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FORCED PORTFOLIO LIQUIDATIONS AND THE IMPLICATIONS ON DAMAGES

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When evaluating a potential case involving a forced liquidation, the measure of damages is not a simple mathematical calculation of net-out-of-pocket ("NOP") losses. Forced liquidations, as a result of margin calls, have many points of inflection where damages can be caused. This article will examine how the actions of the broker dealer in connection with conducting forced liquidations can both cause and exacerbate the customer's damages.

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FINRA registrations held for twenty plus years: Series 3 National Commodities Futures, Series 4 Registered Options Principal, Series 7 General Securities Representative, Series 15 Foreign Currency Options, Series 63 Uniform Securities Agent State Law.

The argument on behalf of the client has to be engaged on many fronts to explain how missteps and actions of the broker dealer occurred and were partially or totally to blame for the damages. Because an account is self-directed, do not automatically assume that convincing a panel is impossible. This article explores the ways that a brokerage client can reach the point of liquidation and the types of issues during the liquidation that can cause damages.

Forced liquidations are low hanging fruit with respect to damages. Every investor should be more than concerned if their broker takes over their account and liquidates some or all of their holdings. It has been observed that the handling of liquidations by broker dealers are not usually in the best interest of the customer and are not done in the most expedient manner, which cause damages to a customer.

First Hurdle to Cross: Customer Agreement and Margin Disclosure

Within every Customer Agreement there is common language addressing liquidations, usually under two topics.

In the first of these clauses, the broker dealer generally states that notwithstanding a general policy of giving customers notice of a margin deficiency, the broker dealer is not obligated to request additional collateral in the event the account falls below minimum maintenance. The second clause generally includes language allowing the broker dealer to liquidate securities and property without notice to the customer to insure "minimum margin requirements" are met.

The phrase "minimum margin requirements", is intentionally vague and the Customer Agreements do not stipulate what the margin requirement is. As a result, only the most sophisticated customers have any idea whether and when their account is approaching a margin deficiency. Moreover, the phrase "margin deficiency" is similarly vague. The measure of unacceptable margin deficiency could mean many things including a brokerage House Requirement, Regulatory Requirement[2], or other defined Risk Requirement which could include Portfolio Margin.

Under the language of the typical Customer Agreement, **the Broker is not obligated to give the customer an opportunity to satisfy a margin deficiency before selling out the securities.** FINRA Rule 4210, the regulatory

2. FINRA Rule 4210 is a regulatory requirement which sets forth the actual percentages of margin which must be maintained in all accounts of customers. These percentages cannot be changed by the broker.

rule governing margin, allows 15 days for the client to remedy a margin call but by industry practice and standards it is usually only one day. In practice, enforcement varies between brokers dealers depending on vagaries of the broker-dealer operations.

Broker dealers rely on this language in their Customer Agreements to argue that they had the right to force a liquidation of the account and were not obligated to ask the customer for additional collateral. Such language can be overcome by an argument that the broker dealer's actions in liquidating the account were done improperly or that mistakes were causing damage to the customer.

Second Hurdle to Cross: FINRA Rule 2264 Margin Disclosure Statement

FINRA has specific rules which require that each broker dealer make the following disclosures to its customers who open a margin account. That margin disclosure statement is set forth in Rule 2664 and states:

(a) No member shall open a margin account, as specified in Regulation T of the Board of Governors of the Federal Reserve System, for or on behalf of a non-institutional customer, unless, prior to or at the time of opening the account, the member has furnished to the customer, individually, in paper or electronic form, and in a separate document (or contained by itself on a separate page as part of another document), the margin disclosure statement specified in this paragraph (a). In addition, any member that permits non-institutional customers either to open accounts online or to engage in transactions in securities online must post such margin disclosure statement on the member's Web site in a clear and conspicuous manner.

- You can lose more funds than you deposit in the margin account.
- The firm can force the sale of securities or other assets in your account(s).
- The firm can sell your securities or other assets without contacting you.
- You are not entitled to choose which securities or other assets in your account(s) are liquidated or sold to meet a margin call.
- The firm can increase its "house" maintenance margin requirements at any time and is not required to provide you advance written notice.
- You are not entitled to an extension of time on a margin call.

This language may be in a separate margin agreement, but often appears as a section of the general Customer Agreement. It is directed at Reg T Customers and Non-institutional accounts.

When assessing a claim for damages, the brokerage firm will argue that it is protected from liability in connection with any margin liquidation by this disclosure. The damages expert may counter that while the broker maintains the right to protect itself in a declining market, *it should not be at the unfair expense of the customer.*

Market Events

Historically there have been many events where the market's price action places stress on broker dealers as it relates to the credit (margin) they extend to their customers. For example, the recent market events related to COVID-19. In March 2020, equity market prices fell over 20% into a bear market (one of the fastest in history coming off an all-time market high) due to concerns of the impact the virus would have on the global economy. Some termed this a "black swan event," since the decline was so sudden and unanticipated. In addition, the energy sector fell further as a result of the 30% drop in oil prices due to the Saudi and Russia dispute regarding production cuts. Based on our collective experience working many cases from past market events (Volmageddon, U.S. Debt credit downgrade, Yuan devaluation), there is no question that this market event has resulted in broker dealers taking actions (margin remedy actions and/or liquidation) which resulted in damages to their customers.

During these periods of stress in the financial system, broker dealers and regulators are on high alert and very focused on the accounts that potentially could become an issue. There is increased scrutiny by the regulators which heightens the sensitivity of the broker dealers with respect to customer margin calls. Market pressures along with heightened regulatory oversight causes irrational actions, bad decisions, and deviations from Standard Operating Procedures (SOPs) and Written Supervisory Procedures (WSPs) by broker dealers in performing customer margin account liquidations.

Before and into the Storm

Imagine a market scenario where the client would be a high net worth individual, active trader or a hedge fund (possibly using a Prime Broker) and is using as much leverage as the broker dealer allows the client and then the market experiences a sudden and sharp reversal. These situations almost always involve portfolios with positions in options (short), options on futures, futures, and leveraged ETFs (2X, 3X and inverse ETFs).

Clients who invest this way are required to qualify for a margin account. There are two types of margin accounts, Reg T and Portfolio Margin. Reg T margin is rules based, while Portfolio Margin is risk based. Brokers have an incentive to extend credit which allows them to capture income in various ways. Interest on debit balances, order flow and short account credits are the most common. This incentivizes them to allow maximum leverage in client margin accounts.

Lower customer margin requirements come with added risk for the broker dealer and the client. Typically, a broker dealer actively manages overall firm risk, but in some instances, doesn't manage its exposure to individual clients as well and permits them to be overly leveraged. When the market experiences an abrupt move to the downside, these accounts are the first to get margin calls and the client is forced to liquidate or the broker dealer takes over and liquidates the client's account.

The following is a list of considerations when analyzing reasons for a liquidation.

- Client is a long-standing customer of the broker dealer. The account may be self-directed, considered a premium account and has access to an assigned customer representative, blurring the line on what might be considered getting investment recommendations.
- The client trades mainly Equities, Equity Options, and ETF's in combinations that makes it difficult to understand at any given time the account's long or short exposure to the market.
- When the Client maintains a large debit balance and/or a large options/ETF margin requirement (combined debit balance) it impacts the risk in the customer account along with the overall financial impact on the brokerage firm. If the client account is large enough and the broker dealer small enough it can affect the broker dealer's regulatory capital.
- Historically, the client generates many margin calls. They can fall into five categories based on the type of Margin Account. Reg T calls, Portfolio Margin calls, House calls, NYSE Calls and Risk Calls. If so, how were they remedied in the past and were all the rules and procedures adhered to?
- Customer is at times highly leveraged and is a highly active trader. The client is typically classified as a "pattern day trader" and is given daily *day trading buying power.*
- Based on the client's trading history with the broker dealer the client may be given preferential margin treatment such as House Requirements waived on certain and/or all securities.

The Liquidation

When the broker dealer issues a margin call, the broker dealer will try to get the customer to act by either depositing funds into the account or making margin/risk reducing trades that meet the margin call. Unfortunately, most customers do not understand what is required with respect to which trades would reduce margin requirements and/or how much a particular trade would reduce the margin call.

As a result, broker dealers may cross over into the recommendation/advice arena related to risk/margin reducing trade recommendations. This action is one area where the broker dealer can cause damages, since generally they do not understand the customer's portfolio investment strategy in aggregate. Such recommendations potentially result in exposing the customer's portfolio to more market risk. In addition, the specific recommendations by broker dealers for margin reductions in fact does not always improve the margin call situation.

Finally, when the liquidation is underway, price distortions occur which cause the margin deficit to increase even though the liquidation was done to correct the margin deficiency. It becomes a self-fulfilling prophecy, resulting in a negative feedback loop causing more damages.

Here are a few actions broker dealers take that in our opinion cause damages to a customer:

- Not understanding the portfolio holdings liquidity and risk characteristics of how each position relates to the other position in the portfolio. When liquidating, broker dealers tend to focus on the largest positions as a priority to liquidate first, which often result in exposing the customer's portfolio to more market risk at the precise wrong time.
- Broker dealer timing of when to initiate the liquidation tends to be at the worst moment – they wait to too long hoping the market will turn or the client will act (wire money or trade) before taking action.
- Broker dealer customer trading systems during stressful periods in the market often have issues either in order executions or margin calculations (buying power). This causes the customer's ability to execute margin/risk reducing trades to be impeded. This results in the broker dealer taking over the account and liquidating the portfolio.
- Customer is taking action to execute risk reducing orders, but the broker dealer disagrees on what the customer is executing or the speed at which the customer is executing orders. Unexpectedly to the customer, the broker dealer shuts the client out of the system and takes over the portfolio and liquidates the holdings in the account.

- Margin/Risk department management overload due to the high volume of accounts with margin issues at the broker dealer. The broker dealer will either sequence through accounts manually or use an automated liquidation trading algorithm disregarding the characteristics of the order as compared to the market conditions resulting in excessive market impact slippage (cost).

Factors to Consider in Evaluating a Liquidation Case

When evaluating a case where a liquidation has occurred there are many factors to consider and evaluate. Here is a list of items to consider in a liquidation case:

- Portfolio holdings, account balances and margin:
  - Concentration
  - Leveraged ETF (2X, 3X and inverse ETFs), Volatility based ETF
  - Short Options or options spreads
  - Short Equity positions
  - Longs and/or shorts or a combination complicates the margin/risk calculations
  - Types of margin accounts and special margin treatment
  - Types of securities approved
  - Cash flow in and out of the account and its effect on leverage
  - Size of debit balance that may require firm regulatory capital
- Market conditions leading up to and during the liquidation:
  - How were margin/risk calls handled in the account prior to the event
  - Changing the margin rules when liquidation is eminent
  - Security, sector or commodity event effecting a customer's portfolio
  - Margin /Risk procedures are not disclosed / understandable
  - Risk Department management overload
- Portfolio consideration when liquidating:
  - Construction – portfolio risk characteristics will have a material impact on liquidation results
  - Leveraged ETF positions
  - Options positions – size, strike vs underlying price, long or short
  - Liquidity of positions
  - Concentration of holding(s) – liquidity and impact costs
- Special House Rules that may impact the liquidation decision: broker dealers often have additional house (risk or position) rules that are considered in addition to either Reg T rules or Portfolio Margin rules.

Damage Calculations

There is no one set methodology when determining damages as a result of a forced liquidation by a broker dealer as opposed to NOP or "well managed account" methods. The methodology used needs to be determined by the timeline of events layered with the missteps by the broker dealer.

Example: An individual retail client was short shares of the VXX Exchange Traded Fund with a market value of $385,164. This was the only position in the account and the margin requirement on the position was at 60% (House Requirement) or $231,098. The account margin equity or credit balance was $248,420.00 prior to the market event. The event was a dramatic spike in the VIX (volatility index) resulting in an increase in the VXX share price from $32.92 to $43.94 in one day, resulting in the account VXX short position increasing to $514,098. At 60% margin, his margin requirement increased to $308,459. With an account value of $144,366 at the close, the House Margin call would be approximately $164,000. The broker dealer never issued a call during regular trading hours even though the client was in a call well before the close.

The broker dealer waited until after the close to issue a margin call while the VXX price continued to rise in after-hours trading. The margin call was sent by email to the client in the early evening leaving him without recourse and the broker liquidated the client's account after hours at prices significantly higher as compared to the close leaving the client with an unsecured debit balance.

The damages requested in this case were based on comparing the account value after the broker dealer liquidated the account to the value when a House Margin call should have been issued allowing the client to take action to remedy the margin call. The difference resulted in a damage amount of approximately $275,000.

An alternative damage analysis would compare the account value after the liquidation to the account value when the account falls below the rules-based NYSE (30%) minimum margin requirement. This occurred around the close of the market when the account had a value of $144,366 versus an account deficit of $38,000 after the liquidation. The difference ($144,366 – (-$38,000)) is a damage amount of $182,366. Although this damage amount is lower, the triggering event is based on a rules-based requirement as opposed to requirement based on the discretion of the broker dealer.

The client secured an award in arbitration with the Panel finding the broker dealer to be liable for failure to timely notify the client and/or liquidate the account when the equity fell below margin requirements. This is in

contradiction to the account agreement and margin disclosure hurdles outlined earlier.

Example: A Hedge Fund was managing a leveraged market neutral investment strategy when equity markets ran in to a period of increased market volatility. The Fund was invested in a portfolio of stocks (long and short), leveraged (3X) ETF/ETNs, inversed leveraged (3X) ETF/ETNs and options on many of the holdings. Historically, the Hedge Fund rarely had any sizable margin calls until the period in question.

The Fund was under Reg T/FINRA margin rules and during the period in question was never in a margin deficit. What caused the margin issue for the Fund was an additional arbitrarily imposed margin calculation by the broker dealer (which was specific and unique to this broker dealer). This additional requirement was a surprise to the Hedge Fund. The Fund executed transactions that they believed would reduce the margin call. Unfortunately, the efforts by the Fund did not reduce the margin call even though the executions reduced the risk level of the portfolio.

As time passed, the arbitrarily imposed margin call became larger even though the Fund was executing risk reducing trades. The problem was not due to the Fund's actions, but because the broker dealer was incorrectly calculating their own arbitrarily imposed margin rule. Specifically, the broker dealer was making incorrect calculations for the leveraged and inversed leveraged ETF/ETN positions (incorrect leverage factor and incorrect polarity). The broker dealer demanded that the Fund sell specific positions (these positions were short the market) to alleviate the call. The Fund argued against those demands because selling those positions would cause the Fund's portfolio to have more market risk. Eventually, the Fund was forced to sell the positions by the broker dealer.

The misstep the broker dealer had in this case was that their calculation of the additional arbitrarily imposed margin rule was incorrect based on their own defined rules. If these positions had been correctly calculated, the additional margin rule would never have been applied and the forced trades would not have been required to be executed. The forced trade positions would had gained in valued, resulting in lost opportunity gains, and therefore, damages.

Summary/Conclusion

We believe that NOP damage calculations should not be the final consideration on how to view damages. Customers who are forced to liquidate or have their account liquidated outright by the broker dealer many times are harmed by the mistakes and missteps of the broker dealer. Often these errors

and misjudgments occur well before the actual liquidation resulting in a timeline for damages that is much longer than initially considered. Market prices get distorted when illiquid or concentrated positions get sold at the "market".

During periods of mass market turmoil, mandated supervisory procedures tend not to be followed or get changed at the last minute to the detriment of the customer. Margin calls and Risk Calls are poorly understood by the client and are not consistently enforced by the broker. As we have outlined, when the broker dealer is liquidating multiple customers at the same time and their personnel get overloaded, they are usually using an automated system creating more distortion in the "market". Broker dealers deviating from their normal procedures can deprive the client from having control of their account when facing a margin call.

HOW TO EVAULATE OPTION CLAIMS IN CUSTOMER DISPUTES

Frederick Rosenberg

This is the second of two articles about options: the first was directed to experts whose analyses are often inadequate to substantiate their opinions,[1] and this article is directed to attorneys evaluating, valuing, and trying option cases. I'm hoping that many will find it to be a basic resource on options variables and their effect on outcomes.

Options cases present unique demands on account analysts who too often merely quantify the Net Out of Pocket (NOP) damages and match trades without providing an understandable options-based rationale for risk and suitability opinions. The absence of appropriate analysis has left attorneys representing parties in options litigation often unprepared to cross examine opposing witnesses or to develop and present substantiating evidence. Since an expert does not conduct cross-examination but offers only opinion evidence, counsel must be fully conversant with the options strategies in dispute and alert to weaknesses and inconsistencies evidenced in the trading analysis.

Option Contract (=100 shares): An option contract is a "Derivative" security that takes its value from another underlying security. The option contract gives a purchaser the right to either buy or sell an underlying security in the future at an agreed price.

Call Option: A call option gives the option buyer the right to take or call the shares of the underlying security from the option seller on or before a given expiration date at the strike price.

Put Option: A put option gives the option buyer the right to sell or put the shares of the underlying security to an option seller on or before a given expiration date at the strike price.

Premium: The premium is the market price of the option at which the trade is made.

Strike Price: The price at which the option can be exercised and assigned prior to expiration. To execute an option, the buyer places an exercise order with a broker, and the Options Clearing Corporation Assigns the option on a random basis, closing out the position and delivering or receiving the security.

Equity and Index Options: Equity Options are option contracts that are written on individual stocks and when exercised require the purchase or

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1. Fred Rosenberg, *Options Costly Pitfalls in Short Options Analysis*, PIABA Journal Vol. 27 No. 1 2020.

delivery of the underlying shares. Index Options are option contracts that are written against a specific index and are cash settlement only. As a general rule, Index Options are too broad to go to zero, have constant and predictable volatility and market correlations, and are the preferred portfolio hedging tool. Hedging is primarily achieved with the purchase (not sale) of out-of-the-money Index Options.

Option Buying: Purchasing an option is a bet on the market's direction and speed and appears to have generally well understood risks and rewards. About 70% of options purchasers lose some or all of their investment, all within expectations. An Option Buyer's maximum loss is the premium paid, but the buyer's upside is unlimited.

Option Selling: Selling an option is also a bet on the market's direction and speed. Depending on the time to expiration, between 70% and 90% of short options are profitable and expire worthless. The strategy depends on time-value decay, the fewer days to expiration the faster the Time Value declines. An Option Seller's maximum profit is limited to the premium received if the option expires worthless, but the seller's maximum loss is potentially unlimited.

Pricing: Objectively, traders want to know if an option is trading above or below its fair price. Determining the fair price for a traded option in comparison with the market price informs whether an option is over or under-valued and ultimately when to buy or sell. Many options sites include an options calculator where variables can be tested to determine the effect on option prices utilizing the Black Scholes formula. Options pricing depends on multiple variables, including:

1) the underlying stock price,
2) the strike price at which the security must be purchased or sold in the future,
3) the days to expiration,
4) volatility and
5) implied volatility.

Black Scholes:[2] In 1973, Fisher Black and Myron Scholes published their formula for option pricing for which Scholes was awarded a Nobel Prize, and Black, who had died and was ineligible to share the prize, was given special mention. The formula was expanded by Robert Merton and is a standard throughout the options community

Millions of option contracts are traded daily, often by computer programs designed to take advantage of small inefficiencies in pricing. The Black-

2. Fischer Black and Myron Scholes, *The Pricing of Options and Corporate Liabilities,* Journal of Political Economy, Vol. 81, No. 3 (1973).

Sholes model uses Standard Deviation of the underlying security as an analog for risk, the time to expiration, the current safe rate, dividends, and the strike price and market value of the underlying security. The formula calculates an Implied Volatility for the option that is essential in pricing models. Outcomes can then be predicted, providing trigger points to close out an open position or unwind a spread.

From those variables, options professionals assess risk and pricing using analytic ratios known as the "Greeks," ratios labeled with Greek alphabet characters.

The "Greeks": There about a dozen "Greeks" that traders use to project outcomes, but here are the top three:

a. **Delta** is the amount of expected movement in the option for every dollar movement in the underlying stock. So, if an underlying stock moved up or down by $1, an option with a Delta of .5 will increase or decrease by 50 cents.

b. **Theta** measures the rate at which the time-premium decays based solely on the remaining days to expiration. Short term options have a high Theta and time-premium decays rapidly and at an accelerating pace. Low Theta options contracts with long-term expirations (>180 days) are virtually unaffected by daily time decay since expiration is too far out to overcome the volatility, speed, and direction of the underlying security.

c. **Vega** is the expected $ price movement in the option for every 1% move in the price of the underlying security, *i.e.*, a 1% move in a $100 stock, $1.00, moves the option price by $0.30 for example.

Speed and direction of the market: Options writers must properly judge both the speed and direction of the market in order to assess risk and return. For every option written, Expiration is the principal objective and the fewer the days to expiration and the deeper out-of-the-money the option is written the faster the Time Value drops. Time Decay is measured by Theta.

Intrinsic Value: This is the value any given option would have if it were exercised that day. It is the amount by which the strike price of an option is in-the-money. All options contracts with intrinsic value will be exercised unless the writer repurchases the option to close the position.

PUT: When the market price of the underlying stock drops below the strike price of a Put Option, the option will be in-the-money and have "intrinsic value" measured by the difference between the strike price and market price, *e.g.* a put option with a strike price of $100 when the market price of the underlying security is $90/share has an intrinsic value of $10 x 100 shares=$1000.

CALL: When the market price of the underlying stock climbs above the strike price of a Call Option, the option will be in-the-money and have

"intrinsic value" measured by the difference between the market price and strike price. A Call option with a strike price of $100 when the market price is $110 has an intrinsic value of $10 x 100 shares=$1000.

Extrinsic value: Extrinsic value, which is also known as **Time Value** of an option, is the amount by which an option's market price exceeds its intrinsic value. It is considered the "risk premium" paid in the market and is directly correlated with the time remaining to expiration.

Open/Close: There are two stages to an option contract, the Opening Transaction that establishes the conditions and terms of the option, and a Closing Transaction in which the opening option contract expires worthless, is exercised, or is repurchased. Open or Close must be marked on order tickets and shown on confirmations and statements.

In-the-Money/Out-of-the-Money (Moneyness): This concept is of critical importance in pricing and managing risk. In-the-money options have intrinsic value and get exercised, out-of-the-money options expire worthless at expiration.

In-the-money put option values increase dollar for dollar with the decline of the underlying stock below the strike price, making repurchase costly. The risk is nearly unlimited as, for example, a $100 stock could become worthless and the put writer could be forced to purchase 100 worthless shares at $100 /sh or $10,000 for each put written, only minimally offset by the $200-$300 in premium taken in.

In-the-money call option values increase dollar for dollar with the rise of the underlying stock above the strike price, increasing the repurchase cost and risking assignment. The risk is substantial depending on time to expiration. For example, a $100 stock could rise to $150, forty dollars above the $110 strike and the call writer could be forced to sell 100 shares @ $110/share, a ten-point profit but forty points ($4,000) thousand dollars below the market offset minimally by the $200-$300 in premium taken in.

Margin: By rule, all options transactions must be in a Type 2-Margin account and all options agreements must also contain a margin agreement. Options opening purchases must be fully paid and are ineligible for margin. Short options, however, because of the potential for substantial loss, will be required to mark-to-market adequate cash or securities to guarantee performance, part of which is the premium received.

Hedging: Unfortunately, selling short is often pitched erroneously as a "hedge," but a true hedge is an insurance policy that protects against catastrophic loss for a price (the premium). If it's protecting your house, the policy may have a $10,000 deductible to keep the premium cost low. If it's a market hedge (*i.e.,* portfolio insurance), an out-of-the-money option is purchased that will increase in value dollar-for-dollar with the stock's adverse

movement deeper into-the-money, thereby providing absolute protection against catastrophe for a specific period (and a good night's sleep to the short seller). With a hedge, it is the purchaser of an out-of-the-money option who is hedging, not the seller who takes on virtually unlimited risk.

Cash Collateralized Short Puts: Because the loss potential on a short put is nearly unlimited, adequate collateral must be maintained in the type 2 account or secured by cash to assure available funds to purchase the underlying stock.

Assignment and Exercise: American style options that are in-the-money can be exercised any time prior to expiration. When an option purchaser wishes to Exercise an option, a notice is sent to the Options Clearing Corporation which will Assign the exercised option randomly to option writers. The Assigned writer will then be obligated to purchase or deliver the underlying shares at the strike price. "Assigned" or "Exercised" will be reported on statements and confirms.

Assignments: Assignments, which should be rare (<2%), bury if not hide the repurchase costs and losses in the equities positions, thereby inflating options profits in most analyses. Higher levels of assignments suggest a pattern of disguising options losses. Quantifying the repurchase cost of assigned options in many cases illustrates that a reported profitable options strategy is a substantial and undisclosed drag on performance and a demonstrable loss.

To calculate the repurchase cost at parity, you will need the price of the stock on the assignment date (something not shown on the trade confirmations or monthly account statements), minus the strike price times the number of shares. Absent the repurchase cost at parity, the success or failure of the strategy cannot be quantified.

Assigned Stock: Where the principal strategy is selling puts to capture premium, assigned stock would normally be sold for an immediate loss. Writing covered calls on assigned shares delays and masks realization of the loss, caps upside recovery, and still carries market risk in the stock. Ideally, there should be no assignments found in trading analysis and the presence of a substantial number of covered calls indicates a failure to execute the strategy properly.

Covered Calls: If the underlying stock is held in the account when the call is written, the option is considered "covered", obviating the collateral requirement because the contract can be fulfilled by delivering out the stock. The underlying stock must be held until expiration or assignment. A Covered Call strategy on a stock is neutral designed to Capture Premium from expiring out-of-the-money Calls. The expectation is that the price of the underlying stock will not rise fast enough to be in-the-money and expire worthless, essentially a bet against the stock. The strategy is then repeated to generate a

small amount of additional income. Given the potential for total loss on the underlying stock, however, the premiums received cushion downside only marginally but caps upside substantially

Short Put Strategy: This neutral to bullish strategy is designed to Capture Premium from the expiration of out-of-the-money puts. The strategy is then repeated to generate a small amount of additional income. The risk can be substantial, however, since the underlying security price could decline to zero, forcing the purchase of worthless stock at the strike price.

Protective Puts and Calls: As with equities positions, the downside risk of a short option can be hedged by purchasing an out-of-the-money "protective" put or call as an insurance policy against sharp adverse movements in the underlying security. The protective option would then increase dollar for dollar with the stock's adverse movement deeper into the money.

Spreads: A spread is the simultaneous purchase and sale of an option on an underlying stock for a net debit or credit and is a risk-controlled approach to options trading. Spreads are entered and liquidated through a "Spread Desk" for a net debit or credit and require a higher level of trading approval than option purchases and covered calls despite being lower risk, and most investors are not approved for trading spreads.

Debit Spread: In a debit spread the cost of an option is offset in part by the premium received from the sale of the same option with a strike price further out-of-the-money. For example, buy the 100 option at $3.00, sell the 105 at $1.50 for a net debit of $1.50, the maximum at risk with an upside of $3.50 if the stock rises to 105 or higher.

Credit Spread: In a credit spread, the premium received from the sale of an option is offset by the cost of the same option with a strike price further out-of-the-money. For example, sell the 100 option at $3.00, buy the 105 at $1.50 for a net credit of $1.50, the maximum gain, and a downside of $3.50 if the stock rises to 105 or higher.

Legging in: Each position in a spread is call a "leg." Investors can leg-in to a spread with a second option position at a later time.

Hedging: A hedge is an insurance policy intended to protect an existing asset against catastrophic loss. Hedging with options requires an existing portfolio to protect, not cash, which is riskless and itself a hedge. Purchasing out-of-the-money puts hedge against sharp declines in the underlying security albeit at a cost and only for a limited period. The strategy has been termed portfolio insurance. A Short Put strategy is the opposite of a hedge with unlimited downside and very limited upside.

Combinations: These consist of the pairing of two options. Some common examples include:

- **A long straddle** is the simultaneous purchase of an at-the-money put and call on the same stock and strike price. Long Straddles are a bet that a volatile option will move substantially in either direction so that the profitable side will more than offset the premiums' cost.
- **Short straddles:** A short straddle is the simultaneous sale of an at-the-money put and call on the same stock at the same strike price betting that the underlying stock will remain unchanged through expiration to capture two expired premiums. The two premiums cushion the loss if one side is assigned.
- **Strangles** are the simultaneous purchase of an out-of-the-money put and call on the same stock expecting a volatile stock to move up or down sufficiently to offset the premium cost.
- **Reverse Strangle** is the sale of an out-of-the-money put and call on the same stock to capture two premiums from low volatile stocks. The two premiums cushion the loss if one side is exercised.
- **Iron Condor:** Another strategy, one that is the source of investor litigation, is the iron condor. The iron condor is constructed by selling an out-of-the-money put and buying an out-of-the-money put with a lower strike, and selling an out-of-the-money call and buying an out-of-the-money call with a higher strike. All options have the same expiration date and are on the same underlying asset. The put and call sides must have the same spread width or the results will be skewed and no longer neutral. This trading strategy earns a net premium and is designed to take advantage of a stock experiencing low volatility. The iron condor is perceived to be a low-risk strategy with a high probability of earning a small amount of premium.

Fundamental Analysis: While an underlying security may be identified through traditional fundamental analysis, the variables controlling option pricing (including implied volatility, fair value, the speed and direction of the market, days to expiration, and moneyness) are essential for quantifying and assessing risk and pricing. Fundamental analysis plays little, if any, role in the options markets and is not a defense in options litigation.

Deconstruction and Analysis: Virtually all option trading can be broken down and deconstructed into its constituent variables no matter how complex the strategy. A portfolio of covered calls written on average 30 days to expiration are distinguishable from portfolios that average 270 to expiration with markedly different risk.

Focus on the premiums: The important variables in options trading analysis are not stock fundamentals, allocation, or sector. Instead, analysis of

options requires analysis of the premiums, days to expiration, moneyness, assignments, expirations, repurchases, and repurchase cost of assigned options to support risk conclusions and testimony.

Options Premium Analysis: This type of analysis is my usual starting point to assess the options strategies. Below is an example. What the analysis reveals is that 93 assignments shifted $1.15 million in costs to the equities, well outside of the normal range for explainable reasons. All opening positions were short on average 247 days to expiration and several in-the-money short positions were assigned months before expiration, which averaged 104 days on close. Were the portfolio hedged to contain loss or legged into spreads, there would have been a comparable number of Buy/Open transactions; but the analysis showed none. Notably, 90% of the equities in the account were assignments. Instead of being sold for an immediate loss, each assigned stock had covered Calls written against it locking it in, capping growth, generating additional premium, but amplifying risk.

In point of fact, filing a pleading in option litigation without reviewing this type of analysis, will leave counsel unprepared for opponents who have.

Option Premium Analysis

Sell Open

Yamana Gold

PUT YAMANA GOLD INC @ $3 EXP 01/15/16		Date	Exp	Asgn			NetShares:		Prem	Amount	stk@mkt	Out of $ / (In the $)	Repo cost*	Days to Exp	Prem / mkt
Put	Account No:	6/26/2015	☐	☐	Sell	Open	10,000		$0.36	$3,639	2.92	($0.08)		203	12.5%
			trades 1		Total		10,000	Avg	$0.36	$3,639				203	
CALL YAMANA GOLD INC @ $5 EXP 01/20/17		**Date**	**Exp**	**Asgn**			**NetShares:**		**Prem**	**Amount**	**stk@mkt**	**Out of $ / (In the $)**	**Repo cost***	**Days to Exp**	**Prem / mkt**
Call	Account No:	2/12/2016	☐	☐	Sell	Open	1,900		$0.30	$578	2.68	$2.32		343	11.4%
Call	Account No:	2/12/2016	☐	☐	Sell	Open	17,800		$0.30	$5,419	2.68	$2.32		343	11.4%
Call	Account No:	2/12/2016	☐	☐	Sell	Open	4,300		$0.30	$1,309	2.68	$2.32		343	11.4%
Call	Account No:	2/12/2016	☐	☐	Sell	Open	3,000		$0.30	$913	2.68	$2.32		343	11.4%
			trades 4		Total		27,000	Avg	$0.30	$8,220				343	
PUT YAMANA GOLD INC @ $2 EXP 01/20/17		**Date**	**Exp**	**Asgn**			**NetShares:**		**Prem**	**Amount**	**stk@mkt**	**Out of $ / (In the $)**	**Repo cost***	**Days to Exp**	**Prem / mkt**
Put	Account No:	2/17/2016	☐	☐	Sell	Open	6,000		$0.44	$2,660	2.50	$0.50		338	17.7%
			trades 1		Total		6,000	Avg	$0.44	$2,660				338	
CALL YAMANA GOLD INC @ $5.5 EXP 01/20/17		**Date**	**Exp**	**Asgn**			**NetShares:**		**Prem**	**Amount**	**stk@mkt**	**Out of $ / (In the $)**	**Repo cost***	**Days to Exp**	**Prem / mkt**
Call	Account No:	3/3/2016	☐	☐	Sell	Open	10,000		$0.24	$2,439	3.03	$2.47		323	8.0%
			trades 1		Total		10,000	Avg	$0.24	$2,439				323	
CALL YAMANA GOLD INC @ $7 EXP 01/20/17		**Date**	**Exp**	**Asgn**			**NetShares:**		**Prem**	**Amount**	**stk@mkt**	**Out of $ / (In the $)**	**Repo cost***	**Days to Exp**	**Prem / mkt**
Call	Account No:	4/20/2016	☐	☐	Sell	Open	13,000		$0.29	$3,823	4.28	$2.72		275	6.9%
Call	Account No:	4/20/2016	☐	☐	Sell	Open	10,000		$0.29	$2,939	4.28	$2.72		275	6.9%
			trades 2		Total		23,000	Avg	$0.29	$6,762				275	
PUT YAMANA GOLD INC @ $4.5 EXP 01/20/17		**Date**	**Exp**	**Asgn**			**NetShares:**		**Prem**	**Amount**	**stk@mkt**	**Out of $ / (In the $)**	**Repo cost***	**Days to Exp**	**Prem / mkt**
Put	Account No:	7/19/2016	☐	☐	Sell	Open	3,000		$0.37	$1,115	5.84	$1.34		185	6.4%
			trades 1		Total		3,000	Avg	$0.37	$1,115				185	
PUT YAMANA GOLD INC @ $4.5 EXP 01/19/18		**Date**	**Exp**	**Asgn**			**NetShares:**		**Prem**	**Amount**	**stk@mkt**	**Out of $ / (In the $)**	**Repo cost***	**Days to Exp**	**Prem / mkt**
Put	Account No:	1/20/2017	☐	☐	Sell	Open	500		$1.70	$852	3.21	($1.29)		364	53.1%
			trades 1		Total		500	Avg	$1.70	$852				364	
	Yamana Gold	trades 23		Sell	Open		111,500	Avg	$0.54	$48,867				237	
						Total Shares									
	Total trades 690			**Sell**	**Open**		**891,500**	**Avg**	**$2.60**	**$2,110,073**				**247**	

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Option Premium Analysis

Buy Close

Yamana Gold

		Date	Exp	Asgn			NetShares:		Prem	Amount	stk@mkt	Out of $ / (In the $)	Repo cost*	Days to Exp	Prem / mkt $
PUT YAMANA GOLD INC @ $4.5 EXP 01/20/17															
Put	Acct No:	12/28/2016	☐	☑	Buy	Close	2,500		$0.00	$0	2.97	($1.53)	($3,825)	23	0.0%
			trades 1		Total		2,500	Avg	$0.00	$0			($3,825)	23	
CALL YAMANA GOLD INC @ $5 EXP 01/20/17															
Covered Call	Acct No:	1/20/2017	☑	☐	Buy	Close	27,000		$0.00	$0	3.21	$1.79		0	0.0%
			trades 1		Total		27,000	Avg	$0.00	$0				0	
CALL YAMANA GOLD INC @ $5.5 EXP 01/20/17															
Covered Call	Acct No:	1/20/2017	☑	☐	Buy	Close	10,000		$0.00	$0	3.21	$2.29		0	0.0%
			trades 1		Total		10,000	Avg	$0.00	$0				0	
CALL YAMANA GOLD INC @ $7 EXP 01/20/17															
Covered Call	Acct No:	1/20/2017	☑	☐	Buy	Close	23,000		$0.00	$0	3.21	$3.79		0	0.0%
			trades 1		Total		23,000	Avg	$0.00	$0				0	
PUT YAMANA GOLD INC @ $4.5 EXP 01/20/17															
Put	Acct No:	1/20/2017	☐	☐	Buy	Close	500		$1.37	($687)	3.21	($1.29)		0	42.8%
			trades 1		Total		500	Avg	$1.37	($687)				0	
PUT YAMANA GOLD INC @ $4.5 EXP 01/19/18															
Put	Acct No:	1/19/2018	☐	☑	Buy	Close	500		$0.00		3.34	($1.16)	($580)	0	0.0%
			trades 1		Total		500	Avg	$0.00				($580)	0	
	Yamana Gold	trades 18			Buy	Close	111,500	Avg	$0.08	($847)			($69,078)	17	
	Buy Close	Trades 487					Avg prem $1.75			($1,270,540)			($1,150,259)	104	

Total Trades 1179	Reported Option P/L $839,446	Est Repo cost ($1,150,259)	Adj Option P/L ($310,813)

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Conclusion

Options cases are often shortchanged by attorneys and their analysts who see only NOPs instead of determining and quantifying the causative factors leading to the contested outcome. Broad diversion from expected outcomes, typically on the loss side, are explainable, quantifiable, and for the most part a foreseeable and preventable consequence of excessive options risk. Did the strategy actually succeed in adding value or fail, and were the contributing factors identified and quantified to support the proof?

A thorough options premium analysis is required to determine if an options strategy was actually implemented properly and that all risks were adequately disclosed and understood. Without adequate preparation and pleading, the learning curve for Arbitrators in a hearing will be steeper than normal.

DISCOVERY DEMANDS IN FINRA ARBITRATION – ONE SIZE DOES NOT FIT ALL DISCOVERY REQUESTS IN FINRA ARBITRATION

Timothy O'Connor[1] *and Sam A. Silverstein*[2]

I. Introduction

Practitioners on both sides of a securities arbitration should carefully consider the relatively simple discovery rules of the FINRA Code of Arbitration Procedure. Unlike the more entangling provisions of state and federal laws, discovery under the FINRA Rules of Arbitration Procedure are straightforward, without the torturous provisions of discovery rules mandated by the court.

Some argue that the FINRA Rules of Arbitration Procedure do not provide sufficient guidance, but most seasoned securities arbitration practitioners representing investors believe that this is all more the reason for them to make the case for relevant documents and information from the outset of the case, right in the Statement of Claim.[3]

The reason for this is because if there is a dispute about the breath of your discovery requests, you can refer the arbitrators to assertions made in the Statement of Claim. Your requests are relevant if you teed-up related issues in your clients' pleading. All the more reason to write detailed Statements of Claim, for one size does not fit all.

In this article, I examine the discovery rules and recommend the best way to use them to your clients' advantage.

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3. *See* FINRA Notice to Members 11-17 (2011), FINRA Notice to Members 13-40 (2013), FINRA Notice to Members 14-40 (2014) and FINRA Notice to Members 18-22 (2018).

II. FINRA Discovery Rules[4]

a) Presumptive Discovery Pursuant To FINRA Rule 12506

Rule 12506 of the FINRA Rules of Arbitration Procedure and the Discovery Guide set forth the documents and information which the respective sides to customer claims are required to provide to opposing counsel without the necessity of a formal discovery demand seeking these items.

The two lists have undergone several changes over the years and there are ongoing initiatives to add yet further and other items to it. One of the most common complaints heard about the lists are that its use of certain generic terminology fails in certain circumstances to fully particularize included documents and information. Given the variety of investment products and customer victimization schemes which forms the basis of the customer complaints, it is incumbent upon a customer's counsel to clearly make the case that specific documents and information are as a matter of course subsumed by one or several items contained on Lists 1 and 2 of the Discovery Guide.[5] Alternatively, customized demands can be a more effective approach when dealing with cases calling for investment vehicle specific demands.[6]

b) Customized Demands For Documents And Information Pursuant To FINRA Rule 12507

While the presumptive discovery categories set forth in List 1 of the Discovery Guide encompass the lion's share of relevant documents and information in customer cases, cases involving esoteric investments and even apparent bread and butter investments require the production of specific categories of documents and information not while specifically particularized

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4. All of the Customer code discovery rules and the Discovery Guide appear at the end of the article as Appendix A.

5. *See* FINRA Notice to Members 11-17 (2011), FINRA Notice to Members 13-40 (2013), FINRA Notice to Members 14-40 (2014) and FINRA Notice to Members 18-22 (2018).

6. *See* FINRA Rule 12507 (2017).

in the Discovery Guide, but nonetheless are encompassed by one or various enumerated items in the Discovery Guide.

For example:

1. Cases involving junk bonds - distressed debt offerings - require attorneys to drill down on TRACE records for each transaction.
2. Cases involving the dumping of failing securities issues into the accounts of unsuspecting customers will require the production of broker dealer's principal holding pages and documents and information evidencing possible cross-sales.
3. Private placement cases require the production of due diligence files, selling agreements, accredited investor questionnaires.
4. Best execution cases require the production of internal market sourcing records, as well as payment for money flow arrangements which broker dealers may have with certain market makers.

And these are just a few examples.

c) How Do I know What Specific Documents and Information Are Needed In My Case?

The answer to the question is this: Seek a consultation with an expert witness or an attorney experienced with claims in the product area of your case.

Whether or not the documents and information you are seeking are presumptively discoverable under Rule 12506 or additional items sought under Rule 12507, it is essential that your discovery demand includes discovery of documents and information related to your specific claim.

From my experience, brokerage firms will not go out of their way to produce specific documents, information and/or witnesses unless claimant's counsel doggedly pursues them with focused requests and demands. Indeed, the discovery demand process is "where the rubber meets the road" and Respondents counsel have meaningful opportunities to size up their adversaries (Claimants counsel) by assessing scope and focus of discovery demands, including their specificity.

Many customer cases have seen subpar recoveries or have even gone down in flames due to the fact that the "smoking gun" was never asked for; opposing counsel won't shoot themselves in the foot if that can be forestalled.

While Respondent's counsel are duty bound under the FINRA Rules to provide presumptive discovery and any additional items requested and ordered for production by an arbitration panel, they surely will not go out of

their way to produce damning documents, information and witnesses unless specifically asked for and even then, the production of such damaging items may easily require discovery motion practice. Claimants' counsel needs to ask for those needles in the haystacks but, before that, reference their existence in the Statement of Claim.

Attorneys who are newcomers to representing customers in FINRA arbitrations are best served taking the time to fully research the documentary and factual underpinnings of their claims or better yet, contacting a competent expert witness or attorney seasoned in this area of securities brokerage customer claims.

The Public Investors Advocate Bar Association (PIABA), a nationwide organization of approximately 400 attorneys, has formed a network of expert witnesses with experience in various product and wrongful conduct-type claims typically pursued by victimized investors. Another source is the Securities Expert Roundtable[7] which consists of highly experienced experts in distinct subjects.

A number of law schools in the State of New York maintain securities arbitration clinics to represent the interests of income/net worth qualified investors. They include Fordham Law School, New York Law School, St. John's, Pace University Law School, Cardozo Law School and Cornell Law School.

In the respondent's arena, the Securities Industry Financial and Markets Association (SIFMA) has its own counterpart network of members who continually circulate updates, bulletins and notices which include topics of interest of broker dealers and their associated persons desirous of avoiding being the target of adversarial claims.[8]

While there are certain customer cases that are so black and white that one might argue that an expert witness is unnecessary, more likely than not whether the decision is made to merely retain an expert to assist in framing a Statement of Claim and drafting Rule 12507 discovery demand and/or actually retaining such an expert to testify at hearings, expert witnesses are an essential resource in this arena.

In the same vein, expert witnesses oftentimes have crossed paths with other expert witnesses. A seasoned expert is one who might assist you in sizing up any disclosed experts retained by Respondent's counsel. Further

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7. *See* http://securitiesexpert.org/ (last viewed June 3, 2020).

8. SIFMA'S headquarters are located at 120 Broadway, 35th Floor, New York, New York 10271 (212) 313-1200 and 1099 New York Avenue, NW, 6th Floor, Washington DC 20001 (202) 962-7300.

yet, as in other areas of the law, opposing expert witnesses can be effectively cross-examined or even neutralized on the basis of available transcripts of their prior testimony, adverse employment history, bogus credentials or lack of meaningful experience or knowledge.

Seasoned experts and attorneys practicing in the area of securities brokerage customer claims can also be a valuable resource when ranking and striking proposed arbitrators pursuant to the FINRA arbitrator selection rules. They can be a useful resource for vetting the decisional history of arbitrators when considering the ranking and striking of proposed arbitrators. FINRA Office of Dispute Resolution maintains an online database of Award going back to 1995; see https://www.finra.org/arbitration-mediation/arbitration-awards.

III. Relevancy of Discovery Demands and the Need for Arbitration Panels to Assure the Provision of all Relevant and Necessary Documents and Information

Many cases involve tens of thousands of pages of documents produced in electronic format. Some will suggest that Respondents counsel can intentionally produce thousands of pages of peripheral or non-essential documents and information so as to bog down the discovery process or otherwise hide that proverbial needle in the haystack. Several rounds of discovery follow-up letters appropriately tailored with headers focusing upon the most relevant documents and information can serve, later on, as the best exhibits in a discovery motion seeking to compel the production of documents that are clearly in their possession.

It is my belief that defense counsel will be loathe to want to face an arbitration panel in the discovery motion context when faced with several pointed letters from claimant's counsel fully particularizing the categories of documents and information which have not been produced with specific reference to the pagination in question or the redactions which have been made on apparently relevant documents.

While it may sound like an unnecessary expenditure of time, Claimants counsel would be wise to spoon feed their adversaries, in plain language, about the clear relevancy and requirements for the production of documents and information when Respondent's counsel might be stonewalling on discovery. Tying specific demands to the Discovery Guide's presumptive discovery list is ideal. Further, many additional demands which might at first glance be deemed to constitute additional documents and information

pursuant to FINRA Rule 12507 can nonetheless fall in List 1 categories of the Discovery Guide.

One of the grounds for a court to vacate an arbitration Award is the failure of an arbitration panel to consider or hear relevant evidence. That is why they often err on the side of allowing everything into evidence and, in discovery, allowing all the utensils found in a kitchen sink.

IV. The Challenges of Collecting Documents from Clients

a) Wealthy Customers and the Discovery Guide

Representing wealthy customers presents unique challenges from your average customer arbitration and nowhere else in the arbitration process – from the filing of a claim through the issuance of an Award – are these challenges more apparent than during discovery. From a claimants' bar perspective, "client control" issues may arise as the long list of detailed financial documentation outlined in the *Discovery Guide* can often be rebuffed or ignored by a client claiming that such sensitive information is irrelevant to her claim.

It has been argued that several of the *Discovery Guide* List 2 categories - specifically those focused on non-brokerage financial documents (tax returns, lists of customer assets and the like) and business ownership - are overly burdensome on customers.[9] After all, without that information, the brokerage firm was perfectly pleased to open the customer's account and engage in the transactions at issue in the arbitration. This argument of burdensome requests is magnified when representing a wealthy customer whose net worth and financial dealing are far larger than the matters that led to the filing of a claim. Seeking $1 million in compensatory damages for such customers, for example, are often a matter of principle and not a matter of principal.

For example, take the case of a CEO who brought a claim stating that his broker misrepresented the nature of two hedge fund investments he purchased which later lost significant value. The customer had multiple accounts at several firms and the two hedge fund investments at issue accounted for a miniscule percentage of his overall investments. Despite the specified nature of his claim – two investments over the course of two years

9. Most notably by PIABA in its Comment Letter to FINRA of August 24, 2010, penned by its then President Scott R. Shewan.

– the *Discovery Guide* mandated that he provide six years of tax returns,[10] financial documents exhibiting his net worth and sensitive corporate documents outlining his ownership and control.

None of this information was pertinent to the issue of whether his broker adequately explained the two investments at issue – a fact the client was not shy about repeating. While other securities accounts are relevant to claims of unsuitability – to determine whether the customer purchased the subject investments at other firms – respondent's counsel in this case knew the two investments could only be purchased through its client. However, pursuant to the *Discovery Guide*, information regarding the other accounts still had to be provided.

b) Senior Citizens and Discovery Documents

While younger generations are accustomed to electronic documents and sharing personal information over the internet, senior citizens are more likely to maintain paper records and are often uncomfortable sharing their personal, financial information. The typical practice of sharing a Dropbox folder or mailing a thumb drive probably will not be an option when representing a senior citizen. Much like the tales you have heard from parents and grandparents, working with seniors during discovery is going to take hard, often manual, labor.

A few years ago, I represented an elderly couple in a Puerto Rico bond case. The husband and wife, 85 and 84 years old respectively, had lived in the same house for over 50 years and shared an email address. It simply was not plausible to expect this couple to upload their statements and tax returns. Luckily, they maintained copies of the documents we needed to provide, however they were in boxes up in their attic. Not expecting this couple to schlep pounds of paperwork to the post office, we went to their house and picked them up ourselves. After scanning them for production to opposing counsel, those documents went right back in the grocery bags we received them in to be returned to the clients.

FINRA may afford seniors certain courtesies, like expedited hearings, but their *Discovery Guide* obligations are the same as any other claimant.

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10. The *Discovery Guide* List 2, Item 1 seeks tax returns dating back three years from the date of purchase through the date the Statement of Claim is filed, not just those filed by the customer but also those filed by entities over which the customer has control. (which, for wealthy customers, can be numerous).

So, what other ways can a practitioner best assist his elderly clients in navigating through FINRA's discovery obligations?

c) Assisting Clients with Their Discovery Obligations

The first step must be performed during the case intake process. A practitioner must let her potential client know the discovery obligations of parties prior to the filing of a Statement of Claim. Glenn S. Gitomer, in his article for PIABA's 18th Annual Meeting in 2010, stated that the client must be made to appreciate the fact that "it will have to open its doors to exhaustive disclosures beyond what the client may consider to be *relevant*. Make it abundantly clear from the outset that the case may be substantially compromised if the client fails to fully and completely cooperate during the discovery process."[11]

Asking the customer, early on, to assess whether she wants to subject herself to such detailed disclosure – what Professor Seth Lipner refers to as "a financial colonoscopy" - in order to bring a claim "puts the ball in their court" and eliminates any risk of the client being surprised by the breadth of documents requested of them. Let me rephrase that – it may not *eliminate* the risk of surprise; it could just *reduce* the risk of surprise by an indifferent, wealthy customer.

Once clients are apprised of their discovery obligations, a practitioner should provide them with detailed instructions related to the *Discovery Guide*. I have found that simply providing a customer with a copy of the *Discovery Guide* is insufficient and often causes the client to be confused and frustrated given the broad language. After all, laymen are not familiar with "the wonderful world of securities arbitration."

In order to avoid these issues, it helps to provide the client with a Word version copy of the *Discovery Guide* with detailed, client-specific comments outlining the exact documents they need to produce and why. These comments will help avoid or reduce confusion on behalf of the client or the person the client has put in charge of producing documents.

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11. Glenn S. Gitomer, *The Intake, Evaluation and Management of Cases Involving Wealthy and Sophisticated Investors*, PIABA 18th Annual Meeting Book, 2010.

d) Stipulation In Lieu of Production

Even if a practitioner follows these two steps, it is still not uncommon for clients, particularly wealthy or elderly ones, to resist the sensitive disclosures outlined in the *Discovery Guide*. So, how does a claimant's attorney avoid having his client become recalcitrant during discovery, exposing the client to costly and potentially damaging motion practice?

Oftentimes, clients are more comfortable providing affirmations or stipulations of their net worth in lieu of providing sensitive financial documents. However, it is rare to find a respondent's counsel willing to accept such an alternative without motion practice. Before proposing to your clients that they can provide an affirmation in lieu of documents, you must make it clear that this alternative has to be approved by the arbitration chairperson and that having a chairperson issue such an order - in contrast to the *Discovery Guide* - is an uphill battle; this is why the two steps listed above are so important to put the client on notice.

One way to support an argument for stipulations instead of documents is to use a firm's own documents against them. It all starts with the New Account Form.

Every new account form provides a financial profile for the customer and, in many instances, these forms are not updated from the time the customer opened her account. This is the financial profile that the broker and the firm's supervisors had when the alleged wrongdoing took place. The profile was created without the wide-ranging and detailed documents listed in the *Discovery Guide*.

V. Discovery Motion Practice

The FINRA Rules of Arbitration Procedure require that before filing discovery motions counsel must articulate their good faith, best efforts towards procuring the cooperation of opposing counsel prior to filing a discovery motion. This is somewhat analogous to the general spirit of the state and federal discovery rules.[12] A finely tailored discovery demand, which has been comprehensively ignored, coupled with proof of several documented phone calls and follow-up letters, will generally suffice this pre-requisite of a good faith effort to gain your opponent's cooperation.

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12. *See* FINRA Manual of Arbitration Procedure Customer Disputes Rule 12505 (2008).

The Initial Pre-Hearing Conference Scheduling Order should also fully particularize and anticipate possible discovery disputes with scheduled deadlines for compliance and motions. Some FINRA panels have become more proactive and have successfully moderated discovery disputes with separate discovery sessions moderated by the panel chair with the resultant rulings directing or declining the production of documents and information sought. See Rule 12500 of the FINRA Manual of Arbitration Procedure/Customer Disputes.

Counsel for any party to an arbitration proceeding are best serving their clients' interests by clearly making known to an arbitration panel the significance of sought-after but contested discovery demands. Most arbitration panels can be expected to provide a reasoned ruling on a discovery dispute when properly and comprehensively provided with the authority and relevance of contested documents, information and witnesses.

Discovery disputes in securities brokerage customer claims filed with the American Arbitration Association or JAMS should expect more *ad hoc* procedures and rulings when faced with discovery disputes depending upon the makeup of the arbitrators sitting on the case, the agreed upon rules of procedures and the venue of the claims.

VI. The Importance of Providing Sufficient Factual Allegations in the Underlying Statement of Claim to Support the Production of Documents and Information

The FINRA Code of Arbitration Procedure affords Claimants counsel wide discretion as to how particularized the Statements of Claim might be.

12302. Filing and Serving an Initial Statement of Claim

(a) Filing Claim with the Director

To initiate an arbitration, a claimant must file the following with the Director:

(1) Signed and dated Submission Agreement; and

(2) A statement of claim specifying the relevant facts and remedies requested

The claimant may include any additional documents supporting the statement of claim.

These provisions notwithstanding, there is a growing trend of Respondents counsel to treat the overly broad Statement of Claim as being ripe for a motion for more particularized Statement of Claim analogous to the rule under the CPLR in the Federal Rules of Civil Procedure. Many argue that such motion to practice is inimical to the spirit of the arbitration process

as a whole and can serve to see arbitration claims degenerate into bogged down and endless documentary exchanges designed to obfuscate, as well as delay an ultimate hearing on the merits.

While some cases are well suited for a brief summary of the nature of a claim and prayer for relief, other types of cases beg for a full particularization of the alleged wrongdoing. Claimants counsel could surely almost hear Respondents counsel at the hearing objecting to documents and witnesses with the battle cry that "It's not in the Statement of Claim and this is the first time we are hearing of this; therefore, it is not relevant."

VII. Stipulations to Facts in Lieu of the Production of Contested Documents and Information

Some arbitration proceedings have been known to drag on with multiple hearing sessions lasting over a period of years when hearing sessions become protracted evidentiary disputes over the admissibility and relevance of documents, information and witnesses. Arbitration panels have been known to fall into this trap adjourning to "executive session" with each successive admissibility objection, with such sessions lasting up to an hour each before resolution can be had. Some argue that Respondent's counsel intentionally delay and stretch out cases over multiple sessions - over months and even years - so that any damning evidence and testimony ultimately becomes lost on the arbitrators at the time of their final deliberations.

Anticipating such delays Claimant's counsel should consider having the arbitration panel chair include a stipulated exhibits filing deadline in the Initial Pre-Hearing Conference Scheduling Order. Such stipulations regarding documents, information and witnesses can go a long way towards assuring that the panel is focused on the merits of the case and not getting lost in the relevant delay tactics and irrelevant arguments. In addition to the stipulation to documents, information and witnesses, stipulations on contested facts can also serve to assure the expedited and efficient use of hearing time without differing the panel from an essential task of giving full and fair consideration to the essence of the arguments on both sides of the fence.

VIII. Orders of Appearance

An Order of Appearance pursuant to Rule 12513 of the FINRA Code of Arbitration Procedure should be a fairly straightforward matter involving the procuring of the arbitration panel chair's signature on an appropriately worded single sheet of paper. Stipulations to the production of witnesses without the involvement of the arbitration panel might be your better route and avoid the cost and time associated with having to make a motion. Prior to filing a proposed Order of Production, counsel for the requesting party is required to make known his or her desire for the production of a particular witness accompanied with a reason for the relevance and necessity of the witness.

Orders of Appearance and Production require all associated persons of a member firm to fully cooperate and appear or otherwise risk regulatory and disciplinary sanctions. Even with a stipulation, an Order of Appearance and Production might be necessary to assure the production of a witness who may have departed from the firm in question but otherwise remains in the industry after having been hired away by another firm.

IX. Subpoenas

Unlike Orders of Appearance and Production for associated persons of a FINRA member firm, many cases require the testimony of employees of broker dealers who are not FINRA registered associated persons. Rule 12512 is the subpoena rule. Examples include receptionists, sales assistants, investment advisor representatives of registered investment advisory firms, cashiers and trading surveillance. In addition to these categories of non-registered employees of brokerage firms, subpoenas may also be necessary for unaffiliated third parties such as family members, accountants, other customers, retired former FINRA registered associated persons.

Somewhat akin to an eviction proceeding, the process of a subpoena for a witness can require congenial efforts, notifications and correspondence similar to that pursued for Orders of Appearance and Production making known to the anticipated witness their apparent involvement, the necessity of their testimony and the anticipated time and place of their anticipated testimony.

Unlike Orders of Appearance, FINRA panels cannot impose any regulatory or disciplinary sanction upon non-associated persons who are not registered and licensed with FINRA. In this context, the process of

compelling by subpoena an uncooperative witness who fails to appear to testify can require a separate foray into federal court to compel their attendance.

X. Preserving On The Record The Failure To Produce Relevant Documents and Information

As the case proceeds through the discovery process and progresses along the various discovery deadlines set in the Initial Pre-Hearing Conference Order, preserve on the record any failure to produce relevant, necessary and/or required documents and information. The substantive hearing sessions on the merits of a case with a fully empaneled FINRA arbitration panel is not the best time or place to make known the failure of opposing counsel to cooperate with the discovery process. In this context, one can clearly hear opposing counsel whining that any such concerns regarding missing documents, information and witnesses should have been pursued many months prior to hearings.

XI. In Closing

As an experienced securities arbitration attorney, I also suggest that diligent Claimants counsel should start the framing of demands for documents and information not, in the first instance, with the issuance of a formal written discovery demand after the receipt of an Answer from Respondent's counsel, but rather, within the four corners of the Statement of Claim.

Statistics show that over 85 % of FINRA venued arbitration claims are settled without proceeding through the issuance of a full award by an arbitration panel. I strongly suggest that in many instances, cases are settled due to the fact that the Respondent firms are not desirous of producing relevant documents and information which might tend to more clearly support the claims set forth in a Claimant's Statement of Claim.

Additionally, it is suggested that claims are also settled by respondent firms due to the simple fact that the production of certain documents and information might serve to expose the firm to regulatory, as well as criminal liability. Respondent firms are also vigilant of the fact that the production of certain documents and information might serve to bring to light the victimization of other customers of the firm, usually serviced by the same broker, who were victimized in similar fashion.

A PRIMER ON CONFIDENTIALITY AGREEMENTS IN SECURITIES ARBITRATIONS RE-THINKING THE FORM

Seth Lipner[1]

Confidentiality Agreements are ubiquitous in securities arbitration, yet there is no standard form or single customary model utilized by even experienced counsel. Often, Respondent's proposed agreements are accepted wholesale by investor counsel. Be warned: Confidentiality Agreements contain provisions that could have important implications; not paying attention to all the terms, or failing to negotiate appropriate ones, can have regrettable and unintended consequences.

This article:

- Analyzes Confidentiality Agreements, trying to achieve a fair balancing of interests and
- Offers a form appropriate for all parties to use.

Trade Secrecy Law Does Not Justify Confidentiality in Securities Arbitration

Financial Services firms typically demand confidentiality over a broad range of internal—and sometimes external—documents. The firms want confidentiality for their:

- Compliance Manuals,
- Commission payout rates,
- Supervisory material,
- Marketing material,
- Internal communications and
- A host of other allegedly "proprietary" documents.

These demands often rest on a false premise: that these types of documents contain "trade secrets."

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Both the federal Economic Espionage Act of 1996 and the state Uniform Trade Secrets Act ("UTSA") require that a party alleging trade secrecy "derive[] independent economic value . . . from [the information] not being known to . . . another person who can obtain economic value from the disclosure or use of the information."[2] By the time a securities arbitration is commenced, the information exchanged in discovery is nearly always stale (i.e., out-of-date) and out-of-date information has no economic value to competitors or would-be competitors.

Documents containing out-of-date information (i.e., information that might once have had the characteristics of a trade secret but no longer qualify for trade secret protection) and documents that do not contain trade secrets include:

- Dated research reports and old marketing material;
- Compliance Manuals;[3]
- Commission pay-out rates that are widely known and fairly uniform throughout the industry;[4] and
- Internal communications between a financial advisor and his supervisor.[5]

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2. 18 U.S.C. § 1839(3) (2020) (emphasis added); Uniform Trade Secrets Act §1.4 (1979) (emphasis added).

3. Compliance Manuals do not have the characteristics of a trade secret. They are widely distributed within the firm, often without express restriction and without labels stating they are confidential. Indeed, nearly every employee in the firm has access to the manual, and can easily reproduce it; these employees are not routinely asked to return or destroy copies upon the completion of employment. These manuals are not kept under lock and key—the way real trade secrets are. In short, Compliance Manuals do not qualify as Trade Secrets. These documents, however, are protected as "literary works" from copying by the Copyright Act. *See* 17 U.S.C. § 102(a).

4. Indeed, some firm publish their pay-out rates. *See, e.g.* UBS WEALTH MANAGEMENT USA, *Understanding our fees, charges, and other compensation*, https://www.ubs.com/us/en/wealth-management/about-us/fees-and-other-compensation.html (last visited May16, 2020).

5. The fact that disclosure might damage a party trying to prevent dissemination does not create a trade secret. The subject of the secret must have "independent economic value . . . from not being generally known" to the alleged owner. *See* 18 U.S.C. § 1839(3)(B) ("the information derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable through proper means by, another person who can obtain economic value from the disclosure or use of the information."); Uniform Trade Secrets Act §1.4 (A trade

Nevertheless, Respondents in securities arbitration seek, and typically obtain, Confidentiality Agreements or Stipulations requiring that at least some documents—documents that do not contain trade secrets—be kept "confidential." This practice is well-ingrained and not likely to change, even if it should.

Financial Privacy Laws Justify Confidentiality of Certain Documents

There can be no serious dispute that documents containing the financial information of any person are entitled to complete confidentiality.

- Banks and financial institutions must maintain published policies and procedures designed to keep their clients' personal information from being disclosed.[6]
- Confidentiality Agreements that protect against disclosure of financial information are justified and ought to be non-objectionable.
- Given the plethora of federal and state privacy laws, one might question the need for express agreements declaring the confidentiality of that which is already protected against public disclosure.[7]

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secret derives independent economic value if competitors would gain "some advantage" or "a competitive edge" from obtaining it.). *See, e.g., Ackerman v. Kimball Int'l Inc.*, 634 N.E.2d 778 (Ind. Ct. App. 1994), *aff'd in relevant part*, *Ackerman v. Kimball Int'l, Inc.*, 652 N.E.2d 507, 508 (Ind. 1995).

6. *See, e.g.*, Bank Secrecy Act ("BSA"), 31 U.S.C. § 5311, *et seq.*; Right to Financial Privacy Act ("RFPA"), 12 U.S.C. § 3401, *et seq,*; Gramm-Leach-Bliley Act ("GLBA"), 15 U.S.C. § 6801, *et seq.*; Fair Credit Reporting Act ("FCRA"), 15 U.S.C. § 1681, *et seq.*; *see generally* WIKIPEDIA, *Financial privacy laws in the United States*, https://en.wikipedia.org/wiki/Financial_privacy_laws_in_the_United_States (last visited May 16, 2020).

7. Many states have both statutes and common law rules creating causes of actions for, inter alia, bringing publicity to private facts. *See* generally, DIGITAL MEDIA LAW PROJECT, *Publication of Private Facts*, http://www.dmlp.org/legal-guide/publication-private-facts (last visited May 16, 2020).

Why Do Brokerage Firms Want All-Inclusive Confidentiality Terms?

The main interest of financial services firms trying to prevent disclosure of such information is threefold:

1. Preventing parties and attorneys who learn about improper activity from publicizing such activity and advertising for cases using that information;
2. Inhibiting customer attorneys from collaborating with other customer attorneys in product cases and multiple-victim cases; and
3. Stopping the news media from investigating and reporting on the causes of financial disasters.

Simply put, the main rationale of Confidentiality Agreements drafted by brokerage firm attorneys is to limit "bad facts" from being known outside that arbitration.

Respondents sometimes try to justify broad Confidentiality Agreements on the ground that arbitration is private dispute resolution. That justification fails because, while arbitration is private *i.e.* the public may not attend the proceedings or access the filings, arbitration is not a "secret" process.[8]

Non-confidential documents thus do not become confidential simply because an arbitration was commenced. The FINRA Discovery Guide has a section—almost a page long—on Confidentiality Agreements.[9] If FINRA believed that arbitration imposed automatic and complete confidentiality on the parties, it would have stated that in one sentence.

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8. *See* FINRA Arbitrators Guide at p. 33, *available at* https://www.finra.org/sites/default/files/arbitrators-ref-guide.pdf *see also* AAA Statement of Ethical Principles, *available at* https://www.adr.org/StatementofEthicalPrinciples ("An arbitration proceeding is a private process. In addition, AAA staff and AAA neutrals have an ethical obligation to keep information confidential. However, the AAA takes no position on whether parties should or should not agree to keep the proceeding and award confidential between themselves. The parties always have a right to disclose details of the proceeding, unless they have a separate confidentiality agreement.").

9. Discovery Guide and Document Production List at p. 4, *available at* https://www.finra.org/sites/default/files/ArbMed/p394527.pdf (hereinafter "Discovery Guide").

The Investor's Interest in Confidentiality – A Study in Conflicting Needs

An investor's desire for confidentiality is different from that of a brokerage firm.

In the hands of a financial services firm or its attorneys, the personal financial information of an investor in arbitration is confidential whether or not an arbitration is extant. Unlike the firm, there is no reason requiring the investor to seek a Confidentiality Agreement from an arbitration Respondent. While investors nevertheless want to enter into a Confidentiality Agreement as to certain documents they provide to Respondent-brokerage firms (such as other brokerage statements, financial statements, tax returns and other items containing personal financial information), the investor's need for protection is not symmetrical with that of the firms. Financial services firms are required by both law and their own policies from publicly disclosing their clients' financial information.[10]

The asymmetry between the confidentiality demands of Respondent firms and the lack of any real need for investors to extract Confidentiality Agreements should be kept in mind by arbitrators when they are asked to rule on issues of confidentiality. The burdens imposed by Confidentiality Agreements are substantial, and the rationale for imposing confidentiality for information that is neither a trade secret nor a person's financial information is thin. Arbitrators must, therefore, be cautious in imposing broad, essentially one-sided obligations that stifle retention and dissemination of information about the cause of financial harm and product failures.

FINRA's Discovery Guide on Confidentiality

The Discovery Guide's section on Confidentiality begins by stating that a party or the arbitrator(s) may "suggest a stipulation . . . that the documents . . . will not be disclosed or used in any manner outside the arbitration of the particular case, or the arbitrators may issue a confidential order."[11]

Yet, aside from a general list of considerations and conflicting interests to be considered in deciding whether a document should be given confidentiality treatment, the *Discovery Guide* offers no guidance with regard to the terms of a Stipulation or the form of a Confidentiality Agreement.

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10. *See* 15 U.S.C. § 6801(b) *et seq*. (2020).

11. *Id.*

This article fills that gap, delineating:

- The appropriate terms for a Confidentiality Stipulation or Agreement in a FINRA arbitration;
- A proposed definition of what is meant by "Confidential"; and
- How confidential documents and information should be treated.

The Article does not address whether any particular document deserves confidential treatment. The proper characterization of a specific document requires analysis of that document.

The goal of the form agreement I propose in the last section of this article is a fair and comprehensive one that addresses the legitimate business, professional and ethical concerns of all parties and their counsel. But first, what follows is a proposed confidentiality agreement recently sent to me by a brokerage firm's attorney.

Agreement Proposed by Brokerage Firm – A One-Sided Form

Brokerage firms typically take up the mantle/cudgel of confidentiality before responding to the FINRA *Discovery Guide's* list of presumptively discoverable documents, often proposing the broadest possible terms. Here is an example:

CONFIDENTIALITY AGREEMENT AND STIPULATION

The parties to this matter (the "Parties") have entered into this Confidentiality Agreement and Stipulation (this "Agreement") to acknowledge and protect the confidentiality of documents and things, as well as the information contained therein, that may be obtained, exchanged and/or produced in this matter. Accordingly, the Parties hereby stipulate and agree that:

1. Each Party may designate as "confidential" any documents and things that it may produce in connection with this matter. Each Party shall designate such documents and things as "confidential" by stamping or otherwise affixing the word "CONFIDENTIAL" upon the documents and things so designated.

2. Any and all documents and things designated as "confidential" and the information contained therein shall be used by the Parties solely for the purpose of the instant matter and shall not be used, either directly or indirectly, for any other purpose and/or in any other proceeding or matter.

3. Any and all documents and things designated as "confidential" and the information contained therein shall be maintained safely and securely and shall be reasonably safeguarded from disclosure by the Parties (and/or their employees, representatives and agents).

4. Any and all documents and things designated as "confidential" and the information contained therein shall not be disclosed to any person or entity except those persons and entities specifically identified in the following subparagraphs:

(a) Counsel of record for each of the Parties, including their employees, representatives and agents who are necessarily involved in this matter.

(b) The Parties, including their employees, representatives and agents who are necessarily involved in this matter.

(c) The arbitration panel and FINRA employees.

(d) Any experts, consultants and independent contractors acting on behalf of the Parties for use in connection with this matter, so long as such experts, consultants and independent contractors agree in writing to be bound by this Agreement.

(e) Any person or entity as may be required by law, by order of any court of competent jurisdiction or by any governmental agency or self-regulatory organization.

(f) Any person that any Party believes in good faith to be a potential fact witness herein, provided that any such person is provided with a copy of this Agreement and agrees in writing to be bound by this Agreement.

5. (a) In the event that any Party is called upon to disclose any documents and things that have been designated as "confidential" and/or the information contained therein in any way, either directly or indirectly, to any person or entity pursuant to subparagraph 4(e) of this Agreement or otherwise, the Party so called upon shall promptly (and prior to any disclosure) notify the producing Party in writing of the proposed disclosure, and in such written notice shall specify the name, employment and/or affiliation and address of the person or entity seeking disclosure and describe with specificity the documents and things and/or information being sought.

(b) In the event that any Party objects to the disclosure of the materials as provided under paragraph 5(a), the objecting Party shall within twenty (20) days notify the Party called upon to disclose the documents and things in writing of such objection and the grounds therefor. If the dispute cannot be resolved, the objecting Party may apply to the arbitration panel, court or other tribunal, as may be appropriate, that has issued the demand, subpoena, order or other legal process seeking the disclosure of materials marked "confidential" pursuant hereto and establish the basis for any ruling

sought. There shall be no disclosure pending a resolution of the dispute by the arbitration panel, court or other tribunal, as may be appropriate, that has issued the demand, subpoena, order or other legal process seeking the disclosure of such "confidential" materials.

6. Documents and things designated as "confidential" or the information contained therein may be referred to in materials such as briefs and memoranda filed with the arbitration panel or made exhibits to such materials or be exhibited during the arbitration in this matter.

7. This Agreement shall have no bearing upon and shall not affect the relevancy, authenticity and/or admissibility of any documents and things or information contained therein.

8. At the conclusion of this matter, all documents and things designated "confidential," as well as any reproductions thereof, shall be destroyed or returned to the producing Party.

9. The Parties acknowledge and agree that a breach of this Agreement shall subject the producing Party to substantial and irreparable harm, the nature and extent of which is not readily quantifiable, such that the producing Party shall be entitled to obtain injunctive relief, to seek damages and/or to apply for other or further protective orders before the arbitration panel, court or other tribunal, as may be appropriate.

10. To the extent that any Party inadvertently produces any documents and things that would be otherwise protected from disclosure by any privilege, immunity or doctrine of law, such production is not intended to be, and shall not be construed to be, a waiver of any such privilege, immunity or doctrine. Any such documents and things that are inadvertently produced shall, after written notice by or to the Party receiving the privileged documents, be promptly returned to the producing Party, and no copies or records shall be kept by the receiving Party.

Inherent Problem with The Proposed Agreement

This proposed Confidentiality Agreement is excessively broad. Not only does it purport to make all documents in the arbitration confidential, it places undo restraints on Claimant's counsel.

The provisions on breadth, use and destruction are the troublesome areas. At the same time, the proposed agreement lacks certain protections and clarifications that should be added—although the form does include an important clause on the inadvertent production of privileged documents; a provision too often omitted.

1) Breadth

The proposed agreement has a broad confidentiality definition that allows any document to be marked "Confidential."[12] The FINRA *Discovery Guide*, as already noted, assumes a narrower scope.

FRCP Guidance Provides Limitations on Trade Secrets

Claimant's counsel should not agree that Respondent can mark "any document" confidential.[13] Confidentiality exists only when there is a legal basis for requiring the receiving party to maintain confidentiality.[14] Federal Rule of Civil Procedure 26(c)(7), for example, provides that, "for good cause shown . . . the court may make any order . . . that a trade secret or other confidential research, development, or commercial information not be disclosed or be disclosed only in a designated way." The Federal Rule itself shows that the proper scope of confidentiality is limited to documents that deserve such treatment.[15]

Trade secrets, as shown at the outset, are typically rarely involved in customer securities arbitrations. Nevertheless, the practice at FINRA is to grant confidentiality broadly over all internal company documents, which firms typically define—albeit loosely because it is not a term known to the law

12. Indeed, some Respondents routinely mark all documents "Confidential."

13. One can never predict what will happen during or after an arbitration. Perhaps outrageous conduct is revealed; are the Claimant and the Claimant's lawyer forever prevented from becoming a whistleblower, a qui tam plaintiff, or prohibited from making a criminal or regulatory referral? Can the Claimant or her lawyer notify the media, or tweet about the result or use other Internet channels to inform the public of egregious misconduct directed at investors? The *Discovery Guide's* admonitions—that the burden of establishing confidentiality is on the party seeking it—implicitly rejects the assertion, sometimes made by Respondents, that everything that takes place in arbitration is veiled in confidentiality.

14. "Sunlight is said to be the best of disinfectants." Louis D. Brandeis, *What Publicity Can Do*, HARPER'S WEEKLY (1913).

15. *See Cipollone v. Liggett Group, Inc.*, 785 F.2d 1108, 1121 (3rd Cir. 1986); *Wilk v. American Medical Association*, 635 F.2d 1295, 1299 (7th Cir. 1980) (citing *American Telephone & Telegraph Co. v. Grad*y, 594 F.2d 594, 596 (7th Cir. 1978), *cert. denied*, 440 U.S. 971 (1979).

-- "proprietary business information."[16] The protection of this sketchy category can be justified because the information—otherwise internal to the firm—is being disclosed only because an arbitration was commenced. Federal Rule of Civil Procedure 26(c)(1)(G) authorizes courts to issue protective orders in discovery where the materials involve "trade secret or other confidential research, development, or commercial information."[17] The word "confidential" in the Rule modifies "commercial information"; not all corporate commercial information is covered. Investors' attorneys should challenge the firms to identify and define categories that properly deserve confidential treatment.

Three categories of protected information should thus be identified in the Agreement:

(a) trade secrets,
(b) proprietary information still being used in the firm's business, and
(c) personal financial information of an individual.

The three categories all have the characteristics needed for "Confidentiality." If the parties wish to include other categories they can do so, but a failure to define the other categories invites over-use of the confidentiality designation, as well as arguments about it.

The category "proprietary business information"—with its inherent vagueness—cries out for a list of examples, such as:

- compliance manuals,
- internal documents regarding investment strategies,
- compliance or supervision, and
- documents of a similar nature.

This type of list gives proprietary business information a context against which to judge the otherwise vague term. But these documents must still be used in the firm's business. Information no longer in use – *e.g.* about a product no longer being sold – should not be deemed confidential or "proprietary." In the absence of some other rational explanation, arbitrators should presume that

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16. The word proprietary means "owned." Copyrights, patents and trade secrets are the typical—and exclusive—forms of business information capable of being owned. *See Sears Roebuck & Co. v. Stiffel Co*., 376 U.S. 225 (1964); *Compco Corp. v. DayBrite Lighting, Inc.*, 376 U.S. 234 (1964). *See also International News Service v. Associated Press*, 248 U.S. 215 (1918) (Brandeis, J., dissenting).

17. Fed. R. Civ. P. 26(c)(1)(G).

the firm's only interest in keeping stale information confidential is to cover up wrongdoing.[18]

The Agreement should also provide that a party may only designate as "Confidential" documents the party in good faith believes fit one of these categories. Overbroad or wholesale designations are unjustified; the good faith requirement is a logical addition.

2) Burden of Establishing Confidentiality

Confidentiality Agreements should expressly state that the burden of establishing the "Confidentiality" of documents shall at all times be on the party seeking confidentiality. The FINRA *Discovery Guide* places the burden of establishing confidentiality on the proponent, but the Agreement, once executed, supersedes the Guide.[19] A provision is needed.

3) Stamping / Automatic Confidentiality

Confidentiality Agreements provide that a party seeking confidentiality should stamp the document "Confidential" to indicate a request for such treatment. Documents so stamped thus come within the Agreement.

The Agreement, however, should also state that all documents containing "the personal financial information of any natural person" will automatically be deemed to be within the restrictions on dissemination contained in the Agreement. Confidentiality of documents containing personal financial information is self-evident; the suggested provision alleviates the need to mark "Confidential" (*e.g.*, tax returns). Adding the provision avoids the risk that documents which contain such information, but which were accidentally not designated might be treated improperly.

A provision creating automatic confidentiality for documents containing personal financial information imposes little or no additional obligation on Respondent since financial services firms owe their customers that level of

18. The amounts and basis of compensation to individuals should be protected from disclosure under the third bullet, above. Firm compensation, as opposed to individual compensation, lacks the necessary privacy interest.

19. Note that the provision is absent from the Agreement above. Claimants' attorneys must be careful to make sure the provision is included.

confidentiality in any event. But, sometimes the financial information on a document is not that of the customer.

Perhaps the document details commission/earnings information of the broker, or the document contains the personal financial information of a third party. Every receiving attorney should recognize such information as being (at least presumptively) private and that disclosure of it would be improper. No attorney should reveal such information, regardless of whether the document was marked "Confidential."

Documents Already in Claimant's Possession

Claimant's counsel will want to carve out from the confidentiality obligations any documents or information already in the Claimant's hands. A document given to Claimant without confidentiality (e.g., an internal marketing material or an internal research report e-mailed by the broker to the customer) does not suddenly become confidential because an arbitration was commenced and Respondent produced another copy of the document during discovery. Nor should such a document be subject to the "destroy/delete" provision prevalent in all these agreements.

Documents Already in Respondent's Possession That Contain Claimant's Financial Information

Documents concerning Claimant's finances in brokerage firm account forms are confidential to the customer. They contain information already provided by the customer and need no stamp of confidentiality to "protect" them. Such account-related documents reflect what Claimant advised Respondent and should not, thereafter, become hostage to a Confidentiality Agreement.

The simplest examples are Claimant's monthly brokerage statements; they should not be marked "Confidential" by Respondent.[20] More to the point, an account analysis or a profit and loss analysis of Claimant's account, or the amount of fees a Claimant paid a firm—even if prepared by Respondent—is not properly designated "Confidential" by Respondent. Claimant should be

20. Consider, for example, if the statement was so marked. The effect is that Respondent is requiring Claimant to destroy his own statements at the end of the arbitration, and that the Claimant must extract a "Confidentiality Agreement" from every advisor or expert to whom it is shown.

able to use, and retain, that document for any purpose, even after the arbitration concludes.[21]

Use Restrictions and Case-Specific Confidentiality

The agreements that Respondents routinely propose contain case-specific use clauses. These clauses state that the confidential documents can be used only in the instant arbitration and for no other purpose.

These use restrictions cannot be justified on the basis of trade secrecy law because trade secrecy is typically not involved. The confidentiality provided for internal documents labelled "proprietary" must be viewed in the context of Respondent's arguably legitimate purpose—preventing public and media disclosure of the firm's internal communications and procedures. But preventing similarly-situated investors from sharing discovered information—subject to restrictions on public dissemination and publicity—is not justified.

Case-specific use provisions, if adhered to literally, create conflicts between and among clients, law firms and experts. They trouble investors' attorneys, especially in cases involving flawed financial products (so-called "product cases") and in cases where multiple investors were harmed by the same financial advisor. Sharing increases knowledge. It also creates efficiencies in cases where many pages of documents might be produced in discovery. It is wrong for firms to use Confidentiality Agreements to prevent similarly situated plaintiffs from collaborating; the sole purpose is to stifle disclosure of wrongdoing.

Case-specific use provisions are also troublesome for expert witnesses engaged for such cases. Experts are often engaged in multiple cases, sometimes brought by different law firms and these agreements require such experts to abide by the case-specific Confidentiality Agreement that governs the parties for that particular case. Experienced experts hesitate to sign such an agreement.

For the lawyer not intending to collaborate with others, a single case use agreement can present problems in the future. A lawyer's professional abilities (and attractiveness to potential clients) depend on experience and accumulated knowledge; the same is true for experts. As a result, case-specific

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21. New Account Forms, correspondence, e-mails between firm and customer, or account summaries created by Respondents should all fall outside the Agreement and its restrictions; they should not be marked Confidential by Respondent. A provision in the agreement such as that suggested here is recommended protection against a Respondent with an over-zealous stamp.

Confidentiality Agreements limit what a lawyer can say when advising a client, or what an expert "knows," must be avoided. [22]

Case-specific use agreements should never be permitted in product cases and in multiple-victim cases. Similarly situated Claimants should be permitted to engage in shared discovery to coordinate their strategy.[23] Case specific

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22. *See* ABA Canon of Professional Ethics, Canon 2 ("A Lawyer Should Assist the Legal Profession in Fulfilling Its Duty to Make Legal Counsel Available"); ABA Canon of Professional Ethics, Ethical Considerations 2-1 ("The need of members of the public for legal services is met only if they recognize their legal problems, appreciate the importance of seeking assistance, and are able to obtain the services of acceptable legal counsel. Hence, important functions of the legal profession are to educate laypersons to recognize their problems, to facilitate the process of intelligent selection of lawyers, and to assist in making legal services fully available."). *Cf.* DR 2-108: Agreements Restricting the Practice of a Lawyer ("(B) In connection with the settlement of a controversy or suit, a lawyer shall not enter into an agreement that restricts his or her right to practice law.") (the same rule should apply to pre-settlement Confidentiality Agreements).

23. So-called "upfront sharing agreements" have been the subject of litigation in state and federal courts, typically in product liability cases. The results of these cases have been mixed, with some courts approving them and other courts rejecting them. *See, e.g., In re Cont'l Gen. Tire, Inc.*, 979 S.W.2d 609, 613 n.3 (Tex. 1998) (requiring that sharing provision be considered by balancing defendant's interest in non-disclosure of trade secret to competitors with plaintiff's interest in sharing discovery with similarly-situated plaintiffs); *Garcia v. Peeples*, 734 S.W.2d 343 (Tex. 1987) (pretrial discovery orders limiting plaintiff's use of discovered documents was overbroad to the extent it prevented plaintiff from exchanging information with similarly situated litigants); *Royal Park Investments SA/NV v. Deutsche Bank National Trust Company*, 192 F. Supp. 3d 400, 406-07 (S.D.N.Y. 2016) ("Sharing discovery 'is an efficient and effective means of avoiding duplicative and costly discovery, as well as avoiding unnecessary delay in the adjudication of cases.'"); *Charter Oak Fire Ins. Co. v. Electrolux Home Prods., Inc.*, 287 F.R.D. 130, 134 (E.D.N.Y. 2012) (granting plaintiffs motion, in products liability case against dryer manufacturer, to modify protective order so that plaintiffs lawyers could share discovery with lawyers representing affiliated corporations in similar litigation against same manufacturer); *Deford v. Schmid Products Co., a Div. of Schmid Laboratories, Inc.*, 120 F.R.D. 648 (D. Md. 1987) (Sharing discovery "is an appropriate goal under the Federal Rules of Civil Procedure, which are intended 'to secure the just, speedy, and inexpensive determination of every action.'") (citing *Cipollone v. Liggett Group Inc.,* 113 F.R.D. 86, 91 (D.N.J. 1986), *aff'd.* 822 F.2d 335, 345 (3rd Cir. 1987)). Sharing discovery materials may be particularly appropriate where multiple individual plaintiffs assert essentially the same alleged wrongs against a national manufacturer of a consumer product. *Defort*, 120 F.R.D at 654 (citing *Ward v. Ford Motor Co*., 93 F.R.D. 579, 580 (D. Colo. 1982)); *Williams*

confidentiality agreements are especially absurd when one law firm represents multiple similarly situated clients. The obvious question that arises is this: Can the lawyer who learns something from a confidential document in one case use that document or information in the lawyer's second case?

Case-specific use agreements seem to require the lawyer to forget facts from case-to-case.[24] A lawyer's knowledge and experience, however, are his/her stock-in-trade, part of the lawyer's skills which make him/her an effective advocate. A Respondent seeking a case-specific confidentiality clause may be violating the Code of Professional Responsibility by seeking to prevent another attorney from fully representing clients.[25]

Case-specific agreements also give Respondents an opportunity to suppress harmful information, by dividing adversaries, interposing losing objections repetitively, and preventing both Claimants and arbitrators from learning what actually happened "behind the curtain." A Confidentiality Agreement that permits similarly situated parties to compare documents and their interpretation prevents this type of gamesmanship by Respondents. Inclusion of a "notice of sharing" provision, together with a clause in the agreement that the sharing part must procure a Confidentiality Agreement from any party with whom the discovery is properly shared, can be included to protect the legitimate interests of the producing party.[26]

Investors in securities arbitrations are often fighting large corporations, they are also typically represented by small law firms fighting powerful law firms with seemingly unlimited resources. Document production in product and multiple victim cases is voluminous and references in the documents can be obscure. Fairness and the search for justice ought not to allow use of a divide—conquer strategy. Respondents who object to discovery sharing provisions are engaged in a nefarious business.

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v. Johnson & Johnson, 50 F.R.D. 31, 32 (S.D.N.Y. 1970))." *Cf. Rosas v. Goodyear Tire & Rubber Company*, No. 5:18-CV-101, 2019 WL 3308481 (S.D. Tx. June 3, 2019) (requiring a balancing of plaintiff's interests in sharing against risk of disclosure of a valuable trade secret).

24. My former partner Stuart Goldberg was fond of quipping: "I am too old to remember what I am supposed to remember; now you want me to remember what I am supposed to forget?"

25. *See supra*, note 21.

26. *See, e.g., Alton v. Medtronic, Inc.*, 3:13-CV-409-PK, 2014 WL 12791878 (D. Or. Mar. 13, 2014).

Destruction of Documents at Case End—Not So Fast

Confidentiality Agreements often require both sides to destroy confidential documents at the end of the case. This typical provision is troubling for two reasons.

1. *Electronic Files* - A promise to "destroy" documents that were exchanged electronically makes no sense. No lawyer can or should promise to "destroy" an electronic document. An appropriate provision would require the parties to destroy hard copies and "to make reasonable efforts to delete electronic copies from servers and computers."

2. *Ethical Rules* - A delete or destroy provision creates a conflict for the lawyer. Attorneys have both "record retention" requirements imposed by Bar rules, and insurance carriers who would look askance at destroying client files before the statute of limitations for attorney malpractice has expired. The destruction-deletion requirement thus ought not to come into effect until after these periods expire.

Once the agreed record retention/malpractice periods expire (so that there is no ambiguity), the party seeking deletion should be required to send written notice to the retaining party, listing the documents to be destroyed (by Bates Stamp).[27] The Agreement should provide a time period where the receiving attorney shall either certify deletion/destruction in writing or otherwise move a Court for an order lifting the requirement or else confirm compliance.

Inadvertent Production of Privileged Documents

Confidentiality Agreements must include a provision addressing the accidental production of documents that were subject to the attorney-client privilege or attorney work product doctrine.[28] Under the law, inadvertent production is a waiver of the privilege, so it is common for attorneys to extend the reciprocal courtesy preserving the privilege by "recalling" such documents. These provisions state that recall negates the waiver.

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27. In the course of a hearing, parties and their counsel learn things about, *inter alia*, the importance of documents; the efforts employed to maintain the confidentiality to establish, e.g. a trade secret; and whether criminal behavior—including perjury—took place. No party can ask another to destroy documents that the hearing showed were either not confidential or are evidence of criminal wrongdoing.

28. Such documents may or may not have been marked "Confidential."

Confidentiality Agreements should include detailed protocols for notice of recall and the time for return.[29]

Some Confidentiality Agreements further provide that if a document was inadvertently produced without a confidentiality designation, the producing party can recall it (without waiver) and replace it with a copy that is appropriately marked.

A Better Form for All Parties

These observations—born of both experience using and fatigue arguing for better Confidentiality Agreements—ought to lead to FINRA adopting a single, fair form:

CONFIDENTIALITY AGREEMENT AND STIPULATION

The parties to this matter (the "Parties") have entered into this Confidentiality Agreement and Stipulation (this "Agreement") to acknowledge and protect the confidentiality of documents and things, as well as the information contained therein, that may be obtained, exchanged and/or produced in this matter. Accordingly, the Parties hereby stipulate and agree that:

1. DESIGNATION / CATEGORIES / GOOD FAITH: Each Party may designate as "Confidential" any documents which the designating party believes in good faith contain (a) trade secrets, (b) proprietary business information, including but not limited to compliance manuals, internal documentation regarding investment strategies, compliance or supervision, and documents of a similar nature, or (c) personal financial information of a person. Any accounts documents pertaining to Claimant that do not otherwise contain confidential material shall not be deemed confidential when produced by Respondent. Further, documents in Claimant's possession that do not otherwise contain confidential material do not become Confidential solely because Respondent marks them "Confidential" when the document is produced.

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29. *See* Federal Rule of Evidence § 502(b) ("Inadvertent Disclosure. When made in a federal proceeding or to a federal office or agency, the disclosure does not operate as a waiver in a federal or state proceeding if:

(1) the disclosure is inadvertent;

(2) the holder of the privilege or protection took reasonable steps to prevent disclosure; and

(3) the holder promptly took reasonable steps to rectify the error, including (if applicable) following Federal Rule of Civil Procedure 26 (b)(5)(B).")

2. PERSONAL FINANCIAL INFORMATION AUTOMATICALLY CONFIDENTIAL: All documents containing the personal financial information of any individual (including but not limited Claimant's financial information or that of the Claimant, and documents describing compensation to Respondent employees) shall be automatically deemed confidential whether marked or not.

3. MARKING / STAMPING: Each Party shall designate such documents and things as "confidential" by stamping or otherwise affixing the word "CONFIDENTIAL" upon the documents and things so designated.

4. BURDEN: The burden of establishing the "Confidentiality" of a document shall at all times be on the party seeking Confidentiality.

5. USE OF CONFIDENTIAL DOCUMENTS: Any and all documents and things designated as "Confidential" and the information contained therein shall be used by the Parties solely for the purpose of the instant matter and shall not be used, either directly or indirectly, for any other purpose and/or in any other proceeding or matter. Notwithstanding the foregoing, Counsel for Claimant shall be allowed to share "Confidential" documents or information with counsel in other arbitration proceedings against Respondent, providing such other arbitrations involve the same or similar investment products or services, or claimants who are otherwise similarly- situated to Claimant. Claimant's Counsel shall provide five (5) days' written notice to Respondent of its intention to share such documents with other counsel, and Respondent shall have five (5) days therefrom to move the arbitrators for a protective order on the ground that such other arbitrations do not involve the same or similar investment products or services or claimants who are otherwise similarly-situated to Claimant here. Any such other counsel receiving such documents must execute a Confidentiality Agreement acknowledging that s/he is bound by the terms of this Agreement.[30]

6. DOCUMENTS TO BE MAINTAINED SECURELY: Any and all

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30. In cases that do not involve widely distributed "failed" investment products, and in cases where no sharing is contemplated, the parties can substitute the following language:

> 5. USE OF CONFIDENTIAL DOCUMENTS: Any and all documents and things designated as "Confidential" and the information contained therein shall be used by the Parties solely for the purpose of the instant matter and shall not be used, either directly or indirectly, for any other purpose and/or in any other proceeding or matter. Notwithstanding the foregoing, Counsel for Claimant shall be allowed to use "Confidential" documents or information in other arbitration proceedings against Wells or UBS, providing such other arbitrations involve clients of Claimant's counsel.

documents and things designated "confidential" and the information contained therein shall be maintained safely and securely and shall be reasonably safeguarded from disclosure by the Parties (and/or their employees, representatives and agents).

7. DISCLOSURE TO THIRD PARTIES: Except as provided in Paragraph 5, *infra*, any and all documents and things designated as "confidential" and the information contained therein shall not be disclosed to any person or entity except those persons and entities specifically identified in the following subparagraphs:

a. Counsel of record for each of the Parties, including their employees, representatives and agents who are necessarily involved in this matter.

b. The Parties, including their employees, representatives and agents who are necessarily involved in this matter.

c. The arbitration panel and FINRA employees.

d. Any experts, consultants and independent contractors acting on behalf of the Parties for use in connection with this matter, so long as such experts, consultants and independent contractors agree in writing to be bound by this Agreement.

e. Any person or entity as may be required by law, by order of any court of competent jurisdiction or by any governmental agency or self-regulatory organization.

f. Any person that any Party believes in good faith to be a potential fact witness herein, provided that any such person is provided with a copy of this Agreement and agrees in writing to be bound by this Agreement.

8. PROCEDURE FOR SUBPOENAS / REGULATORY REQUESTS:

(a) In the event that any Party is called upon to disclose any documents and things that have been designated as "confidential" and/or the information contained therein in any way, either directly or indirectly, to any person or entity pursuant to subparagraph 7(e) of this Agreement or otherwise, the Party so called upon shall promptly (and prior to any disclosure) notify the producing Party in writing of the proposed disclosure, and in such written notice shall specify the name, employment and/or affiliation and address of the person or entity seeking disclosure and describe with specificity the documents and things and/or information being sought.

(b) In the event that any Party objects to the disclosure of the materials as provided under paragraph 8(a), the objecting Party shall notify the Party called upon to disclose the documents and things in writing of such objection and the grounds therefor within the earlier of (i) ten

(10) days, or (ii) the designated Return Date set by any court or arbitration panel. If the dispute cannot be resolved, the objecting Party may apply to the arbitration panel, court or other tribunal, as may be appropriate, that has issued the demand, subpoena, order or other legal process seeking the disclosure of materials marked "confidential" pursuant hereto and establish the basis for any ruling sought. There shall be no disclosure pending a resolution of the dispute by the arbitration panel, court or other tribunal, as may be appropriate, that has issued the demand, subpoena, order or other legal process seeking the disclosure of such "confidential" materials.

9. BRIEFS AND SUBMISSIONS TO PANEL EXCEPTED: Documents and things designated "confidential" or the information contained therein may be referred to in materials such as briefs and memoranda filed with the arbitration panel or made exhibits to such materials or be exhibited during the arbitration in this matter.

10. NO EFFECT ON RELEVANCE: This Agreement shall have no bearing upon and shall not affect the relevancy, authenticity and/or admissibility of any documents and things or information contained therein.

11. DESTROY/DELETE: At the conclusion of this matter, each party shall destroy physical documents that have been designated "Confidential" and shall make reasonable efforts to delete electronic files from computers and services that have been designated "Confidential," as well as any reproductions thereof, except where preservation is required by applicable law or by the party's insurance carriers. Each party seeking deletion shall do so by providing written notice to the receiving party delineating by Bates Stamp number the specific documents to be deleted/destroyed.

12. RIGHT TO INJUNCTIVE RELIEF: The Parties acknowledge and agree that a breach of this Agreement shall subject the producing Party to substantial and irreparable harm, the nature and extent of which is not readily quantifiable, such that the producing Party shall be entitled to obtain injunctive relief, to seek damages and/or to apply for other or further protective orders before the arbitration panel, court or other tribunal, as may be appropriate.

13. INADVERTANT PRODUCTION OF PRIVILEGED DOCUMENTS: To the extent that any Party inadvertently produces any documents and things that would be otherwise protected from disclosure by any privilege, immunity or doctrine of law, such production is not intended to be, and shall not be construed to be, a waiver of any such privilege, immunity or doctrine. Any such documents and things that are inadvertently produced shall, after written notice by or to the Party receiving the privileged documents, be returned to the producing Party within three (3) days, and no copies or records shall be kept or used by the receiving Party. This non-waiver provision

shall also apply to documents inadvertently produced with a "confidentiality" designation; in such cases the producing Party shall be entitled replace such document with a copy marked "Confidential."

Conclusion

Confidentiality Agreements are present in every securities arbitration, and few arbitrators relish determining disputes as to their breadth. For both sides, the only legitimate goal is protection of the parties' real interests in maintaining confidentiality.

Confidentiality Agreements, however, must be done correctly. Lawyers paying little attention to the terms will likely—someday—regret having not been more vigilant negotiating their terms. For those attorneys who take care with respect to such Agreements and arbitrators who must rule on disputes concerning their inclusiveness, negotiating or decreeing the terms can be difficult because FINRA offers no guidance.

Through this article—based on decades "in the trenches" —I seek to make uniform the Confidentiality Agreements that are used at FINRA. FINRA's Discovery Guide should contain an appropriate form of Confidentiality Agreement—such as the one proposed here— for the parties to adopt. Then the parties can proceed with the merits of the case without concerns for the unintended consequences of a poorly drafted Confidentiality Agreement.

INVESTOR'S CORNERED: REGULATION BEST INTEREST- IT'S NOT A FIDUCIARY DUTY, BUT THE INDUSTRY HOPES INVESTORS THINK IT IS

Sara Hanley, Esq., Joe Wojciechowski, Esq., and Bradley Stark, Esq.[1]

The evidence is clear: Fiduciary, conflict-free portfolio management yields greater returns over time and results in less misconduct and fraud.[2] It does not take an extraordinary logical leap to conclude that passive, fiduciary management leads to better returns and less fraud over time. What is considered true fiduciary management, as concluded by the authors of this piece to be passive management utilizing indexing, results in low fees, low costs, stops deleterious market timing, and the removal and avoidance of conflicts of interest which all lead to higher returns and less incentive for fraud and abuse. These facts are clear and cannot be cogently contradicted. Although retail brokerage firms and stock brokers argue that they provide myriad benefits to investors and that they regularly act in their clients' best interests through advertising, the evidence establishes this is simply capitalism and profiteering at work.[3] These firms want investors to believe they are fiduciaries that have their best interests at heart; clearly investors want to believe this or the firms wouldn't spend billions of advertising dollars this way.[4] But when challenged about this duty or when presented with the opportunity to mandate a universal fiduciary duty, Wall Street lashes out aggressively with a resounding screech.

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1. Sara Hanley, Esq. is the founder of Hanley Law and Joe Wojciechowski, Esq. is a partner at Stoltmann Law Offices.

2. See President Obama, Council of Economic Advisors, *The Effects of Conflicted Investment Advice on Retirement Savings*, February 2015.

3. *See* Joseph C. Peiffer and Christine Lazaro, *Major Investor Losses Due to conflicted Advice: Brokerage Industry Advertising Creates the Illusion of a Fiduciary Duty*, Public Investors Arbitration Bar Association Report, March 25, 2015, https://piaba.org/sites/default/files/newsroom/2015-03/PIABA%20Conflicted%20Advice%20Report.pdf

4. PIABA: *Federal Action Needed To Stop U.S. Brokerage Firms Misleading Investors About Role As Fiduciaries, Which Firms Deny To Block Arbitration Claims*, March 25, 2015. https://piaba.org/in-the-media/piaba-federal-action-needed-stop-us-brokerage-firms-misleading-investors-about-role-0 (last viewed June 2, 2020).

It should be obvious therefore that a government entity that is charged with protecting investors would mandate that those managing other people's money and providing investment advice to retail investors, be held to a fiduciary standard. The Securities and Exchange Commission's ("SEC") mission statement literally begins "to protect investors…"[5] Not a watered-down version that parses words and redefines legal terms of art that have be defined for hundreds of years. But a clear, concise regulation that imposes on all financial advisors a uniform fiduciary duty. The SEC had almost ten years after the passage of the Dodd-Frank Act to study the myriad issues impacting retail investors. In fact, the SEC published several reports and made many findings about the retail investment advice industry. Yet for all of its studies and reports, the SEC still refused to submit regulations which would impose a fiduciary duty on financial advisors and investment advisers alike. Even when the Department of Labor submitted regulations imposing a fiduciary duty upon advisors providing advice to those accounts covered by the Department of Labor (DOL) regulations, like pension funds, 401(k)s, and IRAs, for example, the SEC continued to stand idly by. This refusal or apparent apathy by the SEC took place almost entirely under all administrations, so this inaction was not political on its face, not at least in the broader sense.

When a legitimate fiduciary duty is imposed on investment advisers, as has been the law under the Investment Advisers Act of 1940 since at least 1963, the statistical evidence establishes that investors make more money and the advisors take less money. This is one of the primary drivers of investor returns. The lag that fees, commissions, and costs create has a deleterious impact on returns over time. The fiduciary tag tends to reduce the urge for advisors or brokers to trade or churn accounts, and sell expensive annuities or high commissioned alternative investments. Instead, most fiduciaries, in accordance with their duties, adhere to fundamental investment tenets like Modern Portfolio Theory and utilize index-investing. This form of in-active management, results in less market-timing, which again evidence establishes that investors too frequently buy-high and sell-low, and relies on long term, low cost market performance to maximize investor returns.

When charged with the obligation to research, study, and draw-up regulations based on its findings pursuant to the Dodd-Frank law passed in 2010 after the banking industry melted down the world wide economy, the SEC came up with Regulation Best Interest on June 5, 2019, which does not impose a fiduciary duty on anyone under any circumstances. Regulation "Best Interest" is at best a vague, watered-down version of some standard; it's

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5. *See* https://www.investor.gov/introduction-investing/basics/role-sec (last viewed July 29, 2019).

neither the FINRA Suitability Rule and it's certainly not a fiduciary duty rule. This all begs the elephant-in-the-room question: Why won't the SEC impose a universal fiduciary duty upon all licensed professionals who provide investment, insurance, or financial advice?

The conclusion drawn by this piece, which will be accused by some of being jaded or partial, is that broker/dealers cannot drive revenue the way they're used to if they are saddled with a real fiduciary duty. Revenues at brokerage firms are driven by annuities, active-management/trading, and alternative investments.[6] These investment products or quantitative strategies are tougher to sell in a regime predicated on a true fiduciary standard, especially given the clear academic and empirical data and evidence indicating an investor is much better off with passive, index-style management than any other method. The best investment strategies simply cap revenue to a mere management fee, as opposed to far more lucrative commissions, fees, and trails brokers enjoy from selling alternative investments or variable annuities. Perhaps this is a jaded perspective; the authors have spent a combined 50 years advocating for investors. But if the dollars are followed, it becomes clear that the SEC is affected by the big bank lobby. Its paper tiger Regulation BI is the clearest evidence of this fact in at least a decade, probably going back to when Harvey Pitt famously advocated for a "kinder-gentler" SEC, only to have the Enron and WorldCom fiascos erupt months later.[7]

The concept of a "fiduciary" traces its roots as far back as Hammurabi's Code, which discusses the idea of the agency relationship, and the Holy Bible which famously warned "No man can serve two masters; for either he will hate one and love the other, or he will be devoted to one and despise the other."[8] Perhaps the most fundamental explanation of the definition of fiduciary duty was provided by Judge Cordozo in *Meinhard v. Salmon*:

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate.

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6. Securities and Exchange Commission, *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, 17 C.F.R. Part 240 [Release No. 34-86031; File No. S7-07-18] RIN 3235-AM35, at 410-412.

7. Bill Saporito, *Harvey's Pittfalls,* Time Magazine, November 5, 2002 http://content.time.com/time/magazine/article/0,9171,386940,00.html

8. Mathew 6:24.

> Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions (*Wendt v. Fischer,* 243 N.Y. 439, 444). Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.[9]

A mighty standard indeed. Courts nationwide have been applying this fundamental fiduciary concept to broker/dealers for decades in varying circumstances. For example, in *Vogel v. A.G. Edwards & Sons., Inc.* the Missouri court declared that under Missouri law, the "relationship between broker and customer is fiduciary and confidential."[10] In *Vogel,* the court distinguished between non-discretionary and discretionary accounts, ruling that the specific duties owed by brokers in non-discretionary accounts are more limited, but what duties they have are still fiduciary ones.[11] Likewise, in discretionary accounts, regardless of what license the broker holds or what type of account is being managed, the courts have long held the broker-client relationship is a fiduciary one. *See, e.g. Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* which outlines a list of fiduciary duties brokers owe their clients in discretionary accounts.[12] Also, in *Davis v. Merrill Lynch,* the court held stock-brokers are fiduciaries stating:

> Securities brokers…at Merrill Lynch are licensed professionals who hold themselves out as trained and experienced to render a specialized service. Like the clients of real estate agents, securities customers rely on the agent's expertise and expect the agent to act in their best interests. Because we see no significant difference between real estate brokers and securities brokers, we believe that if confronted with the question, the South Dakota Supreme Court would find that securities brokers are fiduciaries that owe their customers a duty of utmost good faith, integrity, and loyalty.[13]

This an interesting commentary to suggest that licensed professionals who hold themselves out as highly trained and experienced, be held to a fiduciary standard. These cases prove that the idea of applying fiduciary principles to the securities brokerage landscape fails for want of simplicity is false. Wall

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9. 249 NY 458, 464 (N.Y. Ct. App. 1928).

10. 801 S.W.2d 746, 752 (Mo. Ct. App. 1990).

11. *Id.*

12. 461 F. Supp. 951, 953 (E.D. Mich. 1978).

13. 906 F.2d 1206, 1215 (8th Cir. 1990).

Street wants everyone to believe everything they do is so complicated. The last thing Merrill Lynch needs is their clients realizing they don't need expensive asset management. None of this caselaw enforcing fiduciary obligations on stock brokers considered the cost or burden of this fiduciary duty. Instead it was rooted in common fiduciary sense. The brokerage firm business is not too complicated to apply a simple across the board fiduciary duty. That is what they want everyone to believe. Courts around the United States have done so for many years, albeit inconsistently. The conclusion therefore would be to introduce uniformity through legislation and regulation. However, like the old saying goes, nothing complicates simple matters like a committee.

Defining fiduciary duty is the Rubik's Cube which has baffled the SEC, FINRA, and other regulators for what seems like generations. This is not for want of trying. FINRA, for example, has stated publicly that it supports a broad fiduciary duty for brokers, calling it a "best interest standard that "…would align the interests of intermediaries with those of their customers; better protect investors by providing a more consistent set of obligations across financial service providers; help ensure that intermediaries eliminate or manage conflicts of interest; and help ensure that intermediaries establish an ethical culture throughout their firms."[14] This comment letter from 2015 was written to the Department of Labor during its deliberations over the now dead DOL Fiduciary Rule, which sought to have a statutorily imposed fiduciary duty on all broker/dealers who managed retirement accounts.

This comment letter went so far as to bullet-point what FINRA believed any best-interest standard should require of brokerage firms:

- Act in their customers' best interest;
- adopt procedures reasonably designed to detect potential conflicts;
- eliminate those conflicts of interest whenever possible;
- adopt written supervisory procedures reasonably designed to ensure that any remaining conflicts, such as differential compensation, do not encourage financial advisers to provide any service or recommend any product that is not in the customer's best interest;
- obtain retail customer consent to any conflict of interest related to recommendations or services provided; and

14. Marcia E. Asquith, FINRA Senior Vice President and Corporate Secretary, Comment Letter, *Re: Proposed Conflict of Interest rule and Related Proposals*, July 17, 2015, at 2; https://www.finra.org/sites/default/files/FINRACommentLetter_DOL_07-17-15.pdf.

- provide retail customers with disclosure in plain English concerning recommendations and services provided, the products offered and all related fees and expenses.[15]

One of FINRA's core gripes with the DOL Rule seems to have been the inconsistencies and confusion it would create. So FINRA proposed uniformity, advocating that the DOL "best interest" rule apply to both retirement and non-retirement accounts equally, and that rules affecting brokers and registered investment advisors be "harmonized."[16] FINRA's illustration points out that, under an all too common circumstance, the same advisor, client, account, and conduct could have multiple standards of conduct; the FINRA broker/dealer Suitability standard, the advisers act fiduciary standard, and the DOL fiduciary Rule – could all apply to the same situation. FINRA also advocated that the context and content of the FINRA suitability rule be used as the foundation for and be expressly incorporated into the DOL fiduciary nomenclature around the definition of "recommendation." [17] Essentially, what FINRA asked the Department of Labor to do was to adopt the suitability rule as part of the fiduciary standard of care. This seemed like a solid start down the road to a uniform fiduciary duty applicable to all brokers.

The Investment Advisers Act of 1940 imposes a fiduciary duty upon "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities . . ."[18] 15 U.S.C. § 80b-l, *et seq. See, e.g., Securities and Exchange Commission v. Capital Gains Research Bureau, Inc. et al.*[19]. For years, the SEC has regulated Investment Advisers and adopted standards and duties in line with this fiduciary requirement. For example, investment advisers, like all fiduciaries, owe a duty of loyalty – the core of the "best interest" standard – and to disclose and eliminate conflicts of interest.[20] The Advisers Act has been interpreted also to establish a duty of care "to make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or

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15. *Id.*

16. *Id.* at 3.

17. *Id.* at 13-14.

18. 15 U.S.C. § 80b-l, *et seq.*

19. 375 U.S. 180 (1963).

20. *See* U.S. Sec. & Exch. Comm'n, Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (2011) at 112-13.

incomplete information."[21] This duty of care means an investment adviser must have a reasonable and independent basis for its recommendations.[22] Put another more simpler way, an investment adviser must perform due diligence on an investment, and understand it sufficiently, prior to advising its clients to invest. This is also the standard mere brokers are held to in FINRA RN 10-22 and reasonable basis suitability under FINRA Rule 2111.05(a).

In 2011, the SEC released its Staff Study that actually recommended a uniform fiduciary standard of conduct for all broker-dealers and investment advisers. What a watershed moment for retail investors. And yet, this uniform standard was never implemented and really never even made it up for a vote. The most, it seems, that the Obama Administration could hope for was to use its executive authority and shoehorn a Fiduciary rule for retirement accounts only through the Department of Labor. Even when FINRA publicly advocated for a more uniform fiduciary standard in 2015, it ultimately went nowhere. An unexpected result in the 2016 Presidential election vaulted one of the most anti-regulation Republicans since Herbert Hoover into office. It only took six weeks for the Trump administration to dismantle the DOL Fiduciary Rule.[23] After the banks and brokerage firms nearly ended Capitalism in 2008, only to be bailed-out by Socialism in 2009, and after every regulator that matters – the SEC, the DOL, FINRA, and certainly dozens of state securities regulators – publicly advocated for a uniform fiduciary standard, and more than ten years later were on the cusp of passing this standard, it was ripped away. The banks and brokerage firms got their way. They gas-lighted their way to a new "uniform" standard called Regulation Best Interest which is now in full effect. This rule is not a fiduciary rule no matter what Wall Street's salesmen say it is.

How does active management persist despite its dismal results?

"We recognized early on that very smart people do very dumb things, and we wanted to know why and who, so we could avoid them." Charlie Munger, Berkshire Hathaway 2009 meeting via *Buffett FAQ*.

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21. *Id.* at 120-21.

22. *In the matter of Alfred* C. *Rizzo,* Advisors Act Release No. 897, 1984 WL 470013 (Jan. 11, 1984).

23. Michael Hiltzin, *Trump's Rollback of the Investment Conflict of Interest Rule is a Direct Attack on Middle-Class Savings,* Los Angeles Times, February 3, 2017.

Behavioral Finance explains how the naive investor is duped into believing in the efficacy of active management and how the industry is free to continue its duping so long as it avoids being a fiduciary.

Modern Portfolio Theory (*MPT) and the brokerage industry today*

MPT and the inability of brokers to beat the market is well known within the industry, but amongst the retail customers, not so much. Brokers are not fiduciaries and fail to advise their clients that they would be better off, on a risk adjusted basis, buying a broad market index fund and not allowing the broker to actively manage their money. The situation is well summarized by Burton Malkiel in "The Random Walk Guide to Investing: Ten Rules for Financial Success". Malkiel writes, "It's true that when you buy an index fund, you give up the chance to boast at the golf course that you picked the best performing stock or mutual fund. That's why some critics claim that indexing relegates your results to mediocrity. In fact, you are virtually guaranteed to do better than average. It's like going out on the golf course and shooting every round at par. How many golfers can do better than that? Index funds provide a simple low-cost solution to your investing problems."[24] The lack of a fiduciary duty means that a broker never need tell his client of the superior results described by Malkiel, or inherent conflicts amongst its products.

Path Dependence[25] and a history of caveat emptor helps explain why the brokerage industry feels no responsibility towards the retail customer, which

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24. Burton Malkiel, The Random Walk Guide to Investing: Ten Rules for Financial Success, 2003 at 137.

25. "Path dependence, the tendency of institutions or technologies to become committed to develop in certain ways as a result of their structural properties or their beliefs and values. As a theory, path dependence is based on the straightforward assumption that 'history matters'… First, it must be demonstrated that, at the creation of the institution or technology under study, a contingency or series of contingencies occurred that led to the selection of one outcome over another, which, given another set of initial conditions, might have led to another outcome having been selected instead…Second, it must be demonstrated how a new technology or organizational form becomes insulated to some extent from change. The factors involved in that insulation, or feedback mechanisms, may be positive (supporting advocates of the path-dependent institution or technology) or negative (interfering with attempts at change from advocates of alternative institutions or technologies). The feedback

is perpetuated thanks to its prodigious lobbying efforts.[26] Over centuries The Prudent Man standard enshrined caveat emptor into law prior to the development of Modern Portfolio Theory in the 1950s. A feedback loop that well insulates Wall Street from change in regard to its obligations towards the retail investor, is obvious.[27] Thus, the history of caveat emptor and the high fees associated with active management create a difficult gravity from which the retail client finds it almost impossible to escape. The SEC, FINRA and Congressional embrace of caveat emptor and the lobbying lucre from the industry keeps them from adopting a fiduciary duty rule.

Behavioral Finance explains how retail investors are so susceptible to the Siren's Song of active management

More is needed to explain the persistence of active management by underperforming overcompensated conflicted salesmen. The Siren's Song of active management, when not accompanied by the statistically grounded fiduciary advice that outsized returns are a statistical and very human behavioral finance mirage, are compelling fodder to the retail broker for his client. This is why a fiduciary obligation should be a bare minimum requirement for anyone that gives financial advice, just as it is for those who give medical or legal advice, teachers, executors, real estate agents, Boards of Directors, Liquidators, guardians, clergy and business partners. Behavioral Finance offers some clues as to why the siren's song of the broker's active management finds resonance in vulnerable investors.

The first useful principle of Behavioral Finance to explain the siren's song of active management is that the human mind is incapable of comprehending randomness. "We are hard-wired to overreact to coincidences," says Persi

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mechanisms that lock in the system under investigation along a particular path might be either cognitive or institutional." Ian Greener, Path Dependence, Encyclopedia Britannica, https://www.britannica.com.topicpath-dependence. (last visited June 2, 2020).

26. E.g., Finance, Insurance and Real Estate was by far the largest donor amongst industry to political campaigns in the 2018 election cycle. Open secrets.Org, Totals by Sector 2018, https://www.opensecrets.org/overview/sectors.php.

27. E.g. Michael S. Edmiston & Bradley R. Stark, The Financial Services Industry's Historic Pattern of Opposition to Reform, "Wolf" is the only Cry, PIABA Journal Vol. 22. No.2 2015.

Diaconis. "It goes back to primitive man. You look in the bush, it looks like stripes, you'd better get out of there before you determine the odds that you're looking at a tiger. The cost of being flattened by the tiger is high."[28] "A funny example of this is when Apple CEO Steve Jobs had to change the programming behind the "shuffle" feature on iPods. Customers complained that when they used this feature the songs that played were often from the same album or by the same artist. Yet this is extremely possible with randomness, as it does not consider what has already been played. Steve Jobs responded to this feedback by altering the shuffle feature to make it less random, defying the point of randomness altogether!"[29] Warren Buffet's famous allegory of random people or chimps becoming heroes for winning coin tosses is a perfect example of an inability to comprehend randomness.[30] The randomness of

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28. Lisa Belkin, N.Y Times, The Odds of That Aug. 11, 2002.

29. https://blogs.glowscotland.org.uk/glowblogs/jceportfolio/2017/10/16/do-humans-really-understand-randomness (last viewed May 28, 2020).

30. "Let's assume we get 225 million Americans up tomorrow morning and we ask them all to wager a dollar. They go out in the morning at sunrise, and they all call the flip of a coin. If they call correctly, they win a dollar from those who called wrong. Each day the losers drop out, and on the subsequent day the stakes build as all previous winnings are put on the line. After ten flips on ten mornings, there will be approximately 220,000 people in the United States who have correctly called ten flips in a row. They each will have won a little over $1,000. Now this group will probably start getting a little puffed up about this, human nature being what it is. They may try to be modest, but at cocktail parties they will occasionally admit to attractive members of the opposite sex what their technique is, and what marvelous insights they bring to the field of flipping. Assuming that the winners are getting the appropriate rewards from the losers, in another ten days we will have 215 people who have successfully called their coin flips 20 times in a row and who, by this exercise, each have turned one dollar into a little over $1 million. $225 million would have been lost, $225 million would have been won. By then, this group will really lose their heads. They will probably write books on "How I turned a Dollar into a Million in Twenty Days Working Thirty Seconds a Morning." Worse yet, they'll probably start jetting around the country attending seminars on efficient coin-flipping and tackling skeptical professors with, "If it can't be done, why are there 215 of us?' By then some business school professor will probably be rude enough to bring up the fact that if 225 million orangutans had engaged in a similar exercise, the results would be much the same — 215 egotistical orangutans with 20 straight winning flips.

markets are counterintuitive to the human mind.[31] The investor must be guided by counterintuitive competent statistical data. Lacking a fiduciary duty, the broker never shares this data and the teachings of Modern Portfolio Theory with his client. Anecdotally, it makes sense that the smartest most accomplished people would be most susceptible to the siren's song because these people are well trained to identify patterns, though none exist in markets to observe for the retail investor. This makes the industry defense of "sophisticated investor understood the risks" because she had a graduate degree from an elite university in a totally different field, horribly egregious.

Humans including retail investors and their brokers who have an incentive to do so, also succumb to a second Behavioral Finance phenomenon, the Overconfidence Bias. This explains why retail investors and brokers intuitively embrace active management. "The overconfidence effect also applies to forecasts, such as stock market performance over a year or your firm's profits over three years. We systematically overestimate our knowledge and our ability to predict on a massive scale. The overconfidence effect does not stop at economics: In surveys, 84 percent of Frenchmen estimate that they are above-average lovers (Taleb). Without the overconfidence effect, that figure should be exactly 50 percent—after all, the statistical "median" means 50 percent should rank higher and 50 percent should rank lower. In another survey, 93 percent of the U.S. students estimated to be "above average" drivers. And 68 percent of the faculty at the University of Nebraska rated themselves "in the top 25 percent for teaching ability."[32] Thus, the retail broker

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The Superinvestors of Graham-and-Doddsville COLUMBIA BUSINESS, Warren Buffett, May 17, 1984 https://www8.gsb.columbia.edu/articles/columbia-business/superinvestors.

31. Whether markets reflect randomness or a Chaotic System is irrelevant to the retail broker and his client. "Random behavior is non-deterministic: even if you knew everything that can be known about a system at a given time in perfect detail, you would still not be able to predict the state at a future time. Chaotic behavior on the other hand is fully deterministic *if* you know the initial state in perfect detail, but any imprecision in the initial state, no matter how small, grows quickly (exponentially) with time." https://www.quora.com/Chaos-Theory-What-is-the-difference-between-chaotic-behavior-and-random-behavior (last viewed May 28, 2020).

32. Rolf Dobelli, *The Overconfidence Effect*, https://www.psychologytoday.com /intl/blog/the-art-thinking-clearly/201306/the-overconfidence-effect (last viewed May 28, 2020)

deludes his client and perhaps partially himself, with the broker having a financial incentive to do so, that the randomness and incomprehensible nature of markets as revealed by statistical methods, does not apply to them.

Finally, humans engage in the Hindsight Bias. "Hindsight bias is a psychological phenomenon in which past events seem to be more prominent than they appeared while they were occurring. Hindsight bias can lead an individual to believe that an event was more predictable than it actually was, and can result in an oversimplification in cause and effect."[33] Therefore, the broker and retail investor upon discovering contrary data to their "beat the market" discussions, engage in hindsight bias to explain away the contrary data and assure themselves they "won't make that knowable mistake again".

The cycle of incomprehensible randomness, overconfidence and hindsight bias is repeated and synergistically reinforcing until the losses are unsustainable. What is reprehensible in this scenario is that the broker knows or should know better, knows the statistical data and that Nobel Prizes were awarded for proving that outsized returns from active management are a Behavioral Finance mirage, but never tells his client!

How the retail brokerage industry dupes the investor by avoiding a fiduciary duty rule

Every broker who has taken a finance class has been instructed on Modern Portfolio Theory and understands that Nobel Prizes have been awarded for proving active management cannot "beat the market" on a risk adjusted basis. The Series 7 exam required to become a broker tests applicants on Modern Portfolio Theory.[34] To become a broker a person must demonstrate to the examiners that they understand they cannot "beat the market" but once they obtain a license to sell stocks they have no obligation to reveal this information

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33. James Chen, *Hindsight Bias*, Updated Mar 19, 2018 https://www.investopedia.com/terms/h/hindsight-bias.asp (last viewed May 28, 2020).

34. Section 3.1 of the Series 7 Exam description by FINRA titled Provides customers with information about investment strategies, risks and rewards, and communicates relevant market, investment and research data to customers states "Portfolio or account analysis and its application to security selection (*e.g.*, diversification, asset allocation principles, concentration, volatility, potential tax ramifications) Portfolio theory (*e.g.*, alpha and beta considerations, Capital Asset Pricing Model (CAPM)), https://www.finra.org/sites/default/files/Series_7_Content_Outline.pdf.

to their clients! Because there is no fiduciary duty owed to the investor, the broker is free to reap the profits of active management without ever telling the investor "look I am likely wasting your time and money and will underperform what you can obtain with 5 basis points fee in an Index Fund that tracks the market on a risk adjusted basis". The broker never tells the investor that their all too human subjective false observations about stock market predictability as we explained with Behavioral Finance, are a mirage. Instead the industry standards set by the SEC, FINRA and Congress dance around being a fiduciary, but remain below that threshold of fiduciary, so as to preserve the ability of the broker to be an active manager without identifying to the investor the folly of their ever so human uninformed foolishness.

In any other profession with a fiduciary duty such as law or medicine, the doctor or lawyer has an obligation to "do no harm" and to explain to the client the folly of their ways, to burst the bubble of mirages afflicting the client and to not encourage the self-harm the client erroneously may unknowingly consent to inflict upon themselves after encouragement by the broker. So long as the brokerage industry avoids being a fiduciary, it can continue to prey upon the retail investor's innate weaknesses explained by behavioral finance with no effort to disabuse the investor of their understandable folly and without any obligation to fully explain Modern Portfolio Theory. The broker has no duty to tell his client the outsized returns of active management are a compelling behavioral finance delusion.

Regulation Best Interest: The Broker-Dealer Standard of Conduct

On June 5, 2019, the SEC voted to adopt a new rule under the Securities Exchange Act of 1934 ("Exchange Act") titled Regulation Best Interest: The Broker-Dealer Standard of Conduct.[35] Regulation Best Interest establishes a standard of conduct for broker-dealers and associated persons when making a recommendation to a retail customer of any securities transaction or investment strategy involving securities.[36] The package of rulemakings and interpretations implemented by the SEC included Regulation Best Interest, the new Form CRS Relationship Summary, and two separate interpretations under

35. Regulation Best Interest, Exchange Act Release No. 34-86031, 84 SEC Docket 134, (July 12, 2019).

36. *Id*. at 33318.

the Investment Advisers Act of 1940. The stated intention of the SEC in implementing the new rules was to heighten the obligations of broker-dealers when making a recommendation to a retail customer and to reduce the potential harm to retail customers from conflicts of interest that may affect the recommendation.[37] Registered broker-dealers must be in compliance with Regulation Best Interest by June 30, 2020.[38]

Regulation Best Interest was intended to improve investor protection by requiring (1) that broker-dealers act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interests of the broker-dealer ahead of the interests of the retail customer; and (2) addresses conflicts of interest by establishing, maintaining, and enforcing policies and procedures reasonably designed to identify and fully and fairly disclose material facts about conflicts of interest, and in instances where it has been determined that disclosure is insufficient to reasonably address the conflict, to mitigate or eliminate the conflict.[39] Regulation Best Interest imposes a new standard of conduct specifically for broker-dealers that is intended to regulate the standard of conduct for broker-dealers beyond the suitability standard.[40] Regulation Best Interest includes disclosure provisions along with specific requirements imposed on the broker-dealer and client relationship.[41]

One of the pillars of Regulation Best Interest is that when making a recommendation of a securities transaction or an investment strategy involving securities, a broker-dealer must act in the retail customer's best interest and cannot place its own interests ahead of the customer's interests.[42] Regulation Best Interest applies to broker-dealers and registered representatives at the point the securities transaction or investment strategy involving securities is made to the customer.[43] Regulation Best Interest sets forth the following four (4) obligations on broker-dealers and their representatives:

> ***Disclosure Obligation:*** Broker-dealers must disclose material facts about the relationship and recommendations, including specific

37. *Id.* at 33318.

38. *Id.* at 33400.

39. *Id*. at 33318.

40. *Id*. at 33319.

41. *Id*. at 33318.

42. *Id.*

43. *Id*.

disclosures about the capacity in which the broker is acting, fees, the type and scope of services provided, conflicts, limitations on services and products, and whether the broker-dealer provides monitoring services.[44] A broker-dealer must disclose, in writing, all material facts about the scope and terms of its relationship with the customer prior to or at the time the recommendation is made.[45] The requirement includes disclosure that the firm or representative is acting in a broker-dealer capacity; the material fees and costs the client will be charged; and the type and scope of services to be offered, including any material restrictions on the
recommendations that could be made to the retail customer.[46] Additionally, the broker-dealer must disclose all material facts relating to conflicts of interest associated with the recommendation that might incline a broker-dealer to make an impartial recommendation, such as conflicts inherent to proprietary products, third party compensation, and payment arrangements.[47]

Care Obligation: A broker-dealer is obligated to use reasonable diligence, care, and skill when making a recommendation to a retail customer.[48] The broker-dealer is required to consider potential risks, rewards, and costs associated with the recommendation offered. The broker-dealer must further contemplate those risks, rewards, and costs in relation to the customer's investment profile. The broker-dealer must have a reasonable basis to believe that the recommendation is in the customer's best interest and does not place the broker-dealer's interest before the interests of the retail customer.[49] When recommending multiple transactions, the broker-dealer must have a reasonable basis to believe that the sum of the transactions are not excessive, even if each is in the customer's best interest when viewed singularly.[50] The point of evaluation of whether or not a broker-dealer

44. *Id*. at 33321.

45. *Id*.

46. *Id.*

47. *Id*.

48. *Id.*

49. *Id.*

50. *Id.*

has fulfilled its duties under the Care Obligation is determined at the time of the recommendation (and not in retrospect).[51]

Conflict of Interest Obligation: Broker-dealers are obligated to establish, maintain, and enforce reasonably created written policies and procedures addressing conflicts of interest related to its recommendations to retail customers.[52] These policies and procedures must be reasonably designed to identify all such conflicts and at a minimum disclose or eliminate them.[53] Essentially, conflicts of interests that generate an incentive for an associated person of the broker-dealer to place its interests or the interest of the firm ahead of the retail customer's interest must be mitigated by the firm's policies and procedures.[54] Importantly, appropriate disclosures must be made to the retail client when a broker-dealer places material restrictions on recommendations that may be made to a retail customer to avoid the associated person's or broker-dealer's interests being put ahead of the customer's interest.[55] Lastly, firm's policies and procedures must be reasonably designed to identify and remove sales contests, sales quotas, bonuses, and non-cash compensation that are premised on the sale of specific securities or specific types of securities within a certain time frame.[56]

Compliance Obligation: Broker-dealers are obligated to establish, maintain and enforce policies and procedures reasonably designed to attain compliance with Regulation Best Interest in its entirety.[57] A broker-dealer's policies and procedures must address conflicts of interest as well as compliance with its Disclosure and Care Obligations under Regulation Best Interest.[58]

In addition to Regulation Best Interest, the SEC also implemented the requirement that broker-dealers and investment advisers utilize a *Form CRS Relationship Summary*. Under the regulation, advisors and broker-dealers are

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51. *Id.*

52. *Id.*

53. *Id.*

54. *Id.*

55. *Id.*

56. *Id.*

57. *Id.*

58. *Id.*

required to provide retail investors a relationship summary at the onset of their relationship.[59] In the relationship summary, firms are required to summarize information about services, fees and costs, conflicts of interest, legal standard of conduct, and whether or not the firm and its financial professionals have disciplinary history.[60] The relationship summary will highlight the Commission's investor education website, Investor.gov, which offers the investing public educational information.[61]

Lastly, as part of the SEC's package of new rules, the SEC provided two (2) interpretations. The first is the *Investment Adviser Interpretation* which clarifies that an investment adviser owes a fiduciary duty to its clients under the Advisers Act.[62] This duty is principles-based and applies to the entire relationship between an investment adviser and its client.[63] The second is the *Solely Incidental Interpretation* which confirms and clarifies the Commission's interpretation of the "solely incidental" prong of the broker-dealer exclusion of the Advisers Act.[64] Specifically, the interpretation states that a broker-dealer's advice as to the value and characteristics of securities or as to the advisability of transacting in securities falls within the "solely incidental" prong of this exclusion if the advice is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions.[65]

Regulation Best Interest Falls Short

In the end, Regulation Best Interest: The Broker-Dealer Standard of Conduct, falls short of a fiduciary standard and fails to adequately protect investors. It is almost certain that broker-dealers and their representatives will extort the rule to attract investor clients only to later take advantage of the client's confusion and deceitfully gained trust. The SEC touts that, "The enhancements contained in Regulation Best Interest are designed to improve

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59. *Id*. at 33492.

60. *Id.*

61. *Id.*

62. *Id.* at 33320.

63. *Id.* at 33331.

64. *Id.* at 33336.

65. *Id.*

investor protection by enhancing the quality of broker-dealer recommendations." [66] Unfortunately, nothing in Regulation Best Interest requires an improvement in the recommendations of broker-dealers nor does it require the broker-dealer to act in the best interest of the client without regard for its own interests. Regulation Best Interest will likely result in only further confusing the public into implicitly trusting the broker-dealer industry to their detriment as they believe their brokers have a fiduciary duty to act in their best interests in the same manner as a fiduciary.

Regulation Best Interest falls short because "Best Interest" is not a fiduciary standard. The SEC made clear it "declined to subject broker-dealers to a wholesale and complete application of the existing fiduciary standard under the Advisers Act because it is not appropriately tailored to the structure and characteristics of the broker-dealer business model (i.e., transaction-specific recommendations and compensation)."[67]

Perhaps the bigger and more important issue is that the industry is not appropriately designed to conduct business in a fiduciary manner, but they are willing to make it appear as though they do to acquire clients and illicit trust from the investing public.

Furthermore, the SEC admits, "We do not believe that any rulemaking governing retail investor-advice relationships can solve for every issue presented."[68] Ironically, however the SEC's Regulation Best Interest is a rule-based concept instead of a principles based model like the fiduciary standard. Under Regulation Best Interest, broker-dealers are not required to give advice without regard to their own interests, instead the rule requires the interests of broker dealers not to be put ahead of the customers.[69] Regulation Best Interest allows broker-dealers to keep their business model, including promoting their interests and conflicted recommendations, so long as the interests of the client are put ahead of the self-serving actions of the broker-dealer. Broker-dealers are not required to improve the recommendations they make to clients as a result of Regulation Best Interest. Instead, they are required to disclose material facts related to conflicts of interest associated with the recommendation that might incline a broker-dealer to make the recommendation. The warning to the broker-dealer's client about the conflict will only be as good as the disclosure, and will only be effective if the client

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66. *Id*. at 33321.

67. *Id.* at 33322.

68. *Id.* at 33323.

69. *Id*. at 33318.

reads and understands the disclosure prior to taking the recommendation of the broker-dealer. An unlikely scenario indeed.

Perhaps, most importantly the disconnect between a fiduciary duty and Regulation Best Interest is that being a fiduciary requires ongoing responsibilities, including the duty of care and the duty to provide on-going advice resulting from the continued monitoring of client accounts in a manner and rate that is in the best interest of the client whereas Regulation Best Interest imposes no such duty. Instead, Regulation Best Interest requires no duties after the sale or investment recommendation is made.

In choosing to adopt Regulation Best Interest, the SEC allowed broker-dealers and financial professionals to avoid a fiduciary standard which would hold them to the highest legal and ethical standard to safeguard the client investor's funds entrusted to their care. By implementing a rule misleadingly titled "Best Interest" the public will undoubtedly be deceived as most will relate "Best Interest" with the standard of a fiduciary because it is generally understood that a fiduciary must act in the client's "best interest". Furthermore, an advisor who is held to the fiduciary standard is generally expected to offer advice without regard to their own interests and to provide ongoing advice and monitoring. Regulation Best interest imposes no such duties. The SEC failed to implement a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing investment advice to retail customers. Unfortunately, instead the SEC created a rule that will likely cause the investing public to believe broker-dealers are held to a fiduciary standard in instances when they are not.

RECENT ARBITRATION AWARDS

Christopher J. Gray

This issue's featured arbitration awards include cases in which FINRA arbitration panels granted noteworthy relief, including awards of punitive damages as well as compensatory damages and attorneys' fees under state Blue Sky statutes. These awards once again demonstrate that these forms of relief can be won with proper case presentation and a receptive panel. This issue's survey also features a case in which a FINRA panel concluded that Claimant's claim was "false" and granted expungement despite the broker-dealer Respondent's payment of $110,000 to settle the underlying claims.

Juan Angel Ibarra Rodriguez and Myriam Rodriguez Gonzalez (Claimants) v. Lone Star National Bank and LPL Financial LLC (Respondents)
Case No. 17-00904
Houston, Texas
Hearing Dates: June 10, 2019 – June 14, 2019; September 23, 2019 – September 27, 2019
Award Date: November 13, 2019
Counsel:

Counsel for Claimants: L. Bradley Hancock, Esq. and Jeffrey D. Anderson, Esq., Holland & Knight LLP, Houston, Texas, and Carlos Yzaguirre, Esq., Yzaguirre Law Firm, PLLC, McAllen, Texas.

Counsel for Respondents: For Respondent Lone Star: Walsh McGurk Cordova Nixon, PLLC, McAllen, Texas as of, on or about, March 6, 2018. Prior to the appearance of Walsh McGurk Cordova Nixon, PLLC, Lone Star was represented by Minerva I. Zamora, Esq. and Erick G. Holguin, Esq., Ellis, Koeneke & Ramirez, L.L.P. from, on or about, June 1, 2017 to, on or about, February 8, 2018.

For Respondent LPL: Jack D. Ballard, Esq., Susan. A. Logsdon, Esq., and Michael A. Rodriguez, Esq., Ballard & Littlefield, LLP, Houston, Texas.

Arbitration Panel:

Allan R. Lazor, Public Arbitrator, Presiding Chairperson
Maryanne M. Esser, Public Arbitrator
Malcolm Edwin Whittaker, Public Arbitrator

Investments at Issue:

LPL and Lone Star made misrepresentations and omissions and recommended unsuitable investments in non-traded REITS that did not fit Claimants' investment objectives and in offshore investments in which Ibarra was not eligible for participation and that the directives and policies of LPL and Lone Star led to the seizure of Claimants' accounts.

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Breach of contract and warranties,
(2) Violations of Texas State Securities Statutes,
(3) Negligent supervision,
(4) Violation of the Texas Business and Commerce Codes,
(5) Violation of consumer protection statutes, negligent misrepresentation, unjust enrichment, and breach of duties,
(6) Unsuitable investment recommendations and violations of FINRA Rules,
(7) Vicarious liability, and
(8) Sale of Securities not registered with the Securities and Exchange Commission.

Relief Requested:

(1) An Order ordering Lone Star and LPL to pay all sums paid in connection with the seizure and/or freezing of Claimants' accounts and/or investments,
(2) All sums lost in Claimants' accounts and/or investments on any or all transactions made or not made,
(3) Damages to Claimants' reputation,
(4) Statutory damages as provided by applicable law,
(5) Attorneys' fees, costs, and other expenses,
(6) Both pre-judgment and post-judgment interest,
(7) Punitive damages, and
(8) Other relief deemed just and proper.

Relief Requested Post Hearing: $13,927,630.81

Award:

(1) Respondent LPL was found to be liable and ordered to pay to Claimants $864,839.70 in compensatory damages,
(2) Respondent LPL was found to be liable and ordered to pay to Claimants $340,000.00 in attorneys' fees pursuant to Texas Civil Practice and Remedies Code Section 38.001,
(3) Respondent LPL was found to be liable and ordered to pay to Claimants $350,000.00 in additional damages pursuant to Texas Business and Commerce Code Section 17.50(b)(1), and

(4) All other relief denied.

Analysis:

This award is noteworthy because of that substantial relief granted to Claimant but even more so because of its tortured procedural history. The award chronicles many twists and turns in the proceeding, including motions to enforce a settlement agreement, motions for sanctions, and a split decision featuring a rare spirited dissent written by Chair Allan R. Lazor. Mr. Lazor strongly disagreed with the other panel members' conclusion that Claimant proved damages and stated in his dissent in relevant part:

> It is axiomatic that all claims for damages of the type asserted by Claimants require a casual nexus between the conduct complained of and the alleged injury for which compensation is sought. Some of the claims require that LPL's conduct must be the producing cause of their injuries, and other claims require only proximate cause.
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> * * *
>
> A necessary element of all of Claimants' theories is that they suffered monetary damages produced or proximately caused by LPL's conduct. I find that Claimants not only failed to prove causation, but they failed to offer evidence that they suffered any monetary damages as a result of their customer relationship with LPL.

Jeffrey A. Walter (Claimant) v. Cambridge Investment Research, Inc. and Equity Concepts, LLC (Respondents)

Case No. 18-04126

Richmond, Virginia

Hearing Dates: Underlying Case Settled, No Hearing, Expungement Hearing January 27, 2020

Award Date: No Published Case Award, Expungement Decided February 13, 2020

Counsel:

Counsel for Claimant: James L. Kauffman, Esq., Bailey Glasser LLP, Washington, District of Columbia

Counsel for Respondents: Todd Ratner, Esq., Todd Ratner PLC, Richmond, Virginia.

Arbitration Panel:

Michael J. Henke, Public Arbitrator, Presiding Chairperson
Carl F. Bowmer, Public Arbitrator
Javier Andres Colon Volgamore, I, Public Arbitrator

Investments at Issue:

Claimant alleged that Respondents purchased whole life insurance policies as investments from which he borrowed money to invest in alternative investments, mostly oil and gas partnerships, including Energy Hunter Partners 2012 – A Drilling & Production Fund, Ltd. ("Energy Hunter"); Genesis Drilling Program IV LP; Genesis Drilling Program VI LP; Genesis Drilling Program IX LP; and Strategic Energy Income Fund IV LP.

Claimant's Claims:

Causes of Action in Statement of Claim:

(1) Violation of the Virginia Securities Act, 13.1.501 *et. seq.*,
(2) Breach of fiduciary duty,
(3) Negligence,
(4) Negligent supervision,
(5) Breach of contract, and
(6) Violation of FINRA rules.

Relief Requested:

(1) Damages in the amount of $348,366.85,
(2) All losses of principal,
(3) All commissions and fees,
(4) Loss of income that would have been received had his account been managed properly, as well as other losses, foreseeable or not, that Claimant allegedly suffered, including non-pecuniary losses,
(5) Attorneys' fees, costs and other expenses,
(6) Interest, both pre-judgment and post-judgment, and
(7) All other sums he is entitled to at law or equity.

Award:

While the underlying case between Claimant and Respondents settled for an undisclosed amount, unnamed parties Alan Joseph Dole and Michael James Thaler, the FINRA broker-dealers, were granted expungement.

Analysis:

This award is noteworthy because the Panel made a finding that Claimant's allegations were "false" and granted expungement, despite the case being settled for the substantial sum of $110,000, which represented a sizeable portion of the damages sought. Unfortunately, this is a more egregious example of a general trend toward FINRA panels granting expungement despite the fact that the Respondents paid a substantial sum

to resolve Claimant's claims. In many cases expungement is granted despite the claims having been previously settled for a sum that would have represented a good result had a claimant won the case on the merits, given arbitrators' proverbial tendency to "split the baby" in damages awards.

Also noteworthy about this award is that the Panel parsed specific paragraphs of the Statement of Claim explaining how they were false based largely upon self-serving broker testimony. For instance, the Panel stated:

> 3.) Paragraph 6 falsely asserts that Dole and Thaler gave Claimant "unsuitable investment advice that lacked adequate due diligence." The testimony of Dole and Thaler, along with various account applications executed by Claimant, demonstrate that he was a sophisticated investor, willing to take significant risks. Dole and Thaler testified about the diligent research they conducted to find the investments they recommended."
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> . . .
>
> 8.) Paragraph 53 falsely asserts that Claimant had a "moderate risk profile." The testimony of Dole and Thaler showed that Claimant was quite willing to take significant risks.
>
> 9.) Paragraph 55 falsely asserts that Claimant "lost his entire $50,000[.00] investment in Energy Hunter." His account statement, however, showed that he received $23,000.00 back from Energy Hunter, not counting the significant tax benefits produced by the investment.

Unfortunately, this award also mirrors a trend in which a respondents' counsel trumpet language in subscription paperwork or a disclosure document that contradicts the claimants' allegations that an investment was solicited via misrepresentations and omissions of fact. Respondents then argue that since the facts the claimant says were omitted are contained in the documents, the claim therefore must be "false." However, it is well-established that providing a prospectus containing disclosures cannot cure an otherwise misleading sales presentation. *See* FINRA NOTICE TO MEMBERS 05-59 (2005) and authorities cited therein. Just because a prospectus or other disclosure document was provided clearly does not mean that a claimant's claims are false or lack merit. Indeed, many sales practice cases that are won

at hearing based on the weight of disputed testimony concerning a misleading oral sales presentation could just as easily be characterized as "false" claims under the twisted reasoning of awards such as this one.

Cynthia A. Burch (Claimant) v. Huntleigh Securities Corporation (Respondent)
Case No. 17-02936
St. Louis, Missouri
Hearing Dates: January 21, 2020 – January 24, 2020
Award Date: March 5, 2020
Counsel:
Counsel for Claimant: Bruce D. Oakes, Esq. and Richard B. Fosher, Esq., Oakes & Fosher, LLC, St. Louis, Missouri.
Counsel for Respondent: Patrick A. Watts, Esq., Watts Law Group, LLC, St. Louis, Missouri.
Arbitration Panel:
Philip J. Glick, Public Arbitrator, Presiding Chairperson
William M. Azkoul, Public Arbitrator
Sheldon Weinhaus, Public Arbitrator
Investments at Issue:
Respondent, through its registered representative, while managing a discretionary account on behalf of Claimant and contrary to Claimant's investment objectives and risk tolerance, invested Claimant's assets in highly speculative, high-risk stocks and options, leveraged Claimant's accounts on margin, and engaged in excessive trading.
Claimant's Claims:
Causes of Action in Statement of Claim:
(1) Breach of fiduciary duty,
(2) Common law fraud,
(3) Negligence/negligent misrepresentation/omission,
(4) Violation of Missouri's Securities Act Sect. 409-5.501 *et al.*,
(5) Breach of contract,
(6) Unjust enrichment, and
(7) Negligent supervision.
Relief Requested:
(1) Compensatory damages of approximately $750,000.00,
(2) Punitive damages,
(3) Attorneys' fees, interest and costs,
(4) Filing and forum fees incurred, and

(5) Such other and further relief as the Panel deems just and proper under the circumstances.

Relief Requested Post Hearing: $585,806.00, $708,378.00, or $953,522.00 (calculated using (3) three separate formulas).

Award:

(1) Respondent was found to be liable and ordered to pay to Claimant $300,000.00 in compensatory damages,

(2) Respondent was found to be liable and ordered to pay to Claimant $200,000.00 in punitive damages pursuant to *Stojkovic v. Weller*, 802 S.W.2d 152 (Mo. 1991); *State Farm Mutual Automobile Ins. Co. v. Campbell*, 123 S. Ct. 1513 (2003); *Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 906 F.2d 1206 (8th Cir. 1990); and *Miley v. Oppenheimer & Co., Inc*., 637 F.2d 318 (5th Cir. 1981),

(3) Respondent was found to be liable and ordered to pay to Claimant $250,000.00 in attorneys' fees pursuant to Missouri Securities Act, Sec. 409.5-509; *McDaniel v. Bear Stearns & Co*., 196 F. Supp. 2d, 343 (S.D.N.Y. 2002); *and First Interregional Equity Corp. v. Haughton*, 842 F. Supp. 105 (S.D.N.Y. 1994), and

(4) All other relief denied.

Analysis:

This award is noteworthy because of the substantial award of compensatory and punitive damages to Claimant and the award of statutory attorneys' fees under Missouri law.

David L. Valponi, individually, as trustee of the Valponi Revocable Trust dtd 2/24/98, as trustee of the Valponi Family Irrevocable Trust FBO Erica Valponi, and as trustee of the Valponi Family Irrevocable Trust FBO Alicia Valponi DTD 07/21/98 and Elizabeth L. Valponi, individually, as trustee of the Valponi Revocable Trust dtd 2/24/98, as trustee of the Valponi Family Irrevocable Trust FBO Erica Valponi, and as trustee of the Valponi Family Irrevocable Trust FBO Alicia Valponi DTD 07/21/98 (Claimants) v. Hilltop Securities, Inc. (Respondent)

Case No. 18-02136

San Francisco, California

Hearing Dates: August 26, 2019, January 27, 2020 – January 31, 2020

Award Date: February 24, 2020

Counsel:

Counsel for Claimants: Philip M. Aidikoff, Esq. Aidikoff, Uhl & Bakhtiari, Beverly Hills, California

Counsel for Respondent: David S. Markun, Esq., Edward S. Zusman, Esq. and Nathan Smith, Esq., Markun Zusman Freniere & Compton, LLP, Pacific Palisades, California.

Arbitration Panel:

Lawrence R. Mills, Public Arbitrator, Presiding Chairperson
Aiden Sharp Adkins, Public Arbitrator

Investments at Issue:

Claimants' investment in various unspecified unit investment trusts.

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Breach of fiduciary duty,
(2) Constructive fraud,
(3) Fraud by misrepresentation and omission,
(4) Breach of written contract,
(5) Failure to supervise and control,
(6) Financial elder abuse,
(7) Violation of State and Federal securities laws, FINRA rules of fair practice and NYSE rules; and
(8) Suitability.

Relief Requested:

(1) General and compensatory damages not less than $950,000.00,
(2) Lost opportunity cost,
(3) Rescission of all allegedly unsuitable investments Respondent recommended,
(4) Cost of proceedings,
(5) Punitive damages,
(6) Interest at the legal rate on all sums recovered,
(7) Attorneys' fees and costs; and
(8) Such other and further relief as the Panel deems just and appropriate.

Relief Requested Post Hearing: $ 734,619.03

Award:

(1) Respondent was found to be liable and ordered to pay to Claimants $699,363.56 in compensatory damages for the suitability and misrepresentation claims only,
(2) Respondent was found to be liable and ordered to pay to Claimants $300.00 in filing fees, and
(3) All other relief denied.

Analysis:

This case took an unusual turn when the parties stipulated to removal of one of the arbitrators on February 4, 2020, after the hearings concluded,

leaving a two-member Panel to decide the case. The Panel then granted a substantial percentage of the total financial relief sought by Claimants.

David B. Saxe and Phyllis K. Saxe as Co-Guardians of the Person and Property of Elana Jill Saxe, an incapacitated person, David B. Saxe and Phyllis K. Saxe as Trustees of the Elana Jill Saxe Supplemental Needs Irrevocable Trust, David B. Saxe, and Phyllis K. Saxe (Claimants) v. RBC Capital Markets, LLC, Janney Montgomery Scott, LLC, and Tracey Schusterman (Respondents)
Case No. 18-02572
New York, New York
Hearing Dates: November 6, 2019 – November 8, 2019, January 2, 2020, January 3, 2020, January 13, 2020, January 14, 2020, February 10, 2020, February 11, 2020
Award Date: March 12, 2020
Counsel:
Counsel for Claimants: Lawrence R. Gelber, Esq., Brooklyn, New York.
Counsel for Respondents: For Respondent RBC Capital Markets, LLC: Jessica Corley, Esq., Peter Isajiw, Esq., and Alexander Noble, Esq., King & Spalding, LLP, New York, New York.
For Respondents Janney Montgomery Scott, LLC and Tracey Schusterman: Theodore R. Snyder, Esq., Murphy & McGonigle, New York, New York.
Arbitration Panel:
Daniel Robbins, Public Arbitrator, Presiding Chairperson
Fred S. Pieroni, Public Arbitrator
Sandra Gale Behrle, Public Arbitrator
Investments at Issue:
Unspecified Securities.
Claimants' Claims:
Causes of Action in Statement of Claim:
(1) Unsuitability,
(2) Securities fraud,
(3) Breach of fiduciary duty,
(4) Breach of duty of good faith and fair dealing,
(5) Negligence,
(6) Violation of FINRA rules and securities industry regulations,
(7) Failure to supervise,

(8) Breach of contract,
(9) *Prima facie tort*, and
(10) Unauthorized trading.

Relief Requested:

(1) At least $421,772.00 for lost opportunities/failure to trade while the account sat idle at Janney Montgomery Scott, LLC, jointly and severally against Respondents Janney Montgomery Scott, LLC and Tracey Schusterman,
(2) At least $145,000.00 arising from lost opportunities/failure to trade while the account sat idle at RBC Capital Markets, LLC, jointly and severally against Respondents RBC Capital Markets, LLC and Tracey Schusterman,
(3) At least $175,532.00 arising from mortgage obligation and related tax penalties, jointly and severally against Respondents Janney Montgomery Scott, LLC and Tracey Schusterman,
(4) Exemplary damages,
(5) Costs, fees, and expenses, including reasonable attorneys' fees, and
(6) Such other and further relief as is proper and accords with the Panel's sense of justice and equity.

Relief Requested After Hearing: $1,072,778.57

Award:

Following an undisclosed prehearing settlement agreement with Respondent RBC Capital Markets, LLC, the Panel found:

(1) Respondents Janney Montgomery Scott, LLC and Tracey Schusterman were found to be jointly and severally liable and ordered to pay to Claimants $152,674.00 in compensatory damages,
(2) Respondents Janney Montgomery Scott, LLC and Tracey Schusterman were found to be jointly and severally liable and ordered to pay to Claimants 9% interest per annum from April 15, 2018 until paid in full, and
(3) All other relief denied.

Analysis:

While the damages awarded represented approximately 14% of the requested amount post hearing, the case is noteworthy because of the unusual bases for liability alleged by Claimant, including lost opportunities to profit based on Respondents' failure to trade while the account sat idle, as well as what the Panel described as "mortgage obligation and related tax penalties" allegedly caused by Respondents.

Philip L. Vujanov

A non-accountholder may compel FINRA arbitration under Rule 12200 for claims involving a broker-dealer's failure to supervise its representative.

Viyella v. Fundacion Nicor, No. 19-25094-CIV-ALTONAGA/Goodman, 2020 U.S. Dist. LEXIS 34300 (S.D. Fla. Feb. 28, 2020):

Fundación Nicor was led by Nicolas Corcione Perez Balladares ("Corcione"), a well-known real estate developer in Panama who was under government investigation for various fraudulent activities. *Viyella v. Fundacion Nicor*, No. 19-25094-CIV-ALTONAGA/Goodman, 2020 U.S. Dist. LEXIS 34300, at *5 (S.D. Fla. Feb. 28, 2020). Fearing that his assets may be frozen by Panamanian authorities, Corcione contacted Candido Viyella, a dually registered broker and investment advisor of Morgan Stanley, about becoming a Morgan Stanley customer to move his assets out of Panama. *Id*. Morgan Stanley rejected Corcione's account application and he was unable to deposit any funds or securities with Morgan Stanley. *Id.* at *6. Meanwhile, Viyella and his family acquired hotel properties through a series of entities and, to finance construction of the hotels, the entities involved issued promissory notes to various foreign investors. *Id.* Viyella sent Corcione text messages recommending he purchase one of the promissory notes. *Id.* at *8. Nicor purchased one of the promissory notes, however, "none of the foreign investors, including Nicor, were ever solicited by Viyella for investment in the hotel project in his role as a financial advisor for Morgan Stanley." *Id*.

After losing its investment in the promissory note, Nicor initiated a FINRA arbitration action against Morgan Stanley and Viyella, alleging that Nicor was induced to buy the note, Morgan Stanley had failed in the supervision of its agent, and Viyella had engaged in "selling away, unsuitability and fraud in violation of FINRA's rules." *Id.* at *7-9. Morgan Stanley and Viyella then filed a joint motion for a preliminary injunction against proceeding in FINRA arbitration, arguing that FINRA Rule 12200 does not compel arbitration. FINRA Rule 12200 states:

Parties must arbitrate a dispute under the Code if:

- Arbitration under the Code is either:
  - (1) Required by a written agreement, or
  - (2) Requested by the customer;
- The dispute is between a customer and a member or associated person of a member; and

> • The dispute arises in connection with the business activities of the member or the associated person, except disputes involving the insurance business activities of a member that is also an insurance company.

Morgan Stanley argued that FINRA Rule 12200 does not compel arbitration because (1) no valid arbitration agreement existed with Nicor, (2) Nicor was never a customer of Morgan Stanley or Viyella and the parties never had a direct transactional relationship, and (3) the dispute involving the promissory note does not arise in connection with Morgan Stanley's business activities. *Fundacion Nicor*, 2020 U.S. Dist. LEXIS 34300, at *10.

Nicor countered, arguing that the Morgan Stanley Client Agreement it signed, which was ultimately rejected by Morgan Stanley, constitutes an agreement to arbitrate. In the alternative, Nicor argued that (1) FINRA Rule 12200 constitutes an agreement to arbitrate, (2) Nicor is a customer under FINRA Rule 12200 because "customer" is defined broadly under the FINRA Code, and (3) the dispute arises in connection with the business activities of Morgan Stanley because part of its business is its duty to supervise its representatives. *Id*.

The Court began by noting "FINRA Rule 12100(k) broadly defines a customer as one who is not a broker or a dealer." *Id.* at *13. It then reviewed two factually similar Eleventh Circuit cases discussing the definition of "customer": (1) *Multi-Financial Sec., Corp. v. King*, 386 F.3d 1364 (11th Cir. 2004) (finding claimant was a customer for purposes of arbitration even though no direct transactional relationship existed), and (2) *MONY Sec. Corp. v. Bornstein*, 390 F.3d 1340 (11th Cir. 2004) (finding claimant was a customer of the member's representative who provided bad investment advice). *Fundacion Nicor*, 2020 U.S. Dist. LEXIS 34300, at *15. Morgan Stanley argued that *King* and *Bornstein* were distinguishable as, here, Nicor actually attempted to become a customer and filled out an account application, which was explicitly rejected by Morgan Stanley. *Id.* at *16. The Court found Morgan Stanley's argument unpersuasive:

> [Morgan Stanley] provide no legal authority supporting their argument that Nicor applied to open an account with Morgan Stanley which means he is not a customer under *King* and *Bornstein*. And [Morgan Stanley's] insistence the Court should follow the FINRA's guidance on the definition of a customer under a different rule fails to persuade. Again, the *King* court declined to limit the definition of a customer to require a direct relationship with the NASD member. The Eleventh Circuit in *King* specifically noted other NASD rules provided more information about who is a customer but nevertheless determined it need not look to extrinsic evidence to decide whether

> King was a customer because the definition of customer as one who is not a broker or dealer was unambiguous.

Id. at *16-17 (internal citations omitted).

The Court then addressed Morgan Stanley's argument that the dispute with Nicor does not arise out of the business activities of Viyella or Morgan Stanley. *Id*. at *18. Citing *Pictet Overseas Inc. v. Helvetia Tr.*, 905 F.3d 1183, 1188 (11th Cir. 2018), Morgan Stanley argued that Rule 12200 "was intended to bind a FINRA member's associated persons to arbitrate disputes only when the dispute arises in connection with the business activities of the associated person undertaken in his or her capacity as an associated person of a FINRA member." *Id.* In distinguishing *Pictet* from the present situation, the Court noted that the Eleventh Circuit held the claims were not arbitrable "because the dispute did not arise in connection with the partners' business activities in their capacity as associated persons of Pictet Overseas." *Id*. at *19. Rather, the dispute arose "in connection with the partners' business activities in their capacity as associated persons of Banque Pictet, and Banque Pictet was not a FINRA member." *Id.* The Court found the present facts more analogous to *King*:

> In *Pictet*, the associated persons were not involved in the sale [and] it was an independent asset manager who engaged in the fraud[;]" while in *King* and in this case, "the associated person sold the product directly to the investor. King's claim arose from the actions of the registered representative in giving advice regarding investments at a time when he was a person associated with a brokerage firm in the business of providing investment advice through its representatives. Similarly, Nicor alleges Viyella persuaded it to purchase the promissory note from [the entity] while Viyella was a financial advisor at Morgan Stanley.

Id. at *20 (internal citations omitted).

As such, the Court found that "Nicor's claims arise in connection with Morgan Stanley's business activities because Nicor alleges Morgan Stanley failed to supervise Viyella," consistent with both *King* and *Bornstein*:

> King's claim, like Nicor's, was that the FINRA member failed to supervise its representative, and the Eleventh Circuit held "King's claim of negligent supervision satisfies the [business activities] condition." Similarly, the court in *Bornstein* held that a FINRA member violated its duty to supervise its representative was arbitrable because "supervision of associated persons arises in connection with the member's business."

Id. at *20-22 (internal citations omitted). As such, the Court denied the joint motion for preliminary injunction against proceeding in FINRA arbitration. *Id*. at *24.

Federal Court affirms $3.3 million FINRA arbitration award which includes $3 million in discovery sanctions.

Jose S. Torres, et al., v. Morgan Stanley Smith Barney LLC, No. 19-cv-22977 MGC (S.D. Fla. Apr. 13, 2020):

The former customers of Morgan Stanley suffered losses after investing in Puerto Rico bond and fund investments. After initiating a FINRA arbitration proceeding, the arbitration panel granted the customers' motion to compel Morgan Stanley to produce certain documents relevant to the dispute. Morgan Stanley produced two documents in response to the motion to compel order and represented that no additional documents could be located. It later became evident that Morgan Stanley had not produced all responsive documents, despite its representations. Ultimately, the arbitration panel ordered Morgan Stanley to pay $3,000,000 in monetary sanctions for its conduct in addition to compensatory damages.

Following the award, the customers filed a petition to confirm their award in federal court. Shortly after, Morgan Stanley filed a motion to vacate the arbitration award, arguing: (1) the discovery sanctions imposed against it – nearly twelve times the compensatory damages awarded and almost six times the claimed attorneys fees in the case – was punitive in nature, in violation of applicable law and beyond the authority of the arbitrators and (2) two of the three arbitrators failed to comply with FINRA's disclosure rules.

In response, the customers noted that the Federal Arbitration Act ("FAA") creates a heavy presumption of confirming awards and that judicial review of such awards are extremely narrow. Further, the customers asserted (1) Morgan Stanley failed to establish biases or other misbehavior which prejudiced it, (2) monetary sanctions are not reviewable under the FAA when authorized by the parties' agreement, (3) even if sanctions were reviewable, Morgan Stanley failed to preserve the issues on review by failing to raise them during the arbitration proceeding, (4) and even if the sanctions were reviewable and properly preserved, the monetary penalties are not prohibited by law nor did the arbitration panel commit any legal error. Ultimately, the court granted the customers' petition to confirm their arbitration award and denied Morgan Stanley's motion to vacate the award.

Court finds that customers of a broker-dealer firm expressly and impliedly waived their right to arbitrate claims in FINRA.

Leith v. Berthel, No. C088365, 2020 Cal. App. Unpub. LEXIS 1754 (Mar. 17, 2020):

The Leiths initiated a FINRA arbitration action in 2016 against Berthel, Fisher & Company Financial Services, Inc. ("Berthel Fisher") and their former investment advisor, Shawn Davis. *Leith v. Berthel*, No. C088365, 2020 Cal. App. Unpub. LEXIS 1754, at * 1 (Mar. 17, 2020). In their statement of claim, the Leiths allege that, between 2005 and 2010, Respondents recommended unsuitable, high-risk, and illiquid investments. *Id.* at *2. They further allege that they were falsely promised that the investment recommendations would allow them high returns with low risk. *Id*. The Leiths received annual investment "score cards" which were supposed to reflect the actual value of their investments and they allege that the "score cards" were misrepresented so that they did not discover their actual losses until 2016, when they "discovered the truth" about their investments in April 2016, and filed their arbitration claim five months later. *Id*.

After filing an answer to the claims, Defendants informed the Leiths that they intended to file a motion to dismiss pursuant to FINRA Rule 12206, which states that a claim is ineligible for arbitration if "six years have elapsed from the occurrence or event giving rise to the claim." *Id.* at *3. Defendants argued that the "occurrence or event giving rise to the claim" was the date of the investment purchase by the Leiths between 2005 and 2010 and, thus, their claims were ineligible to be heard in FINRA arbitration. Counsel for the Leiths believed the motion to dismiss had merit and agreed to dismiss the claims without prejudice:

> [T]o avoid the cost and expense associated with a motion that counsel for the parties agreed "would probably be granted," the Leiths stipulated to voluntarily dismiss their arbitration case. "[C]onsistent with FINRA Rule 12206(b)," the parties stipulated that the dismissal would be "without prejudice," and therefore "not prohibit the Leiths from pursuing [their] claim[s] in a court of competent jurisdiction . . . The parties entered into the stipulation "solely for the mutually beneficial[] purpose of avoiding [the] cost and expense associated with [defendants] filing a motion to dismiss the arbitration pursuant to FINRA Rule 12206."

Id. at *3-4.

Eight months after the stipulation, the Leiths filed substantially similar claims against Defendants in court. *Id.* at *4. Approximately eleven months later, the Leiths retained new counsel and, after an unsuccessful mediation,

informed Defendants of their desire to return to arbitration. *Id*. at *4-5. Defendants rejected the proposal to arbitrate, arguing that the Leiths "had waived their right to arbitration by abandoning the prior arbitration proceeding and pursuing their claims in court." *Id*. The Leiths then filed a petition to compel arbitration, which was tentatively granted by the court prior to oral arguments because Defendants failed to tentatively establish prejudice, which the court termed a dispositive issue. *Id.* at *5. Following oral arguments, the court determined that Defendants adequately demonstrated prejudice and reversed its tentative ruling, denying the Leiths' petition to compel arbitration:

> In finding prejudice, the trial court relied on three factors, namely that (1) returning to arbitration would not vindicate the purpose of arbitration to serve as an expeditious, efficient, and cost-effective method of resolving the underlying dispute, (2) a renewed FINRA rule 12206 motion likely "would in the end result in return of the matter to the Superior Court," and (3) the claims at issue likely could not be consolidated with a related arbitration claim pending against defendant Davis and his new employer, WFG Investments, Inc.

Id. at *6.

The Leiths appealed. It was undisputed that a valid arbitration agreement was in place and that the Leiths' claims fell within the scope of the agreement. *Id.* at *7. The only issue for the appellate court was whether the Leiths expressly or impliedly waived their right to compel arbitrate.

The Leiths argued that, regardless of acting in a manner inconsistent with an intent to invoke arbitration, they did not prejudice defendants and thus, no waiver occurred. Specifically, the Leiths argue: (1) the party seeking to demonstrate waiver must establish prejudice, which Defendants failed to do, and (2) in assessing prejudice, the trial court improperly considered the likelihood that a renewed FINRA rule 12206 motion would be granted and lead to a return of the matter to the court. *Id*.

In its analysis, the appellate court noted that no single test delineates conduct which constitutes waiver of arbitration. *Id*. at *8. The court analyzed factors previously identified by the California Supreme Court which may be considered in reviewing waiver:

> (1) whether the party has taken actions inconsistent with the right to arbitrate; (2) whether the litigation machinery was substantially invoked and whether the parties were well into preparation of a lawsuit before the party notified the opposing party of an intent to arbitrate; (3) whether a party requested arbitration close to the date of trial or unreasonably delayed seeking arbitration; (4) whether a defendant seeking arbitration filed a counterclaim without demanding arbitration; (5) whether important intervening steps took place before

> the party demanded arbitration (e.g., the party took advantage of discovery procedures not available in arbitration); (6) whether the party demanding arbitration engaged in bad faith or willful misconduct; and (7) whether the party delayed the demand for arbitration in a way that affected, misled, or prejudiced the opposing party.

Id. at *8-9.

The appellate court, in analyzing express waiver, found that, "unlike an implied waiver, an express waiver leaves little room for ambiguity about whether the party's actions were intentional. Accordingly, we agree … that a showing of prejudice is unnecessary when there has been an express waiver." *Id.* at *11. The appellate court concluded that the Leiths had expressly waived their right to arbitrate when they "voluntarily abandoned their pending FINRA arbitration claims" by voluntarily and intentionally stipulating to dismissal in favor of proceeding in a judicial forum. *Id*. The fact that the stipulation was "without prejudice" was of no consequence.

The appellate court further found that even if there was no express waiver, substantial evidence exists to support the trial court's finding of prejudice and implied waiver. *Id.* at *14. Citing various decisions, the court noted that prejudice "typically is found where the petitioning party has unreasonably delayed seeking arbitration or substantially impaired an opponent's ability to use the benefits and efficiencies of arbitration" and "prejudice also is found where the petitioning party has gained some advantage by resorting to the court system or where the delay in demanding arbitration has substantially impaired the other side's ability to participate in arbitration." *Id.* at *15.

The appellate court found that Defendants were prejudiced by the Leiths change of position and abandonment of their initial FINRA arbitration proceeding, their unreasonable delay in demanding a return to arbitration, the time and expense incurred in the failed mediation, and the time and expense incurred preparing for the upcoming trial. *Id*. at *19. As to whether the trial court erred in considering whether a renewed FINRA Rule 12206 motion to dismiss may be granted, the appellate court deemed it a harmless error, as it is "not reasonably probable that a result more favorable to the Leiths would have been reached in the absence of consideration of a renewed FINRA rule 12206 motion." *Id.* at *20. Consequently, the appellate court found no reversible error and affirmed the lower court's denial of the petition to arbitrate. *Id*.

Court holds that the definition of "customer" under FINRA Rule 12200 is to be interpreted broadly and no direct relationship between the customer and FINRA member is required.

Raymond James Fin. Servs. v. Armijos, No. 19-CIV-81692-RAR, 2020 U.S. Dist. LEXIS 74531, at *1 (S.D. Fla. Apr. 27, 2020):

Defendants were victims of a fraud orchestrated by a group of Miami-based real estate developers, in which the developers "formed a complex web of mutual funds and bond issuers that would raise capital from foreign investors through a series of financial products and then lend the capital raised back to the developers." *Raymond James Fin. Servs. v. Armijos*, No. 19-CIV-81692-RAR, 2020 U.S. Dist. LEXIS 74531, at *5-6 (S.D. Fla. Apr. 27, 2020). The developers owned and controlled the borrower, lender, and issuer of the financial products. *Id*. at *6. In order to promote their financial products, the developers created a Registered Investment Advisor firm, Biscayne Capital International, LLC ("Biscayne Capital"). Raymond James & Associates, Inc. ("RJA") served as its clearing firm, "performing back-office execution and administrative functions." *Id.*

One of the developers involved in the scheme, Frank Chetburn, served as an Investment Advisor Representative of Biscayne Capital. *Id.* Chetburn had also been a Registered Representative of Raymond James Financial Services, Inc. ("RJFS") from March 2008 until he was terminated in August 2008. *Id.* at *10. Despite his termination, Chetburn continued to hold himself out as a RJFS broker for years after his departure. *Id.* at *11.

In late 2007, Chetburn solicited Edith Hinojos, "a 'finder' for Bear Stearns," to join Biscayne Capital and fulfill the role of identifying potential investors in Latin America *Id.* at *6-8. In order to do so, Chatburn touted his relationship with "Raymond James":

> Chatburn told Hinojosa that he worked with Raymond James, which he touted as a well-known American brokerage firm with lots of resources and employees. Hinojosa Decl. ¶ 7. Chatburn even asked Hinojosa to join him at Raymond James. *Id.* Importantly, Chatburn always referred to "Raymond James" generally and never distinguished between any subsidiary entities or divisions.

Id. at *7. Chatburn further indicated to Hinojosa that the financial products "would be sold by Biscayne Capital through Raymond James" and were vetted and approved by Raymond James *Id*. When given a tour of the Raymond James offices, Hinojosa stated that she saw signage for "Biscayne Capital" on the wall of the Raymond James office. *Id*. at *8. "On the tour, she was told that Raymond James was committed to the long-term success of Biscayne Capital and that she could work with Biscayne Capital within the Raymond James

platform," and that "Raymond James would provide Hinojosa's clients with accounts." *Id.* Ultimately, Hinojosa joined Biscayne Capital "based on Chatburn's representations and the stellar reputation of Raymond James."

Upon joining Biscayne Capital, Hinojosa began to promote Biscayne Capital's financial products by labeling them "part of the Raymond James portfolio of products." *Id.* at *10. Hinojosa's former clients at Bear Stearns, the Defendants in this action, ultimately moved their accounts from Bear Stearns to Raymond James as a result, and each Defendant signed a custodial agreement with RJA. "Notably, the letterhead on these agreements simply read 'Raymond James.'" *Id.*

Defendants, after investing with Biscayne Capital, proceeded to initiate a FINRA arbitration proceeding against RJA. *Id*. at *13. The arbitration panel then granted Defendants' request to amend their claims to add RJFS as a respondent. The arbitrators found that, even though Defendants did not have an arbitration agreement with RJFS, "RJFS was a proper party to the Arbitration under the FINRA Code." *Id.* at *14. In the arbitration:

> Defendants allege that both RJA and RJFS are liable for aiding and abetting in the fraud perpetuated by the Biscayne Individuals [(which includes Chatburn and others)], and the entities they controlled, gross negligence, negligence, breach of fiduciary duty, and for failure to supervise its agents.

Id. Following the arbitrators' ruling, RJFS filed for a preliminary injunction and declaratory relief, seeking to enjoin Defendants from pursuing arbitration claims against it in FINRA and a declaration that Defendants' claims against RJFS are not arbitrable under Rule 12200 of the FINRA Code and, more specifically, that Defendants "are not and never were 'customers' of RJFS within the meaning of FINRA Rule 12200 or otherwise." *Id.* In sum, RJFS urged to the Court to apply a narrow definition of customer: "one who has a ***direct*** relationship with a FINRA member either through a) a written customer agreement or b) a direct purchase from the FINRA member." *Id.* at *20.

At the outset, the Court noted that all of the record evidence indicated that Chatburn always referred to Raymond James in the "global sense" and never distinguished between Raymond James entities, thus, "[m]uch of the confusion in this case seems to center around what it means to be "Raymond James":

> RJFS maintains that it and RJA are wholly separate entities under the same parent company, Raymond James Financial, Inc. RJFS' corporate representative testified that RJA and RJFS share a campus, share resources when possible, and ultimately report to the same General Counsel for compliance matters. RJA and RJFS also share a database of client records and information that allows employees of

> either entity to search the parent company's records. As part of Chatburn's Agreement, RJFS makes clear that it contracts on behalf of itself and RJA, and Chatburn was authorized to sell RJA products, a process known as "selling away." Given the interrelatedness of these similarly-named entities, one can understand how referring to any of them as "Raymond James," as Chatburn constantly did, could cause confusion.

Id. at *12-13 (internal citations omitted).

The Court began its analysis by finding, even absent a written agreement to arbitrate, the FINRA Code "serves as a sufficient written agreement to arbitrate, binding its members to arbitrate a variety of claims with third party claimants." *Id.* at *20. FINRA Rule 12200, states that "[p]arties must arbitrate a dispute under the Code" if (1) "[r]equested by a customer;" (2) "[t]he dispute is between a customer and a member or associated person of a member;" and (3) "[t]he dispute arises in connection with the business activities of the member or associated person…" *Id.* at *17. The Court noted that FINRA does not define "customer' except that a "customer shall not include a broker or dealer." *Id.* at *18. The Court then looked at the Second Circuit's decision in *Citigroup Glob. Mkts., Inc. v. Abbar*, 761 F.3d 268, 275 (2d Cir. 2014) (holding that a customer, while not a broker or dealer, either "(1) purchases a good or service from a FINRA member, or (2) has an account with a FINRA member."). *Id.*

The Court found that the undisputed facts in the case easily satisfied *Abbar's* definition of "customer" under FINRA Rule 12200: Chetburn solicited clients while registered with RJFS; Chetburn had solicited and promoted Raymond James financial products to Defendants; and Chetburn "held himself out to be a representative of Raymond James in the global sense." *Id.* at *19-20. Finally, the Court noted that other courts have found that "a 'selling away' relationship where the associated person of a FINRA member sells the financial products of an affiliated company to an investor is sufficient to establish a customer relationship." *Id.* (citing *Viyella v. Fundacion Nicor*, No. 19-25094-CIV-ALTONAGA/Goodman, 2020 U.S. Dist. LEXIS 34300 (S.D. Fla. Feb. 28, 2020); *Multi-Financial Sec., Corp. v. King*, 386 F.3d 1364 (11th Cir. 2004); *MONY Sec. Corp. v. Bornstein*, 390 F.3d 1340 (11th Cir. 2004)).

The Court concluded by finding that no direct transaction between a customer and FINRA member is necessary for Rule 12200 to apply:

> Moreover, the absence of a direct customer relationship between RJFS and the Defendants is of no moment. Again, the Court must look to the unambiguous language of the Code, which makes clear that the definition of 'customer' is broad … In sum, there is no requirement

> that a party directly transact with a FINRA member to qualify as a "customer" for purposes of Rule 12200.

Armijos, 2020 U.S. Dist. LEXIS 74531, at *22. The Court found that RJFS failed to show a substantial likelihood of success in establishing that Rule 12200 bars the arbitration and denied RJFS' motion.

Wunderlich Securities moves to vacate a $11.4 million award following a Zoom hearing.

Wunderlich Secs., Inc, et al. v. Dominick & Dickerman, LLC, et al, No. 20-cv-3507 (S.D.N.Y. May 5, 2020):

Dominick & Dickerman LLC and Michael J. Campbell, a managing director at the firm (together "Claimants"), initiated a FINRA arbitration proceeding against Wunderlich Securities, Inc. and Gary Wunderlich, its founder and CEO (together "Wunderlich"), following the sale of assets, comprising Dominick & Dickerman LLC's private wealth management business, to Wunderlich Securities. Claimants alleged Wunderlich was guilty of common law fraud, negligent misrepresentation, breach of contract, violation of Section 10(b) of the Securities exchange Act of 1934, and violation of FINRA Rule 2010. The evidentiary hearing was held in-person at the offices of Claimants' counsel on December 17, 18, 19 and March 3, 4, 5, 6, and 10. Upon agreement by counsel, the final hearing day, on March 12, was held via Zoom due to concerns surrounding the Coronavirus situation. Wunderlich alleges that, throughout the hearing, the arbitrators were inattentive. The day after the conclusion of the hearing, Wunderlich filed a motion requesting the Panel to recuse itself for the following:

> Chairman Hollyer not following the evidence and not running the hearing in accordance with FINRA scripts or rules; biased rulings in favor of one side and contrary rulings for the other side directly limiting evidence presented by one side and expanding evidence for the other side; and the Panel not paying attention to evidence as it was presented, questioning witnesses during presentation instead of waiting until the parties had completed presentation, and substituting personal knowledge for the evidence submitted by the parties.

The panel declined to permit the parties to brief the issue and unanimously denied the motion. The Panel proceeded to award Claimants $11.4 million, which included interest, attorneys' fees and expenses.

Wunderlich subsequently filed a petition to vacate the arbitration award in the U.S. District Court, Southern District of New York. Wunderlich asserts that the arbitration award should be vacated on several grounds. First,

Wunderlich argues that the award ought to be vacated because the arbitration panel failed to identify the grounds on which Claimants won or which Wunderlich is liable, *i.e.,* the arbitration panel must rule on each count brought by Claimants and give some basis for the remedy imposed. Second, Wunderlich argues the panel issued inconsistent evidentiary rulings and violated FINRA's guidelines in denying Wunderlich a full and fair opportunity to present their case. Finally, Wunderlich argues that the panel exceeded its authority and manifestly disregarded Delaware law. As to the Zoom hearing, Wunderlich asserts that the Panel was inattentive throughout, and especially during the final hearing day through Zoom:

> The Panel's distraction continued on March 10, 2020 with Arbitrator Gross constantly checking her iPad and Arbitrator Finard spending significant time throughout the hearing working on his laptop and paying only partial attention to the evidence and testimony. During the last day of the Arbitration, March 12, 2020, the proceedings were held via Zoom videoconference due to concerns over the COVID-19 outbreak. Once again, the Panel was inattentive, with Arbitrator Finard looking at other screens, typing, and eating during the course of the presentation. Arbitrator Gross even blocked her screen during the hearing, preventing the parties from confirming that she was even participating. And at one point during closing arguments for WSI and Mr. Wunderlich, Chairman Hollyer walked away from his screen. The presentation resumed once Chairman Hollyer returned to his screen.

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 Samuel Edwards at sedwards@sseklaw.com, or David Meyer at dmeyer@meyerwilson.com or Robin S. Ringo at rsringo@piaba.org for assistance.

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The following Comment Letter regarding *File No. SR-FINRA-2020-012; Proposed Rule Change to Amend FINRA Rule 8312* was submitted to the Securities and Exchange Commission by Samuel Edwards on May 26, 2020. (prepared with the assistance of David Neuman and Hugh Berkson).

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

Re: SR-FINRA-2020-012
Proposed Rule Change to Amend FINRA Rule 8312 to Allow the Dissemination of IAPD Information Through BrokerCheck

Dear Mr. Fields:

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

FINRA proposed, by way of SR-FINRA-2020-012, an amendment to FINRA Rule 8312 to allow dissemination of the SEC's Investment Adviser Public Disclosure ("IAPD") information through FINRA's BrokerCheck. In essence, the proposed rule would allow additional information to be displayed on BrokerCheck when the individual is dually licensed as both a FINRA associated person and investment advisory representative. PIABA supports the proposed rule and believes it would benefit the investing public to access more information on BrokerCheck and simplify investors' ability to access public information on their potential financial advisor. The rule promotes inclusion of information that is already publicly available on the SEC's

website, and PIABA supports the inclusion of this information to be disseminated on BrokerCheck too.

While the rule proposal is a step in the right direction, PIABA continues to urge FINRA to go much further in the information it provides to the investing public concerning its registered representatives. Investors should be able to view all relevant information that is available in the CRD system about the firm and advisor with whom they choose to do business – which firm and advisor almost always serve as a trusted and exclusive source of investment information and advice. BrokerCheck currently excludes certain information that is contained in the CRD system, such as tax liens or bankruptcies that were filed more than 10 years ago, or how many times their advisor failed their examinations. This information can be accessed by the public in some cases, but only if the public knows how to navigate a labyrinthine system of varying state regulators. Florida, for example, provides a complete and thorough disclosure from the CRD system – one that is far more thorough than what FINRA provides through BrokerCheck. However, not all registered representatives are licensed in Florida, so this same information may not be available to an investor whose broker is only registered in Montana. As FINRA appears to acknowledge the value is providing publicly available information, we encourage, once again, FINRA to make *all* publicly available CRD information available via a BrokerCheck report so that information is easily accessible for all investors, regardless of their state or the state where their advisor and brokerage firm are registered.

PIABA also asks FINRA to include additional, more complete information concerning brokerage firms via BrokerCheck. Currently, FINRA's BrokerCheck website provides very little relevant information for investors to check on the brokerage firm where they may be entrusting their life savings. For example, there are almost no references to customer complaints regarding firms published on BrokerCheck. There is also a complete dearth of information regarding how many of a firm's registered representatives have customer complaints or regulatory events indicated on their own CRD records. Studies have shown that a firm maintaining a greater percentage of brokers with "red flags" indicated on their CRDs are more likely to face additional investor complaints in the future.[1] Providing more information to investors regarding the nature of the firms with whom they entrust their life savings can only be a good thing, and can only promote investor protection. Such disclosures would also surely encourage greater compliance with FINRA rules

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1. *See*, for example, *How Widespread and Predictable is Stock Broker Misconduct*?, McCann, Quin, Yan (June 2016)(available at https://www.slcg.com/pdf/working papers/McCann%20Qin%20and%20Yan%20 on%20BrokerCheck%20Final.pdf).

and investor protection as firms would be greatly incentivized to try and limit the number of disclosures on their report, thereby actually protecting investors before wrongdoing occurs.

Finally, PIABA notes that BrokerCheck or state disclosures are only as good as the information available within the CRD system itself. Unfortunately, there has been a wave of advisors using a variety of tools to obtain expungement of customer complaints from their records. While FINRA has recently suggested modest rule changes, nothing yet has been enacted. Moreover, the proposed changes put forth so far will do very little to stop the abuses of the expungement process. From 2016 to 2018, advisors were having complaints expunged in 81% of cases, even though FINRA deems that expungement should only be granted in "extraordinary" circumstances. When hundreds, if not thousands, of customer complaints are being expunged from the BrokerCheck system every year, a serious question arises whether they can or should rely on the information provided by BrokerCheck.

In summary, PIABA supports the proposed rule to provide the IAPD information on BrokerCheck, but urges FINRA to take further steps to enhance BrokerCheck and curb the abuses of the expungement process.

Very truly yours,
Sam Edwards

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The following Comment Letter regarding *File No. SR-FINRA-2020-011; FINRA proposed rule change to address brokers with a significant history of misconduct* was submitted to the Securities and Exchange Commission by Samuel Edwards on May 5, 2020. (prepared with the assistance of Jason Kane).

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

Re: File No. SR-FINRA-2020-011 (FINRA proposed rule change to address brokers with a significant history of misconduct)

Dear Mr. Fields:

I write on behalf of the Public Investors Advocate Bar Association ("PIABA"), an international, not-for profit, voluntary bar association that consists of attorneys who represent investors in disputes with the securities industry. Since its formation in 1990, PIABA's mission has been to promote the interests of the public investor by, among other things, seeking to protect such investors from abuses in the dispute resolution process, working with regulators and legislators to help craft rules and laws that better protect investors, and advocating for public education related to investment fraud and industry misconduct. Our members and their clients have a fundamental interest in the rules promulgated by the Financial Industry Regulatory Authority ("FINRA") that govern the practices of brokers and broker-dealer firms.

PIABA is supportive of FINRA's proposed rule changes to address brokers with a significant history of misconduct. Those rule changes would: (1) allow a Hearing Officer to impose conditions or restrictions on the activities of a respondent when a disciplinary matter is appealed; (2) amend FINRA Rule 9520 to require member firms to adopt heightened supervision for statutorily disqualified brokers while an eligibility request is under review by FINRA; (3) amend FINRA Rule 8312 to allow the disclosure through BrokerCheck of the status of a member firm as a "taping firm" under FINRA Rule 3170; and (4) require a member firm to submit a written request to FINRA for a materiality consultation and approval of a continuing membership application, if required, when a person that has – in the prior five

years – one or more "final criminal matters" or two or more "specified risk events" seeks to become an owner, control person, principal or registered person of a member firm.

The proposed rule changes recognize that there continue to be several holes in the FINRA regulatory framework that allow bad actors to continue to abuse investors, even when FINRA is aware of the bad conduct. By way of example, a troubled broker is currently allowed to maintain his or her access to the securities markets while a disciplinary matter is appealed to the National Adjudicatory Council ("NAC"). Similarly, a FINRA member firm is currently able to continue to profit from the sales of a statutorily disqualified broker simply because an eligibility request was made to FINRA. Moreover, the full regulatory process involved to remove a bad broker or expel a brokerage firm with a history of abusing investors takes significant time and, if the bad actor is allowed to continue abusing investors while this process is ongoing, FINRA cannot appropriate protect the public. As FINRA states on page 5 of the notice:

> a FINRA enforcement proceeding could involve a hearing before a Hearing Panel, numerous motions, an appeal to the NAC, and further appeals to the SEC and federal courts of appeals. Moreover, even when a FINRA Hearing Panel or Hearing Officer imposes a significant sanction, the sanction is stayed during appeal to the NAC, many sanctions are automatically stayed on appeal to the SEC, and they potentially can be stayed during appeal to the courts. When all appeals are exhausted, the respondent's FINRA registration may have terminated, limiting FINRA's jurisdiction and eliminating the leverage that FINRA has to incent the respondent to comply with the sanction, including making restitution to customers.

The obvious and concerning question in that years long process involving a troubled broker that FINRA now recognizes is: "what is he or she doing to his or her customers while the appeal is pending?" PIABA members have seen many cases over the years where bad actors have used the appeal process to perpetuate additional fraud against the investing public and appreciate that FINRA is attempting to now stop this from continuing.

PIABA notes, as it has in the past, that a broker or broker-dealer should not be able to conduct business as usual during a disciplinary appeal. Brokers or broker-dealers should have restrictions in place during the pendency of an appeal to make sure they do not continue with abusive behavior and further injure investors while appealing a disciplinary action. Moreover, such members should be required to provide clear and convincing evidence of a manifest error by the trier of fact and show the likelihood of success of the underlying appeal before any restrictions are removed. This would provide

the appropriate balance between protecting the investing public and due process for brokers and member firms.

As FINRA also explained in its notice, there are "persistent issues with some member firms despite FINRA's tools to identify recidivist brokers and the supervision rules in place." As a result, FINRA needs to be able to strengthen its ability to actually stop these bad actors immediately, not just be able to identify them and then put them in a years long process that allows further misconduct. An employing broker-dealer should be informed immediately of any condition or restriction imposed on one of its brokers. After notification, heightened supervision plans need to be documented and enforced if a broker-dealer maintains its relationship with a disciplined broker. In a self-regulatory environment, broker-dealer registration and supervision is one of the hallmarks of our country's regulatory framework. FINRA's steps here provide benefits by closing an obvious regulatory gap.

As practitioners who represent the victims of broker misconduct, PIABA members are often amazed at the regulatory histories of some of the brokers our clients or perspective clients are complaining about. We are often left wondering: "how is this person still registered?" or "why did this brokerage firm give this person access to the securities markets?" While we are pondering those questions, the person we are talking to is dealing with the devastation of having lost their life savings and a recidivist broker is likely stalking his or her next prey. Any arguments against these proposed rule changes based on minor compliance costs are far outweighed by the very important investor protection benefits they provide.

PIABA supports these rule changes and continues to encourage FINRA to address the enormous risks that recidivist brokers present to the investing public. PIABA appreciates the opportunity to comment on these proposed rule changes. Thank you for your consideration.

Respectfully submitted,
Samuel B. Edwards, President
Public Investors Advocate Bar Association

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The following PIABA Comment Letter regarding *File No. SR-FINRA-2020-007; FINRA proposed rule change to suitability and non-cash compensation rules to clarify and conform to Reg BI* was submitted to the Securities and Exchange Commission by Samuel B. Edwards on April 15, 2020 (prepared with the assistance of Jason Kane).

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

Re: File No. SR-FINRA-2020-07
(FINRA proposed rule change to suitability and non-cash compensation rules to clarify and conform rules to Reg BI)

Dear Mr. Fields:

I write on behalf of the Public Investors Advocate Bar Association ("PIABA"), an international, not-for profit, voluntary bar association that consists of attorneys who represent investors in disputes with the securities industry. Since its formation in 1990, PIABA's mission has been to promote the interests of the public investor by, among other things, seeking to protect such investors from abuses in the arbitration process, seeking to make the arbitration process as just and fair as possible, and advocating for public education related to investment fraud and industry misconduct. Our members and their clients have a fundamental interest in the rules promulgated by the Financial Industry Regulatory Authority ("FINRA") that govern the practices of brokers and broker-dealer firms.

PIABA is generally supportive of FINRA's proposed amendments to FINRA Rules 2111 (Suitability), 2310 (Direct Participation Program), 2320 (Variable Contracts of an Insurance Company), 2341 (Investment Company Securities), and 5110 (Corporate Financing Rule – Underwriting Terms and Arrangements) and Capital Acquisition Broker ("CAB") Rule 211 (Suitability) that would: (1) make clear that these rules do not apply to recommendations that will be subject to Regulation Best Interest ("Reg BI"), (2) remove the element of control from the quantitative suitability obligation, and (3) conform these rules governing non-cash compensation to Reg BI's limitations on sales contests, sales quotas, bonuses and non-cash compensation.

PIABA supports this specific rule change because of the incremental benefit it provides to investors. On page 5, FINRA states that "compliance with Reg BI would result in compliance with Rule 2111 because a broker-dealer that meets the best interest standard would necessarily meet the suitability standard." PIABA appreciates that, despite all of Reg BI's shortcomings, FINRA is at least making clear that Reg BI is a more rigorous standard than Rule 2111. This is a small improvement.

As outlined in PIABA comment letter dated August 7, 2018, PIABA was initially encouraged by the SEC's initial Notice of Proposed Rulemaking noting that it was "in complete agreement with the premise and intent of this proposed rulemaking to heighten the standard of conduct required of brokers when they recommend securities and securities strategies to retail customers."[1] However, as rulemaking process continued throughout 2018 and into 2019, PIABA became more and more concerned before ultimately determining that Reg BI fell "far short of what investors need and deserve."[2] As outlined in PIABA's joint press release with the Consumer Federation of America, that was because:

- The standard will not actually require brokers to act in their customers' best interest.
- The standard will not prevent broker from placing their own interests ahead of customers' interests.
- The standard will apply on a transaction by transaction basis regardless of the nature of the relationship between the broker and customer.
- While theoretically an enhancement to FINRA rules, the required "point of sale" cost and conflict of interest disclosures will not provide investors with timely, usable information.
- Investment Advisers will be able to satisfy the standard through disclosure alone, allowing them to place their interests ahead of their clients' interests.
- The disclosures will be confusing and will not help investors make informed decisions.[3]

Reg BI should have gone further. Calling it "Regulation Best Interest" but not actually providing a standard that requires advisors to act in their clients' best interest is a problem because it lulls investors into a false sense of security

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1. *See* PIABA comment letter dated August 7, 2018 attached hereto as exhibit 1.

2. *See* Joint Press Release of PIABA and Consumer Federal of America dated attached hereto as exhibit 2.

3. *Id.*

that there is a fiduciary duty. It is ironic that PIABA is commenting on this proposed rule change at the same time that the SEC is seeking comment on a rule that would require more transparency to the names of mutual funds.

PIABA continues to be amazed that the financial services industry is still fighting a uniform fiduciary duty. Unfortunately, the industry's lobbying efforts were successful yet again and Reg BI is not the sweeping change that it was marketed to be.

Additionally, PIABA supports FINRA's efforts to "modify the quantitative suitability obligation under FINRA Rule 2111.05 (c) to remove the element of control that currently must be proved to demonstrate a violation." Control should not be required (nor should it ever have been) to show that a series of transactions were unsuitable, even if suitable while viewed in isolation. Common sense mandates that one small risky, illiquid transaction may be suitable, where a series of those same transactions is decidedly not.

Finally, PIABA supports the removal of internal sales contests of securities. Retail investors' life savings are too important to be subjected to sales goals and contests similar to the way a used car dealership might incentivize its car dealers.

To summarize, PIABA supports the clarifications regarding Reg BI's application of existing FINRA Rules but continues to highlight all of the disappointing problems and imperfections of Reg BI.

Respectfully submitted,
Samuel B. Edwards
PIABA President

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The following PIABA Comment Letter regarding *S.E.C. Names Rule Comment – S7-04-20* was submitted to the Securities and Exchange Commission by Samuel Edwards on April 15, 2020 (prepared with the assistance of Dayton Haigney).

Vanessa A. Countryman, Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: S.E.C. Names Rule Comment- S7-04-20

Dear Ms. Countryman:

I write on behalf of the Public Investors Advocate Bar Association ("PIABA"), an international, not-for profit, voluntary bar association that consists of attorneys who represent investors in disputes with the financial services industry. Since its formation in 1990, PIABA's mission has been to promote the interests of the public investor by, among other things, advocating for public education related to investment fraud and industry misconduct. Our members and their clients have a fundamental interest in the rules promulgated by the Securities & Exchange Commission ("SEC" or the "Commission") that govern the investment products and investment services offered to the public.

PIABA appreciates the opportunity to comment on 17 CFR 270.35d-1 ("Names Rule") and would fully support a change or update to the Names Rule that would improve investor protection. At the outset, PIABA notes, at least at the time of writing this letter, that most comment letters sent to the SEC appear to have been submitted on behalf of individual investors. That is, of course, because the transparency of fund names is crucially important to individual investors. Oftentimes, investors, especially those who are not sophisticated, base their purchase of funds solely upon the name of the fund. Retail investors frequently do little to check on the portfolio holdings of a fund or the specific strategy of a fund beyond looking at the name on their monthly account statement. Indeed, many investors would not know how to check fund holdings if that thought even occurred to them. This is especially problematic for 401k investments, which are almost exclusively invested in mutual funds that employers select and comprise the retirement funds and savings for many Americans. Any changes or interpretations of the Names Rule should be undertaken with a full measure of investor protection in mind.

PIABA feels strongly about this issue because there are countless examples of misleading names that caused significant harm to unsuspecting investors. Perhaps the most notable example is what occurred with Bear Stearns at the beginning of financial crisis of 2007-2008, which was marked by the collapse of two Bear Stearns hedge funds in July of 2007. These two funds consisted of collateralized debt obligations backed by non-traditional sub-prime loans. Besides the low quality of the securities owned by the funds, the fund managers employed an investment strategy of substantial leverage, ranging from 10 to 25 times the net asset value of the holdings. This was unequivocally a very risky strategy and one that required incredible sophistication for any investor to be able to evaluate. Nevertheless, Bear Stearns marketed the funds to 'accredited' retail investors under the names- **"High-Grade Structured Credit Strategies Fund"** and **"High-Grade Structured Credit Strategies Enhanced Leverage Fund"**. Although the name of the second fund referenced the term 'leverage', the term 'high-grade' is what likely stood out in the minds of the investors who were sold the funds. Billions of dollars were lost in these two Bear Stearns funds. Similar events happened with funds marketed by Morgan Keegan & Co. that were also structured finance funds, but used names to suggest they were more traditional funds and Charles Schwab's Yield-Plus series of funds that were marketed as money market and even treasury security alternatives. Sadly, with the current crisis in the financial markets, PIABA members are seeing similar misleading names result in large, unsuspecting investor losses.

PIABA believes that the proposed changes to the Names Rule is a step in the right direction to attempt to better protect investors. However, PIABA recommends that the rule go farther. For example, the portfolios of many individual investors contain a large concentration of index funds. The release indicates that the Names Rule does not currently apply to "indices" which suggests that funds that are meant to follow an index (most trade as Exchange Traded Funds – ETFs) will not be covered under this rule. The release does not indicate whether ETF's that are based on an index are subject to the Names Rule. As a number of those index-based ETFs include leverage and other complex strategies and do not always track an index as direct as many investors might suspect, PIABA believes this is a dangerous oversight. Any inquiry into the Names Rule should include a review with respect to the applicability of the Names Rules to index funds and ETF's. The release also notes that the Names Rule "does not apply to the use of terms that suggest an investment strategy (such as "growth" or "value")". PIABA contends that the Names Rule should apply to the investment strategy of a fund, particularly were the investment strategy entails a high degree of risk. The terms "growth"

and 'value" should not used to mislead investors as to aggressive, high risk funds.

The release further states that, "[t]he Names Rule does not apply to the use of the terms 'actively managed', 'tax managed', 'long-term', and 'short-term'". These are the types of words investors rely upon when choosing to invest in a fund. PIABA believes the exclusions the SEC is making are fir important descriptive words that investors often rely upon and that the investor is best protected if every word used within a name is subject to scrutiny by the Commission under the auspices of the Names Rule. There should be no safe harbors when it comes to naming funds.

PIABA very strongly believes that the names utilized by funds must accurately and fully reflect the securities and industry sectors held by the funds. The Commission questioned whether a test that requires that the type of investment suggested by a fund's name contribute at least a minimum amount (*e.g.,* 80 percent) of a funds return. Although a percentage minimum may be helpful to investors, the requirement may serve to foster the creation of funds and products which are inherently unsuitable to investors. PIABA urges the Commission to tread cautiously with respect to mandating minimum asset holdings of a particular fund, instead forcing funds to accurate describe the fund and its characteristics in the name of the fund.

Affinity fraud occupies one of the darkest spaces of investment fraud. PIABA commends the Commission for recently publishing an investor alert on affinity fraud[1]. PIABA strongly feels that the Commission should adopt a strict moratorium of the use of well-known organizations, particular affinity groups, or the reference to a specific population of investors (*e.g.,* "veterans" or "municipal employees") in fund names.

The majority of comment letters submitted to the S.E.C. to date deal with concerns about "ESG" (environment, social, and governance) funds. The release notes that close to three hundred funds currently use terms such as "ESG", "Clean", "Environmental", "Impact", "Responsible", "Social", or "Sustainable" in their names. While PIABA recognizes that some individuals may prefer to invest in such a manner, ESG investing involves two obvious pitfalls. First, many of these funds invest in start-ups which may not be suitable for many individual investors. Second, the funds sometimes place a premium on ESG at the expense of a reasonably safe return on investment. While PIABA maintains that ESG funds should invest as their name implies, such funds should describe more concerning the investments in the fund than just ESG and may deserve extra scrutiny by the Commission.

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1. https://www.sec.gov/oiea/investor-alerts-bulletins/ia_affinityfraud.html.

With respect to disclosure of risk, investor protection would be best served by requiring all fund names to list a risk factor between one to ten to allow investors to easily ascertain whether a particular fund fits their risk tolerance. Many of the terms often used to describe fund and investment objects are not easily understood and often misinterpreted, and a simple number system should be something more easily understood by the investing public.

Finally, the release requests comments on whether consideration should be given to repealing the rule. Inasmuch as this the Names Rule exists primarily for the protection of investors; no justifiable reason exists for the repeal of the rule. To the contrary, the Commission should increase its efforts to apply the rule to protect investors when reviewing new funds for approval. Repealing the rule would unquestionably allow unscrupulous fund managers and promoters to use names that would mislead and ultimately hurt investors.

As set forth above, investors heavily rely on the names of funds when making investment decisions. In proposing any changes to the Names Rule, the Commission should place the interests of investors above any other concerns.

Thank you for your consideration herein.

Sincerely,
Samuel B. Edwards
PIABA President

The following PIABA Comment Letter regarding *File No. SR-FINRA-2020-005; FINRA Proposed Rule Change to Apply Minimum Fees to Requests for Expungement of Customer Dispute Information* was submitted to the Securities and Exchange Commission by Samuel Edwards on March 18, 2020 (prepared with the assistance of Daren Luma).

Ms. Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F St. NE
Washington, DC 200549-1090

RE: FINRA Proposed Rule Change to Apply Minimum Fees to Requests for Expungement of Customer Dispute Information – File No. SR-FINRA-2020-005

Dear Ms. Countryman:

I write on behalf of the Public Investors Advocate Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors. Since its formation in 1990, PIABA has promoted the interests of the public investor in all dispute resolution forums, while also advocating for public education regarding investment fraud and securities industry misconduct. Our members and their clients have a fundamental interest in the rules promulgated by the Financial Industry Regulatory Authority ("FINRA") that relate to investor protection.

We appreciate the opportunity to comment on FINRA's proposed rule changes to the FINRA Code of Arbitration for Customer Disputes and the FINRA Code of Arbitration for Industry Disputes in regard to the fee structure for requests for the expungement of customer dispute information. While PIABA supports FINRA's current proposal to apply minimum fees to requests for the expungement of customer dispute information, it is disappointed that FINRA has chosen to only focus on fees for expungement requests, rather than on the host of other proposed rules that were part of FINRA's request for comments on expungement filed over two years ago.[1] FINRA's other proposed rules, such as codifying current FINRA guidance that expungement

1. *See* FINRA Regulatory Notice 17-42, *Expungement of Customer Dispute Information* (December 2017).

should be limited only to information that has "no meaningful investor protection or regulatory value;" a specially trained arbitrator pool to consider expungement requests; strict time limitations on expungement requests; requiring a recommendation for expungement be granted by a unanimous three arbitrator panel; and requiring parties seeking expungement to appear in person or via videoconference at the expungement hearing are all more impactful to investor protection and limiting the improper abuse of the expungement process than FINRA's current proposal regarding minimum fees for expungement requests. [2] While FINRA does note that it "is separately developing other changes to the current expungement framework, including codifying as rules the Notice to Arbitrators and Parties on Expanded Expungement Guidance,"[3] PIABA believes that FINRA should have prioritized these other important rules proposals concerning expungement, rather that moving forward first on minimum expungement fee proposals.

As discussed in greater detail below, while PIABA supports FINRA's request to amend its rules to apply minimum fees to requests for the expungement of customer dispute information it believes that FINRA's proposal should be revised to require that all requests for the expungement of customer dispute information be heard before a three-person arbitration panel.

A. FINRA's Proposed Revision of Expungement Request Fees.

PIABA agrees with FINRA that associated persons and member firms are taking advantage of the current fee structure and avoiding paying proper fees associated with requests for expungement. In particular, the practice of adding a small monetary claim to a request for expungement in a "straight in" expungement request[4] is a particularly egregious abuse of the process. FINRA

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2. PIABA submitted extensive comments to FINRA regarding proposed expungement rules revisions during the comment period for FINRA Regulatory Notice 17-42. *See* PIABA Comment Letter to Marcia Asquith, FINRA Regulatory Notice 17-42, *Expungement of Customer Dispute Information* (February 2, 2018), attached as Exhibit A. FINRA did not attach PIABA's comment letter to this rule filing because it deemed our letter "not applicable to this filing." *See* SEC Release No. 34-88251; File No. SR-FINRA-2020-005 (February 20. 2020), 11172.

3. *See* SEC Release No. 34-88251; File No. SR-FINRA-2020-005 (February 20. 2020), fn3.

4. FINRA defines a "straight in" expungement request as a separately filed arbitration seeking expungement, as contrasted to expungement requests made by associated persons during the pendency of a FINRA customer arbitration.

details how under the current FINRA arbitration rules a party seeking expungement can add a small monetary claim to its expungement request and ensure that its filing and hearing session fees are decreased by over 96% and also ensure that the expungement request is heard by a single arbitrator rather than a three arbitrator panel.[5] Disturbingly, this abusive process has become the norm. According to FINRA, parties seeking expungement added a small monetary claim in 2,356 requests for expungement – representing 76% of straight in expungement requests - between January 2016 and June 2019.[6]

FINRA's proposal primarily seeks to address these abusive tactics by requiring fees for expungement requests be assessed at least as much as a non-monetary claim, thereby removing the benefit of adding a small monetary claim. Thus, FINRA proposes that: (1) filing fees for expungement requests be assessed at the higher of the non-monetary fee or the claim amount; (2) that a minimum member surcharge equal to a non-monetary claim be assessed against the applicable member firm in straight-in expungement requests; (3) that hearing sessions fees for expungement requests be at least equal to a non-monetary claim; and (4) that process fees for straight-in expungement requests be assessed against the applicable member firm at least equal to non-monetary claims. PIABA agrees with these proposed rules and with the disincentivizing of adding nominal monetary claims to expungement requests.

PIABA also agrees with FINRA's proposal that filing fees be assessed for all expungement requests, including those made during an existing customer arbitration. Currently, a member firm or associated person that requests expungement during a customer-initiated arbitration is not required to pay a filing fee. However, as FINRA Notes:

> A request for expungement is a claim that a party is requesting the arbitrators to decide. Under the Codes, if a party files a claim or adds a claim in an answer to a statement of claim, the respondent must pay all required filing fees. As an expungement request is also a claim, the party requesting this relief should also pay a filing fee.[7]

PIABA agrees that a request for expungement made by a respondent in a customer-initiated arbitration is equivalent to a non-monetary counterclaim and should be assessed a filing fee consistent with that. We further agree that this fee is commensurate with arbitrators "unique and distinct role" in the

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5. *See* SEC Release No. 34-88251; File No. SR-FINRA-2020-005 (February 20. 2020), 11167, fn24.

6. *Id.* at 11169-70.

7. SEC Release No. 34-88251; File No. SR-FINRA-2020-005 (February 20. 2020), 11167.

expungement process and the additional steps arbitrators are required to take in deciding expungement requests. PIABA further believes that requiring the payment of a filing fee at the time an expungement request is made would discourage the frivolous addition of such requests by respondents in statements of answer.

B. FINRA Rules Should Require That all Expungement Requests are Heard by a Three Person Arbitration Panel.

Throughout the rule filing, FINRA acknowledges the desirability of expungement requests to be heard before a three-person arbitration panel, rather than a single arbitrator. FINRA firsts states:

> FINRA believes that most expungement requests should be decided by a three-person panel. Expungement requests may be complex to resolve, particularly straight-in requests where customers typically do not participate in the expungement hearing. Thus, having three arbitrators available to ask questions and request evidence would help ensure that a complete factual record is developed to support arbitrators' decision at such expungement hearings.[8]

FINRA later speculates that the proposed rule change *should* result in more three-person arbitration panels hearing expungement requests, noting: "The proposed rule change should also result in more expungement requests being heard by a three-person panel. A three-person panel will help ensure a complete factual record to support the arbitrators' decision, particularly in straight-in requests that often do not include customer participation and can be complex to resolve."[9]

However, in discussing the economic impact of the proposed rule changes, after first stating that that the proposed rules would "trigger a three-person panel for all straight in requests," FINRA admits that the "impact of this change may be small because parties may still jointly agree to a single arbitrator."[10]

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8. SEC Release No. 34-88251; File No. SR-FINRA-2020-005 (February 20. 2020), 11167.

9. SEC Release No. 34-88251; File No. SR-FINRA-2020-005 (February 20. 2020), 11169.

10. FINRA Rules 12401(c) and 13401(c) permit parties to FINRA arbitration to agree to a single arbitrator to decide their case, even if the filing amount would otherwise require a three-person arbitration panel.

In other words, considering that virtually all straight in expungement requests are between registered representatives and their present/former employing member firms who have aligned interests in favor of expungement, there is no mechanism in the proposed rules that would prevent these aligned parties from simply agreeing to have the expungement matter heard by a single arbitrator, irrespective of the fact the filing fees would now be higher. Moreover, since, unlike FINRA's prior broader expungement rules proposal, FINRA's current rules proposal does not alter or revise FINRA's default Neutral List Selection System, a registered representative and member firm that agreed to have a straight-in expungement request heard by a single arbitrator would be able to collectively strike eight out of the ten arbitrators listed on a generated list, virtually assuring the most favorable arbitrator possible will preside over the expungement request.

As such, contrary to FINRA's assertion, given current FINRA rules permitting parties to agree to a single arbitrator, there is no reason to believe that there will be a material increase in the number of expungement requests heard by a panel of three arbitrators under FINRA's current rules proposal.

PIABA believes that rather than hoping that the new rules "should" result in more expungement requests are heard before three-person arbitration panels, FINRA should ***require*** this under the revised arbitration rules. As FINRA noted, there are worthwhile reasons for expungement requests to be heard before a three-person arbitration panel, rather than a single arbitrator, and as such FINRA should close the remaining loophole in its rules and ensure that all such expungement requests are adjudicated by three-person arbitration panels.[11]

PIABA appreciates the opportunity to submit these comments and urges the Commission to approve the proposed rules with the revisions suggested above.

Respectfully submitted,
Samuel Edwards, PIABA President

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11. As noted above, *see* note 2 *supra*, PIABA has already submitted an extensive and detailed comment letter to FINRA regarding the full breath of suggested revisions to FINRA's expungement framework that go far beyond a mandated requirement for a three-person arbitration panel to hear all expungement requests. While PIABA will refrain from discussing all of these additional issues and considerations at this point, it believes there is no reason to refrain from mandating a three-person arbitration panel handle expungement requests, even if further proposed revisions will be forthcoming from FINRA when it addresses the other proposed changes to the expungement framework.

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The following PIABA Comment Letter regarding *File No. S7-25-19 Proposed amendments to the definition of "accredited investor"* was submitted to the Securities and Exchange Commission by Samuel Edwards on March 16, 2020. (prepared with the assistance of Jason Kane).

Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F St NE
Washington, DC 200549-1090

RE: Proposed amendments to the definition of "accredited investor" File No. S7-25-19

Dear Ms. Countryman:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities disputes all across the nation. Since its formation in 1990, PIABA has promoted the interests of the public investor in all dispute resolution 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 U.S. Securities & Exchange Commission (the "SEC" or the "Commission") relating to investor protection.

PIABA appreciates the opportunity to comment on the Commission's proposed amendments to the definition of "accredited investor" ("Amendments to the Accredited Investor Definition") and notes that the Amendments to the Accredited Investor Definition follow the SEC's related June 18, 2019 concept release on harmonization of securities offering exemptions (the "Concept Release"). As such, much of this comment letter pertaining to the Amendments to the Accredited Investor Definition echoes PIABA's position on the Concept Release as stated in PIABA's September 24, 2019 comment letter (PIABA's September 24 letter).[1]

PIABA is concerned its comments in the September 24, 2019 letter have been disregarded in the Commission's current rulemaking. In its proposal, the Commission is wholly focused on increasing the number of individuals who

1. *See* PIABA letter dated September 24, 2019, attached hereto as Exhibit 1.

may participate in the private securities markets. While increasing the numbers of "eligible" investors may expand businesses' access to capital, our members have seen all too often this easier access results in rampant abuses that rob investors of their hard-earned savings. This is especially true of older investors, who often meet the very lax financial definition of "accredited investor", even though they are completely unsophisticated. ***PIABA again stresses and reminds the Commission of its primary objective of protecting investors.*** While access to capital and capital formation are laudable goals for the Commission, its main obligation is to protect investors. Simply put, PIABA believes the Amendments to the Accredited Investor Definition will actually undermine investor protection.

As the Commission points out in the Amendments to the Accredited Investor Definition, its review of the definition of accredited investor is mandated by the Dodd-Frank Act, passed in the aftermath of the 2008 financial crisis.[2] Dodd-Frank calls for the definition of accredited investor to be reviewed every four years to determine whether it "should be adjusted or modified for the ***protection of investors, in the public interest, and in light of the economy***." (Emphasis added). As described throughout this and PIABA's September 24 letter, the Amendments to the Accredited Investor Definition directly contradict Congresses' mandate in Dodd-Frank as they fail to protect investors and nothing has happened in the economy that justifies the substantial increase in risk to investors that the Commission suggests.

The Amendments to the Accredited Investor Definition fail to address numerous serious issues with the current definition of accredited investor. For instance, the financial standard included in the accredited investor definition has not been updated in 37 years. The income and net worth thresholds set in 1982 and existing today define an accredited investor as an individual with a net worth of $1 million or more, or with an individual income in excess of $200,000 per year or joint income with a spouse in excess of $300,000 per year. As the Commission notes, historically, the definition of accredited investor "intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or fend for themselves render the protections of the Securities Act's registration process unnecessary." However, the Commission gives little concern to the fact that what it meant to have $1,000,000 or make an annual income of $200,000 in 1982 is far different than what it means today, especially if those numbers are being used to identify investors with "financial sophistication" who can presumably "fend for themselves."

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2. SEC, "Amending the "Accredited Investor" Definition," 85 Fed. Reg. 2574, 2575 (Jan. 15, 2020).

In 1982, only 1.8% of households could meet either of the financial thresholds of an accredited investor. Now, 13% of households qualify under these threshold. Moreover, the experience of our members is that those who qualify under this standard are often older, retired investors who have saved through a 401k for their entire lives and accumulated this money from long work histories, not prior investment experience. Furthermore, that level of wealth, in the experience of our members, rarely coveys any appropriate level of sophistication. To the contrary, many of those who meet the current accredited investor definition are undeniably unsophisticated and, if the rule is adopted, even more people will unknowingly be losing the protections of the securities laws. This simply is not what Congress intended when it enacted Dodd-Frank and when it instructed the Commission to revisit this standard every four years.

Far from the only organization expressing surprise about the Commission's failure to change the income and net worth thresholds associated with being an accredited investor, even large Registered Investment Advisors ("RIAs") expressed surprise that 1982 levels of income and net worth still pass muster according to the Commission. According to Gerard Klingman of Klingman & Associates:

> While we believe allowing more private market access to experienced investors is a good thing, the SEC must take a long-term approach to protecting smaller and less-knowledgeable investors. To our surprise, the SEC did not propose changes to the minimum threshold limits: over $200,000 income ($300,000 joint) or $1 million net worth. In fact, the SEC has not increased these thresholds since introducing them in 1982, ignoring nearly 40 years of inflation. We recently read that in 1982, around 0.5% of U.S. citizens met the income limit, while nearly 9% do today — an 18-fold increase.
>
> The SEC is now at a crossroads as the rising number of eligible accredited investors is coinciding with the rising general interest in private markets. If we use history as a guide, investors will undoubtedly need to be protected from themselves, particularly in these less liquid and transparent markets. While these proposed rules move forward to ensuring investors understand the potential risks, they still need to ensure investors are financially equipped to withstand their potential fallout.[3]

The Commission's explanation as to why the reduction of investor protection over the past 37 years is acceptable is quite concerning.

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3. Godt, Nick, "Top Advisors Weigh In: Should the SEC Expand the Accredited Investors Pool?" *Financial Advisor IQ*, 19 Feb. 2020.

Specifically, the Commission argues that advances in the internet and social media somehow mitigate the need for the protection of the securities laws.[4] This premise is misguided, at best. First, while the Commission is correct in noting that the development of the internet and social media has resulted in more information being available to investors, the Commission ignores that those same developments have resulted in far more *misinformation* bombarding the investing public. Many known fraudsters have used these mediums to purposely mislead investors and fleece them of millions of dollars. Second, many investors who meet the accredited investor financial threshold are senior citizens who may not be utilizing the internet and social media for investment research. The Commission has provided no support that this group of investors, which is substantially larger than when Rule 501 was first adopted, does not need the protections of the Securities Act.

In addition, the Commission has expressed concerns that if the financial thresholds are increased, it may disproportionately impact certain geographical regions in which households have less wealth but also lower costs of living.[5] However, the Commission's concerns do not adequately address the concerns raised above that substantially larger numbers of individuals now qualify as accredited investors than when the financial thresholds were initially adopted. The Commission's concerns about geographical differences in net worth and income surely were the same in 1982, yet standard thresholds have been used for the past 37 years. This rationale does not justify making *no* adjustment to the financial thresholds.

Even more troubling than the Commission's decision to make no changes to the financial thresholds is it consideration of expanding the definition of accredited investor to include those advised by RIAs or broker-dealers. PIABA strongly opposes this suggestion. If the Commission were to take this action, it would render the individual accredited investor definition meaningless, making RIAs and broker-dealers the arbiter of all securities protections to investors. This is completely unacceptable and, especially in light of the Commission's failure to adopt a universal fiduciary standard for all those who provide investment advice to retail customers, would be a disaster for investor protection.

Moreover, the Commission claims that it is "not aware from our enforcement experience or otherwise of disproportionate fraud in this expanded space."[6] However, PIABA's letter of September 24, 2019 contained

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4. *Supra* note 2 at 2594.

5. *Id.* at 2595.

6. *Id.* at 2600.

almost three pages of bullet points describing fraudulent private placements, all of which were enforcement actions taken by the Commission. The vast majority of these investments were purchase through RIAs and broker-dealers. These fraudulent private placements were "sold, not bought" as a result of the efforts of RIAs and broker-dealers and a rule that would allow this to happen to every investor through a RIA or broker-dealer would surely result in an entirely new list of fraudulent private placements that rob mom and pop investors of their life savings. The lure of large commissions makes it too tempting for unscrupulous financial advisors to solicit these investments to unsophisticated investors. The Commission's consideration here would essentially impart the sophistication level of any unscrupulous financial advisors to their victimized clients. This proposal takes away even the appearance of protection to vulnerable investors and cannot possibly be supported under Dodd-Frank.

PIABA is also greatly concerned with the Commission's focus on supporting issuers at the detriment of investors. For example, the Commission worries that increasing the financial thresholds to the accredited investor definition could have disruptive effects on the Regulation D market. That market currently raises ***$1.7 trillion per year***. The fact that Regulation D is such a large portion of capital formation is evidence in and of itself that private offerings have become more available than they were otherwise intended. Expanding those offerings to more unsophisticated investors will both decrease investor protection and also hurt capital markets as expanding the investor base for private placements will almost surely encourage fewer companies to take on the effort to "go public" and provide the necessary information for the SEC to regulate them. This will neither be good for investors nor the capital markets.

In closing, PIABA reiterates its offer to engage with the Commission on this issue, including providing access to our clients who have been harmed by the wrongful sales of private offerings. PIABA believes it would be very helpful for the Commission to get to know the investors it is now willing to deem sophisticated and not in need of the protections of the securities laws. PIABA feels confident that if the Commission meets these individuals and hears their stories, the Commission will better understand PIABA's grave concerns.

Sincerely,
Samuel Edwards,
President