRATORS AND PARTIES ON EXPANDED EXPUNGEMENT GUIDANCE (last updated Sep. 2015).

available to the investing public, regulators or prospective broker-dealer employers.[4]

FINRA itself even acknowledges the problem in the very training materials it provides its arbitrators. "Investors rarely attend the required expungement hearing after a settlement. When the investor does not attend the hearing, arbitrators will hear only the position of the party requesting expungement. Typically, because the case has settled, there has been no hearing on the merits and, thus, no testimony or documentary evidence presented before the parties reach settlement."[5]

FINRA itself is in the best position to determine whether a customer claim or complaint "has no meaningful investor protection or regulatory value," knows the key documents in the firm's and/or broker's possession which relate to the underlying claims, and has the incentive to decide whether to protect its CRD.

FINRA's abdication of its duties appears to be an effort to avoid appearing as the heavy in deciding which brokers get an unopposed expungement and which must fight for it.

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4. FINRA, FINRA OFFICE OF DISPUTE RESOLUTION EXPUNGEMENT TRAINING 8. (Oct. 2016) [hereinafter FINRA EXPUNGEMENT TRAINING], *available at* https://www.finra.org/sites/default/files/FINRA-Expungement-Training.pdf.

5. FINRA EXPUNGEMENT TRAINING, *supra* note 4, at 13.

RECENT ARBITRATION AWARDS

Jason M. Kueser

Heath Marell, Susan Marell, and James Marell, Claimants v. Mark Allan Plummer and Texas E&P Partners, Inc.
Case No. 16-00955[1]
Washington, D.C.

Claimants' Counsel: Matt Simmons, Esq., Law Offices of Matt Simmons, Esq., Rockville, Maryland.

Respondents' Counsel: Charles W. Gameros, Jr., P.C., Hoge & Gameros, L.L.P., Dallas, Texas.

Arbitrators: Christopher M. McMurray, Public Chairperson; Karen L. Crump-Wilson, Public Arbitrator; Jeffrey Axelrad, Public Arbitrator.

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 are jointly and severally liable for and shall pay to Heath Marell compensatory damages in the amount of $193,634.85 plus prejudgment interest at the rate of 6% from March 28, 2017 until the

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1. Claimants asserted the following causes of action: omission of facts, breach of contract, failure to pay dividends, failure to supervise, negligence, failure to execute, intentional fraud, deceit and misrepresentation. Claimants' claims related to their investment in Chestnut GEB Joint Venture and Chestnut 2007 4x4 Joint Venture.

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 in the amount of $338,549.00, interest in the amount of $425,878.00, punitive damages in the amount of $200,000.00, and attorneys' fees in the amount of $25,000.00. At the close of the hearing, Heath Marell requested compensatory damages in the amount of $193,634.85, James Marell requested compensatory damages in the amount of $51,869.85, and Susan Marell requested compensatory damages in the amount of $54,267.00.

In the Statement of Answer, Respondents requested dismissal of the Statement of Claim, assessment of all forum fees against Claimants, attorneys' fees, and for all other relief to which Respondents may be entitled.

date of the award and post judgment interest at the rate of 10% per annum from the date of the award until payment of the award.

2. Respondents are jointly and severally liable for and shall pay to James Marell compensatory damages in the amount of $51,869.85 plus interest at the rate of 9% per annum from March 28, 2017 until payment of the award.
3. Respondents are jointly and severally liable for and shall pay to Susan Marell compensatory damages in the amount of $54,267.00 plus interest at the rate of 9% per annum from March 28, 2017 until payment of the award.
4. Other than forum fees, the parties shall bear their own costs and expenses incurred in this matter.
5. Any and all claims for relief not specifically addressed herein, including punitive damages and attorneys' fees are denied.

This award is significant in that it represents a full recovery of Claimants' compensatory damages. The panel also assessed 100% of the hearing session fees, cancellation fees, and adjournment fees to Respondents. Unfortunately, the arbitrators did not award attorneys' fees, punitive damages, or other relief.

Estate of Kari Lyn Larson, Tab R. Larson, and Jan A. Larson, Claimants v. Ameriprise Financial Services, Inc., Respondent
Case No. 16-01613[2]
Omaha, Nebraska

Claimant's Counsel: James B. Luers, Esq., Wolfe, Snowden, Hurd, Luers and Ahl, Lincoln, Nebraska.

Respondents' Counsel: Edward A. Walton, Esq., Ameriprise Financial Services, Inc., Troy, Michigan.

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2. Claimants asserted the following causes of action: breach of fiduciary duty; omission of facts; breach of contract. The causes of action relate to Claimants' allegations that Respondent made improper distributions to an individual who was not a proper beneficiary of a non-qualified account and two IRA accounts.

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.

In the Statement of Claim, Claimants requested compensatory damages of $440,158.00, plus unspecified attorneys' fees, costs, and other relief.

In the Statement of Answer, Respondent requested that the claims asserted against it be denied in their entirety and an award of its costs and fees.

Arbitrators: Marilyn R. Lewis, Public Chairperson; Steven Meyrich, Public Arbitrator; John R. Loss, 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. Respondent is liable for and shall pay to Tab R. Larson and Jan A. Larson the sum of $418,000.00 in compensatory damages; and 2. Respondent is liable for and shall pay to the Estate of Kari Lyn Larson the sum of $22,158.00 in compensatory damages.

This award is noteworthy in that it represented a full recovery of Claimant's alleged losses; however, despite that, the Panel ordered the parties to each pay one-half of the total hearing session fees of $5,625.

Madeleine Carrero, Individually and as Trustee of Fideicomiso Ulises Barros, and Ulises Barros Carrero, Claimants v. UBS Financial Services, Inc. and UBS Financial Services, Inc. of Puerto Rico, Respondents.
Case No. 15-02661[3]
Miami, Florida

Claimants' Counsel: Barry Blum, Esq., Melanie Cherdack, Esq. and Jean-Pierre Bado, Esq., Genovese Joblove & Battista P.A., Miami, Florida.

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3. Claimants asserted the following causes of action: misrepresentation; negligence; breach of contract; breach of fiduciary duty; overconcentration in violation of FINRA and NASD rules; unsuitability; unauthorized trading and use of loan facilities; failure to supervise in violation of FINRA and NASD rules; unjust enrichment; market manipulation; and violations of the Puerto Rico and Federal Securities Act. The causes of action relate to Claimants' investments in tax free government bonds issued by various Puerto Rican government agencies and instrumentalities and closed-end bond funds.

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 compensatory damages of over $2,000,000.00 and less than $5,000,000.00, rescission, punitive damages, pre- and post-award interest, attorneys' fees, and costs.

In the Statement of Answer, Respondents requested rejection and dismissal of Claimants' claims in their entirety and expungement of all references to this matter from the Central Registration Depository ("CRD") records of non-party Ramon Almonte ("Almonte").

Respondent's Counsel: Matthew E. Wolper, Esq. and Wes Holston, Esq., Bressler, Amery & Ross, P.C., Fort Lauderdale, Florida and Guillermo J. Bobonis, Esq., Bobonis, Bobonis & Rodriguez Poventud, San Juan, Puerto Rico.

Arbitrators: Paul J. Burkhart, Public Chairperson; Gerald Silverman, Public Arbitrator; Joseph Benalt, 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 compensatory damages as follows:

Claimant Carrero:	$538,994.70
Claimant Trust:	$ 94,817.66
Claimant Barros:	$159,265.25

2. Respondents are jointly and severally liable for and shall pay to Claimants interest on the above-stated sums at the rate of 4.75% per annum accruing from October 1, 2015 through the date of service of this Award. Post judgment interest, if any, shall accrue in accordance with the Code of Arbitration Procedure (the "Code").
3. Other than forum fees which are specified below, the parties shall each bear their own costs and expenses incurred in this matter.
4. Respondents are jointly and severally liable and shall reimburse Claimants the sum of $600.00 representing the non-refundable portion of the initial claim filing fee paid by Claimants to FINRA Office of Dispute Resolution.
5. Non-party Almonte's (CRD #1014799) request for expungement of his CRD record is denied.
6. Any and all claims for relief not specifically addressed herein, including Claimants' request for attorneys' fees and punitive damages, are denied.

This award is significant in that, while it represents less than full recovery, the size of the award is noteworthy. In addition, while the Panel awarded pre-judgment interest, ordered Respondents to reimburse Claimant for the non-refundable portion of the filing fee they paid FINRA, and ordered Respondents to pay the full hearing session fees of $25,650.00, the Panel did not award attorneys' fees or costs.

CASES & MATERIALS

Joseph Wojciechowski

Supreme Court Deals Blow to SEC Sanctioning Power

Kokesh v. SEC, 581 U.S. _____; 137 S. Ct. 1635 (2017)

The Supreme Court took up the issue of whether disgorgement levied by the SEC in an enforcement action is within the definition of "penalty" found in 28 U.S.C. § 2486. Under that statute, a five-year statute of limitation applies to any "action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture pecuniary or otherwise."

Kokesh was sued by the SEC for using his Registered Investment Advisory firm as a means to defraud and misappropriate $34.9 million from his business-development clients from 1995 through 2009. After a five-day trial, a jury returned a verdict in favor of the SEC. The trial court determined that the civil monetary penalties were limited by the five-year statute of limitation set forth in 28 U.S.C. § 2462, meaning $29.9 million of the $34.9 million that was stolen fell outside the limitation period. The court agreed with the SEC however, finding that disgorgement was not a "penalty," as that term has been defined under § 2462. As such, Kokesh was ordered to pay the full $34.9 million as disgorgement. Kokesh appealed and the Tenth Circuit affirmed, holding disgorgement is not a "penalty" and therefore, the five-year statute of limitation did not apply to disgorgement. *See Kokesh v. SEC*, 834 F.3d 1158 (10th Cir. 2016). The Supreme Court granted certiorari to resolve a circuit split over whether disgorgement claims in SEC proceedings are subject to the five-year limitation period under 28 U.S.C. § 2462.

In an 8-0 opinion authored by Justice Sotomayor, the Court determined that SEC disgorgement constitutes a penalty and, therefore, is subject to the five-year statute of limitation set forth in § 2462. The SEC action seeking disgorgement was a pecuniary, punitive sanction for violations against the State and clearly sought to punish and deter others as opposed to compensating a victim. Disgorgement orders are payable to the court, not victims, and it is up to the discretion of the court to determine how, when, and to whom the money will be distributed. Therefore, disgorgement is distinguishable from restitution paid to victims because it is in fact a sanction paid to the government. As such, the Supreme Court held that SEC disgorgement "bears all the hallmarks of a penalty: It is imposed as a consequence for violation of a public law and it is intended to deter, not to compensate."

A Very Blunt 7th Circuit Gives Investors Something to Work With

Patel v. Mahendra Wagha, No. 16-2905, 2017 U.S. App. LEXIS 14706 (7th Cir. Aug. 9, 2017)

Plaintiff sued his investment advisor after he invested funds intended to be withdrawn for use in only four months in a speculative options strategy, which resulted in losses. A jury returned a verdict for Plaintiff-investor, awarding him damages for breach of contract and securities fraud. The district court remitted the securities fraud portion of the verdict, finding Plaintiff had not shown loss causation. The Defendants appealed.

Defendants argued that once the District court resolved the only claim under federal law, it lost subject-matter jurisdiction, which required dismissal of the state law claim. In an opinion by Judge Easterbrook, the Seventh Circuit held that state law claims were properly decided under the District Court's supplemental jurisdiction under 28 U.S.C. § 1367 because both the state and federal law claims were tried together.

Plaintiff did not appeal the district court's decision to remit the jury verdict awarding damages for securities fraud under § 10(b) and SEC Rule 10b-5. But Judge Easterbrook saw fit to succinctly explain why the District court was wrong in its assessment of loss causation. The District court, he said, understood loss causation to mean proof that the securities were not worth what the buyer paid for them. "But the premise of the district court's holding - that the securities laws are concerned only with inaccurate pricing - is incompatible with *SEC v. Zandford*, 535 U.S. 813 (2002), and *United States v. Naftalin*, 441 U.S. 768 (1979) which hold that securities laws forbid fraud in all aspects of securities transactions, whether or not the fraud affects the instruments' prices."

The court explained that securities fraud takes many forms, including procuring securities known to be unsuitable to a client's investment goals, after promising to further these goals. The difference between how the unsuitable options fared versus how the instruments defendants should have purchased fared, is a loss caused by the securities fraud. "…[D]istrict judges should avoid this kind of error in the future." The court also found, that just because a contract allowed for the purchase of options, did not mean the investor consented to speculative options trading because options can also be used conservatively.

Courts Continue To Weigh-In on Definition of "Customer"

UBS Financial Services v. Zimmerman, No. 16-cv-155, 2017 U.S. Dist. LEXIS 44967 (E.D.N.C. Mar. 28, 2017).

In another recent case decided by a federal court defining "customer" for the purposes of pursuing arbitration through FINRA, UBS sought a preliminary injunction against an investor who purchased shares of a leveraged structured note underwritten by UBS, through his account at Schwab. The investor suffered a 40% loss in the note, called the "Monthly Pay 2xLeveraged Exchange Traded Access Security."

Initially, the court granted UBS's motion for preliminary injunction to enjoin Zimmerman from pursuing arbitration. Zimmerman then sought arbitration against other UBS entities, including UBS AG, UBS Group, and UBS Securities. These entities then filed another motion for preliminary injunction, first unsuccessfully arguing the previous injunction applied to these other UBS entities. However, the court did enjoin the arbitration because these entities had no written agreement to arbitrate and because Zimmerman was not a customer of any of them.

The court determined Zimmerman was not a customer, stating in order to be a customer of a FINRA member firm, there must a be a "direct relationship" with the FINRA member; "an indirect or attenuated relationship is insufficient. For an individual investor to claim his status as a FINRA member's customer he must purchase goods or services directly from a FINRA member." The court determined the underwriting services performed by the UBS entities "creates only an attenuated connection between [Zimmerman] and [UBS]."

Wilson-Davis & Co., Inc. v. Mirgliotta, 16-cv-3056, 2017 U.S. Dist. LEXIS 64970 (N.D. Ohio Apr. 28, 2017)

Plaintiff clearing firm and FINRA member sought a preliminary injunction preventing Defendant investors from arbitrating claims in connection with investments in VGTel, Inc., New Market Enterprises, and Q Lotus. Investors filed a FINRA claim against multiple defendants for over $700,000 in losses. Mirgliotta's financial advisor was Larry Werbel, who was registered with Summit Brokerage Services, but the accounts were carried by TD Ameritrade. Werbel transferred their accounts and Werbel opened IRAs at Wilson-Davis, another broker/dealer. However, Mirgliotta later testified that he never signed the paperwork and that the documents were forged by Wilson-Davis representative Christopher Cervino. He similarly testified that he never authorized the transfer of funds, although he knew it happened.

After the accounts were opened at Wilson-Davis, Cervino proceeded to trade a penny stock called VGTel. Wilson-Davis earned commissions on these trades. Shortly thereafter, Efran Eisenberg a/k/a Edward Durante, sent Mirgliotta an email detailing instructions for $565,000 of their funds to be wired from their Wilson-Davis accounts to their account at Liberty Bank. From there, the money was to be transferred to New Market Enterprises. Mirgliotta testified he could not recall whether he spoke to Cervino about these instructions, but knew he spoke to someone about these transactions. He did testify he believed Cervino was involved in the scam, however. The wires were approved and processed by Wilson-Davis, who received a fee for doing so. Mirgliotta brought a FINRA claim against several member firms, including Wilson-Davis, alleging negligence, negligent supervision, and vicarious liability.

Wilson-Davis filed a complaint seeking 1) a declaratory judgment that the Mirgliotta's were not their customers and 2) an injunction enjoining the arbitration from proceeding. There was no written agreement requiring arbitration, so the court looked to the definition of "customer" under FINRA Rule 12200. The court looked to the two factors in Rule 12200 and the interpretation of the Rule by the Second Circuit in *Abbar v. Citigroup*, 761 F.3d at 274-75. The court determined that the Mirgliottas had accounts at Wilson-Davis and were therefore "customers," quoting *Abbar*, in which the court stated "[a]n account holder as a reasonable expectation to be treated as a customer, whether or not goods or services are purchased directly from the FINRA member. Likewise, the FINRA member should anticipate that account-holders may avail themselves of the arbitration forum to dispute transactions arising from the account." Wilson-Davis argued that Werbel was actually the customer because Mirgliotta claimed that the accounts were fraudulently opened arising from forged signatures. The court stated "Wilson-Davis cannot avoid arbitration by relying on its employee's fraud" and ordered the parties to arbitration.

If You File a Motion to Vacate, Prepare To Pay Opponent's Attorney's Fees

DiPietro. v. First Allied Secs., Inc., No. CV-14-00502, 2017 U.S. Dist. LEXIS 51338 (D. Ariz. Apr. 4, 2017)

An investor sued First Allied in arbitration for losses sustained in investments sold to her by First Allied independent contractor-registered representative DiPietro. First Allied filed an answer and third-party claim against DiPietro. He responded by filing a counter claim against First Allied, who

settled with the investor, but pursued its third-party claim against DiPietro. The FINRA panel awarded damages, attorney's fees, interest and costs to First Allied. DiPietro filed a motion to vacate the award, which was denied. First Allied moved for attorney's fees, and that motion was stayed pending DiPietro's appeal to the Ninth Circuit. The Ninth Circuit affirmed the holding of the district court and remanded the issue of fees. DiPietro's motion for rehearing *en banc* was also denied.

The District Court then took up the issue of First Allied's petition seeking $157,630 in attorney's fees. First Allied argued it was entitled to an award of fees pursuant to Arizona law and the independent contractor agreement. DiPietro argued the independent contractor agreement contained a California choice of law clause and that California law does not allow for an award of attorney's fees related to an appeal of an arbitration award. DiPietro further argued the fee issue should be submitted to the arbitration panel. Lastly, DiPietro argued the fees sought were unreasonable.

The court sided with First Allied on all issues. First, the independent contractor agreement expressly provided for indemnification and reasonable attorney's fees. California law expressly allows for payment of attorneys fees when contracted for between the parties. Further, under Arizona law, an award of fees is allowed even if they are not included in a contract in connection with affirming, modifying, or vacating an arbitration award. So, regardless of which law applied, First Allied was entitled to its fees. However, the Court did find the fees to be unreasonable and unjustifiable for the amount of work performed and used its discretion to lower the amount of attorney's fees to $75,000.

Moomjian v. TD Ameritrade, Inc., No. 15-cv-0952, 2017 U.S. List LEXIS 10909 (N.D. Tex. Jan. 9, 2017)

Federal Court denied a motion to vacate an arbitration award and granted T.D. Ameritrade's motion for attorney's fees. The grounds for granting fees was found in the parties' contract, which specifically stated "if any party unsuccessfully resists confirmation or enforcement of an arbitration award rendered under this Agreement, then that party shall pay all costs, attorney's fees, and expenses incurred by the other party or parties confirming or enforcing the award." T.D. Ameritrade sought $33,177.50 in fees for 147.9 hours of work. Plaintiff argued those fees were unreasonable. The court applied a twelve factor test to determine whether the loadstar figure (based on reasonable hours and reasonable fees in the community for similar work) should be adjusted upward or downward.

The court determined that the billing submitted by T.D. Ameritrade did not reflect the application of "billing judgment," which refers to the usual practice of law firms in writing off unproductive, excessive, or redundant hours. The party seeking fees is required to exercise billing judgment. Because TD Ameritrade did not exercise the requisite "billing judgment," the court used its discretion to reduce the amount of the fees awarded by 10% to $29,816.10.

Class Plaintiffs Get Creative Against Broker/Dealers But Lose…This Time

Vaccaro v. New Source Energy Partners, L.P., No. 15-cv-8954, 2016 U.S. Dist. LEXIS 175511 (S.D.N.Y. Dec. 19, 2016)

Plaintiffs brought a putative class action on behalf of all investors in Series A Preferred Units from New Source Energy LP. Plaintiffs sued New Source, the officers and directors of New Source at the time of the offering, and various brokerage firms who acted as underwriters of the offering, including Stifel Nicolaus, Robert W. Baird, Oppenheimer, Janney Montgomery Scott, and Wunderlich Securities.

The class plaintiffs alleged the registration statement and prospectus made material false and misleading statements and omitted material information. Specifically, the Class alleged the disclosure materials failed to adequately disclose the ongoing cash flow problems as a result of pending litigation with a substantial contractor and because of the downturn in the price of oil and natural gas.

Specific to the underwriter-brokerage defendants, Plaintiffs brought a claim under Section 12(a)(2) of the Securities Act of 1933, alleging the New Source Preferred Units were sold by prospectus that contained material misstatements or omissions. Under Section 12(a)(2), Plaintiffs need not allege scienter, reliance, or causation, unless the claims sound in fraud. Further, underwriter defendants can be held liable for mere negligence.

The court dismissed the complaint without prejudice granting leave for Plaintiffs to replead. The court examined, in detail, the risk disclosures contained in the prospectus, along with ongoing representations made in SEC filings for the company, and determined that the core allegations of omission were unfounded. The company disclosed in no uncertain terms that the global decline in oil prices was having a serious ongoing impact on the company's balance sheet. New Source also disclosed ongoing litigation with a key contractor negatively impacting cash flow, including its ability to pay dividends. The court stated "Defendants disclosures were as precise and exhaus-

tive as is required by Sections 11 and 12(a) of the Securities Act. Plaintiffs take issue with the extent and specific wording of the disclosures, but Defendants need not characterize the facts in the way the Plaintiffs prefer." Because the court determined the prospectus did adequately disclose the complained of material facts, the brokerage defendants could not be liable under § 12(a)(2).

In re Forcefield Energy, Fed. Sec. L. Rep. (CCH) P99,686, 2017 U.S. Dist. LEXIS 54606 (S.D.N.Y. Mar. 29, 2017)

Plaintiff class members brought several causes of action against a number of defendants in connection with an alleged fraudulent stock manipulation scheme. The scheme involved the chief executives of Forcefield, including its President and CEO, paying undisclosed kick-backs to a number of stockbrokers to promote and sell the company's stock, and paying other promoters to publish positive information about the company, in an attempt to pump-up the stock price. Upon disclosure of these facts by a website and the arrest of the company's CEO just as he was boarding a plane to Costa Rica, the stock price plummeted to near $0, leaving the shareholders with a near total loss.

The stockbrokers who illegally paid to push and promote Forcefield stock were registered representatives with various FINRA broker/dealers. Because the stockbrokers were clearly primary violators of § 10(b) and the rules promulgated thereunder, the class plaintiffs sought to hold the broker/dealer defendants liable under § 20(a) of the Exchange Act. In order to establish a claim under § 20(a), plaintiffs had to prove some level of culpable participation by the brokerage defendants or, alternatively, prove recklessness.

Plaintiffs alleged that the brokerage firm defendants were liable under two theories: 1) the Broker Defendants' knowledge may be imputed to the broker/dealers via agency, and 2) the broker/dealers were reckless because they failed to adequately supervise the stock broker defendants. The court found neither theory persuasive and dismissed the broker/dealer defendants from the case.

The stock broker defendants' knowledge could only be imputed to the Broker/dealers if the brokers were acting within the scope of their authority. The plaintiffs, the court held, failed to adequately plead that the stock brokers were acting within the scope of their authority when they accepted the kickbacks to promote Forcefield stock. In fact, the Plaintiffs actually pleaded facts that defeated the agency claim. For example, plaintiffs specifically pleaded that the stock brokers hid the kickbacks from their clients and that

they received these payments from a "brown bag" middle man. There were no allegations that any of the brokerage defendants knew about the kickbacks. Importantly, whether an action occurs in the ordinary course of business is a question of fact usually not fit for adjudication at the motion to dismiss stage, the court determined the complaint still needs to plead "some facts from which it could be inferred that the acts were within the agency's scope."

Plaintiffs also argued the "culpable participation" element was satisfied by the broker/dealer defendants' recklessness by failing to supervise the stock brokers. Although courts have held a failure to supervise can satisfy the culpable participation element to establish liability under Section 20(a), the plaintiffs failed to plead facts supporting their theory. Again, the facts actually pleaded undermined the theory altogether. In a footnote, the court stated "we find it telling that the SEC investigated the Brokerage Defendants in connection with the scheme, but did not name the Brokerage Defendants in the civil complaint brought against the broker defendants."

New York Court Explains Statutes of Limitation for Breach of Fiduciary Duty

Averick v. Glickenhaus, No. 650235/2016, 2017 N.Y. Misc. LEXIS 1580 (Apr. 27, 2017)

Plaintiffs filed suit to hold an investment advisor liable for losses sustained during the financial crisis. The investment advisor moved to dismiss based on statute of limitations grounds, and the motion was granted.

At issue was whether a three-year or six-year limitation period applied to Plaintiffs' breach of fiduciary duty claim. Under New York law, the statute of limitations for breach of fiduciary duty is three years if the plaintiff alleges injury to property, and six years when the relief sought is equitable in nature or sounds in fraud.

The court held the three-year limitations period applied because the plaintiff sought monetary damages and fraud was not an essential element of plaintiffs claim. The core of Plaintiffs' complaint was that the investment advisor did not follow her instructions to take her out of the market in 2008. Because she received her monthly account statements clearly reflecting she was still in the market and losing money, she could not make a colorable claim for deception or fraud. The court also determined that the claim arose in 2008 or 2009 at the latest when she suffered damages as a result of Glickenhaus's failure to take her out of the market.

Plaintiff argued the open repudiation doctrine tolled the statute of limitations until the fiduciary relationship ended. But under New York law, the open repudiation doctrine does not apply in claims seeking money damages, only equitable or accounting relief. Plaintiff also argued that equitable tolling or the "continuous representation" doctrine tolled the running of the statute of limitations. The court found neither persuasive. Because Plaintiff could not allege she was actively misled by the Defendant, equitable tolling did not apply.

More interesting, however, is the court's analysis of the continuous representation doctrine. New York does recognize the continuous representation doctrine, which tolls the statute of limitations where there is a "continuous representation" of the plaintiff by the professional. But this doctrine only applies when the professional continues to represent the plaintiff "in connection with the particular transaction which is the subject of the action and not merely during continuation of a general professional relationship." In this case, the court held the instruction to take the plaintiff out of the market was a specific, discreet investment decision unrelated to the advice plaintiff received from Glickenhaus over the years. The court noted it would not matter even if it applied this doctrine to Plaintiff because she did not commence the action within three years of ending the professional relationship with defendant.

Brokers Sue FINRA For Unfair Arbitration Process

Webb v. FINRA, Inc., No. 16-cv-4664, 2017 U.S. Dist. LEXIS 103301 (N.D. Ill. July 5, 2017)

Brokers sued FINRA for breach of contract alleging that FINRA violated its contractual promise to provide an arbitration that "would achieve fair, just, and equitable results," after their case against their former firm was dismissed. The brokers sued for breach of contract and sought a declaratory judgment that FINRA rules were unable "to enforce and promote just and equitable principles of trade and business, to maintain high standards of commercial honor and integrity and to prevent fraudulent and manipulative acts and practice" and "to create fair, just, and equitable resulted for disputes to be decided on their merits."

FINRA moved to dismiss on multiple grounds, but namely, the doctrine of arbitral immunity was deemed dispositive by the Court. This immunity specifically applies to arbitrators and is analogous to judicial immunity. Although the Seventh Circuit has not specifically defined the out limitations of arbitral immunity, the court suggested case law establishes it does apply to

forum sponsors like FINRA when the dispute involves issues in the normal course of the arbitration process. The court cited to one case where the Seventh Circuit suggested, in a hypothetical, that there could be circumstances where a forum sponsor, like FINRA, could be the proper party to a suit, but found this case did not fall into that very specific example. In *Caudle v. American Arbitration Association*, 230 F.3d 920 (7th Cir. 2000), the court suggested, in the event a party paid for an arbitration process and the arbitral forum literally failed to provide the arbitration, this situation would create a viable suit beyond the limits of arbitral immunity. The court dismissed the complaint and the plaintiffs have appealed.

California Court Declines to Hold Brokerage Firm Liable for Broker's Promissory Notes, But Provides Possible Roadmap

Berry v. Foothill Secs., Inc., No. C075105, 2017 Cal. App. Unpub. LEXIS 5280 (Cal. App. 3rd Dist. Aug. 1, 2017)

Berry appealed the trial court order granting Foothill Securities' motion for summary judgment. Berry was a client of financial advisor Matthew Trulli, who was an independent contractor representative of Foothill Securities. Berry invested in a number of traditional investments through Trulli, including mutual funds and an annuity. Berry never interacted with anyone at Foothill other than Trulli.

Trulli then solicited Berry to loan him money for his winery business. The first loan was memorialized through a promissory note. After he was technically in default on the first $100,000, he asked Berry for more money and he invested another $40,000. This loan was memorialized by a handwritten note and the check was written to Trulli personally. Berry never received any confirmations or other correspondence about these loans from Foothill. There was nothing in the record indicating Trulli ever represented or indicated in any way to Berry that these loans were somehow affiliated with or backed by Foothill.

Trulli defaulted on the loans and Berry sued Foothill for breach of fiduciary duty, negligence, and fraud through intentional misrepresentation. None of these causes of action seem to touch on Foothill's negligence in connection with supervision or control person liability. This was clearly a mistake. The court determined that by soliciting these loans from Berry, Trulli was not acting within the scope of his employment. The court did say whether Trulli was an independent contractor or an employee was not controlling because the issue was whether the conduct was within the scope of his employment. The court

determined that by soliciting personal loans for an outside, unaffiliated business, Trulli was not acting as an agent of Foothill.

The court did highlight enterprise liability, however, stating "where the question is one of vicarious liability, the inquiry would be whether the risk was one 'that may fairly be regarded as typical of or broadly incidental' to the enterprise undertaken by the employer. Accordingly, the employer's liability extends beyond his actual or possible control of the employee to include risks inherent in or created by the enterprise." Based on the undisputed facts in this case, the court affirmed the decision granting the motion for summary judgment.

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 *SR-FINRA-2017-025 Proposed Rule Change Relating to Revisions to the Definition of Non-Public Arbitrator* was submitted to the Securities and Exchange Commission by Marnie C. Lambert on August 18, 2017 (prepared with the assistance of David P. Neuman).

Mr. Brent Fields, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: SR-FINRA-2017-025
Proposed Rule Change Relating to Revisions to the Definition of Non-Public Arbitrator

Dear Mr. Fields:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by the Financial Industry Regulatory Authority ("FINRA") that govern the conduct of securities firms and their representatives. In particular, our members and their clients have a particular interest in FINRA rules relating to FINRA's Code of Arbitration Procedure and the arbitrator selection process.

The Commission seeks comment regarding proposed changes to the definition of "non-public" arbitrator under FINRA Rules 12100(r) and 13100(r). The proposed rule seeks to redefine a non-public arbitrator as a person who is otherwise qualified to serve as an arbitrator, but is disqualified from serving as a "public" arbitrator under the Code.

The purpose of the rule change is to close a gap in eligibility which was created when the arbitrator definitions were changed in 2015. Under the previous rule change, hundreds of arbitrators were re-classified from public to non- public. However, there were a number of persons who did not meet the criteria outlined under the definition of "non-public" arbitrators, rendering them completely ineligible to serve as arbitrators.

PIABA supports this proposed rule change. The gap created by the previous rule change should be closed so that otherwise qualified arbitrators can serve as non-public arbitrators. PIABA believes that having as many qualified, fair, and neutral arbitrators as possible will help advance the integrity of the arbitration process. This rule proposal is a step in the right direction.

PIABA also hopes that FINRA will continue its other efforts to ensure a fair and efficient arbitrator pool. PIABA has had prior concerns about the lack of diversity in the arbitrator pool. PIABA hopes that FINRA will continue (and perhaps increase) its efforts to recruit new arbitrators to help increase the diversity of the pool.

Moreover, many constituents of FINRA arbitration, including PIABA, have had concerns about the number of "traveling" arbitrators (arbitrators who are selected to serve in the arbitrator pool outside of their nearest arbitration site), especially in the "public" pool. This is a bigger problem for small and mid-size cities. Scheduling issues with traveling arbitrators can delay the arbitration process, and the traveling arbitrators may not understand a neighboring state's laws and procedures as much as a local arbitrator. PIABA hopes that FINRA will continue its efforts to recruit new arbitrators to expand "public" pools, especially in small and mid-size cities, and decrease the occurrence of traveling arbitrators.

Additionally, PIABA welcomes any efforts to lower or eliminate certain thresholds required for one to become a FINRA arbitrator. Under the current rules, arbitrators are required to have a minimum of 5 years of professional experience and at least two years of college-level education to become an arbitrator. Considering that there are no educational requirements to sit for the Series 7 exam (and thus, the broker whose conduct at issue has no such educational requirement to qualify as a registered representative), there should be no requirement that an arbitrator has to have some college-level education in order to be qualified.

Whether someone has taken college-level courses does not necessarily mean that such person cannot grasp the concepts being discussed and considered during the arbitration process. As long as the person can understand and pass the arbitrator training courses, they should be qualified to become arbitrators.

In sum, PIABA supports the proposed rule change, and PIABA also hopes that FINRA will continue its efforts to provide more qualified, fair, neutral, and diverse arbitrators. I want to thank you for the opportunity to comment.

Very truly yours,
Marnie C. Lambert
PIABA President

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The following PIABA Comment Letter regarding the *IA-BD-Conduct-Standards In Response to Chairman Clayton's Request for Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers* was submitted to the Securities and Exchange Commission by Marnie C. Lambert on August 11, 2017 (prepared with the assistance of Benjamin Edwards, Charles Field and Christine Lazaro).

Brent Fields, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609
Via email to *rule-comments@sec.gov*

Re: IA-BD-Conduct-Standards
In Response to Chairman Clayton's Request for Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers

Dear Mr. Fields:

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

On June 1, 2017, Chairman Clayton issued a Public Statement, seeking comment on a number of questions regarding broker and investment adviser standards of conduct.[1] PIABA welcomes this opportunity to comment, as it has commented on the prior SEC requests on this topic.[2] PIABA hopes that the

1. Chairman Jay Clayton, *Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers* (June 1, 2017), available at https://www.sec.gov/news/public-statement/statement-chairman-clayton-2017-05-31.

2. PIABA, *Comment Letter to the SEC on Study Regarding Obligations of Brokers, Dealers, and Investment Advisers* (Sept. 3, 2010), available at https://piaba.org/

SEC moves forward with a uniform fiduciary standard for brokers and investment advisers, as permitted by Dodd-Frank.[3]

PIABA will address certain of the questions raised by Chairman Clayton.

Question: *Retail investors have expressed confusion about the type of professional or firm that is providing them with investment advice, and the standards of conduct applicable to different types of relationships. To what extent has this reported confusion been addressed? If meaningful confusion remains, is the confusion harming retail investors or resulting in other costs? If so, what steps should be taken to address this situation? What disclosures, advertising, or other information do investment advisers and broker-dealers provide to retail investors currently, and how do those contribute to or mitigate any investor confusion? Are there specific disclosure requirements or other steps the Commission should consider to address any confusion regarding applicable standards?*

There is one thing about which there can be no confusion: investors do not understand the factors distinguishing investment advisors from brokerage firms. This problem is exacerbated by the industry's continued marketing efforts that serve to mislead the investing public.

There have been a number of studies conducted that confirm that investors are confused about the duties they are owed and with whom they are doing business. In its original report to Congress, the "Study on Investment Advisers and Broker-Dealers" (the "SEC Study"),[4] the SEC studied the extent to which retail customers were confused about the status of the person from whom they receive financial services. The SEC reviewed two studies which it sponsored (the "Seigel & Gale Study" and the "RAND Report"), and a study conducted by Consumer Federation of America (the "CFA Survey").

The SEC Study found that, based on the comments, studies and surveys it had reviewed, investors did not understand the differences between investment advisers and broker-dealers. The SEC determined that this misunderstanding is compounded by the fact that many retail investors may not have the

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piaba-newsroom/piaba-comment-letter-study-regarding-obligations-brokers-dealers-and-investment-advis; PIABA, *Comment Letter to the SEC on Duties of Brokers, Dealers, and Investment Advisers* (July 3, 2013), available at https://piaba.org/piaba-newsroom/piaba-comment-letter-duties-brokers-dealers-and-investment-advisers-july-3-2013.

3. The Dodd–Frank Wall Street Reform and Consumer Protection Act, § 913, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

4. SEC, *Study on Investment Advisers and Broker-Dealers* ("SEC Study") (Jan. 2011), available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

"sophistication, information, or access needed to represent themselves effectively in today's market and to pursue their financial goals."[5] The SEC Study concluded that, "it is important that retail investors be protected uniformly when receiving personalized investment advice or recommendations about securities regardless of whether they choose to work with an investment adviser or a broker-dealer. It is also important that the personalized securities advice to retail investors be given in their best interests, without regard to the financial or other interest of the financial professional, in accordance with a fiduciary standard."[6]

The Seigel & Gale Study utilized focus groups to examine how investors differentiate the roles, legal obligations, and compensation between investment advisers and broker-dealers.[7] The focus group participants did not understand that there were differing roles and legal obligations between investment advisers and brokers. The participants were also confused by the different titles used within the industry, and did not understand terms such as "fiduciary."[8]

In 2006, the SEC commissioned RAND to study whether investors understood the obligations of brokers and investment advisers.[9] RAND examined the business practices of brokers and investment advisers, and conducted an investor survey.[10] Because of the complex affiliations and relationships between firms offering different services, RAND had difficulty determining with certainty the brokers' and investment advisers' respective business practices.[11] RAND also noted that it could be difficult for investors to understand the differences in the services provided by the firms because of the lack of uniformity in how information was presented.[12] Through its interviews of brokers and investment advisers, RAND learned that the firms believed investors will trust them without necessarily understanding their

5. *See id.* at 101.

6. *See id.* at 101.

7. *See id.* at 95.

8. *See id.* at 96.

9. *See id.*

10. *See id.*

11. *See id.* at 97.

12. *See id.*

services and responsibilities.[13] Through its investor survey, RAND learned that investors did not understand the differences between brokers and investment advisers, and found their titles confusing.[14] Survey participants noted that "the interchangeable titles and 'we do it all' advertisements made it difficult to discern" brokers from investment advisers.[15] Investors believed that their financial professional was acting in their best interest.[16]

The CFA Survey was conducted in 2010 on behalf of 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.[17] The CFA Survey found that a majority of investors believe a broker is held to a fiduciary standard.[18]

More recent studies have been conducted following the issuance of the SEC Report, confirming the same information the SEC reported. For example, a 2015 study confirmed that most retail customers think their financial advisor – regardless of which type of advisor it is – is a fiduciary.[19] Further, the industry is aware of the confusion. In a survey open to all brokers, investment advisers, and insurance consultants and producers, 97 percent of them said "investors don't understand the differences between brokers and investment advisers."[20]

As demonstrated by the Seigel & Gale Study and the RAND Report, investors' confusion between brokers and investment advisers is aggravated

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13. *See id.*

14. *See id.* at 98.

15. *Id.*

16. *See id.*

17. *See* infogroup/ORC, *U.S. Investors & The Fiduciary Standard: A National Opinion Survey* (Sept. 15, 2010), available at https://www.cfp.net/docs/public-policy/us_investors_opinion_survey_2010-09-16.pdf?sfvrsn=2.

18. *See* SEC Study, *supra* note 4 at 100.

19. *See* Spectrem Group, *Fiduciary – Do Investors Know What It Means* (2015), available at http://spectrem.com/Content_Whitepaper/fiduciary.aspx.

20. *See* fi360-ThinkAdvisor, *Trustworthy Advice and Individual Investors: Will Regulators Act in Investors' Best Interest?* (Aug. 2013), available at http://www.fi360.com/uploads/media/fiduciarysurvey_resultsreport_2013.pdf; *see also* fi360-ThinkAdvisor, *Seeking Trustworthy Advice for Individual Investors – Financial Intermediaries Indicate Strong Support for Fiduciary Standard* (Feb. 2015), available at http://www.fi360.com/uploads/media/2015fiduciarysurvey.pdf.

by the industry's confusing use of titles. The individuals working for the firms are bestowed with impressive titles such as "Financial Advisor," "Financial Consultant," "Retirement Consultant," and "Wealth Manager."[21] Brokers are never called brokers.

Investors are also confused by firm advertising. In a study conducted by PIABA in 2015, PIABA examined the websites of nine different brokerage firms (the "PIABA Report").[22] PIABA examined Allstate, UBS, Morgan Stanley, Berthel Fisher, Ameriprise, Merrill Lynch, Fidelity, Wells Fargo, and Charles Schwab and found that the firms' advertising presents the image that the firms are acting in a fiduciary capacity.[23]

The following are examples of the advertising included in the PIABA Report:

UBS:

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.[24]

Morgan Stanley:

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.[25]

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21. *See* Consumer Federation of America & Americans for Financial Reform, *Financial Advisor or Investment Salesperson? Brokers and Insurers Want to Have it Both Ways*, 5-6 (Jan. 18, 2017) ("CFA/AFR Report"), available at http://ourfinancialsecurity.org/wp-content/uploads/2017/01/Financial-Advisor-or-Investment-Salesperson.pdf.

22. *See* PIABA, *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* (Mar. 25, 2015) (the "PIABA Study"), available at https://piaba.org/system/files/pdfs/PIABA%20Conflicted%20Advice%20Report.pdf.

23. *See id.* at 1.

24. *Id.* at 9.

25. *Id.* at 10.

Ameriprise:

Focus on your dreams and goals

Once you've identified your dreams and goals, and you and the advisor have decided to work together, you can count on sound recommendations that address your goals. You'll be able to clearly see and discuss how the actions and decisions you make today will affect your tomorrow. 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.

Personalized advice and recommendations on an ongoing basis

Perhaps the best thing about working with a personal financial advisor is that your financial plan is custom made for you. The financial advisor you choose to work with knows all about you. When and if you experience a life change, your priorities shift or you have a pressing financial question, you can contact your advisor for information and financial advice that's meaningful to you. You may meet a few times during a year and have several discussions. Your advisor will make every effort to be available to you when needed.[26]

Wells Fargo:

Are we working toward common goals?

A healthy relationship with your Financial Advisor should make you feel that your best interests are the top priority, no matter what is happening in the market and no matter the size of your portfolio. Furthermore, you should like your advisor, and both you and your advisor should feel that all concerns are heard and addressed.

Are we sharing information and asking questions?

Your financial consultant should provide you with the relevant information needed to help you feel informed about financial events that pertain to your investments. Your Financial Advisor may also answer any questions you might have about your monthly statements. Stay in contact to ensure that your advisor is current on your objectives and can make changes when necessary.[27]

Charles Schwab:

For many years, we've encouraged investors like you to "Talk to Chuck" so we could help you manage through the array of investing challenges and opportunities. I still encourage you to do that. We'll share with you our passion for investing and our thoughts on how to do it well, and we'll listen to you to understand how we can help you reach your goals. But going forward, you'll be hearing more about the values we stand for and why they might matter to

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26. *Id.* at 11.

27. *Id.* at 14.

you. Our communications will emphasize the fundamental belief we share with you: a belief that through personal engagement and a relationship of mutual respect, your financial goals and a better tomorrow are within reach.

Does my broker discuss the risks in my investment portfolio?

All investors need to understand the various risks in their investment portfolio and their tolerance level for those risks. But, how much and how often do you discuss these risks with your broker? Is your broker proactive about communicating possible risks as things change in the markets, economy or in your personal situation?[28]

In January 2017, almost two years later, Consumer Federation of America and Americans for Financial Reform looked at these same firms (the "CFA/AFR Report").[29]

UBS:

On the firm's homepage, a rotating banner reads: "Advice. Beyond investing." A prospective client who navigates to the firm's Investing webpage will see the following statement: "Building an investment plan and an optimal asset allocation strategy to meet your unique needs requires careful consideration and often, outside expertise. Our UBS Financial Advisors are committed to helping you with this process, allowing you to spend more time on the activities you truly enjoy…UBS Financial Advisors take a holistic wealth management approach to carefully understanding your overall financial situation, unique needs and goals, and deliver an optimal investment solution to meet them."[30]

Morgan Stanley:

The firm's "Wealth Management" webpage states: "You have meaningful goals. Our Financial Advisors can help you reach them. For nearly 80 years, we have worked with individuals, families, businesses, and institutions—to deliver services and solutions that help build, preserve and manage wealth. We understand our clients' aspirations, and we're as devoted to their goals as they are." The webpage further states: "The Path to Reaching Your Goals Begins with a Financial Advisor: Morgan Stanley Financial Advisors harness the firm's global resources and intellectual capital to help create a financial strategy that works for you."[31]

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28. *Id.* at 15.

29. *See* CFA/AFR Report, *supra* note 21.

30. *Id.* at 9.

31. *Id.*

Ameriprise:

The website features a 44-page "Client Relationship Guide" whose stated purpose is to give clients a better understanding of the company and the services it offers. It states: "Our commitment to you: We provide personal, high-quality advice. Our approach is based on sound financial principles and a full view of your needs. We go beyond the numbers to understand your needs and provide you with clear actions you can take to help you achieve your dreams and feel more confident about the future. We tailor our advice to your personal objectives, time horizon, and risk tolerance, as well as other factors."[32]

Wells Fargo:

The center of the Wells Fargo homepage features the statement: "Helping Clients Succeed Financially. We provide advice and guidance to help maximize all elements of your financial life, whenever and however you need it." A prospective client who clicks on the "Why Invest With Us" tab will find the following statement under the "Our Advisors" heading: "A Financial Advisor can provide the advice and guidance you need to focus on your short- and long-term goals while navigating life's financial opportunities and turning points. Start planning now for the future. Choose a Financial Advisor from the firm that lives and breathes a client-centered approach to advice."[33]

Charles Schwab:

The homepage of the firm's website features the question: "How will you help me with my financial goals?" The answer, in big, bold font: "A Schwab Financial Consultant can help you create a plan tailored to your needs." It continues: "It starts with a conversation and a fresh perspective, discussing your long- and short-term goals. We evaluate your current investments then create specific recommendations." The website describes the benefits of meeting with a financial consultant this way: "Your Financial Consultant can work with you to create a holistic plan with specific investment recommendations and a clear explanation of the benefits and risks….Your plan will reflect your priorities, from retirement income and estate planning to insurance and debt management. And you can meet regularly to keep your plan up to date as your life evolves.[34]

Very little changed between the time the PIABA Report and the CFA/AFR Report were issued. Firms continue to present themselves as providing all-encompassing advice, with no differentiation between the firms' investment

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32. *Id.* at 8.

33. *Id.*

34. *Id.* at 7.

adviser services and brokerage services. Investors remain confused by this ambiguous advertising. Simply correcting the advertising at this point will not be able to remedy the misunderstandings pervasive throughout the investing public. Further, as the RAND Report pointed out, investors will trust brokers and investment advisers without understanding the scope of the services they offer. The confusion regarding brokers and investment advisers is so deeply ingrained, investors are left with the impression that both are obligated to act in their best interests. At this point, the best way to address investor confusion will be to hold both brokers and investment advisers to a fiduciary duty.

Question: *Have potential conflicts of interest related to the provision of investment advice to retail investors in various circumstances been appropriately identified and, if so, have they been appropriately addressed? Are there particular areas where conflicts are more prevalent, have greater potential for harm, or both? To what extent are retail investors being, or expected to be, harmed by these conflicts currently and in the future? For example, do certain types of relationships result in systematically lower net returns or greater degrees of risk in retail investors' portfolios relative to other similarly-situated investors in different relationships? Are there steps the Commission should take to identify and address these conflicts? Can they be appropriately addressed through disclosure or other means? How would any such steps to address potential conflicts of interest benefit retail investors currently and over time? What costs or other consequences, if any, would retail investors experience as a result of any such steps? For example, would broker-dealers or investment advisers be expected to withdraw from or limit their offerings or services in certain markets or products?*

The current rules governing brokers and investment advisers do not provide adequate protections for retirement investors. FINRA Rule 2111, (the "Suitability Rule"), governing brokers, 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 may sell a mutual fund with high expenses rather than a functionally identical fund, which may cost the investor less but pay the broker less. These conflicts are not adequately managed by the current rules.

The following enforcement actions demonstrate that the prevailing culture within the industry is to place the financial interests of the firms above the interests of the investors. Firms overcharge investors, recommend higher fee share classes, recommend replacements of existing mutual funds and annuities, and recommend complex products with opaque fee structures. This conduct is not limited to one sector of the brokerage industry – it occurs in firms both large and small. Note further that the violations carry across the broad spectrum of investment types.

Mutual Funds:

FINRA "fined Oppenheimer & Co. Inc. $2.25 million and ordered the firm to pay restitution of more than $716,000 to affected customers for selling leveraged, inverse and inverse-leveraged exchange-traded funds (non-traditional ETFs) to retail customers without reasonable supervision, and for recommending non-traditional ETFs that were not suitable."[35]

FINRA "ordered Barclays Capital, Inc. to pay more than $10 million in restitution, including interest, to affected customers for mutual fund-related suitability violations. These suitability violations relate to an array of mutual fund transactions including mutual fund switches. Additionally, the firm failed to provide applicable breakpoint discounts to certain customers. Barclays was also censured and fined $3.75 million."[36]

FINRA "ordered five firms to pay restitution estimated at more than $18 million, including interest, to affected customers for failing to waive mutual fund sales charges for eligible charitable organizations and retirement accounts."[37]

FINRA "ordered 12 firms to pay restitution totaling more than $4 million and fines totaling more than $2.6 million for failing to apply available sales charge discounts to customers' purchases of Unit Investment Trusts (UITs), and related supervisory failures."[38]

FINRA "ordered Wells Fargo Advisors, LLC, Wells Fargo Advisors Financial Network, LLC, Raymond James & Associates, Inc., Raymond James

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35. FINRA Press Release, *FINRA Sanctions Oppenheimer & Co. $2.9 Million for Unsuitable Sales of Non-Traditional ETFs and Related Supervisory Failures* (June 8, 2016), available at http://www.finra.org/newsroom/2016/finra-sanctions-oppenheimer-co-29-million-unsuitable-sales-non-traditional-etfs.

36. FINRA Press Release, *FINRA Sanctions Barclays Capital, Inc. $13.75 Million for Unsuitable Mutual Fund Transactions and Related Supervisory Failures* (Dec. 29, 2015), available at http://www.finra.org/newsroom/2015/finra-sanctions-barclays-capital-inc-1375-million-unsuitable-mutual-fund-transactions.

37. FINRA Press Release, *FINRA Orders an Additional Five Firms to Pay $18 Million in Restitution to Charities and Retirement Accounts Overcharged for Mutual Funds* (Oct. 27, 2015), available at http://www.finra.org/newsroom/2015/finra-orders-5-firms-pay-18-million-failing-waive-fund-sales-charges.

38. FINRA Press Release, *FINRA Sanctions 12 Firms a Total of $6.7 Million for Failing to Apply Sales Charge Discounts to Customers' Purchases of UITs* (Oct. 20, 2015), available at http://www.finra.org/newsroom/2015/finra-sanctions-12-firms-67-million-failing-apply-sales-charge-discounts-uits.

Financial Services, Inc. and LPL Financial LLC to pay more than $30 million in restitution, including interest, to affected customers for failing to waive mutual fund sales charges for certain charitable and retirement accounts."[39]

Variable Annuities:

FINRA "fined Houston-based VALIC Financial Advisors, Inc. (VFA), a total of $1.75 million for failing to identify and reasonably address certain conflicts of interest in the firm's compensation policy for instances when customers elected to move assets out of their VALIC variable annuities (VA), many of which were held in retirement plan accounts. The firm also failed to adequately supervise its VA business, including the sale of VAs with multiple share classes."[40]

FINRA "fined eight firms, including VOYA Financial Advisors, five broker-dealer subsidiaries of Cetera Financial Group, Kestra Investment Services, LLC, and FTB Advisors, Inc., a total of $6.2 million for failing to supervise sales of variable annuities (VAs). FINRA also ordered five of the firms to pay more than $6 million to customers who purchased L-share variable annuities with potentially incompatible, complex and expensive long-term minimum-income and withdrawal riders."[41]

FINRA "fined MetLife Securities, Inc. (MSI) $20 million and ordered it to pay $5 million to customers for making negligent material misrepresentations and omissions on variable annuity (VA) replacement applications for tens of thousands of customers. Each misrepresentation and omission made the replacement appear more beneficial to the customer, even

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39. FINRA Press Release, *FINRA Orders Wells Fargo, Raymond James, and LPL Financial to Pay More Than $30 Million in Restitution to Retirement Accounts and Charities Overcharged for Mutual Funds* (July 6, 2015), available at http://www.finra.org/newsroom/2015/finra-sanctions-wells-fargo-raymond-james-and-lpl-30-million.

40. FINRA Press Release, *FINRA Fines VALIC Financial Advisors, Inc. $1.75 Million for Failure to Prevent Conflicts of Interest in its Compensation Policy and for Other Supervisory Failures Related to Variable Annuity Sales* (Nov. 28, 2016), available at http://www.finra.org/newsroom/2016/finra-fines-valic-financial-advisors-inc-175-million-failure-prevent-conflicts.

41. FINRA Press Release, *FINRA Fines Eight Firms a Total of $6.2 Million for Supervisory Failures Related to Variable Annuity L-Shares* (Nov. 2, 2016), available at http://www.finra.org/newsroom/2016/finra-fines-eight-firms-total-62-million-supervisory-failures-related-variable-annuity.

though the recommended VAs were typically more expensive than customers' existing VAs. MSI's VA replacement business constituted a substantial portion of its business, generating at least $152 million in gross dealer commission for the firm over a six-year period."[42]

Puerto Rican securities:

FINRA "ordered Santander Securities LLC to pay approximately $4.3 million in restitution to certain customers who were solicited to purchase Puerto Rican Municipal Bonds (PRMBs). Additionally, the firm will pay restitution of $121,000 and make offers of rescission to buy back the securities sold to certain customers impacted by the firm's failure to supervise employee trading. FINRA also censured and fined Santander $2 million for supervisory failures related to sales of PRMBs and Puerto Rican closed-end funds, and for failing to reasonably supervise employee trading in its Puerto Rico branch office."[43]

FINRA "censured and fined UBS Financial Services Incorporated of Puerto Rico (UBS PR) $7.5 million for supervisory failures related to the suitability of transactions in Puerto Rican closed-end fund (CEF) shares. In addition, FINRA ordered UBS PR to pay approximately $11 million in restitution to 165 customers who were forced to realize losses on their CEF positions."[44]

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42. FINRA Press Release, *FINRA Sanctions MetLife Securities, Inc. $25 Million for Negligent Misrepresentations and Omissions in Connection With Variable Annuity Replacements* (May 3, 2016), available at http://www.finra.org/newsroom/2016/finra-sanctions-metlife-securities-inc-25-million-negligent-misrepresentations-and.

43. FINRA Press Release, *FINRA Sanctions Santander Securities LLC $6.4 Million for Supervisory Failures Related to Sales of Puerto Rican Bonds* (Oct. 13, 2015), available at http://www.finra.org/newsroom/2015/finra-sanctions-santander-64-million-pr-bond-supervisory-failures.

44. FINRA Press Release, *FINRA Sanctions UBS Puerto Rico $18.5 Million for Supervisory Failures Regarding Sales of Puerto Rican Closed-End Funds and Related Loans* (Sept. 29, 2015), available at http://www.finra.org/newsroom/2015/finra-sanctions-ubs-puerto-rico-185-million-supervisory-failures.

Other Complex Products:

FINRA "announced . . . that Albany, New York-based Purshe Kaplan Sterling Investments (PKS) will pay nearly $3.4 million in restitution to a Native American tribe, after the tribe paid excessive sales charges on purchases of non-traded Real Estate Investment Trusts (REITs) and Business Development Companies (BDCs). In addition to ordering restitution, FINRA fined PKS $750,000 for its failures to supervise the sales of these securities."[45]

FINRA "fined Merrill Lynch, Pierce, Fenner & Smith, Inc. $5 million for negligent disclosure failures in connection with the sale of five-year senior debt notes to retail customers. In particular, Merrill Lynch failed to adequately disclose certain costs, making it appear that the fixed costs were lower than they actually were."[46]

FINRA "censured LPL Financial LLC and fined it $10 million for broad supervisory failures in a number of key areas, including the sales of non-traditional exchange-traded funds (ETFs), certain variable annuity contracts, non-traded real estate investment trusts (REITs) and other complex products, as well as its failure to monitor and report trades and deliver to customers more than 14 million trade confirmations. In addition to the fine, FINRA ordered LPL to pay approximately $1.7 million in restitution to certain customers who purchased non-traditional ETFs. The firm may pay additional compensation to ETF purchasers pending a review of its ETF systems and procedures."[47]

FINRA "ordered RBC Capital Markets to pay a $1 million fine and approximately $434,000 in restitution to customers for supervisory failures resulting in sales of unsuitable reverse convertibles."[48]

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45. FINRA Press Release, *FINRA Orders Purshe Kaplan Sterling Investments to Pay $3.4 Million in Restitution to Native American Tribe; Firm Also Fined $750,000 for Failures to Supervise* (Feb. 22, 2017), available at http://www.finra.org/newsroom/2017/finra-orders-purshe-kaplan-sterling-pay-34-million-native-american-tribe.

46. FINRA Press Release, *FINRA Fines Merrill Lynch $5 Million for Failing to Disclose Material Facts in Sales of Volatility-Linked Structured Notes to Retail Customers* (June 23, 2016), available at http://www.finra.org/newsroom/2016/finra-fines-merrill-lynch-5-million-related-return-notes-sales.

47. FINRA Press Release, *FINRA Sanctions LPL Financial LLC $11.7 Million for Widespread Supervisory Failures Related to Complex Products Sales, Trade Surveillance and Trade Confirmations Delivery* (May 6, 2015), available at http://www.finra.org/newsroom/2015/finra-sanctions-lpl-117-million-widespread-supervisory-failures.

48. FINRA Press Release, *FINRA Orders RBC to Pay Fine and Restitution Totaling More Than $1.4 Million for Unsuitable Sales of Reverse Convertibles* (Apr. 23,

FINRA "fined Merrill Lynch, Pierce, Fenner & Smith Incorporated $1.9 million for fair pricing and supervisory violations in connection with more than 700 retail customer transactions in distressed securities over a two-year time period. Merrill Lynch was also ordered to pay more than $540,000 in restitution, plus interest, to affected customers."[49]

FINRA "fined Citigroup Global Markets Inc. $1.85 million for failing to provide best execution in approximately 22,000 customer transactions involving non-convertible preferred securities, and for related supervisory deficiencies for more than three years. FINRA also ordered Citigroup to pay more than $638,000 in restitution, plus interest, to affected customers."[50]

FINRA "fined LPL Financial LLC $950,000 for supervisory deficiencies related to the sales of alternative investment products, including non-traded real estate investment trusts (REITs), oil and gas partnerships, business development companies (BDCs), hedge funds, managed futures and other illiquid pass-through investments."[51]

FINRA "fined Berthel Fisher & Company Financial Services, Inc. and its affiliate, Securities Management & Research, Inc., of Marion, Iowa, a combined $775,000 for supervisory deficiencies, including Berthel Fisher's failure to supervise the sale of non-traded real estate investment trusts (REITs), and leveraged and inverse exchange-traded funds (ETFs)."[52]

2015), available at http://www.finra.org/newsroom/2015/finra-orders-rbc-pay-fine-and-restitution-totaling-more-14-million.

49. FINRA Press Release, *FINRA Fines Merrill Lynch $1.9 Million and Orders Restitutin of $540,000 for Fair Pricing and Supervisory Violations Related to Purchases of Distressed Securities* (Dec. 16, 2014), available at http://www.finra.org/newsroom/2014/finra-fines-merrill-lynch-19-million-and-orders-restitution-540000-fair-pricing.

50. FINRA Press Release, *FINRA Fines Citigroup Global Markets Inc. $1.85 Million and Orders Restitution of $638,000 for Best Execution and Supervisory Violations in Non-Convertible Preferred Securities Transactions* (Aug. 26, 2014), available at http://www.finra.org/newsroom/2014/finra-fines-citigroup-global-markets-inc-185-million-and-orders-restitution-638000.

51. FINRA Press Release, *FINRA Fines LPL Financial LLC $950,000 for Supervisory Failures Related to Sales of Alternative Investments* (Mar. 24, 2014), available at http://www.finra.org/newsroom/2014/finra-fines-lpl-financial-llc-950000-supervisory-failures-related-sales-alternative.

52. FINRA Press Release, *FINRA Fines Berthel Fisher and Affiliate, Securities Management & Research, $775,000 for Supervisory Failures Related to Sales of Non-Traded REITs and Leveraged and Inverse ETFs* (Feb. 24, 2014), available at

Firms struggle to ensure their suitability obligations are not overshadowed by the firm's own interests. Obviously, there is a cultural problem whereby the Suitability Rule, standing on its own, is not sufficient to provide investors with adequate protection. FINRA enforcement decisions and guidance have made clear that "a broker's recommendations must be consistent with his customers' best interests."[53] However, FINRA itself has recognized that a central failing it has observed is a firm not putting customers' interests first.[54] This is a significant issue. "The harm caused by this may be compounded when it involves vulnerable investors (e.g., senior investors) or a major liquidity or wealth event in an investor's life (e.g., an inheritance or Individual Retirement Account rollover). Poor advice and investments in these situations can have especially devastating and lasting consequences for the investor."[55]

The principal reason the Suitability Rule fails to ensure investors' interests come first is derived from the issues inherent in the compensation practices within the industry. PIABA's concern regarding improper compensation incentives is not novel. It has been recognized for some time that the compensation structure of the brokerage industry has the potential to harm investors. In 1995, the SEC released the Report of the Committee on Compensation Practices (the "Tully Report"), which recognized that paying brokers compensation that differed based on the product sold raised questions as to whether a broker rendered "objective advice or simply maximize[ed] commission income."[56] For example, a broker may choose to recommend B share mutual funds to a client, instead of lower cost A shares because the broker is paid more when B shares are sold.[57] Brokers may also recommend

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http://www.finra.org/newsroom/2014/finra-fines-berthel-fisher-and-affiliate-securities-management-research-775000.

53. *See* James S. Wrona, *The Best of Both Worlds: A Fact-Based Analysis of the Legal Obligations of Investment Advisers and Broker-Dealers and A Framework for Enhanced Investor Protection*, 68 Bus. Law. 1, 19, n. 137 (2012) (collecting sources).

54. FINRA 2015 Regulatory and Examination Priorities Letter (2015), available at http://www.finra.org/industry/2015-exam-priorities-letter.

55. *Id.*

56. SEC Committee on Compensation Practices, *Report on Broker-Dealer Compensation* (April 10, 1995) ("Tully Report"), available at https://www.sec.gov/news/studies/bkrcomp.txt.

57. *See e.g.*, *In Re Belden*, SEC Release No. 47859, 2003 WL 21088079 (May 14, 2003)("As a result of Book's purchase of Class B shares, Belden received significantly greater commissions than he would have received had Book purchased

transactions for the primary purpose of generating commissions for the broker.[58] Research has demonstrated that when investors purchase mutual funds through brokers, they pay more for the advice because of conflicts of interest.[59] There is evidence that brokers do not effectively manage these conflicts, and end up giving unfairly biased investment advice.[60]

In 2013, FINRA echoed the Tully Report's concerns when it released a report on conflicts of interest, praising brokerage firm efforts to mitigate the financial incentive to recommend one product over another.[61] However, conflicts persist and continue to harm investors. As demonstrated by the enforcement actions highlighted above, firms continue to offer unfairly biased advice.

Firms and brokers must be held to a higher standard than that imposed by the Suitability Rule so the culture of self-interest within the industry is replaced with one of well-earned trust and confidence. While FINRA endeavors to treat the Suitability Rule as a best interest conduct standard, the rule itself is silent

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the Class A shares. Indeed, as Belden testified, this is the precise reason that he recommended the Class B shares instead of the Class A shares. In short, Belden put his own interest before that of his customer.").

58. *See e.g.*, *In the Matter of the Application of Scott Epstein for Review of Disciplinary Action Taken by Finra*, SEC Release No. 59328, 2009 WL 223611 (Jan. 30, 2009)("The record shows that Epstein's mutual fund switch recommendations served his own interest by generating substantial production credits, but did not serve the interests of his customers. Epstein abdicated his responsibility for fair dealing when he put his own self-interest ahead of the interests of his customers.").

59. *See* Donald C. Langevoort, *Brokers As Fiduciaries*, 71 U. Pitt. L. Rev. 439, 448 (2009) ("There is evidence that investors pay significantly more for mutual fund investments sold via the broker channel, without receiving any better fund performance. The conflicts of interest here are clear enough-brokers are tempted to push high load shares, shares of funds that pay for "shelf space" (i.e., featured presence in brokers' recommendations) or of proprietary funds sponsored by the broker's firm, which are naturally more profitable for the firm."). *See also* White House Council of Economic Advisers, *The Effects of Conflicted Investment Advice on Retirement Savings* 10-14 (Feb. 2015) ("CEA Report"); available at https://obamawhitehouse.archives.gov/sites/default/files/docs/cea_coi_report_final.pdf.

60. *See* CEA Report, supra note 59.

61. FINRA, Report on Conflicts of Interest 26–30 (Oct. 2013) ("FINRA Conflicts Report"), http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf.

as to the firms' management of conflicts of interest. Brokers are told to recommend appropriate investments, they are not explicitly told that to do so, they must put their customer's interests ahead of their own and eliminate, to the extent possible, conflicts which may lead to unfairly biased advice. Brokers must be obligated to act in the best interests of the investor, which means placing investors' interests above their own and appropriately eliminating or at least managing the conflicts of interest that are pervasive throughout the industry. The Suitability Rule is not sufficient on its own to remove and manage these conflicts and ensure that brokers have acted in their clients' best interests.

Conflicted advice causes substantial harm to investors. Just looking at retirement savers, SaveOurRetirement.com estimates that investors lose between $57 million and $117 million every day due to conflicted investment advice, amounting to at least $21 billion annually.[62] The Council of Economic Advisers estimate retirement investors are suffering $17 billion in losses annually due to conflicted advice they receive from financial advisors.[63] Something more than the Suitability Rule is needed to ensure that investors are protected, and have an appropriate remedy if a firm or broker fails to adhere to the requisite standards.

Question: *Is there a trend in the provision of retail investment advice toward a fee-based advisory model and away from a commission-based brokerage model? To what extent has any observed trend been driven by retail investor demand, dependability of fee-based income streams, regulations, or other factors? To what extent is any observed trend expected to continue, and what factors are expected to drive the trend in the future? How has any observed trend impacted the availability, quality, or cost of investment advice, as well as the availability, quality, or cost of other investment products and services, for retail investors? Does any such trend raise new risks for retail investors? If so, how should these risks affect the Commission's consideration of potential future action?*

Following the adoption of the Department of Labor's Conflict of Interest Rule (the "DOL Rule"), many thought firms would shift to the fee-based advisory model to avoid the need to comply with the Rule's Best Interest

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62. *See* Save our Retirement, *Comment Letter to the Dep't of Labor* (May 8, 2015), available at http://saveourretirement.com/cms/wp-content/uploads/2015/02/DOL-SOR-Letter-Comment-Period-Request-5-8-15.pdf.

63. *See* CEA Report, *supra* note 59. "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.

Contract Exemption. However, firms continue to offer a wide variety of options to retirement investors. Many of the large brokerage firms will continue to offer commission-based alternatives for their clients, including Merrill Lynch, Morgan Stanley, Wells Fargo Advisors, LPL Financial, Raymond James, UBS and Edward Jones.[64] Some firms will offer primarily fee-based accounts, but will offer self-directed accounts and the use of robo-advisers for those investors who want to pay transaction based fees.[65] Some firms are tweaking their existing options to ensure compliance with the DOL Rule's requirements, by changing account minimums and fees.[66] Some firms are incorporating the option of robo-advice more broadly for retirement accounts.[67] UBS has announced it will shift how it compensates advisors to mitigate conflicts of interest rather than changing what it offers investors.[68]

The vast majority of brokerage firms and financial advisors have stated, without equivocation, that they will continue to offer the full panoply of financial products to small investors, once the DOL Rule 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 DOL Rule goes into effect, including, but not limited to, mutual funds and exchange traded products.[69] 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 DOL Rule goes into effect.[70] Likewise, Edward Jones

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64. Michael Wursthorn, *A Guide to Brokers' Retirement-Account Plans*, Wall Street Journal (May 23, 2017), available at https://www.wsj.com/articles/a-guide-to-brokers-retirement-account-plans-1495558474?tesla=y&mg=prod/accounts-wsj.

65. E.g., Merrill Lynch and JP Morgan Chase. *See id.*

66. E.g., Morgan Stanley, Wells Fargo, LPL Financial, Raymond James, and Edward Jones. *See id.*

67. E.g., Wells Fargo, LPL Financial, and Raymond James. *See id.*

68. Bruce Kelly, *UBS latest to shift broker compensation ahead of DOL fiduciary rule*, Investment News (June 2, 2017), available at http://www.investmentnews.com/article/20170602/FREE/170609979/ubs-latest-to-shift-broker-compensation-ahead-of-dol-fiduciary-rule.

69. 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.

70. Andrew Welsch, *Raymond James Follows Morgan's Lead in Keeping Commissions Under Fiduciary Rule*, OnWallStreet.com (Oct. 27, 2016), available at https://www.onwallstreet.com/news/raymond-james-follows-morgans-lead-in-

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.[71] A recent survey of representatives affiliated with 14 major independent brokerage firms 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 DOL Rule.[72] 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.[73]

Several brokerage firms have also reduced their fees for small investors and/or account minimums, in response to the DOL Rule. As a result, the DOL Rule has benefitted small investors by providing them with lower fees, and access to services and accounts, which 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.[74] 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.[75] In addition, Edward Jones will continue to have a minimum investment requirement of $5,000 for its Guided Solutions Fund Account.[76] Similarly, LPL Financial has announced that it will be reducing the account minimum for its Optimum Market Portfolios from $15,000 to $10,000, in anticipation of the DOL Rule.[77] Charles Schwab has also recently

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keeping-commissions-under-dol.

71. Andrew Welsch, *Fiduciary Ready: Edward Jones Unveils Compliance Plans*, OnWallStreet.com (Aug. 19, 2016), available at https://www.onwallstreet.com/news/fiduciary-ready-edward-jones-unveils-compliance-plans.

72. Diana Britton, *Delay or not IBDs Moving Toward a Fiduciary Future*, WealthManagement.com (Apr. 5, 2017), available at http://www.wealthmanagement.com/industry/delay-or-not-ibds-moving-toward-fiduciary-future.

73. *Id.*

74. Greg Iacurci & Christine Idzelis, *Broker-dealer Split on Commissions in Wake of DOL Fiduciary Rule*, Investment News (Oct. 30, 2016), available at http://www.investmentnews.com/article/20161030/FREE/161029902/broker-dealers-split-on-commissions-in-wake-of-dol-fiduciary-rule.

75. Welsch, *supra* note 71.

76. *Id.*

77. Janet Levaux, *LPL Cuts Prices, Account Minimums Ahead of DOL Fiduciary*

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.[78]

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 DOL Rule goes into effect.[79] These representatives reported that they believe that they can operate in the best interest of their clients, while still offering commission based products.[80]

In short, investors continue to have the full range of products and services available to them. Any standards adopted by the SEC should acknowledge that conflicts of interest are pervasive throughout the industry and firms will continue to face challenges when trying to balance the interests of their clients with those conflicts. Any standards adopted should require mitigation of conflicts of interest to the extent possible.

Question: *As of the applicability date of the Fiduciary Rule, there will be different standards of conduct for accounts subject to the Department of Labor's rule and those that are not, as well as existing differences between standards of conduct applicable to broker-dealers and those applicable to investment advisers when providing investment advice. What are the benefits and costs of having multiple standards of conduct?*

Investment advisers and brokers may be held to different standards even when they provide similar personal investment advice to their retail clients. Investment advisers are principally governed by the Investment Advisers Act of 1940 (the "Advisers Act").[81] Under the Advisers Act, an investment adviser owes a fiduciary duty to its clients. This includes an affirmative duty of utmost

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Rule, ThinkAdvisor.com (Mar. 16, 2016), available at http://www.thinkadvisor.com/2016/03/16/lpl-cuts-prices-account-minimums-ahead-of-dol-fidu.

78. Charles Schwab Press Release, *Schwab Announces Schwab Intelligent Advisory* (Dec. 13, 2016), available at http://pressroom.aboutschwab.com/press-release/schwab-investor-services-news/schwab-announces-schwab-intelligent-advisory.

79. Britton, *supra* note 72.

80. *Id.*

81. 15 U.S.C. § 80b-1, *et seq.*

good faith, and full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading clients. The Advisers Act represents a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.[82]

Brokers are governed by the Securities Exchange Act of 1934,[83] and conduct rules promulgated by the Financial Industry Regulatory Authority (FINRA), as well as state statutory and common law. Unlike their investment-adviser counterparts, brokers who provide personalized investment advice are held to the "suitability standard" found in the Suitability Rule if state law does not otherwise impose a fiduciary duty.[84] The suitability standard only requires the broker to "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile."[85]

Adopted in 2016, the DOL Rule expanded the scope of fiduciary duty for persons who provide financial advice to retirement investors.[86] The DOL has expanded the scope of the fiduciary definition to better protect ERISA plan participants, beneficiaries and IRA owners from "conflicts of interest, imprudence, and disloyalty."[87] The DOL adopted new exemptions, intended to preserve existing business models, including the Best Interest Contract Exemption.[88] However, brokers and investment advisers acting pursuant to the exemption are bound by the "impartial conduct standard."[89] The impartial conduct standard includes giving prudent advice in the investor's best interest,

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82. *Sec. Exch. Comm'n v. Capital Gains Research Bureau*, 375 U.S. 180, 192 (1963).

83. 15 U.S.C. § 78a, *et seq*.

84. *See* FINRA Rule 2111.

85. *Id.*

86. Dep't of Labor, *Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice; Final Rule*, 81 Fed. Reg. 20,946 (Apr. 8, 2016) ("DOL Final Rule"), available at http://webapps.DOL.gov/FederalRegister/PdfDisplay.aspx?DocId=28806.

87. *Id.*

88. *Id.*

89. *Id.* at 20,947.

avoiding misleading statements, and charging no more than a reasonable amount.[90]

The lack of a uniform standard of conduct creates a discrepancy between the law and investors' reasonable expectations. As discussed above, investors expect brokers to act as their fiduciary based on the brokerage firms' advertisements that promise the investors disinterested investment advice.[91] Such promises of impartial investment advice create a reasonable expectation of a fiduciary duty,[92] which must be protected under the principles of agency law and contract law. [93] Indeed, as discussed above, empirical studies have shown that investors are likely to believe that brokers are fiduciaries: in one study, more than 60% of the survey participants believed that brokers have a fiduciary duty.[94]

However, the fact remains that the law recognizes that there can be differences in the duties owed by investment advisers and brokers. Brokers may provide advice with significant conflicts of interest present, notwithstanding that the investors believe the broker is acting in their best interests. The courts will often look to the regulatory structure governing the broker rather than the investors' expectations. For example, in *Thomas v. Metropolitan Life Insurance Co,* investors brought a claim under section 80b-6 of the Advisers Act. [95] The investors alleged that the broker with an insurance company who advised the plaintiffs on investing their retirement funds made material omissions concerning the company's conflicts of interest which were created by the company's commission structure, fees, job-retention policies, and other incentives.[96] The court, however, upheld the district court's dismissal

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90. *Id.*

91. *See* Arthur B. Laby, *Selling Advice and Creating Expectations: Why Brokers Should Be Fiduciaries,* 87 WASH. L. REV. 707, 764-66 (2012) (documenting that brokerage firms have long advertised that they provide personalized advice); *see also* PIABA Study, supra note 22.

92. Laby, *supra* note 91, at 767–71 (2012) (citing dissenting opinion of *SEC v. Capital Gains Research Bureau, Inc.*, 306 F.2d 606, 617 (2d Cir. 1962) upheld by the U.S. Supreme Court in 375 U.S. 180).

93. Laby, *supra* note 91, at 760 (2012).

94. Laby, *supra* note 91, at 751 (2012) (citing the CFA Survey and the RAND Report, *see* discussion of SEC Study, *supra*).

95. *Thomas v. Metro. Life Ins. Co.,* 631 F.3d 1153 (10th Cir. 2011).

96. *Thomas v. Metro. Life Ins. Co.*, No. CIV-07-0121-F, 2008 WL 4619822, at *1 (W.D. Okla. Oct. 16, 2008).

of the Advisers Act claim and concluded that the representative was a broker who did not owe a fiduciary duty to the retail investors.[97] The outcome in *Thomas* is typical of the instances where investors suffer from conflicted advice and fail to obtain a judicial remedy.

In a 2015 study, the White House found that costs of conflicted advice are hefty: annual costs for retirement savers of $17 billion.[98] The White House estimates were based on the assumption that there were $1.7 trillion in retirement assets invested in mutual funds and annuities, and had calculated the costs based on the investment into those asset classes.[99] However, it is estimated that approximately $3.3 trillion is invested in IRAs, meaning retirement savers may be losing $33 billion per year if the same assumptions regarding the cost of conflicts are made.[100]

Even the industry agrees that a uniform fiduciary standard for brokers and dealers and its uniform examination are necessary.[101] Maintaining a uniform standard of conduct would lessen the compliance costs for brokerage firms who are also registered as investment advisers. Those savings could be significant, considering the number of dually registered brokerage firms: the SEC found in 2011 that 88% of investment adviser representatives are also registered representatives of broker-dealer firms.[102] The harmonization of standards would allow these dual registrants to save compliance costs that result from working under two sets of regulations.

Without a uniform fiduciary duty, retail investors remain vulnerable to conflicted advice and a legal imbalance in available judicial remedies. Without uniform standards, persons seeking financial advice are left to fend for themselves in deciding whether their financial advisor is serving two masters or only one, and whether one of those masters is the advisor's financial self-

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97. *Thomas*, 631 F.3d at 1166.

98. CEA Report, *supra* note 59.

99. *See id.* at 19.

100. *See id.*

101. *See Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals to Improve Investment Adviser Oversight*, Hearings Before the H. Subcomm. on Capital Mkts. and Gov't Sponsored Enters., 112th Cong. 21 (2011) (statement of John Taft, Chairman, The Securities Industry and Financial Markets Association [SIFMA]), available at https://financialservices.house.gov/uploadedfiles/112-58.pdf.

102. SEC Study, *supra* note 4 at12 (citing letter from Angela C. Goelzer, FINRA, dated Nov. 3, 2010).

interest. Investors are unjustly burdened with the cost from conflicted advice. For this reason, consumer advocates have voiced their support to impose a heightened standard of conduct on the brokerage firms and individuals who provide personalized investment advice to investors.[103]

Differences in the standards applicable to brokers and investment advisers, and now, those advising retirement investors, should be eliminated. The SEC should consider adopting a standard no less stringent than that adopted by the DOL.

Question: *If the Commission were to proceed with a disclosure-based approach to potential regulatory action, what should that be? If the Commission were to proceed with a standards-of-conduct-based approach to potential regulatory action, what should that be? Should the standards for investment advisers and broker-dealers be the same or different? Why?*

Disclosure has been the hallmark of the securities industry. However, the effectiveness of disclosure is questionable. For example, studies in the field of behavioral economics have been applied to disclosure issues.[104] There are a number of cognitive biases that may influence investors, including "the hindsight bias, the (flawed) reliance on heuristics (including the availability heuristic), the presence of overconfidence and overoptimism, the endowment effect (and other framing related biases), and the confirmation bias."[105] Other research has argued that "not only may disclosure of conflicts of interest provide no additional protection to beneficiaries, but it may actively encourage both beneficiaries and advisers to ignore the conflicts."[106] Other studies have found the disclosure may lead to more biased advice. For example, if a broker has "just done something upfront and honest (disclosed conflicts of interest),

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103. *See Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals to Improve Investment Adviser Oversight*, Hearings Before the H. Subcomm. on Capital Mkts. and Gov't Sponsored Enters., 112th Cong. 128 (2011) (statement of Barbara Roper, Director of Investor Protection, Consumer Federation of America), available at https://financialservices.house.gov/uploaded files/112-58.pdf.

104. *See* Francis J. Facciolo, *Do I Have A Bridge for You: Fiduciary Duties and Investment Advice*, 17 U. Pa. J. Bus. L. 101, 110 (2014)

105. *Id.* (citing Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 Stan. L. Rev. 1, 7-9 (2003)).

106. *Id.* at 111 (citing Daylian M. Cain et al., *When Sunlight Fails to Disinfect: Understanding the Perverse Effects of Disclosing Conflicts of Interests*, 37 J. Consumer Res. 836, 837 (2011) (discussing prior research)).

they may tend to unconsciously give themselves moral license to take a little advantage of their customers."[107]

The SEC's own studies of the financial literacy of investors suggest that disclosure is insufficient to protect investors.[108] The SEC's Financial Literacy Study recognized that:

According to the Library of Congress report, studies consistently show that American investors lack basic financial literacy. For example, studies have found that investors do not understand the most elementary financial concepts, such as compound interest and inflation. Moreover, many investors do not understand other key financial concepts, such as diversification or the differences between stocks and bonds, and are not fully aware of investment costs and their impact on investment returns. According to the Library of Congress report, studies show that investors lack critical knowledge that would help them protect themselves from investment fraud. In particular, surveys demonstrate that certain subgroups, including women, African-Americans, Hispanics, the oldest segment of the elderly population, and those who are poorly educated, have an even greater lock of investment knowledge than the average general population.[109]

The Financial Literacy Study identified: "(i) methods to improve the timing, content, and format of disclosures; (ii) useful and relevant information for investors to consider when either selecting a financial intermediary or purchasing an investment product; and, (iii) methods to improve the transparency of expenses and conflicts of interest."[110]

It is important to note that mere disclosure is not sufficient to protect an investor or for a broker or investment adviser to satisfy his obligations to an

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107. Robert A. Prentice, Moral Equilibrium: Stock Brokers and the Limits of Disclosure, 2011 Wis. L. Rev. 1059, 1099 (2011) (citing Max H. Bazerman & Ann E. Tenbrunsel, *Blind Spots: Why We Fail To Do What's Right and What To Do About It* 116 (2011)).

108. See SEC Office of Investor Education and Advocacy, *Study Regarding Financial Literacy Among Investors* (August 2012) (the "Financial Literacy Study"), available at http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf.

109. *Id.* at 15 (citing Federal Research Division, Library of Congress, Financial Literacy Among Retail Investors in the United States (Dec. 30, 2011), attached to the Financial Literacy Study as Appendix 1).

110. *Id.* at Executive Summary, iii-vi.

investor.[111] Disclosures must be set forth in plain English. If the risks or the conflict cannot be adequately expressed to be fully understood by the client, the disclosure is meaningless.

Based on the overall ineffectiveness of disclosure, conflicts of interest cannot be wholly mitigated through disclosure. To the extent the SEC wishes to incorporate disclosure into its rulemaking, the SEC should look to Nevada's statutory fiduciary duty, which contains a disclosure requirement. That provision requires that "[a] financial planner shall disclose to a client, at the time advice is given, any gain the financial planner may receive, such as profit or commission, if the advice is followed."[112]

This form of disclosure may help customers assess any conflicts of interest. As the compensation to the recommending agent increases, we expect that investors will grow increasingly skeptical of the recommendations.

If the SEC were to proceed with a standards-of-conduct-based approach to potential regulatory action, it should follow the recommendation the SEC staff gave in 2012, when it recommended that "the standard of conduct for all . . . providing personalized investment advice about securities to retail customers . . . shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice."[113] Any standard adopted should be no less stringent than the DOL Rule.

The standards of conduct for brokers and investment advisers should be the same. Inconsistent standards generate needless confusion and create opportunities for intermediaries to profit through regulatory arbitrage by shifting transactions from one governing standard to another. As discussed above, many studies establish that the public does not understand the regulatory distinctions between brokers and investment advisers. Most investors already believe their investment professional owes them a fiduciary

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111. *See In re Dept. of Enforcement v. Gerald J. Kesner Lakewood, Co.*, 2010 WL 781456, *9 (FINRA 2010); *see also In re Chase*, SEC Release No. 34-47476, 2003 WL 917974, *4 (SEC 2003) ("Mere disclosure of risks is not enough. A registered representative must 'be satisfied that the customer fully understands the risks involved and is ... able ... to take those risks.'" (quoting *In re Patrick G. Keel*, SEC Release No. 34-31716, 1993 WL 12348 (SEC 1993))).

112. Nev. Rev. Stat. Ann. § 628A.020.

113. SEC Study, *supra* note 4 at 109-10 (Jan. 2011).

duty. A harmonious standard for investment advice would reduce the opportunity for confusion and exploitation.[114]

Question: *If the Commission were to impose new requirements, should private remedies be available for violations of any new requirements? If so, in what venue or venues should such claims be brought? Should the Commission establish uniform rules, or should parties determine available remedies by contract, so long as not inconsistent with the securities laws?*

Private Remedies Should be Available for Violations of New Fiduciary Requirements

Private remedies should be available to the retail customers for violations of any new requirements the SEC imposes. A private right of action can supplement an agency's public enforcement.[115] Reinforcing the new rule through private remedies is also consistent with the overarching goal of the securities laws and regulations—which is to protect investors. Investors should have the ability to protect themselves through a private right of action. A fiduciary relationship is a relationship of trust between the financial advisor and the investor. When that trust is broken, investors must have a remedy available to them, else the fiduciary standard becomes meaningless.

It is not as though private remedies for securities sales violations are rare. Private remedies are available throughout the securities laws: Customers can sue under sections 11[116] and 12[117] of the Securities Act of 1933; under sections 21D,[118] 21F,[119] and 29[120] of the Securities Exchange Act of 1934. Additionally,

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114. *See* Christine Lazaro & Benjamin P. Edwards, *The Fragmented Regulation of Investment Advice: A Call for Harmonization*, 4 Mich. Bus. & Entrepreneurial L. Rev. 47, 52 (2014) (explaining that "harmonizing standards for investment advice is the best solution to address the shortcomings of the existing regulatory systems").

115. *See* Richard B. Stewart and Cass R. Sunstein, *Public Programs and Private Rights*, 95 Harv. L. Rev. 1193, 1214 (1982).

116. 15 U.S.C. § 77k (civil liabilities on account of false registration statement).

117. 15 U.S.C. § 77l (civil liabilities arising in connection with prospectuses and communications).

118. 15 U.S.C. § 78u-4 (private securities litigation).

119. 15 U.S.C. § 78u-6 (securities whistleblower incentives and protection).

120. 15 U.S.C. § 78j (manipulative and deceptive devices).

investors can arbitrate under the rules promulgated by the FINRA if the contract provides for arbitration or the customer demands it.[121]

In order to fully and efficiently achieve the Congressional purpose to protect the investor, it is imperative that the SEC provide the private remedy for the violations of the rule upfront. Recognizing private remedies through judicial gloss of the "implied-right-of-action" has proved to be inefficient and limited in scope. Although Rule 10b-5 was first written in 1948,[122] it was not until 1971 that the United States Supreme Court recognized the private right of action for securities fraud pursuant to Rule 10b-5.[123] To avoid the unnecessary delay and ambiguities in protecting the investor's rights, the SEC should make private remedies explicit and available with the new regulation.

The SEC Should Establish Uniform Rules to Govern the Private Remedies

Retail consumers often lack the information and the bargaining power necessary to obtain fair contractual terms.[124] The SEC should establish uniform rules to govern the private remedies so that investors can benefit most from the new regulation.

Contractual limitation of remedies should be prohibited because they carry the risk of emasculating the fiduciary duty, or significantly reducing the protections to the retail investor. Therefore, it is necessary that the SEC establish a uniform rule to provide the retail investors with safeguards that protect them against unfair contract terms. Current laws and regulations

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121. FINRA Rules 10300 *et seq*.

122. Employment of Manipulative and Deceptive Devices, 13 Fed. Reg. 8,183 (Dec. 22, 1948), *amended by* 16 Fed. Reg. 7,928 (Aug. 11, 1951).

123. In 1964, the Supreme Court first took a permissive approach in *J. I. Case Co. v. Borak*, recognizing implied right to private actions upon finding that private remedies were necessary to effectuate congressional purpose to protect the investors. *See*, 377 U.S. 426, 433 (1964). Then it took another seven years before the Supreme Court expressly recognized the private remedies for the violations of Rule 10b-5 in *Superintendent of Ins. of State of N. Y. v. Bankers Life & Cas. Co*. 404 U.S. 6, 13 n.9 (1971).

124. *See* Stacy-Ann Evy, *Contracting in the Age of the Internet of Things: Article 2 of the UCC and Beyond* 44 Hofstra L. Rev. 839, 893–94 (2016) (on information asymmetry); *see generally*, Albert Choi and George Triantis, *The Effect of Bargaining Power on Contract Design*, 98 Va. L. Rev. 1665 (2012) (on how bargaining power asymmetry impacts contract design of nonprice terms).

already place some safeguards against contractual provisions that purport to limit the damages where the private right of action is allowed. Indemnification provisions that violate the SEC's public policy are unenforceable,[125] and provisions that limit the scope of liability or damages in violation of the existing laws and regulations are invalid.[126] Consistent with these existing principles, the SEC should consider disallowing contractual provisions that purport to indemnify the brokers from breach of fiduciary duties, limit the damages to net out-of-pocket losses, or confine the scope of liability to grossly negligent conduct.

Further, the Commission should prohibit mandatory class-action waivers by exercising its authority under section 15 of the Securities Exchange Act of 1934[127] to prohibit mandatory pre-dispute arbitration clauses.[128] Evidentiary burdens to prove breach of fiduciary duty can be too expensive for a single plaintiff to bear.[129] Therefore, pre-dispute class-action waivers could be cost-prohibitive for financially-harmed investors to seek private remedies.[130] Promulgating a rule that prohibits class action waivers is consistent with, and would solidify, FINRA's decision that a firm's practice requiring customers to waive their rights to bring class claims against member firms violates FINRA's rules.[131]

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125. 17 C.F.R. § 230.484 (2017).

126. *See* 15 U.S.C. § 78cc.

127. *See* 15 U.S.C. § 78o(o).

128. *See id.* (The SEC can prohibit or limit mandatory pre-dispute arbitration when doing so would be "in the public interest and for the protection of consumers.")

129. For example, in ERISA breach of fiduciary duty cases, the courts have required plaintiffs to prove breach of fiduciary duty itself and the causal nexus between the breach and the loss in investment. *See, e.g.*, Holdeman v. Devine, 572 F.3d 1190, 1194 (10th Cir. 2009).

130. Proving the requisite causations can be difficult. *See* Lauren N. Fromme, *Unreliable Securities for Retirement Income Security: Certifying the ERISA Stock-Drop Class*, 64 VAND. L. REV. 301, 328 (2011). To meet the evidentiary burden, expensive expert fees may be necessary for a plaintiff to prevail her claim. Thus, class actions can be cost-prohibitive to individual plaintiffs.

131. *In the Matter of Department of Enforcement v. Charles Schwab & Company, Inc*. FINRA Complaint No. 2011029760201 (April 24, 2014).

Conclusion

PIABA thanks the SEC for the opportunity to comment on this important issue. PIABA looks forward to the SEC's rulemaking designed to unify the standards applicable to brokers and investment advisers.

Very truly yours,
Marnie C. Lambert
PIABA President

The following PIABA Comment Letter regarding the *RIN 1210-AB82; Request for Information Regarding the Fiduciary Rule and Prohibited Transaction Exemptions* was submitted to the Employee Benefits Security Administration by Marnie C. Lambert on August 7, 2017 (prepared with the assistance of Teresa Verges).

Office of Exemption Determinations
Employee Benefits Security Administration
Attn: D-11933
U.S. Department of Labor
200 Constitution Avenue, N.W., Suite 400
Washington, D.C. 20210

Re: RIN 1210-AB82; Request for Information Regarding the Fiduciary Rule and Prohibited Transaction Exemptions

To Whom It May Concern:

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

The Department of Labor is examining the Conflict of Interest Rule (the "Rule") and accompanying prohibited transaction exemptions (the "PTEs"). In furtherance of that examination, the Department seeks input the may "form the basis of new exemptions or changes/revisions to the rule and PTEs."[1] PIABA strongly opposes any changes or revisions which would eliminate or minimize the investor protections contained in the current Rule and PTEs.

1. Dep't of Labor, *Request for Information Regarding the Fiduciary Rule and Prohibited Transaction Exemptions*, 82 Fed. Reg. 31278 (July 6, 2017) ("Request for Information"), available at https://www.federalregister.gov/documents/2017/07/06/2017-14101/request-for-information-regarding-the-fiduciary-rule-and-prohibited-transaction-exemptions.

PIABA has commented on the Department's efforts in connection with the Rule and PTEs several times over the past seven years.[2] PIABA has also testified during the Department's public hearing on the Rule and PTEs.[3] Throughout this time period, PIABA has supported the Department's efforts to ensure that those who provide retirement advice are held to the standards originally contemplated within the Employee Retirement Income Security Act (ERISA). PIABA remains hopeful that the result of those efforts, the Rule and PTEs, will not be undone in response to complaints within the industry that it is not practical to act in the best interests of clients.

The Department has asked a number of questions in its request. We have chosen to focus on four of the questions.

Question 3: *Do the Rule and PTEs appropriately balance the interests of consumers in receiving broad-based investment advice while protecting them from conflicts of interest? Do they effectively allow Advisers to provide a wide range of products that can meet each investor's particular needs?*

Pursuant to the Rule and PTEs as currently drafted, investors will be able to receive a wide range of investment advice, while also receiving some protection from the myriad conflicts within the financial services industry.

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2. *See*, PIABA, *Comment Letter to the Dep't of Labor* (Feb. 3, 2011), available at https://piaba.org/system/files/comment_letter_pdfs/DOL%20-%20%20Definition%20of%20the%20Term%20Fiduciary,%20Feb%203%202011.pdf; 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; PIABA, *Comment Letter to the Dep't of Labor* (Mar. 17, 2017), available at https://piaba.org/system/files/comment_letter_pdfs/DOL%20Comment%20Letter,%20RIN%201210-AB79%20(March%2017,%202017).pdf; PIABA, *Comment Letter to the Dep't of Labor* (Apr. 17, 2017), available at https://piaba.org/system/files/comment_letter_pdfs/DOL%20Comment%20Letter,%20RIN%201210-AB79%20(April%2017,%202017).pdf; PIABA, *Comment Letter to the Dep't of Labor* (July 21, 2017), available at https://piaba.org/system/files/comment_letter_pdfs/DOL%20Comment%20Letter,%20RIN%201210-AB82%20(July%2021,%202017).pdf.

3. Joseph Peiffer, *Statement for the Record Submitted to the United States Department of Labor Employee Benefits Security Administration On Conflict of Interest Proposed Rule Public Hearing* (Aug. 11, 2015), available at https://piaba.org/piaba-newsroom/congressional-testimony-statement-record-submitted-united-states-department-labor-emp.

Many of the large brokerage firms will continue to offer commission-based alternatives for their clients, including Merrill Lynch, Morgan Stanley, Wells Fargo Advisors, LPL Financial, Raymond James, UBS and Edward Jones.[4] Firms have varied on their approach to compliance with the requirements of the Rule and PTEs. Some firms will offer fee-based accounts and allow those who want to pay transaction based fees do so through a self-directed account or with the use of a robo adviser.[5] Some are tweaking their existing options to ensure compliance with the requirements of the BIC exemption.[6] Some firms are incorporating the option of robo advice more broadly for retirement accounts.[7] UBS has announced it will shift how it compensates advisors rather than changing what it offers investors.[8]

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.[9] These representatives reported that they believe that they can operate in the best interest of their clients, while still offering commission based products.[10] 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.[11]

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4. Michael Wursthorn, "A Guide to Brokers' Retirement-Account Plans," Wall Street Journal (May 23, 2017), available at https://www.wsj.com/articles/a-guide-to-brokers-retirement-account-plans-1495558474?tesla=y&mg=prod/accounts-wsj.

5. E.g., Merrill Lynch and JP Morgan Chase. *See id.*

6. E.g., Morgan Stanley, Wells Fargo, LPL Financial, Raymond James, and Edward Jones. *See id.*

7. E.g., Wells Fargo, LPL Financial, and Raymond James. *See id.*

8. Bruce Kelly, "UBS latest to shift broker compensation ahead of DOL fiduciary rule," Investment News (June 2, 2017), available at http://www.investment news.com/article/20170602/FREE/170609979/ubs-latest-to-shift-broker-compensation-ahead-of-dol-fiduciary-rule.

9. Diana Britton, "Delay or not IBDs Moving Toward a Fiduciary Future", WealthManagement.com (Apr. 5, 2017), available at http://www.wealth management.com/industry/delay-or-not-ibds-moving-toward-fiduciary-future.

10. *Id.*

11. Greg Iacurci & Christine Idzelis, Broker-dealer Split on Commissions in Wake of DOL Fiduciary Rule", Investment News (Oct. 30, 2016), available at http://www.investmentnews.com/article/20161030/FREE/161029902/broker-dealers-split-on-commissions-in-wake-of-dol-fiduciary-rule.

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.[12]

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 traded products.[13] 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.[14] 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.[15] A recent survey of representatives affiliated with 14 major independent brokerage firms 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.[16] 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.[17]

Several brokerage firms have also reduced their fees for small investors and/or 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

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12. *Id.*; Andrew Welsch, "Raymond James Follows Morgan's Lead in Keeping Commissions Under Fiduciary Rule", OnWallStreet.com (Oct. 27, 2016), available at https://www.onwallstreet.com/news/raymond-james-follows-morgans-lead-in-keeping-commissions-under-dol.

13. Jim Wiggins, "Morgan Stanley to Preserve Client Choice for Retirement Accounts", Morgan Stanley.com/press releases (Oct. 26, 2016), available at https://www.morganstanley.com/press-releases/morgan-stanley-to-preserve-client-choice-for-retirement-accounts.

14. Welsch, *supra* note 12.

15. Andrew Welsch, "Fiduciary Ready: Edward Jones Unveils Compliance Plans", OnWallStreet.com (Aug. 19, 2016), available at https://www.onwallstreet.com/news/fiduciary-ready-edward-jones-unveils-compliance-plans.

16. Britton, *supra* note 9.

17. *Id.*

services and accounts, which 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.[18] 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.[19] In addition, Edward Jones will continue to have a minimum investment requirement of $5,000 for its Guided Solutions Fund Account.[20] Similarly, LPL Financial has announced that it will be reducing the account minimum for its Optimum Market Portfolios from $15,000 to $10,000, in anticipation of the Rule.[21] 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.[22]

The lack of any adverse impact to small investors from a fiduciary rule is further borne out by an extensive study that was done in 2012, 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 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.[23] This study found no statistical difference

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18. Iacurci & Idzelis, *supra* note 11.

19. Welsch, *supra* note 15.

20. *Id.*

21. Janet Levaux, "LPL Cuts Prices, Account Minimums Ahead of DOL Fiduciary Rule", ThinkAdvisor.com (Mar. 16, 2016), available at http://www.think advisor.com/2016/03/16/lpl-cuts-prices-account-minimums-ahead-of-dol-fidu.

22. Michael Cianfrocca, "Schwab Announces Schwab Intelligent Advisory", Charles Schwab press release (Dec. 13, 2016), available at http://pressroom.about schwab.com/press-release/schwab-investor-services-news/schwab-announces-schwab-intelligent-advisory.

23. 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-

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.[24] 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 which do not have a fiduciary standard, that they provide a broad range of products to such clients, and that they allow for commission based compensation.[25]

In short, the anticipation of the Rule has not resulted in any meaningful reduction of options for investors. In fact, it has resulted in firms accelerating their development of robo-advisers, offering additional options for investors. As a result of the Rule and PTEs, brokerage firms will be offering more services and investment products to small investors than they did prior to the enactment of the Rule.

Question 5: *What is the likely impact on Advisers' and firms' compliance incentives if the Department eliminated or substantially altered the contract requirement for IRAs? What should be changed? Does compliance with the Impartial Conduct Standards need to be otherwise incentivized in the absence of the contract requirement and, if so, how?*

PIABA strongly opposes the elimination or substantial alteration of the written contract requirement because it provides the *sole* enforcement mechanism to ensure firms' compliance with the Impartial Conduct Standards. The Department recognized after years of research and study that the significant costs to retirees of conflicted advice, combined with the fundamental shift of retirement assets to IRAs and non-ERISA plans, required imposition of fiduciary standards on financial advisors providing retirement investment advice. The Impartial Conduct Standards and related requirements of the PTEs represent an appropriate accommodation between protecting investors and allowing firms to continue receiving most forms of compensation that would otherwise be prohibited under the conflict of interest rule. However, these standards would be rendered meaningless without an enforcement mechanism. The department rightly described this requirement as a "critical safeguard" with respect to investments in IRAs and non-ERISA retirement plans.[26]

Dealer%20Fiduciary%20Standard%20on%20Financial%20Advice.aspx.

24. *Id.*

25. *Id.*

26. Dep't of Labor, *Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice; Final Rule*, 81 Fed. Reg. 20946, 21,020 (Apr. 8,

Although the Department has the authority to set the standards for providing retirement investment advice and grant exemptions, it has no enforcement jurisdiction over IRAs. Rather, that jurisdiction is vested in the Internal Revenue Service (IRS), and the sole statutory sanction for engaging in an illegal transaction is the assessment of an excise tax.[27] Moreover, the IRS does not actively enforce the prohibited transactions provisions with respect to IRAs. Instead, the excise tax (equal to 15% of the amount involved) is *generally self-enforced*, which means that a financial firm must first realize it has engaged in a prohibited transaction, self-report the violation and pay the tax. The Department recognized that the possible imposition of an excise tax is an inadequate incentive to ensure compliance with the new standards.[28]

Additionally, unlike participants and beneficiaries of plans covered by Title I of ERISA,[29] IRA owners do not have an independent statutory right to bring an action against fiduciaries for violations of the prohibited transactions rules or exemptions. As such, providing retirement investors a mechanism by which to enforce these standards is critical given the Department's lack of jurisdiction to do so.

Establishing standards for retirement investment advice, without more, will not provide investors with a clear-cut, unambiguous, and effective means of seeking redress for their broker's violations of those standards. Firms often argue that there is no private right of action for violations of SRO rules, relying on the holdings in a few cases while ignoring case law that states violations of SRO rules may be evidence of a breach of the applicable standards, supporting a claim for negligence or breach of fiduciary duty, and ignoring FINRA's statements that investors can make claims based upon violations of SRO rules in FINRA arbitration.[30] Requiring that firms incorporate the Impartial Conduct

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2016) ("DOL Final Rule"), available at http://webapps.DOL.gov/FederalRegister/PdfDisplay.aspx?DocId=28806.

27. *Id.* at 20,953; 26 U.S.C. § 4975(a)-(b).

28. DOL Final Rule, *supra* note 26 at 21,021.

29. Under Title I, the Department, plan participants may bring civil actions to enforce the fiduciary duty and prohibited transactions. 29 U.S.C. §1132(a)(2), (3) and (5).

30. *See, e.g., Thompson v. Smith, Barney, Harris, Upham & Co.*, 709 F.2d 1413, 1419 (11th Cir. 1983)(no private right of action based on violations of SRO rules); *Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 492 (6th Cir. 1990) (same). However, other cases have held that SRO rules may be informative as to the applicable standard of conduct. See, e.g., *Vucinich v. Paine, Webber, Jackson & Curtis, Inc.*, 803 F.2d 454 (9th Cir. 1986)(the court held that" violations of the

Standards in an express contract with their customers, however, assures that investors have a remedy in court and in arbitration when fiduciaries fail to comply with those standards. Specifically, investors can bring an action for breach of contract under state law, which would control the enforceability of any and all contractual provisions.[31]

Moreover, the contractual requirement does not impose significant additional litigation risks or costs to firms. Brokerage firms in the U.S. universally enter into written agreements with their customers that are enforceable under state law. The PTE's contractual requirement merely adds terms to contracts that already exist, providing "clarity to the fiduciary nature of the undertaking,"[32] ensuring that retirement investors can bring an action for violation of those standards and creating a powerful incentive for financial firms and advisors to adhere to the impartial conduct standards. We strongly

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professional standards of brokers may be the basis for a finding of professional negligence."); *In re Thomson McKinnon Securities, Inc.*, 141 B.R. 559 (Bankr. S.D.N.Y. 1992)(if a stockbroker's conduct violates a rule of the stock exchange, a client who sustains damages as a result of such breach has a claim for breach of the stockbroker's fiduciary duty); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng*, 697 F.Supp. 1224 (D.D.C. 1988)(the violation of SRO rules may be a factor for the consideration by the jury as to whether the stockbroker acted as a reasonable person in his conduct towards his customer and their account). Additionally, FINRA itself has stated that claims may be brought in arbitration for violations of SRO rules. Ms. Fienberg, formerly the president of NASD Dispute Resolution, speaking at the NASAA (North American Securities Administrators Association) presentation entitled "NASAA Listens Forum," in Washington DC on July 20, 2004, stated:

In SRO NASD arbitration, unlike in court, you get an equitable result. You do not have to have a claim that is cognizable under state or federal law. It can be cognizable under NASD rules. So for example, there's only one cause of action under the federal securities laws, that's 10(b), it's very limited, has a short statute of limitations. The rules that are applied by arbitrators looking for equitable relief are much broader than if they had to strictly follow the law.

The import of this statement by the then CEO of FINRA-DR is that arbitration is an equitable proceeding, rather than an action strictly governed by law. Indeed, according to Ms. Fienberg, claimants are not even required to have a claim cognizable at law. This is further supported by FINRA rule. FINRA arbitration rules require only a statement of claim, specifying the relevant facts and remedies requested. FINRA Rule 12302(a)(2).

31. DOL Final Rule, *supra* note 26 at 21,008, 21,020.

32. *Id.* at 21,022.

urge the Department not to eliminate or dilute the written contract requirement of the BIC exemption.

Question 6: *What is the likely impact on Advisers' and firms' compliance incentives if the Department eliminated or substantially altered the warranty requirements? What should be changed? Does compliance with the Impartial Conduct Standards need to be otherwise incentivized in the absence of the warranty requirement and, if so, how?*

The elimination or substantial alteration of the BIC exemption's warranty requirements would invariably reduce financial firms' incentives to comply with their obligations to adopt and implement anti-conflict policies and procedures, because there would be no effective enforcement mechanism. The Department recognized that implementation of anti-conflict policies and procedures (and policing for compliance with those procedures) serve as critical safeguards to the exemption's protections.[33] In order to ensure compliance with these requirements, the BIC exemption further requires that the firm make a warranty in its contract with IRA investors, committing to compliance with its obligations under the exemption, including that it has adopted and implemented anti-conflict policies and procedures. The warranty requirement was promulgated to create "an express enforceable promise of compliance with the policies and procedures condition."[34]

The warranty requirement serves as a powerful incentive for firms to adopt and implement anti-conflict policies and procedures, and carefully police conflicts of interest. By requiring an express warranty in the contract between investors and the firm, the warranty provides a mechanism to enforce these requirements in the first place, specifically, through a breach of contract action governed by state law.

Question 11: *If the Securities and Exchange Commission or other regulators were to adopt updated standards of conduct applicable to the provision of investment advice to retail investors, could a streamlined exemption or other change be developed for advisers that comply with or are subject to those standards? To what extent does the existing regulatory regime for IRAs by the Securities and Exchange Commission, self-regulatory bodies (SROs) or other regulators provide consumer protections that could be incorporated into the Department's exemptions or that could serve as a basis for additional relief from the prohibited transaction rules?*

The current rules governing brokers and investment advisers do not provide adequate protections for retirement investors. The FINRA suitability

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33. *Id.* at 21,041.

34. *Id.*

rule, governing brokers, 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 may sell a mutual fund with high expenses rather than a functionally identical fund, which may cost the investor less but pay the broker less. These conflicts are not adequately managed by the current rules.

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.[35] The Council of Economic Advisers estimate Americans are suffering $17 billion in losses annually due to conflicted advice they receive from financial advisors.[36] The Department has estimated that full compliance with the Rule and PTEs would cost the industry $16 billion over ten years, but will result in investor gains of between $33 billion and $36 billion.[37]

The Rule and PTEs go further than the current FINRA standards in that they require either elimination of conflicts, or adequate management of the conflicts to ensure that the broker adheres to the Impartial Conduct Standards. These steps are needed to ensure that retirement investors are protected, and have an appropriate remedy if a firm or broker fails to adhere to the standards. Under the other rules currently governing brokers and investment advisers, investors will continue to suffer significant losses in their retirement account because of unmitigated conflicts of interest. Accordingly, unless the SEC adopts a standard no less stringent than that adopted by the Department, brokers and investment advisers should be required to adhere to the Rule and PTEs as they were originally adopted.

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35. *See*, Save our Retirement, *Comment Letter to the Dep't of Labor* (May 8, 2015), available at http://saveourretirement.com/cms/wp-content/uploads/2015/02/DOL-SOR-Letter-Comment-Period-Request-5-8-15.pdf.

36. *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. "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.

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. 12,319, 12,320 (Mar. 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.

Conclusion

PIABA thanks the Department for the opportunity to comment on its request for information. PIABA is hopeful that the Department will permit the Rule and PTEs to be fully implemented on January 1, 2018, so that investors will receive the protections they have been promised and are entitled to receive. A great deal of thought was given to the adoption of the Rule and PTEs to ensure that investors would receive these important protections, while ensuring that the industry would continue to have flexibility in how it rendered advice and service. To undo the Rule and PTEs would unfairly skew that balance in the favor of the industry at the expense of investors.

Very truly yours,
Marnie C. Lambert
PIABA President

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The following PIABA Comment Letter regarding the *RIN 1210-AB82; Request for Information Regarding the Fiduciary Rule and Prohibited Transaction Exemptions* was submitted to Employee Benefits Security Administration by Marnie C. Lambert on July 21, 2017 (prepared with the assistance of Christine Lazaro).

Office of Exemption Determinations
Employee Benefits Security Administration
Attn: D-11933
U.S. Department of Labor
200 Constitution Avenue, N.W., Suite 400
Washington, D.C. 20210

Re: RIN 1210-AB82; Request for Information Regarding the Fiduciary Rule and Prohibited Transaction Exemptions

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 postponement of the January 1, 2018 applicability date of the exemptions (collectively, the "PTEs") which accompany the Department of Labor's Conflict of Interest Rule (the "Rule"). Previously, the Department solicited comments on its proposal to delay implementation of the Rule and the PTEs[1] in response to the President's

1. *See*, Dep't of Labor, *Definition of the Term "Fiduciary"; Conflict of Interest Rule-Retirement Investment Advice; Best Interest Contract Exemption (Prohibited Transaction Exemption 2016-01); Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs (Prohibited Transaction Exemption 2016-02); Prohibited Transaction Exemptions 75-1, 77-4, 80-83, 83-1, 84-24 and 86-128*, 82 Fed. Reg. 12319 (Mar. 2, 2017) ("Proposal for Delay"), available at https://www.federalregister.gov/

Memorandum to the Secretary of Labor directing 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."[2] Despite eventually setting the applicability deadline for the Rule and certain aspects of the PTEs as June 9, 2017 (a delay from the original April 10, 2017 deadline), the many conditions of the PTEs are not set to be implemented until January 1, 2018.[3] The Department now seeks comment on whether a further delay of the PTEs would "reduce burdens on financial services providers and benefit retirement investors by allowing for more efficient implementation responsive to recent market developments."[4]

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.[5] The Department received over 300 comment letters on the

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documents/2017/03/02/2017-04096/definition-of-the-term-fiduciary-conflict-of-interest-rule-retirement-investment-advice-best.

2. White House, *Presidential Memorandum on Fiduciary Duty Rule* (Feb. 3, 2017), available at https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-memorandum-fiduciary-duty-rule.

3. *See*, Dep't of Labor, *Definition of the Term ''Fiduciary''; Conflict of Interest Rule—Retirement Investment Advice; Best Interest Contract Exemption (Prohibited Transaction Exemption 2016–01); Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs (Prohibited Transaction Exemption 2016–02); Prohibited Transaction Exemptions 75–1, 77–4, 80–83, 83–1, 84–24 and 86–128*, 82 Fed. Reg. 16902 (Apr. 7, 2017) ("Notice of Delay"), available at https://www.federalregister.gov/documents/2017/04/07/2017-06914/definition-of-the-term-fiduciary-conflict-of-interest-rule-retirement-investment-advice-best.

4. Dep't of Labor, *Request for Information Regarding the Fiduciary Rule and Prohibited Transaction Exemptions*, 82 Fed. Reg. 31278 (July 6, 2017) ("Request for Information"), available at https://www.federalregister.gov/documents/2017/07/06/2017-14101/request-for-information-regarding-the-fiduciary-rule-and-prohibited-transaction-exemptions.

5. *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,

2010 proposal, held a public hearing at which 38 speakers testified, and then received an addition 60 comments following the public hearing.[6] The Department met with various stakeholders over the next several years.[7] This process resulted in the Department withdrawing the 2010 proposal and submitting a new proposal in April 2015.[8] In 2015, the Department received over 3,000 comment letters and over 300,000 submissions made as part of 30 separate petitions submitted.[9] The Department held four days of public hearings at which over 75 speakers testified.[10] On April 8, 2016, the Department filed its final rule in the Federal Register.[11] It provided for an initial applicability date of April 10, 2017 for the Rule and certain conditions of the PTEs; and a second applicability date of January 1, 2018 for the remaining conditions of the PTEs.[12] The Department provided for a phased implementation period to allow firms the benefit of the relevant PTEs while the firms made changes necessary to be in full compliance by January 1, 2018.[13] In support of the final rule, the Department prepared a 395 page Regulatory Impact Analysis.[14]

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 plans and their

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2016) ("DOL Final Rule"), available at http://webapps.DOL.gov/FederalRegister/PdfDisplay.aspx?DocId=28806.

6. *Id.* at 20957.

7. *Id.*

8. *Id.*

9. *Id.* at 20958.

10. *Id.*

11. *Id.* at 20946.

12. *Id.*

13. *Id.*

14. *See*, Dep't of Labor, *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.

affected financial services and other service providers to adjust to the basic change from non-fiduciary to fiduciary status."[15]

Due to the uncertainty surrounding the implementation of the Rule and PTEs following the issuance of the Presidential Memo, the Department sought to give firms additional time to comply with the Rule and PTEs.[16] After filing its request for comments on whether a delay would be appropriate, the Department received approximately 193,000 comment and petition letters: "Approximately 15,000 commenters and petitioners support a delay of 60 days or longer, with some requesting at least 180 days and some up to 240 days or a year or longer (including an indefinite delay or repeal); and, by contrast, 178,000 commenters and petitioners oppose any delay whatsoever."[17] Notwithstanding the overwhelming support for the Rule and PTEs moving forward as originally approved, the Department delayed the Rule and PTEs. The Department delayed the applicability date of the Rule until June 9, 2017, and delayed the applicability dates of the PTEs so that the Impartial Conduct Standard would be implemented on June 9, 2017, but many other conditions of the PTEs would not be implemented until January 1, 2018.[18]

Now, the Department has filed a request for information as to whether a further delay of implementation of the remaining conditions of the PTEs is warranted.[19] However, the Department's rationale behind the request for information is flawed. The Department asks whether a delay will "reduce burdens on financial services providers and benefit retirement investors by allowing for more efficient implementation responsive to recent market developments." While the Department understandably has to be cognizant of the burdens of any rulemaking on financial services companies, its mission is to "foster, promote, and develop the welfare of the wage earners, job seekers, and retirees of the United States…"[20] Similarly, the Employee Benefits Security Administration's ("EBSA") mission is to "assure the security of the retirement, health and other workplace related benefits of America's workers and their families. [It] will accomplish this mission by developing effective

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15. DOL Final Rule, *supra* n. 5 at 20946.

16. *See*, Notice of Delay, *supra* n. 3.

17. *Id.* at 16903.

18. *See*, *id.*

19. *See*, Request for Information, *supra* n. 4.

20. Dep't of Labor, *Our Mission*, available at https://www.dol.gov/general/aboutdol/mission.

regulations; assisting and educating workers, plan sponsors, fiduciaries and service providers; and vigorously enforcing the law."[21]

After being drafted, vetted, withdrawn, re-written, vetted, approved and revised again, the Rule and the PTEs are just the type of "effective regulations" required of the EBSA. Moreover, the Rule and PTEs have already been adopted and, in large part, gone into effect. A change in the Administration does not make the work done by the Department and EBSA less meaningful or appropriate. The Department's Request for Information focuses on the wrong stakeholders – the impact on financial services companies rather than retirement savers. The Department should be questioning whether delay or evisceration of the full implementation of these effective regulations will allow it to foster, promote, and develop the welfare of wage earners and retirees. The Department (and the financial services companies) should be spending its time, money and efforts getting ready to start "vigorously enforcing" the Rule and PTEs.

Moreover, to the extent there have been any recent "market developments" they have included developments such as mutual fund clean shares, which have only moved forward in anticipation of the applicability of the Rule and PTEs.[22] Further delay and/or gutting of the Rule and PTEs would only have a detrimental impact on the development of these types of new products. In the meanwhile, retirement investors will continue to be harmed by unmitigated conflicts of interest that exist with old products and limited ability to address any violations of the Impartial Conduct Standard.

Further Delay of the PTEs will be detrimental to retirement investors

It is crucial that the Rule and the PTEs continue to progress so that retirement investors may be fully protected. Currently, brokers, often called

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21. Dep't of Labor, Employee Benefits Security Administration, *Our Mission*, available at https://www.dol.gov/agencies/ebsa/about-ebsa/about-us/mission-statement.

22. *See*, *e.g.*, Greg Iacurci, *DOL fiduciary rule pushes indexed annuity carriers to develop new products*, Investment News (May 25, 2017), available at http://www.investmentnews.com/article/20170525/FREE/170529942/dol-fiduciary-rule-pushes-indexed-annuity-carriers-to-develop-new; Greg Iacurci, *New mutual funds under DOL fiduciary rule could save investors at least 0.50% in returns: Morningstar*, Investment News (Apr. 18, 2017), available at http://www.investment news.com/article/20170418/FREE/170419918/new-mutual-funds-under-dol-fiduciary-rule-could-save-investors-at.

financial advisors, are governed primarily by FINRA rules and state law (which is inconsistent across the country). 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 fee, high expense fund to the 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 the conflicts of interest which may have influenced the broker's recommendation. This conflicted advice costs investors $17 billion each year.[23]

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 and mitigate 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 investment product that, even if suitable, is not in a customer's best interest given the costs, fees, commissions, lack of liquidity, and potential surrender charges.

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.[24] 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."[25] Those safeguards include warranties that the firms have done what they are required to do, and a contract that clearly sets forth the financial advisors' obligations to the retirement investor.

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23. *See*, White House Council of Economic Advisers, *The Effects of Conflicted Investment Advice on Retirement Savings* (Feb. 2015); available at https://obama whitehouse.archives.gov/sites/default/files/docs/cea_coi_report_final.pdf.

24. DOL Final Rule, *supra* n. 5 at 20991.

25. *Id.* at 21003, 21004.

If the PTEs are not permitted to be fully implemented on January 1, 2018, retirement investors will continue to be harmed by the same conflicts of interests that made the Rule and PTEs necessary in the first place. PIABA members represent investors who have been harmed under the current standards in mandatory, binding arbitration actions. PIABA has previously provided multiple stories of retirement investors who have been harmed under the prior standards.[26] This harm cannot be allowed to continue.

For years, retirement investors have been sold products that do little more than benefit the financial advisors and firms selling them. Financial advisors have sold retirees complex, non-conventional investments such as Real Estate Investment Trusts (REITs) and structured products. Losses on these investments are not readily apparent because they are not traded on an exchange. The lack of public trading hides the high expenses built into the REITs, which over the years greatly reduces the value of the investments. These types of investments have a number of risks associated with them, which often make them inappropriate investments for retirement funds. Yet, they generate high payments to the firms and financial advisors selling them. Of course, a firm's inability to continue to sell products such as these will impact a firm's bottom line, increasing the burden on the firm. However, this is not a valid justification for undoing investor protection. Firms must operate fairly, earing a profit while providing retirement investors the services and protections they have been promised, and deserve.

Retirement investors are entitled to do business with financial advisors who are acting in their best interest. ERISA and the Internal Revenue Code require nothing less. While the Rule and PTEs currently require that those providing advice to retirement investors act pursuant to the Impartial Conduct Standards, retirement investors should be given assurances that the conduct standards are more than mere marketing fluff – that firms and financial

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26. *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; PIABA, *Comment Letter to the Dep't of Labor* (Mar. 17, 2017), available at https://piaba.org/system/files/comment_letter_pdfs/DOL%20Comment%20Letter,%20RIN%201210-AB79%20(March%2017,%202017).pdf; and Joseph Peiffer, *Statement for the Record Submitted to the United States Department of Labor Employee Benefits Security Administration On Conflict of Interest Proposed Rule Public Hearing* (Aug. 11, 2015), available at https://piaba.org/piaba-newsroom/congressional-testimony-statement-record-submitted-united-states-department-labor-emp.

advisors will hold themselves to those standards and that if they fail, there will be a remedy available to harmed retirement investors. The BICE contract and accompanying warranties will help ensure that retirement investors have confidence in the standards and the relationship between them and their financial advisors.

Something more than the standards themselves is needed to ensure that financial advisors stay true to their word. Financial advisors have presented themselves in their advertisements and on their websites as trusted counselors and advisors for years.[27] Yet, that has not prevented firms from denying that there is any duty to act in an investor's best interest when faced with such claims in an arbitration.[28] Delaying or removing the warranty and contract aspects of the PTEs will perpetuate this dichotomy and give firms the ability to challenge the obligations under the impartial conduct standards.

Retirement investors seek help to manage their funds because they are unable to navigate the complex financial services market alone. They expect that they will receive appropriate advice, and that if something goes wrong, they will have some way to try to make it right. Further delaying the key investor protections within the PTEs will remove these protections, leaving retirement investors with little more than a hope that their financial advisor is acting in their best interests.

The remaining aspects of the PTEs are essential to ensure investor protection

The Rule and PTEs are of vital importance today 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 retirement investors more responsible for ensuring they have the necessary funds to support themselves in retirement. One-time

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27. *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) ("PIABA Report"), available at https://piaba.org/system/files/pdfs/PIABA%20Conflicted%20Advice%20Report.pdf; *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. 18, 2017), available at http://ourfinancialsecurity.org/wp-content/uploads/2017/01/Financial-Advisor-or-Investment-Salesperson.pdf.

28. *See*, PIABA Report, supra n. 27 at pp. 9-16.

transactions like rollovers will involve *trillions* of dollars over the next five years and are often among the most significant financial decisions families will ever make.[29] As funds are rolled into IRAs from workplace retirement plans, investors will seek guidance and advice from financial advisors.

Some firms have already begun making changes necessary to comply with the existing Rule and PTEs.[30] Any further delay will mean the Department is sending a clear message that the regulations it has spent years preparing are simply not that important, and if firms just delay, they will not have to do anything. What are firms to do when new regulations are released?

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,

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29. "Rollovers" are expected to approach $2.4 trillion cumulatively from 2016 through 2020. *See*, RIA, *supra* n. 14.

30. See, e.g., Merrill Lynch tweet (Nov. 10, 2016) ("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."), available at https://t.co/OMw73LvR6d; Morgan Stanley Press Release, *Morgan Stanley to Preserve Client Choice for Retirement Accounts* (Oct. 26, 2016) ("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."), available at https://www.morganstanley.com/press-releases/morgan-stanley-to-preserve-client-choice-for-retirement-accounts; 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-based retirement account arrangements."), available at http://www.morganstanley.com/articles/DOL-fiduciary-rule; 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) ("CFA Report"), available at http://consumerfed.org/wp-content/uploads/2017/01/1-31-17-DOL-Rule-Delivering-Benefits_Fact-Sheet.pdf.

(iii) far from driving up investors' costs, the rule is already responsible for significant cost reductions.[31]

It is important that the Rule and PTEs continue to move forward so that the industry has certainty in its obligations, and retirement investors receive the protections they need, have been promised, and to which they are entitled.

The industry has not offered any legitimate reasons for delaying or eliminating the key aspects of the Rule and PTEs. Firms will have had over a year and a half to implement key aspects of the BICE: the warranties and contract. These aspects of the exemption will provide certainty as to a firm's obligations and will offer retirement investors some assurances that the firms are doing what is required of them. Retaining these aspects of the BICE will increase litigation costs only if firms are not adhering to them. These aspects of the BICE will ensure that retirement investors have a means of holding firms accountable when they fail to adhere to the standards.

Moreover, retaining these aspects of the BICE should not hamper a firm's ability to do business. Several states have long considered brokers fiduciaries under state common law.[32] Firms operating in those states continue to offer the same levels of advice and continue to do business. They have not closed shop because of the potential litigation consequences of being held to a fiduciary standard. A 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.[33] Moreover, FINRA registered firms are also already subject to a ban on class action waivers, yet they continue to do business with the investing public.[34]

What is the point of the protections offered by the Rule and the PTEs if there is no meaningful enforcement of them? All aspects of the PTEs currently awaiting implementation should move forward without any further delay so that retirement investors receive the protections intended by the Rule.

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31. CFA Report, *supra* n. 30.

32. *See*, e.g. California, Georgia, Florida, Missouri, Puerto Rico, South Carolina, and South Dakota.

33. *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.

34. *See*, FINRA Rules 2268(f) and 12204.

Conclusion

Further delaying the full implementation of the Rule and PTEs will cost investors their hard earned retirement money. 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.[35] The Council of Economic Advisers estimate Americans are suffering $17 billion in losses annually due to conflicted advice they receive from financial advisors.[36] It is essential that there be full implementation of the Rule and PTEs to ensure that firms are not diverting funds from retirement investors due to their improper and overreaching conflicts of interest.

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.[37] In each case, the federal judge determined that the Rule and PTEs should go forward.[38] 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

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35. *See*, Save our Retirement, *Comment Letter to the Dep't of Labor* (May 8, 2015), available at http://saveourretirement.com/cms/wp-content/uploads/2015/02/DOL-SOR-Letter-Comment-Period-Request-5-8-15.pdf.

36. *See*, White House Council of Economic Advisers, *The Effects of Conflicted Investment Advice on Retirement Savings*, *supra* n. 23. "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.

37. *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).

38. *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).

> 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.[39]

The Department has previously justified the Rule and its implementation period, which contemplates the remaining conditions of the PTEs becoming effective in January 2018. Nothing has changed which would justify a reconsideration at this time. The Department also pointed out that full compliance with the Rule and PTEs would cost the industry $16 billion over ten years.[40] Conversely, underperformance of investments due to poor fund selection could cost IRA investors between $95 billion and $189 billion over the next 10 years, and these costs may be reduced by between $33 billion and $36 billion with full implementation of the Rule and PTEs.[41] Consequentially, neither the industry nor the Department can justify further delay of the full implantation of the Rule and PTEs.

Accordingly, the Department should proceed with the applicability timeline set forth in the Rule and PTEs and ensure that investors are protected.

Respectfully submitted,
Marnie C. Lambert, President

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39. *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).

40. *Id.*

41. Proposal for Delay, *supra* n. 1.

The following PIABA Comment Letter regarding the *FINRA Regulatory Notice 17-20 – Proposed Amendments to Rule Governing Communications with the Public* was submitted to the Financial Industry Regulatory Authority by Marnie Lambert on June 29, 2017 (prepared with the assistance of the Thomas Costello, Adam Gana and Adam Weinstein).

Ms. Jennifer Piorko Mitchell
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Re: FINRA Regulatory Notice 17-20 – Proposed Amendments to Rules Governing Communications with the Public

Dear Ms. Mitchell:

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 17-20 seeks comments concerning the effectiveness of FINRA Rules 3270 and 3280. FINRA Rules 3270 and 3280 impose requirements on registered representatives and broker-dealers for the reporting and supervision of outside business activities and private securities transactions carried out away from the firm. Specifically, under Rule 3270, a registered representative is required to give written notice to his FINRA member firm. Rule 3270's supplementary material sets forth what the member firm must do once it received such written notice of an outside business activity. It is the member firms' responsibility to review the outside business activities of their registered representatives and determine whether, and under what conditions (if any), to allow outside business activity to proceed. Further, the member firm must determine whether the activity is actually an outside securities activity (as opposed to merely a business activity) that is subject to

the requirements of Rule 3280, which specifically applies to securities transactions. Rule 3280 requires that private securities transactions that take place away from the registered representative's member firm be approved, recorded on the firm's books and records, and supervised as if the transaction were executed on behalf of the member.

FINRA Rules 3270 and 3280 were designed to prevent unsupervised securities sales or fraudulent securities activities by registered representatives of member firms (*e.g.*, Ponzi schemes, promissory note sales, sales of unregistered securities, and other investment scams). Accordingly, proper implementation of and training on these rules by firms is crucial to preventing registered representatives from taking unfair advantage of the goodwill that they may have because they are licensed securities professionals. In fraudulent investment scams, registered representatives also often use the good reputation of their member firms to perpetrate frauds that they may not have otherwise been able to perpetrate. Thus, Rules 3270 and 3280, if they are properly implemented, can also offer member firms protection from liability and reputational damage by enabling the detection and prevention of some types of misconduct by their registered representatives. Moreover, under FINRA Rule 3010 and NTM 01-79, member firms are required to reasonably supervise and ensure compliance with the Rules 3270 and 3280.

Issues raised by the involvement of registered representatives in private securities transactions and improperly participating in an outside business activity away of a member firm have been the subject of NASD guidance since at least the mid-1980s. In NTM 86-65, the NASD noted that off-site representatives who operate both securities businesses and outside business activities were the most frequent participants in unauthorized private securities transactions. There is no evidence that the NASD's concerns about the risks of outside business activities and private securities transactions have abated or lessened over time. In 2001, the NASD quoted the North American Securities Administrators Association ("NASAA") as finding private securities transactions to be among the top 10 investment scams that year. *See* NTM 01-79, fn. 2. Again in 2011, NASAA's Enforcement Report (for 2010) identified "selling away" (*i.e.*, when registered representatives sold someone an investment product not sold or approved by their member firms) in the top 10 specific violations that NASAA members (*i.e.*, state securities regulators) took enforcement actions on.[1] As far as PIABA is aware, FINRA does not publish

1. As far as PIABA is aware, FINRA does not publish similar information such as annual statistics on the number of selling away cases pursued by FINRA Enforcement or the number of registered representatives that have been punished by

statistics on the number of registered representatives that have been punished by fine, suspension and/or a permanent bar for improperly engaging in private securities transactions.

It has been the experience of PIABA members that the investor losses from unreported (or inadequately supervised or prohibited) outside businesses and private securities transactions are still a major concern for PIABA members and our clients. Representatives who sell away can raise *millions* of dollars from dozens (and sometimes hundreds) of investors, which all too often are not fully recouped by the investors (if they are lucky enough to recoup anything). The result is irreparable damage to the victims' retirement savings. Over the years registered representatives continue to find new and creative ways to engage in these improper outside business activities and/or private securities transactions (examples include using outside business activities – both disclosed and undisclosed – to funnel customer funds, engaging in high risk trading that is not supervised by the member firm through a disclosed Registered Investment Advisory ("RIA"), or using other professional designations/fields such as being a Certified Public Accountants, insurance agent, or attorney to solicit investment for private ventures).

The rules currently provide a framework for regulating and supervising registered representatives in outside business activities and private securities transactions; however, FINRA has largely left member firms to devise supervisory procedures to comply with Rules 3270 and 3280.[2] This has led to inconsistencies across the industry, which have allowed unscrupulous registered representatives to continue, and even increase, their misconduct. Comparatively, FINRA has provided more guidance on the supervision of member firms' dually registered Investment Advisory Representatives ("IAR"s) with respect to their private securities transactions conducted away from their member firms. For example, the NASD issued NTM 91-32, 94-44, and 96-33, which all provided more specific guidance on supervising registered representatives, who are also investment adviser representatives, in such securities transactions and how record on the member firm's books and records in compliance with FINRA rules.

PIABA believes that it would help investors if FINRA would provide similar more specific guidance to member firms concerning the supervision of outside business activities of its registered representatives, which is a more

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fine, suspension and/or a permanent bar for improperly engaging in private securities transactions.

2. The last time FINRA provided guidance on the supervision of outside business activities was in 1999. *See* NTM 99-45.

complex area of supervision. Issues with FINRA's existing guidance include the following: (1) a lack of recommended standards of conduct for the supervision of outside business activities; (2) the failure to sufficiently acknowledge and address the impact of shifts in the securities industry and the various models of doing business within the industry; (3) the failure to be pro-active in revising examination techniques/standards to account for changes in the way the securities industry does business (and the way scams are being perpetrated), too often revising or adopting new standards/techniques only after they are implemented by the SEC. These deficiencies result in delays to brokerage firms understanding the type and level of supervision expected of them with respect to outside business activities and private securities transactions, which then leaves investors susceptible to being victimized by their brokers.

PIABA proposes that FINRA issue an updated Regulatory Notice to provide guidance on the proper supervision of outside business activities and private securities transactions designed to detect infractions of the rules and to prevent registered representatives from participating in either without the advance knowledge and approval (with limitations, if necessary) of member firms. PIABA also suggests that any updated guidance issued by FINRA be thorough and specific like the guidance provided by SEC Staff Legal Bulletin No. 17: Remote Office Supervision ("SEC Bulletin").[3]

The SEC Bulletin clearly delineates various activities and categories of supervision that should be implemented with respect to remote offices and outside business activities, and PIABA believes that any updated guidance by FINRA on outside business activities and private securities transactions should be modeled after the SEC Bulletin. PIABA would like to see FINRA's updated guidance specifically address the following:

1. **Inspection requirements** – Identify criteria to determine how often inspections should occur and whether they should be announced in accordance with SEC decisions and prior guidance. *See* NTM 98-38 and NTM 99-45.
2. **"For Cause" Inspections** – PIABA is unaware of any specific guidance by FINRA on what factors a firm should consider in deciding whether to conduct a "for cause" inspection of an office due to the presence of red flags. FINRA should provide evaluative criteria or some examples from its examination experiences to assist in determining whether additional inspections would be warranted under certain circumstances.

3. *See* https://www.sec.gov/interps/legal/mrslb17.htm.

3. **Inspection of personal or outside business activity computers and phones** – While the SEC and FINRA have sanctioned firms for not inspecting personal computers, there is no specific guidance on the procedures for carrying out such audits. For instance, FINRA could specify that the registered representative is required to link their personal computer to the firm's network for a key word search.
4. **Inspection of personal and outside business activity email accounts** - While the SEC and FINRA have sanctioned firms for not supervising either personal email accounts or outside business activity email accounts, FINRA should provide specific guidance on the method and frequency of inspecting such accounts.
5. **Inspection of outside business activity bank accounts** – While the SEC has sanctioned firms for not supervising d/b/a and outside business activity bank accounts, FINRA should provide specific guidance on the method and frequency of inspecting such accounts.
6. **Inspection of social media** – There is no specific guidance on how frequently a firm should conduct pubic searches of a registered representative's social media to ensure compliance with the firm's policies on participation on a personal social media site. FINRA should provide such guidance
7. **Contacting investors** - While the SEC has sanctioned firms for not independently verifying information, there is no guidance as to when and how a firm should contact investors as part of an investigation into red flags. For instance, unusual liquidations of securities, large transfers of funds, and/or lack of adequate explanation by the registered representative as to why the transaction occurred should prompt a supervisor to call the client. PIABA is also aware of brokers downplaying the significance or reason for a supervisor's contact with a client, which can result in the client not taking additional steps necessary for the firm to be able to protect them. FINRA should provide specific guidance on when client contact is necessary and what should be communicated in such contact.

PIABA supports a Regulatory Notice as described above for the benefit of the investing public and members, which would provide updated and specific guidance on implementing, enforcing and supervising outside business activities and private securities transactions under existing FINRA rules. Technological developments have made supervision of employee activities easier and more efficient, but have also provided employees with additional ways in which they can communicate with investors about outside business

activities or private securities transactions. FINRA needs to ensure that members firms know how to use all the tool at their disposal to supervise such communications.

PIABA thanks you for the opportunity to comment on this important topic.

Very truly yours,
Marnie C. Lambert
PIABA President

The following PIABA Comment Letter regarding the *Special Notice Dated March 21, 2017* was submitted to the Financial Industry Regulatory Authority by Marnie Lambert on June 19, 2017 (prepared with the assistance of the Adolfo Anzola, Adam Gana, Dayton Haigney, Nicole Iannarone, Aaron Israels, Christine Lazaro, David Neuman and William Young, Jr.).

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Re: *Special Notice Dated March 21, 2017 – Engagement Initiative Comment on Potential Enhancements to Certain Engagement Programs*

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 ("FINRA") that govern the conduct of securities firms and their representatives. In particular, our members and their clients have a powerful interest in FINRA rules relating to the information provided to investors.

We want to thank you for the opportunity to comment on FINRA's Special Notice dated March 21, 2017, regarding potential enhancements to certain engagement programs. PIABA would like to comment on the following issues identified in the Special Notice: 1. Engagement in Committees; 2. The Rulemaking Process; 3. Regulatory Guidance; 4. Investor Education; and 5. Enforcement and Awards Databases.

I. Engagement in Committees

Page 10 of the Special Notice has numerous questions about engagement in committees. PIABA has a particular interest in the Investor Issues Committee. Most of the investing public and many PIABA members were

unaware that such a Committee even existed. Upon further research, it appears that the Investor Issues Committee was created in December 2013 and its formation was announced in a December 17, 2013, press release by FINRA.

While PIABA appreciates that this Committee was formed, there are a number of concerns related to its purpose, membership, and transparency. Initially, we believe that FINRA should disclose the identities of the Committee members (as well as those of other FINRA committees) on the FINRA website. We also believe that FINRA should disclose the goals or objectives for this Committee, the process for qualifying Committee members, the member nomination and selection process, the length of member terms, and disclosure of when member positions become available. Further, the Committee's meeting minutes should be recorded and made public, so that the investing public knows what the Committee is doing on its behalf.

PIABA is also concerned about the current composition of the Investor Issues Committee, based on the contents of the December 2013 Committee disclosure. The December 2013 press release disclosed the names of 13 members of the Committee, including:

a) Brandon Becker - Chief Legal Officer of TIAA-CREF;
b) Roger Ganser – Chairman of BetterInvesting and Managing Director of Venture Investors LLC (a venture capital firm);
c) Catherine Heron - Senior Counsel for Capital Research and Management Company ("CRMC");
d) Paul Roye - Senior Vice President for CRMC.

If FINRA is looking for diverse perspectives on this Committee, then why are there two senior officers from the same firm, which happens to be a privately-owned investment company? Moreover, some of the other Committee members, such as Lawrence Greenberg (the Chief Legal Officer for Motley Fool) have strong industry ties. PIABA believes that such a Committee should have more investor advocates on the Committee and fewer with industry ties—especially when one considers the title of the Committee. Who better to discuss "investor issues" than individuals that defend investor rights? At a minimum, a PIABA member should be invited to serve on this Committee.

PIABA would like to see more public or investor advocates on the Investor Issues Committee as well as on all of FINRA's committees, including the FINRA Board of Governors. While the FINRA Board of Governors has its purported "public" governors, it would appear from their backgrounds and/or current positions that most of them are not what PIABA would consider to be investor advocates:

a) Carol Anthony (John) Davidson – former executive for Tyco International; Dell, Inc.; and Eastman Kodak;

b) Shelly Lazarus – executive at Ogilvy & Mather, the advertising agency which created the FINRA BrokerCheck ads;[1]
c) Joshua Levine – former executive at E-Trade, Morgan Stanley, and DeutschBank who now works for ESP Technologies Corp., who provides clearing and technology services for mutual funds, hedge funds, and other financial companies;
d) Eileen Murray – CEO of Bridgewater Associates, an investment management firm;
e) Randal K. Quarles – an executive with Cynosure Group, a company that manages private equity investments.

These purported "public" governors are not in a good position to advocate for the investing public since they are not in touch with the real issues that confront the typical retail investor.[2] In order to truly make the Board of Governors more "public" and, thus, put FINRA's Board in the best position to work towards balanced financial markets, the FINRA Board should incorporate more investor advocates such as attorneys that represent claimants, academics, and consumer protection professionals. Likewise, FINRA should disclose its process for selecting new Board members including, but not limited to, what qualifications they must have to even be considered, how they are nominated/selected, how long their terms are, how many terms they may serve, how often Board positions become available, and how/if interested parties can apply to be considered for a seat on the Board of Governors.

PIABA is also concerned about the significant crossover between and among Board members and service on committees. For example, Elisse Walter, Luis Viciera, and Brigitte Madrian are all currently on the FINRA Board of Governors, and they are also listed as members of the Investors Issues Committee as of December 2013. In order to properly diversify the committees, FINRA should add investor-friendly members even if that means limiting the number of FINRA Governors on any given committee (or limiting how many committees a Governor may serve on). It is through the integration of pro-investor points of view into existing committees, and FINRA governance generally, that FINRA can promote diversity of opinion and ideas.

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

2. Indeed, it does not appear that Mr. Levine, Ms. Murray or Mr. Quarles would even qualify to be "public arbitrators" under FINRA Rule 12100 so PIABA questions why it is appropriate for them to serve as "public" governors on FINRA's Board of Governors.

In the Special Notice, FINRA also asked questions about advisory and *ad hoc* committees. PIABA supports FINRA's commitment to the National Arbitration and Mediation Committee ("NAMC"), which has made significant improvements to the FINRA arbitration and mediation processes, although everyone should agree that further improvements are needed.[3] This is one committee where PIABA does have representation, along with a number of FINRA member firms, and the combination of both perspectives has resulted in well-vetted and reasonable recommendations being made to the FINRA Board that truly take into account FINRA's stated goal of "investor protection." We would encourage FINRA to discuss the success of the NAMC with Rick Berry as a potential model for other committee membership within FINRA, especially committees that specifically address investor issues.

There have been numerous task forces in the past related to important issues in FINRA arbitration, such as the Discovery and Arbitrator Training Manual, and most recently the Dispute Resolution Task Force. We believe that good practice dictates that, to the extent these committees or task forces are implemented, the composition and existence of such should be disclosed on the FINRA website. FINRA already identifies members of the NAMC on its websites and PIABA does not see any reason why FINRA could not follow the same practice for *all* committees and task forces.

PIABA hopes that FINRA will re-visit the participation of industry versus non-industry members on its various boards, committees and task forces. Non-industry "public" investor representatives bring an essential, and too often missing, viewpoint to FINRA, an organization with one clear mission – "to provide investor protection and market integrity." Similarly, FINRA should continue to strive for demographic and geographic diversity on its boards, committees and task forces.

II. Rulemaking Process

FINRA has requested comments on its rule making process, primarily related to transparency and creating additional participation from interested parties. FINRA's proposed rules often garner significant feedback from parties, such as PIABA, who regularly monitor rule proposals and provide substantive

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3. The names and affiliations of NAMC members, currently 13 with 7 "public" and 6 industry members, are disclosed on FINRA's website at *https://www.finra.org/arbitration-and-mediation/national-arbitration-and-mediation-committee-namc*. FINRA Rules 12102, 13102, and 14102 provide that "At least 50 percent of the NAMC shall be Non-Industry members."

comments and feedback. Repeat commenters stay abreast of potential rule changes by reviewing proposed rule filings, regulatory notices, various FINRA board agendas and news releases that relate to rulemaking priorities and considerations.

PIABA generally supports measures that make FINRA rulemaking more transparent and assessable to those affected. In this regard, PIABA feels that FINRA should publish FINRA's response to rule comments with the Regulatory Notice announcing SEC approval of the corresponding rule. Commenters put substantial amounts of time into the preparation of written comments and understanding why FINRA did or did not incorporate comments into the rule is helpful in promoting transparency. Further, this process may also assist commenters in further understanding FINRA's rationale used in evaluating comments, which could prove beneficial for commenters' use in the future.

PIABA supports extending the time to comment on Regulatory Notices from the typical 45 days to 60 days. Commenters spend substantial time preparing their comments. Interested parties may be late alerted to a new Request for Comment if they are not regularly monitoring new publications. Further, many comments are submitted on behalf of organizations, such as PIABA or SIPC, for which multiple individuals and committees render input prior to the submission of the final comment letter to FINRA. As such, PIABA feels that extending the comment period may ease the burden on comments from interested parties, which could lead to more in-depth feedback.

As FINRA is beginning to evaluate whether a rule change should be made at the committee or board level, it may wish to provide an informal mechanism for early feedback from stakeholders. Informal feedback at the rule consideration and early drafting stages would provide FINRA with more voices at the most meaningful phase of rule consideration, affording time and flexibility in rule drafting.

Finally, PIABA believes that it might be helpful for FINRA to consolidate its postings of proposed rules and regulatory notices. For parties who are less familiar with the rulemaking process, creating one web page that could host all notices in a central location could be beneficial.

III. Regulatory Guidance

FINRA requests comment regarding regulatory guidance, including such topics as whether more interpretive guidance related to its rules is warranted, and if so, in what form such regulatory guidance should be. FINRA also seeks feedback regarding possible comments on proposed rule guidance, prior to its

finalization.

PIABA appreciates FINRA making guidance available upon request. However, PIABA is concerned that guidance could also have unintended consequences that may detrimentally impact FINRA arbitration proceedings and/or the application of FINRA rules. To address such concerns, PIABA requests that FINRA make public its intention to interpret/address a particular rule or issue, and request comments *before* making a final decision to issue the potential guidance. Such a process would help to ensure that only necessary guidance is provided by FINRA and that such guidance reflects not just the interest of the financial industry, but also its customers. It would serve to help reduce, or avoid, the likelihood and magnitude of any unintended consequences. Notice of proposed regulatory guidance should be published in a similar manner as proposed FINRA rules, with a corresponding comment period.

IV. Investor Education.

FINRA is also seeking input regarding its various investor education tools and resources. PIABA believes that investor education is a cornerstone to protecting the public. Most investors begin their financial education process when they encounter individuals employed in the financial industry. Unbiased educational tools that are accessible and broadly marketed to the public are critical.

The financial industry prospers by generating fees from customers. As a result, there is a tension between the revenue generating goal of the financial industry and the preservation and growth of capital of the pubic investor. Most investors have been told, and therefore believe, that their financial advisor is acting as their fiduciary. But those same customers are often unaware of the high fees charged for 'investment advice' and financial products. The availability of better tools and resources would go a long way towards thwarting investment misconduct and assisting investors in maximizing returns through the avoidance of excessive fees and unsuitable investments.

PIABA commends FINRA on the expansion of investor education tools available on its website. The section of the website dedicated to investors represents a vast improvement from what existed in the past. PIABA feels that supplements and modifications to the website, as well as additional marketing, could assist investors in making sound financial decisions. FINRA has required firms to prominently display links and references to BrokerCheck on their websites and materials. FINRA could add a prominent link on its main

BrokerCheck page to the main "Investor" page, for increased awareness of the available tools and resources.

a. Fee Charged by Advisors

One of PIABA's major concerns related to education is making sure that customers understand how they are being charged for investment services and the impact fees have on their portfolios. The FINRA website should include a section devoted to investment fees and expenses incurred by investors and the long-term impact fees have on an investment portfolio. FINRA should also adopt rules and regulations requiring financial institutions to make prominent disclosure of fees and expenses paid by investors.

With the advancement of technology, the financial industry generates impressive account statements detailing the investment holdings of their customers. Oftentimes, the account statements contain graphs showing the account holdings together with information regarding unrealized gains/losses. Invariably, one piece of information that is not contained on the account statements: the total dollar amounts paid to the financial institutions and advisors in fees and costs.

PIABA members routinely examine account statements in evaluating potential investor claims. Even with a trained eye, it is difficult to locate or calculate the fees charged to a customer's account or deducted from a customer's investment. Oftentimes, it takes a forensic review by an expert to determine the amount of fees actually paid by an investor. Most investors do not have the ability to readily ascertain how much a financial institution is charging to hold assets, and even if the amount is disclosed, the ultimate impact of those fees on the investor's account. However, due to truth in lending regulations, these same investors can quickly look at their monthly credit card bills to find out the exact rate of interest and the amounts being charged and the impact of that rate if the "minimum" amount is paid each month. No such disclosure requirements exist for the benefit of customers of securities firms.

The FINRA website does not currently have a section dedicated to fees and expenses charged to investors. A strong component of investor education requires an understanding of these costs and how these costs impact investor's accounts and goals. As part of the engagement initiative, FINRA needs to determine how to educate the public concerning investment fees and commissions. FINRA should consider adopting additional rules requiring investment institutions to prominently display the dollar amount of fees charged on the first page of their monthly statements. Likewise, financial

institutions should be required to set forth the annual percentage fee charged with respect to both the net asset value of accounts and as a percentage of the net gains/losses achieved on account as well as the long-term impact of such fees. Armed with information as to how fees impact an account and the amounts paid with respect to actual returns, individual investors will have better insight as to how fees affect both the short and long-term performance of their investment accounts.

b. Fiduciary Rule

PIABA has been very active in supporting the Department of Labor Conflict of Interest ('Fiduciary Duty') Rule and is critical of rules that create or foster conflicts of interests between customers and advisors. As such, PIABA believes that the FINRA website should include a section detailing the relationship between financial advisors and their customers.

The Fiduciary Rule is critical. Traditionally, registered investment advisers have been held to a fiduciary standard whereas broker-dealers have argued that the lesser suitability standard applies to their business. Investors with claims against financial institutions are often surprised to learn that their investment professional argues that no fiduciary duty exists. It is common for a financial institution with advertisement campaigns touting how it acts in the best interests of its customers to suddenly adopt the position that it is a mere order taker with no fiduciary responsibility when faced with a legal claim in a securities arbitration.[4]

The FINRA website should contain a section that specifically addresses the inherent conflict of interests between financial institutions and their investing customers and the different roles and standards of care that advisors can assume.

c. Access to Attorneys

PIABA also believes that the FINRA website should include a recommendation that investors seek legal advice from a qualified lawyer if they have questions about the way their accounts were handled. The FINRA

4. *See* PIABA's March 25, 2015 report, "Major Investor Losses Due to Conflicted Advice: Brokerage Industry Advertising Creates the Illusion of a Fiduciary Duty," available for download at: https://piaba.org/system/files/pdfs/PIABA%20Conflicted %20Advice%20Report.pdf.

website contains several sections detailing steps an aggrieved investor can take with respect to complaints. The section details the arbitration process and making complaints to FINRA. However, the website currently lacks prominent directions as to how to locate an attorney.

FINRA does have a webpage devoted to finding an attorney:

http://www.finra.org/arbitration-and-mediation/how-find-attorney

However, this web page is not easily accessible from the FINRA navigation tree. It is very difficult to find the page if one begins, like many investors, at the main landing page *http://www.finra.org*. At a minimum, the reference and link to this page should also be added to the existing "Have a Problem" navigation menu and subpages. In particular, investors should be advised that they may want to seek private legal counsel *before* FINRA's existing advice to "1. Contact the firm.... complain in writing."

FINRA should also include prominent language on the "for investor" pages indicating that it acts as an industry sponsored self-regulating authority. The name "Financial Industry Regulation Authority" is deceiving to investors. Most investors reasonably believe that FINRA is a governmental agency. Investors should be advised that FINRA is, in fact, a self-regulatory organization. Investors should also be advised that other options exist for making complaints about a broker or brokerage firm including, but not limited to, state securities regulators, the SEC, state and federal law enforcement and state attorneys general. They should also be reminded that they can hire a private attorney to pursue recovery on their behalf.

FINRA should make a pragmatic disclaimer that it cannot protect all investors from all misconduct. Unfortunately, too many aggrieved investors who make complaints to FINRA believe that FINRA will not only process the complaint, but also seek to recover money on the investors' behalf. Obviously, FINRA's role is different and it is incumbent on the organization promoting "Investor Protection" to make clear its capabilities and limitations.

There are a limited number of organizations whose primary function is investor education. PIABA established The PIABA Foundation with the express purpose of investor education (*http://piabafoundation.org*). The significance of The PIABA Foundation as an educational tool is expanding. Last year, The PIABA Foundation held its first public symposium in California and plans to expand its public symposiums.

The materials generated by The PIABA Foundation and other investor advocacy groups would be helpful to investors seeking a broader understanding of investment issues and we therefore suggest that links to such groups be included on the FINRA website as part of investor education tools. Similarly, links to other entities that serve a similar purpose, such as the North

American Securities Administrators Association ("NASAA"), should be added for the benefit of investors looking for additional resources.

d. BrokerCheck

One of FINRA's primary educational tools is BrokerCheck. It appears that substantial amounts of marketing are devoted to the system, and it has recently received a substantial overhaul in appearance and functionality. While there have been notable improvements to the FINRA BrokerCheck system and regulatory reporting, there is still much to be desired from an investor and practitioner standpoint.

BrokerCheck generally fails to provide an exact duplication of a broker's actual legacy CRD report. Often times, complaints and settlements are omitted from BrokerCheck that appear on the CRD, for no apparent reason.

The search function within the database is very cumbersome and provides results that are often totally unrelated to the search query, or worse, incomplete or incorrect. For example, if a broker is searched and his *former* employing firm is included in the search, the search will result in nothing being found due to the fact that the broker no longer works at his/her former firm. This undermines the whole point when an investor (who may be unaware of the broker's current affiliation) is frustrated and stops searching.

Further, once the user locates the broker, it is important that they find the "Detailed Report" (and not just rely on the broker landing web page). The "Detailed Report" link has become very small and is placed in a location where it is not as easy to find as it once was. It is essentially hidden from an inexperienced user. The detailed report contains information that users may not be able to locate on the broker landing page (which may only show misleading descriptions provided by the broker), and it presents disclosures in an organized manner that is easier to understand compared to the interactive landing page.

Another issue from the recent BrokerCheck formatting changes has been to remove the "report as of date" when accessing a detailed report. This used to be printed on the first page of the detailed report. By not having it, users are unable to tell when a report was generated, which can be very important in tracking changes to disclosure information. PIABA urges FINRA to immediately reinstate the access date.

V. Enforcement and Awards Databases

PIABA's objectives and concerns regarding industry enforcement are focused on transparency, including providing investors and their advocates the most accurate and timely disciplinary and decision information possible. The enforcement database requires a near perfect search parameter for a query to generate a proper result, often resulting in no result at all. The ease of use and corresponding utility of the current database search function is therefore of concern. In addition to broader parameter searches, the function should allow for categorization. For example, category searches by subject matter, by firm, by branch and by registered representative/licensee. This would allow the user to focus on specific issues, individuals or firms to determine how pervasive a problem or improper conduct may be.

The FINRA award database is also found wanting in ease of use and search function utility. Much like the disciplinary action search function, the award database is cumbersome and brings up results often out of chronological sequence with no relation to the query made. Organizing the search terms by category (*e.g.* Claimant, Respondent or Claimants Representative and Respondent Representative) would likely reduce the number of unrelated search results. The lack of case context for the awards is another issue, as awards typically are not explained decisions, and have very little framing of the facts and basis for the determination. Making the related pleadings (Statement of Claim and Answer at minimum) publicly available as part of the award record would help in resolving some of the current shortcomings. Placing the award database link on the *http://www.finra.org* home page would also be helpful to those not familiar with the site, or that an award database even exists. Similarly, FINRA should consider improved scanning and OCR of older awards in the database so that they are captured (and readable) in the search results.

Conclusion

As you can see, PIABA feels that there are still more FINRA engagement programs that could be improved upon, but PIABA commends FINRA's efforts to create such programs as well as to enhance them over time. For example, PIABA feels that the "Senior Helpline" has been an effective education tool that has proven beneficial to the investing public in general. PIABA feels that outreach and feedback requests, such as that requested in this Special Notice Dated March 21, 2017, will help to make sure all FINRA

engagement programs continue to improve and serve their intended purpose. Accordingly, I want to thank you for the opportunity to comment.

Very truly yours,
Marnie C. Lambert
PIABA President

The following PIABA Comment Letter regarding the *SR-FINRA-2017-009 Proposed Rule Change to Amend the Customer and Industry Codes to Expedite List Selection in Arbitration* was submitted to the Securities and Exchange Committee by Marnie Lambert on June 1, 2017 (prepared with the assistance of the Darlene Pasieczny).

Mr. Brent Fields, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File No. SR-FINRA-2017-009
Proposed Rule Change to Amend the Customer and Industry Codes to Expedite List Selection in Arbitration

Dear Mr. Fields:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitration proceedings. Since its formation in 1990, PIABA has promoted the interests of the public investor in the securities arbitration forum, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by the Financial Industry Regulatory Authority ("FINRA") and ensuring that investors' claims are expeditiously resolved in the FINRA Dispute Resolution forum.

PIABA supports the rule changes proposed in SR-FINRA-2017-009, which would update the default timing of when arbitrator ranking lists are sent to the parties, so that lists will be generated within about 30 days after the original date the last answer is due, regardless of whether the parties have agreed to extend an answer deadline.

This change reflects the already-existing general practice of securities arbitration attorneys. It is our members' experience that respondents frequently seek extensions of time for answering a statement of claim. Our members generally agree to such a request but premise their agreement on the willingness of opposing counsel to notify FINRA that the parties want all other deadlines running from the original answer date (*e.g.*, the generation of the arbitrator selection list) to remain unchanged despite the extension of the

answer deadline.[1] Documenting this common practice unnecessarily creates additional work for counsel and FINRA, and can sometime result in problems if there is a misunderstanding or one of the parties reneges.

According to FINRA's Dispute Resolution Statistics through April, 2017, the turnaround time for arbitration proceedings is 14.4 months,[2] which is still longer than most investors want to wait. Therefore, PIABA also supports the proposed rule change because the sooner the arbitrator(s) are appointed, the sooner the Initial Pre-Hearing Conference will take place which, of course, results in the scheduling of the final hearing dates and other important deadlines.

Thank you for giving PIABA the opportunity to comment on this proposed rule change.

Very truly yours,
Marnie C. Lambert
PIABA President

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1. In limited instances, the parties may agree to attempt to resolve a case prior to the respondent filing an answer to the statement of claim. In that situation, it is not uncommon for the parties to agree to extend the answer and the other deadlines that run the other original answer deadline. More specifically, the parties may not want FINRA to generate the arbitrator lists for ranking due to the associated costs. Because the current proposal does not impact FINRA Rule 12207(a), which permits the parties to "agree in writing to extend or modify any deadline for … [r]eturning arbitrator or chairperson lists," the parties may continue to extend the list selection deadline, if necessary, by agreement.

2. *See* Dispute Resolution Statistics, available at https://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics (last accessed May 31, 2017).