PIABA BAR JOURNAL

VOLUME 29, NO. 1 • 2022

a publication of

Public Investors Advocate Bar Association

PIABA BAR JOURNAL

VOLUME 29 2022 NO. 1

EDITORIAL BOARD

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FINRA ARBITRATION'S PERSISTENT UNPAID AWARD PROBLEM: PIABA'S[1] THIRD REPORT CONCERNING FINRA'S REFUSAL TO TACKLE THE UNPAID ARBITRATION AWARD PROBLEM HEAD-ON

Hugh Berkson and David P. Meyer[2]

If the goal is to protect people from suffering devastating injuries, would it be best to install seatbelts before the car accident, or after? Retirement savers and other individual investors today have no meaningful protection against unscrupulous stockbrokers, investment advisors, and firms who handle hundreds of millions of customer dollars but conduct business without sufficient capital reserves or liability insurance. Wall Street and the securities industry as a whole encourages Americans to trust their financial professional with their retirement savings. But few investors understand that the securities industry does not mandate protections to ensure investors can be made whole after successfully proving a claim for recoverable losses against their financial advisor. American investors have enjoyed the benefits of a stock market that has risen to all-time highs without a meaningful correction for the last decade, and a national economy that has flourished under the most adverse of circumstances. Despite these favorable dynamics, unpaid arbitration awards

1. The Public Investors Advocate Bar Association ("PIABA"), is an international, not-for-profit, voluntary bar association of lawyers who represent investors in securities and commodities arbitration and litigation. PIABA's mission is to promote the interests of the public investor in securities and commodities arbitration by seeking to: protect such investors from abuses in the arbitration process; make securities arbitration as just and fair as systematically possible; and, educate investors concerning their rights.

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David P. Meyer, managing principal of the Meyer Wilson law firm based in Columbus, Ohio, is the current PIABA President and serves on PIABA's Board of Directors.
The authors offer their deepest thanks to Robin Ringo, PIABA's Executive Director, as well as Tiffany Zachary and Ashley Ringo, whose research and analysis of arbitration awards was critically important in developing this report. The authors also thank the members of PIABA's Executive Committee, including Sam Edwards, Michael Edmiston, Darlene Pasieczny, and Christine Lazaro, for their input and editorial suggestions.

are still hovering at more than 24% of all dollars awarded to investors in arbitration administered through the Financial Industry Regulatory Authority ("FINRA"). Nearly 30% of all FINRA awards in customer claimants' favor in 2020 went unpaid.

Many investors do not discover the misconduct in their investment accounts until there is a market correction. For these investors, most of whom rely on their own savings – often in a retirement plan - rather than a pension to fund their retirements, a meaningful market downturn will likely reveal unprecedented harm to America's retirees and those on the verge of retirement. Since the industry has shown no interest in taking steps to ensure it maintains the same sort of financial responsibility it preaches to its customers, it is time for regulators and legislators to mandate seat belts, in the form of a national investor recovery pool.

The problem of unpaid securities arbitration awards is not a new one. Twenty-one years ago, the U.S. General Accounting Office ("GAO") issued a report on unpaid awards.[3] In its survey of investors who received arbitration awards during 1998, the GAO estimated 49% of the awards went unpaid, an additional 12% were only partially paid, and nearly 80% of the total $161 million awarded to investor claimants that year went unpaid.[4] While FINRA now publishes some recent data on unpaid award statistics, and has implemented or proposed certain rule changes to try to curb abusive industry practices, neither FINRA nor state and federal regulators have directly addressed the fundamental lack of meaningful recovery protection. The problem of unpaid arbitration awards is only growing, thanks in large part to the increasing role of investment advisers, and their common use of commercial and for-profit arbitration forums other than FINRA Dispute Resolution for which there is no public reporting and little regulatory accountability. This report contains PIABA's third analysis of the problem of unpaid arbitration awards, and a renewed call for substantive remedial measures to protect retirement savers and all other individual investors.

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3. See United States General Accounting Office, Report to Congressional Requesters, Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards (June 2001), available at https://www.gao.gov/products/gao-01-654r, last accessed July 8, 2021.

4. Id. at page 33.

BACKGROUND

A. PIABA'S FIRST REPORT

PIABA published its first official position paper on the unpaid award problem on February 26, 2016, titled Unpaid Arbitration Awards – A Problem The Industry Created – A Problem The Industry Must Fix (the "2016 Report").[5] The 2016 Report presented a comprehensive survey of the problem an¬¬d potential cures. The data available at the time revealed that in one out of three cases in which an investor pursued their claims through an arbitration hearing, successfully proved their claims, and won an award against an industry party, the industry party did not pay. In practical terms – the investor used the dispute resolution process and forum forced upon them by the industry, and won their case, but recovered nothing. The 2016 Report also revealed that nearly one dollar out of every four dollars awarded to investors in arbitration went unpaid.

PIABA presented a detailed analysis of a number of proposed cures for the problem, including: expanding coverage by the Securities Investor Protection Coverage ("SIPC"); requiring increases of net capital; instituting an insurance requirement; and, finally, creating a national investor recovery pool (the "Pool"). PIABA concluded that expanding SIPC was not a viable option since SIPC's authority is limited to ensuring that securities or cash missing from an investor's account are returned (within limits - $500,000 for securities and cash, and $250,000 for cash alone). SIPC does not cover other types of losses, such as those associated with sales practice abuses by an industry professional. Absent legislative amendments, SIPC was not capable of addressing the problem.

PIABA concluded mandating insurance for brokers and investment advisers was appealing, but insurance has practical limitations such as claim exclusions for losses resulting from intentional wrongdoing and policy limits that are exhausted after just one or two claims. While PIABA did not challenge FINRA's argument that insurance would be too expensive, it appears that at least one state that mandated insurance for registered investment advisors ("RIAs") saw no change in the number of RIA firms operating within the

5. A copy of the original report is available at: https://piaba.org/system/files/pdfs/Unpaid%20Arbitration%20Awards%20-%20A%20Problem%20The%20Industry%20Created%20-%20A%20Problem%20The%20Industry%20Must%20Fix%20%28February%2025%2C%202016%29.pdf. The authors would like to thank Scot Bernstein, current PIABA member, and former member of its Board of Directors, for his work on the topic in 2004. His work was instrumental in the preparation of the 2016 Report.

state.[6] PIABA concluded that increasing net capital requirements to levels sufficient to address the unpaid award problem was unworkable because net capital requirements are designed simply to ensure that failing firms have sufficient funds to operate as they wind up and transfer customer assets to other, solvent, firms. Furthermore, raising net capital requirements will likely cause industry members to complain that they could not be profitable if they had to set aside sufficient reserves to address their potential/likely liabilities to their customers.

PIABA recommended that a national investor recovery pool be instituted, as it was the best and least expensive option. While certain states had already instituted their own investor recovery pools, those pools were of limited value insofar as maximum payouts were limited, and the pools generally required a finding of a violation of state or federal securities law to enable participation in the pool. Given that arbitrators sit in equity, and rarely issue reasoned awards, unwitting investors lucky enough to be in a state with such a pool could prove their case and get an unpaid award that would be ineligible to draw from the limited state pools. PIABA confirmed that FINRA itself maintained the ability to institute a pool relating to FINRA arbitration awards without a legislative mandate.[7]

PIABA proposed a detailed structure for the proposed Pool, addressing funding (to be potentially sourced from FINRA profits, assessments made upon FINRA members, or assessments made upon individual investors). PIABA also set forth a structure to determine requisite funding for both claims and administrative costs and discussed the types of claims to be paid, the amounts to be paid on those claims, and the timing for claim eligibility.

B. FINRA'S RESPONSE

In the days following the publication of PIABA's 2016 Report, Richard Ketchum, then-head of FINRA, was questioned on Capitol Hill concerning a variety of subjects – including the issues surrounding unpaid arbitration awards. He acknowledged that "something should be done about it," and

6. Oregon instituted a mandatory insurance requirement for RIAs in January 2018. There were 267 firms registered in Oregon in 2018, 268 in 2019, and 273 in 2020.

7. The legal basis to promulgate the Pool was addressed in detail in PIABA's 2016 Report at p. 25. In short, FINRA can create the Pool by way of a rule proposal, and the '34 Act allows the SEC to issue a mandate to FINRA and/or impose rules on broker/dealers.

indicated an intent to work with the Securities & Exchange Commission (the "SEC").[8] Mr. Ketchum even went so far as to indicate that FINRA was not writing off the Pool idea, but rather: "We are looking at whether, one way or another, there should be a fund to try to at least address the small investors that are terribly harmed."[9]

FINRA did not institute a Pool, nor were there obvious clues to what, exactly, it was doing to remedy the problem. Rather, two years after PIABA's 2016 Report was published, FINRA responded with what it titled "Discussion Paper – FINRA Perspectives on Customer Recovery."[10] FINRA's positions were disappointing and unsurprising. First, FINRA attempted to minimize the problem, pointing out that only 18% of all customer claims go to hearing, and of those, 7% of all customer awards include some measure of damages, and of those awards, 2% are unpaid.[11] Thus, at surface level, FINRA asserted that the unpaid award problem made up only 2% of awards. However, FINRA's statistics also showed that investors who took their cases to hearing from 2012 through 2016 won only 38.89% of the time. For those fortunate enough to win their cases, the victories were often pyrrhic insofar as the investors' awards went unpaid 28.57% of the time.

FINRA pointed out that it incentivizes award payment by taking steps to revoke the memberships of associated persons and member firms who fail to pay awards. It also pointed out that other dispute resolution forums – such as courts – offer no guarantee of recovery. What FINRA did not address, however, is the importance of holding its members – who preach the need for individuals to maintain financial discipline – to a similar standard when it comes to their own ability to make restitution.

FINRA's discussion paper boasted of its other efforts to curb the problem of unpaid arbitration awards. For example, FINRA pointed out customers' ability to take inactive firms and associated persons to court, rather than proceeding in arbitration. That "solution" does nothing to curb the problem

8. Waddell, Melanie, FINRA Mulls Crackdown on Arb Award Deadbeats, ThinkAdvisor (March 3, 2016), available at: https://www.thinkadvisor.com/2016/03/03/finra- mulls-crackdown-on-arb-award-deadbeats/, last viewed April 11, 2021.

9. March, Ann, FINRA May Create Fund for Unpaid Arbitration Awards, Financial Planning (March 16, 2016), available at: https://www.financial-planning.com/news/finra- may-create-fund-for-unpaid-arbitration-awards, last viewed April 11, 2021.

10. See FINRA, Discussion Paper- FINRA Perspectives on Customer Recovery (February 8, 2018), available at: https://www.finra.org/sites/default/files/finra_perspectives_on_ customer_recovery.pdf, last viewed March 31, 2021.

11. Id. at p. 5.

itself insofar as it only shifts the responsibility away from FINRA. The regulator also addressed, in summary terms, other rule proposals it was considering. Those proposals included: allowing investors to go to court when the FINRA respondents were unlikely to be able to pay; providing more information regarding unpaid awards via the Central Registry Directory ("CRD") system; and, potential rule changes to prevent brokers from using the tactic of switching firms or firms from moving assets to a new firm rather than paying an award, leaving a wake of unpaid awards behind.

FINRA also addressed the various suggestions PIABA raised two years previously in its 2016 Report, including: raising net capital requirements; creating a fund for unpaid awards; expanding SIPC's coverage; requiring insurance; greater disclosure requirements; and, bankruptcy code changes. FINRA's discussions of all the options were set forth in a summary fashion across two pages and offered nothing substantial beyond what PIABA had discussed two years previously. Of particular importance, FINRA buried in its discussion the following statement: "FINRA believes that Congress or the SEC should be involved in any decision to create a second brokerage industry fund for unpaid arbitration awards, especially to the extent it would cover claims that Congress has determined should not be covered by SIPC."[12] FINRA, despite acknowledging that it maintained the power to establish the unpaid arbitration award restitution fund without Congress or SEC's involvement, abdicated its responsibility by taking the position that it had no intent to create the fund absent a mandate passed down by the SEC or Congress.

C. PIABA'S SECOND REPORT

PIABA started researching a second report in November 2017 and published the report shortly after FINRA published its Discussion Paper. On March 7, 2018, PIABA released its second report on the issue, titled Unpaid Arbitration Awards – The Case For An Investor Recovery Pool ("Second Report").[13] PIABA's analysis of 2017 data revealed that 36% of investors who won their cases in FINRA arbitration collected nothing, and 28 cents of each dollar awarded went unpaid. Two years following the 2016 Report, and despite

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12. Id. at 17.

13. A copy of the report is available at: https://piaba.org/system/files/2018-03/REPORT%20-%20Unpaid%20Arbitration%20Awards%20%28March%207%2C%20%2018%29.pdf, last viewed April 11, 2021.

FINRA'S efforts to curb the problem, the unpaid arbitration award problem had worsened.

PIABA's Second Report focused on the relationship between the total of unpaid awards and fines assessed against FINRA members as a result of their wrongdoing. For the years 2014 through 2016, FINRA fines against its members exceeded unpaid awards by a margin of no less than 3 to 1. PIABA also viewed FINRA's net income and compared it to the unpaid awards outstanding. Once again, for the years 2014 through 2016, FINRA's profits would have wiped out unpaid awards in two out of three years with minimal impact to FINRA'S bottom line.

PIABA concluded that the problem of unpaid arbitration awards was not getting any better since the GAO had looked at the issue twenty-one years previously. Instead, investors continued to be subjected to an easily prevented harm, and the problem could no longer be ignored. PIABA urged FINRA to institute a Pool.

D. FINRA'S RESPONSE TO THE SECOND REPORT

Just as two years elapsed between the 2016 Report and FINRA's substantive response, the same pattern occurred following PIABA's Second Report. Rather than address the problem head-on, FINRA instituted a number of measures that painted at the corners of the problem.In September 2020, FINRA put into place amended Membership Application Program ("MAP") rules with the stated intent of incentivizing timely payment awards.[14] FINRA summarized the changes:

The amendments will address situations where: (1) a FINRA member firm hires individuals with pending arbitration claims, where there are concerns about the payment of those claims should they go to award or result in a settlement, and the supervision of those individuals; and (2) a member firm with substantial arbitration claims seeks to avoid payment of the claims should they go to award or result in a settlement by shifting its assets, which are typically customer accounts, or its managers and owners, to another firm and closing down.[15]

Making it more difficult, if not impossible, for brokers and firms to leave a wake of unpaid awards behind them by moving to another firm addresses

14. See https://www.finra.org/sites/default/files/2020-05/Regulatory-Notice-20-15.pdf, last viewed June 20, 2021.

15. Id.

what is colloquially called the "cockroaching problem." When the light of investor claims reveals the reprobate (and often destitute) brokers, those same aggrieved investors found the brokers scurrying to new firms to continue the same wrongful conduct that got them in trouble in the first place.[16] Other firms that could not or would not pay awards adopted a tactic whereby they sold whatever assets they had, thereby leaving nothing but an empty shell behind as the firm's principals continued doing business under the shingle of a new firm. While a welcome improvement, FINRA's rule changes do not address the underlying problem of brokers and firms being unable to pay awards and customers being left with nothing.

In November 2020, FINRA sought to adopt Rule 4111, which would identify member firms with risk disclosures significantly higher than their similarly sized peers as "restricted firms," and require those restricted firms to maintain deposit accounts to which they would have limited access without FINRA's explicit approval.[17] The stated purpose of the rule proposal, which was adopted by the SEC on July 30, 2021, was to discourage future misconduct by firms and brokers with a significant history of misconduct.

Most recently, in December 2020, FINRA published a list of associated persons and firms whose membership was revoked as a result of their failure to pay arbitration awards.[18]

While PIABA applauds each step FINRA takes to address abusive industry practices that harm investors, all of FINRA's steps focus on various ways to encourage good behavior and discourage bad behavior without actually addressing the problem. The newly adopted rules do not address the problems that arise when FINRA members violate the rules and are found

16. McCann, Quin and Yan found that, not only would a bad broker moving to a new firm be likely to continue their ill conduct, but previously problem-free brokers would be significantly more likely to commit misconduct if their co-workers have acted wrongfully. In other words, a bad apple can spoil the bunch. They also found that the bad brokers tended to congregate within a few firms, making it substantially more likely that those firms' customers would be victimized. See McCann, Craig; Quin, Chuan; Yan, Mike, How Widespread and predictable is stock Broker Misconduct (June 2016) available at: https://www.slcg.com/pdf/workingpapers/McCann%20Qin%20and%20 Yan%20on%20BrokerCheck%20Final.pdf, last viewed June 12, 2021.

17. See SEC Release No. 34-90527, available at: https://www.sec.gov/rules/sro/finra/2020/34-90527.pdf, last viewed June 20, 2021.

18. See https://www.finra.org/arbitration-mediation/member-firms-and-associated-persons-unpaid-customer-arbitration-awards, last viewed June 20, 2021.

liable therefor. PIABA continues to insist that a structure be put into place to help those who suffer the effects of unpaid awards.

THE PROBLEM

A. THE CURRENT PROBLEM

FINRA's latest statistics indicate that 2019 saw 27% of all cases in which investors were awarded money go unpaid, with the amount unpaid equaling 20% of all money awarded to investors that year.[19] FINRA has not yet reported 2020 statistics, so PIABA's staff did what it had previously done in 2016 and 2018: it pulled from the FINRA website all the publicly available customer arbitration awards issued in 2020, reviewed those awards, and determined whether they were paid.[20] Unsurprisingly, 2020 saw far fewer awards issued due to the COVID-related shutdown of in-person hearings. For 2020, FINRA reported 64 awards in customer claimant cases, with total awards of $20,895,826.21. PIABA's analysis showed that, of those totals, 19 customer awards and a total of $5,050,328.98 went unpaid. While the dollar amount of unpaid awards seems modest compared to other years' experience, it reflects 24% of all dollars awarded in 2020 were unpaid.[21] Nearly three out of every ten awards in Claimants' favor went unpaid in 2020.

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19. See https://www.finra.org/arbitration-mediation/statistics-unpaid-customer-awards-finra-arbitration, last viewed April 20, 2021.

20. The authors extend their deepest and most sincere thanks to Ashley Ringo, Tiffany Zachary, and Robin Ringo for their outstanding efforts to analyze the data necessary to draw conclusions regarding 2020 unpaid awards before FINRA reports those figures at some point in the future.

21. PIABA's staff pulled every award FINRA reported in both 2019 and 2020 and extracted relevant information from each. The authors, and Mr. Meyer's law clerk, Jared Connors, analyzed the summary reports to make determinations regarding which awards were, or were not, paid. For those cases in which FINRA's Brokercheck reported that the Respondents against whom the awards were issued lost their licenses before the awards were issued, failed to participate in the hearings, lost their licenses after the awards were issued because of a failure to pay awards, or filed for bankruptcy protection after the awards were issued, PIABA assumed the awards were unpaid. Using the same calculus, PIABA estimated that 2019 saw nearly $18 million in unpaid awards (compared to FINRA's reported $19 million), and 18.4% of all dollars awarded were unpaid (compared to FINRA's reported 20%). Thus, PIABA's methodology served to underreport unpaid awards. The authors are

The 2019 and 2020 figures are consistent with the history of FINRA's reported statistics, which, between 2015 and 2019, have ranged from 12% of dollars unpaid in 2015 to a high of 34% in 2018, and percentage of all awards ranging from 22% in 2015 to a high of 34% in 2017. In short, the problem is not improving since PIABA's initial 2016 Report.

Worse yet is the trend of FINRA-licensed brokers leaving the industry (often in a cloud of scorn following regulatory or customer complaints) and joining the ranks of SEC-registered investment advisors ("IAs").[22] The SEC does not administer a dispute resolution forum for IAs like FINRA does for brokers. PIABA, despite its best efforts, found no centralized database demonstrating the results of claims made against investment advisors. Based a sample of 167 various investment advisory agreements, PIABA members found that nearly 60% of the contracts included a pre-dispute arbitration provision, and 40% of those mandated the arbitration be conducted through the American Arbitration Association ("AAA"): a national private company that does not disclose statistical information regarding claims, award rates, or collection. Even in the absence of publicly available databases showing the results of IA arbitration hearings, be they through AAA or another private company such as JAMS, it is fair to conclude from regulatory actions and discipline that RIAs are misbehaving at the same rate as brokers. The North American Securities Administrators Association ("NASAA") 2020 enforcement report shows that its members named 200 broker-dealer firms in enforcement actions in 2019, and 193 investment advisory firms during the same period. Similarly, 391 individual brokers were named in 2019 enforcement actions while 434 investment advisor representatives were so named.[23]

therefore confident in stating that their estimate of 24% of all dollars awarded in 2020 going unpaid is a conservative estimate.

22. Banned brokers often exploit fragmented regulatory structures to establish themselves as investment advisers after losing their FINRA registration. Wusthorn, Michael, The Barred Brokers in Our Midst, The Wall Street Journal (Nov. 3, 2016), available at: https://www.wsj.com/articles/the-barred-brokers-in-our-midst-1478165406, last visited April 22, 2021 (noting the research was made particularly difficult thanks to the lack of a centralized database of brokers and advisers beyond a simple name search).

23. NASAA 2020 Enforcement Report, available at https://www.nasaa.org/wp-content/uploads/2020/09/2020-Enforcement-Report-Based-on-2019-Data-FINAL.pdf, last viewed April 22, 2021.

These statistics are not anomalies:

> *In 2017, 377 enforcement actions were brought against RIA firms and investment advisor representatives combined, NASAA enforcement reports show. In comparison, about 270 were brought against brokers and brokerage firms in the same year. In the previous two years, enforcement actions between advisors and broker-dealers differed by about 40, NASAA figures show.*[24]

While NASAA's enforcement actions demonstrate that there as many dishonest investment advisers as there are brokers, there are no statistics showing how many claims are filed by customers against those bad IAs. Accordingly, there are no statistics showing what percentage of arbitration awards brought against IAs in AAA, JAMS, or other private dispute resolution forums go unpaid. As long as regulation of IAs is fragmented, spread across the SEC and various states without centralized oversight or reporting, there is no meaningful chance that the situation will improve.

B. THE PROBLEM ON THE HORIZON

A future market downturn will disproportionally affect those who have retired or are on the verge of retirement. This can be attributed, in large part, to the general shift by employers away from offering defined benefit retirement plans (pensions) and toward defined contribution plans (401(k)s). The 401(k) plan came into being in 1980, as a quirk of the tax code:

> *401(k)s are an accident of history. In 1980, a benefit consultant working on revamping a bank's cash bonus plan had the idea of adding an employer matching contribution and taking advantage of an obscure provision in the tax code passed two years earlier clarifying the tax treatment of deferred compensation. Though 401(k)s took off in the early 1980s, Congress did not intend for them to replace traditional pensions as a primary retirement vehicle, and 401(k)s are poorly designed for this role.*[25]

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24. Keyes, Garrett, Bad RIAs are Just as Much a Problem as Bad Brokers, Lawyers Claim, Financial Advisor IQ (Aug. 1, 2019), available at: https://financialadvisoriq.com/c/2455443/283193, last viewed April 22, 2021.

25. Morrisey, Monique, Report: The State of American Retirement Savings, at p. 2, Economic Policy Institute (December 10, 2019), available at https://www.epi.org/publication/the-state-of-american-retirement-savings/, last viewed March 31, 2021.

The shift into defined contribution plans has accelerated over time. In 1989, assets held in traditional pension plans made up 72% of personal disposable income, while assets held in IRAs and 401(k) plans made up 31% of personal disposable income. In 2016, assets held in pension plans grew to 87% of personal disposable income while assets held in IRAs and 401(k) plans jumped to 102% of personal disposable income.[26] Yet, keep in mind many Americans do not have access to 401(k) plan participation, and most American families have little to no retirement savings. In 2016, those aged 56-61 had a median retirement savings of $21,000.[27] Those same families had median retirement savings of $37,056 in 2007 – right before the 2008 recession.[28] For those with means to participate, their 401(k) savings are subject to the vicissitudes of the markets. While defined benefit (pension) plans are subject to strict regulations designed to ensure that the requisite payouts are made to beneficiaries regardless of market movements, 401(k) plans and IRAs offer no such certainty.[29]

Coupled with the higher percentage of retirement assets in 401(k) plans and/or IRAs, America is on the leading edge of the mass Baby Boomer retirement wave. "The number of Americans aged 65 and older is projected to nearly double from 52 million in 2018 to 95 million by 2060, and the 60-and-older group's share of the total population will rise from 16 percent to 23

26. Id. at 4.

27. Id. at 8.

28. Id.

29. Elkins, Kathleen, A brief history of the 401(k), which changed how Americans retire, CNBC (Jan 5, 2017)("'The great lie is that the 401(k) was capable of replacing the old system of pensions,' former American Society of Pension Actuaries head Gerald Facciani tells The Journal. 'It was oversold.'"), available at https://www.cnbc.com/2017/01/04/ a-brief-history-of-the-401k-which-changed-how-americans-retire.html, last viewed March 31, 2021. See also Broadbent, John; Palumbo, Michael; and Woodman, Elizabeth The Shift From Defined Benefit to Defined Contribution Plans – Implications for Asset Allocation and Risk Management (December 2006)("The transition from [defined benefit] to [defined contribution] in private sector pensions is shifting investment risk from the corporate sector to households, available at: https://www.bis.org/publ/ wgpapers/cgfs27 broadbent3.pdf, last viewed March 31, 2021.

percent."[30] Statistics show that the pace of Boomer retirements is accelerating.[31]

In addition to the growth of the 401(k) market, assets in IRAs have boomed as well. At the end of the second quarter 2020, there were $10.83 trillion in IRAs, representing more than one third of the retirement market assets.[32] Based on data from mid-2019, three-quarters of households that owned traditional IRAs held them with investment professionals.[33] Nearly thirty percent were held with full-service brokerage firms.[34]

The stage is therefore set: the markets are trading at all-time highs, more people than ever are retiring (or on the verge of retiring), and their retirement savings are more heavily subject to market movements. When a market correction comes, weaknesses in poor (or fraudulent) investments schemes will be more apparent and likely result in shocking losses. Investors victimized by their financial professional's mismanagement or fraud will roll the dice whether a successful arbitration claim will result in any actual recovery. Retirement- age Americans who do not have the time to rebuild lost savings may ultimately turn to the state and federal welfare systems. In sum, the securities industry shifts the problem of unpaid awards from itself to the American taxpayer. This is an abhorrent dereliction of responsibility by a securities industry that profits massively from of its "trust your advisor" encouragement.

30. Mather, Mark; Scommegna, Paola; Kilduff, Lillian, Fact Sheet: Aging in the United States (July 15, 2019), available at: https://www.prb.org/aging-unitedstates-fact-sheet/, last viewed March 31, 2021.

31. Fry, Richard, The Pace of Boomer retirements has accelerated in the past year, (November 9, 2020), available at: https://www.pewresearch.org/fact-tank/2020/11/09/the- pace-of-boomer-retirements-has-accelerated-in-the-past-year/, last visited March 31, 2021. (Finding that 3.2 million more Boomers retired in the third quarter of 2020 as compared to the same quarter in 2019.).

32. Investment Company Institute, The Role of IRAs in US Households' Savings for Retirement, 2020, available at: https://www.ici.org/system/files/attachments/pdf/per27- 01.pdf, last viewed August 18, 2021.

33. Investment Company Institute, The Role of IRAs in US Households' Savings for Retirement, 2019, p. 22, available at: https://www.ici.org/pdf/per25-10.pdf, last viewed August 18, 2021.

34. Id.

PROPOSED REMEDIES

A. LEGISLATIVE REMEDY

The unpaid award problem is not a new one – having been brought forward more than 20 years ago by the General Accounting Office and having been the focus of PIABA's increasing scrutiny for the last five years. FINRA can solve the problem head-on by instituting a Pool, but it has steadfastly refused to do so and taken the position it will not do so unless ordered by the SEC or Congress. If FINRA remains resolute in its refusal to institute a Pool absent an instruction from Congress or the SEC, then PIABA asks the SEC and Congress to intervene to address the problem and order FINRA to do its job and protect investors.

In contemplating a legislative remedy, it is helpful to review the scenario that led to the passage of the Securities Investors Protection Act (which created SIPC) in 1970. FINRA's Discussion Paper gave SIPC short shrift as a potential cure for the problem. But while PIABA's 2016 Report also identified issues with trying to extend SIPC coverage (such as SIPC's current inability to address recompense for broker fraud and the caps on individual claims payable by SIPC), SIPC as a perennial and well-funded resource pool bears good lessons for how and when a legislative remedy can be crafted.

SIPC was created in what would now be considered an unimaginable time frame. In the late 1960s, the markets were experiencing what was called the "paperwork crunch."[35] What had been a largely retail-based system saw an increasing number of large financial intermediaries and institutional investors participate.[36] The long-serving analog and mechanical back-office systems could handle keeping the majority of shares in firms' street names and delivering the relatively small number of physical share certificates when needed, until trading volumes moved into the tens of millions of shares.[37] Firms could not keep up with the deluge of paper and hundreds of thousands of transactions were left unsettled on a daily basis. Accordingly, dividends

35. See https://www.sipc.org/about-sipc/history, last viewed June 20, 2021.

36. See https://optimizeronline.com/the-paperwork-crisis/, last viewed June 20, 2021.

37. Id.; see also Study of Unsafe and Unsound Practices of Brokers and Dealers – Report And Recommendations of the securities and Exchange Commission 92nd Congress, 1st Session, House Document 92-231, P. 13 (December 1971), available at: http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/ collection/papers/1970/1971_1201_SECUnsafe_01.pdf.

were sent to the wrong people since corporate record books were not updated as required.[38] The problem became significant enough the markets were forced to close one weekday each week to allow the firms to catch up.[39]

The problem was summarized:

> *Widespread failures of broker-dealer firms and concern for the fund so their customers had followed a prolonged period of easy business. Rising brokerage income and rising security prices had produced a general euphoria. In this mood, expansion of sales effort and overhead had not been properly supported by more capital and stronger back office effort. A veritable explosion in trading volume clogged an inadequate machinery for the control and delivery of securities. Failures to deliver securities and to make payment ricocheted though the industry and firms lost control of their records and of the securities in their possession or charged to them. Operational conditions deteriorated so severely that securities markets were required to cease trading one day each week at one point, and later to limit daily trading hours. Those conditions should not be allowed to recur.*[40]

The paperwork crunch inevitably led to serious market downturns in 1969. The Dow Jones Index fell 20% through the course of 1969. It continued falling through June 1970.

Entering into 1970, there were two principal institutional protections in place for investors: firms were required to register with the SEC and were further subject to net capital and minimum capital requirements.[41] Those mechanisms were, however, flawed. First, the capital requirements were not applied to all firms equally.[42] Second, it was unclear how, exactly, registration or net capital requirements would help individual investors recover losses from the firms. Net capital figures could be manipulated by a variety of measures and had little correlation to a firm's actual ability to make investors victimized by its ill conduct whole again.[43] The individual exchanges' additional

38. Id.

39. Id.

40. Id. at p. 1.

41. Sowards, Hugh L.; Mofsky, James S., "THE SECURITIES INVESTOR PROTECTION ACT OF 1970." The Business Lawyer, vol. 26, no. 4, 1971, pp. 1271–1288, at 1272, available at: www.jstor.org/stable/40684808, last viewed March 28, 2021.

42. Id. at 1272.

43. Id. at 1272-1273.

requirements placed upon member firms added little to the already failing federal safeguards.[44] When calls for additional regulation grew louder, the industry resisted:

> *Quite naturally, leading industry representatives argued for an insurance program by way of self-regulation, that 'such an administrative mechanism would be preferable to creation of another layer of governmental regulation which would be unwieldy as well as unnecessary.' Perhaps. But the industry had been slow to respond to the rapidly emerging need for a new and constructive protection program, and Congress became understandably impatient. The result was the 1970 Act [which created SIPC] which practically spelled an end to self-regulation in this area.*[45]

Rather than trust the industry to fix the problem itself, Congress stepped in and enacted the Securities Investor Protection Act and SIPC in December 1970. Investors regained confidence in the markets, which allowed those markets to rebound for a period thereafter. This bears repeating: Congress stepped in when the industry refused, and the capital markets flourished thereafter.

Just as the securities industry resisted the imposition of the Securities Investor Protection Act, it is resisting PIABA's call for the institution of a Pool. FINRA, days after the initial Report was issued, had its CEO, Richard Ketchum testify on Capitol Hill. In response to Senator Warren's question of whether more regulation was needed to ensure investors recovered their losses, Ketchum responded "Something should be done about it; I do believe that we want to work with the [Securities Exchange Commission] on this."[46] Nothing happened for two years, and then Senator Warren introduced legislation that would require FINRA to establish a fund to be used to reimburse aggrieved investors when the firms and brokers were unable to do so.[47] The Securities Industry and Financial Markets Association ("SIFMA") offered its take on Senator Warren's legislation, renouncing the problem and offering no solution. "We strongly support exploring reforms to reduce the number of unpaid

44. Id. at 1275.

45. Id. at 1277 (citations omitted).

46. Waddell, Melanie, Finra Mulls Crackdown on Arb Award Deadbeats, ThinkAdvisor (March 3, 2016), available at: https://www.thinkadvisor.com/2016/03/03/finra-mulls-crackdown-on-arb-award-deadbeats/?t=legal-compliance refchannel-blogs, last viewed March 28, 2021.

47. See Compensation for Cheated Investors Act, S. 2499, 115th Congress (2017-2018).

arbitration awards . . . An industry-financed pool, however, is unfair to the broker-dealers who honor their arbitration award obligations, is essentially a tax on investors, and introduces numerous moral hazards."[48] As addressed below, SIFMA's excuses are thin; and for now, investors find themselves much as they did in 1970 as calls for passage of the Securities Investors Protection Act were growing louder. It is clear that, left to its own devices, the profit and deregulation-oriented securities and investment advice industry will do nothing to fix the problem. As time and conduct has made abundantly clear, neither will FINRA. Congress must therefore step in and mandate a solution to this long-standing problem.

B. SEC DODD-FRANK REMEDY

If Congress cannot or will not act, and FINRA maintains course and refuses to remedy the problem on its own, the SEC has the authority to step in under Section 921 of the Dodd-Frank Act.[49] The relevant provision authorizes the SEC to:

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

Section 921 also authorizes the SEC to impose the same sort of limitations on IAs. Thus, the SEC could require that, as a condition of including a mandatory arbitration clause in its customer agreements, firms participate in an investor recovery pool. The benefit of having the mandate issued by SEC as opposed to Congress is that the SEC sits closer to its constituents, is better equipped to balance competing interests of the securities industry and its customers, and perhaps most importantly, is not swayed by lobbyists in the same way elected officials can be. Another important benefit to the SEC taking

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48. SIFMA Submits Testimony Raising Concerns with Unpaid Arbitration Legislation (S. 2499) (June 28, 2018), available at: https://www.sifma.org/resources/news/sifma-submits-testimony-raising-concerns-with-unpaid-arbitration-legislation-s-2499/, last viewed March 28, 2021.

49. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

action is that, under the powers authorized by Section 921, this investment pool remedy could be applied to SEC-registered RIAs as well as FINRA-licensed brokers, ensuring that investors are protected across the industry regardless of whether their financial professional is an IA, a broker, or both.

C. THE NATIONAL INVESTOR RECOVERY POOL

PIABA's suggestion for the Pool's structure has not changed in a material way since it first suggested the program in 2016. In summary: the Pool would provide a source of recovery for investors who pursue a claim all the way through a final award, and have exhausted reasonable efforts to collect the award from the respondent. The Pool would be designed to be liquidated every year. If investor claims exceed the size of the Pool in any given year, the claims would be paid on a pro-rata basis. Investors who receive recoveries from the Pool would subrogate their claims to the Pool, which would then maintain the right and ability to seek recovery from the firms and brokers who failed to pay.

PIABA's 2016 Report addressed a variety of details concerning how the Pool should be structured, including the definition of "unpaid awards," the manner in which compensatory and punitive damages would be addressed, when pro-rata distributions would be made, claim eligibility timing, an appellate process to resolve disputed claims, and year-to-year funding processes. PIABA's analysis of those issues has not changed since its first Report. Two key elements, however, are worthy of update.

1. SIZE OF THE POOL

PIABA, again, recommends that the previous three years of unpaid award experience be used to establish a funding threshold for the pool for the current year. Using three years of data helps mitigate and smooth unusual highs or lows in unpaid awards. Thus, if one were to rely exclusively on FINRA's published figures, unpaid awards appear as follows:

2017: $22 Million
2018: $31 Million
2019: $19 Million

The average is $24 million, which would be the amount used to fund the 2021 Pool (exclusive of administrative costs, which PIABA contends should be addressed by FINRA).

2. FUNDING UPDATE

The viability of the Pool depends on reliable funding. There are a variety of means to achieve such funding: (1) FINRA fine monies assessed against member firms and associated persons violating FINRA rules; (2) assessments on FINRA members; and, (3) fees levied on the investing public. The pros and cons of each are addressed below.

(i) FINRA FINE MONIES

While using FINRA fine monies collected maintains appeal – since using the monies paid by bad actors to address issues raised by (presumably other) bad actors avoids any sort of moral hazard complaints that firms acting appropriately should not subsidize others who are not – FINRA will surely contend that it simply cannot afford to redirect those funds.

FINRA recently reported its year-end 2020 figures. Last year, FINRA reported that it enjoyed $19.8 million dollars of net income for 2020.[50] FINRA further reported that it had issued $57 million in fines that year.[51] The fine money, which was more than sufficient to address the $5 million of unpaid awards in 2020, was not used to reimburse those investors. Rather, FINRA spent $90.2 million (taking $33.2 million from reserves and adding it to the $57 million in penalties recovered in 2020) and spent it in two broad categories.[52] FINRA spent $73.8 million in the first category, which it describes as: "Capital initiatives or nonrecurring strategic expenditures that promote more effective and efficient regulatory oversight by FINRA (including leveraging technology and data in a secure manner) or that enable improved compliance by member firms, and capital initiatives required by new legal, regulatory or audit requirements." FINRA spent $16.4 million in the second category, which it describes as: "Activities to educate investors, promote compliance by member firms through education, compliance resources or similar projects, or ensure our employees are highly trained in the

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50. 2020 FINRA Annual Financial Report, p. 8, available at: https://www.finra.org/sites/default/files/2021-06/2020-annual-financial-report.pdf, last viewed August 17, 2021.

51. Id. at p. 3.

52. FINRA, Report On The Use Of 2020 Fine Monies (May 27, 2021), available at: https://www.finra.org/about/annual-reports/report-use-2020-fine-monies, last viewed August 17, 2021.

markets, products and businesses we regulate." While PIABA encourages FINRA's efforts to improve surveillance/compliance infrastructure and investor education, those efforts do not and will not address the issue of unpaid awards.

(ii) ASSESSMENTS ON MEMBER FIRMS AND/OR REGISTERED REPRESENTATIVES

If FINRA were to assess a fee to each firm or registered representative (which would surely be passed along to customers in the way of higher commissions or account maintenance fees), the cost per firm is exceedingly modest. If FINRA were to assess the fee per firm (without regard to each firm's assets under management), the cost in 2019 would have been $6,350.11 per firm.[53] If, instead, FINRA were to assess each registered representative, the 2019 fee would have been $107.26 per representative.[54]

When PIABA last suggested that industry players be required to fund the pool, the entirely expected retort was "Why should firms that follow the rules pay for the bad actors?" There is a myriad of reasons. First, one could simply address it as the cost of doing business. Since neither the SEC nor FINRA have established any sort of insurance requirement, the fees required to fund the pool would be far less than insurance premiums. Consider, for example, the fact that many states mandate automotive insurance for drivers, and malpractice insurance for attorneys and doctors -– regardless of their claim history. While the vast majority of those doctors, attorneys, and drivers will never cause harm to another, as a matter of public policy, it was decided that it would be best to spread the risk of harm across the entire pool of participants. Likewise, the "moral hazard" fearmongering promoted by the industry to suggest that an insurance requirement or investor recovery pool would encourage more violations of securities laws by financial professionals is unconvincing. One cannot argue with a straight face that the presence of insurance encourages reckless driving, or the provision of negligent medical

53. The average unpaid awards from 2016 through 2018 was $22.3 Million (see https://www.finra.org/arbitration-mediation/statistics-unpaid-customer-awards-finra-arbitration), and there were 3,517 firms registered with FINRA in 2019 (see https://www.finra.org/rules-guidance/guidance/reports-studies/2020-industry-snapshot).

54. FINRA reports that there were 624,674 registered representatives in 2019. See https://www.finra.org/rules-guidance/guidance/reports-studies/2020-industry-snapshot, last viewed June 20, 2021.

or legal services. Second, the complaint "[i]t's unfair to charge us for that" falls on deaf ears when considering the fact that the industry continues to enjoy record profits year after year. The large wirehouses have reported healthy, if not record, profits through 2020. For example, UBS reported a 137% jump in fourth quarter profits over the 2019 figures;[55] Charles Schwab reported "record operating performance" as "an extraordinary capstone to an extraordinary year";[56] Edward Jones, the largest firm measured by the number of advisors, said its 2020 revenue grew 7% and profits 18%; and the trend continues for other firms like Morgan Stanley and Raymond James (as examples).[57] Independent firms are no different: the 25 largest independent broker-dealers reported a 4.3% increase in revenue in 2020.[58]

Even if firms were unable to pass the costs along to their customers, the financial burden of $6,350 per firm or $107 per registered representative is exceedingly modest given the industry's health and the Pool's robust benefits.

55. Amaro, Silvia, UBS Reports 137% Jump in profit, but has concerns over economic recovery, CNBC, Jan 26, 2021, available at: https://www.cnbc.com /2021/01/22/ubs- earnings-q4-2020.html, last viewed June 5, 2021.

56. Fitzgerald, Maggie, Schwab Earnings top estimates in first reports since TD Ameritrade merger, accounts near 30 million, CNBC (Jan. 19, 2021), available at: https://www. cnbc.com/2021/01/19/charles-schwab-q4-2020-earnings-.html, last viewed June 5, 2021.

57. UBS: https://www.nasdaq.com/articles/ubs-group-ubs-q1-earnings-rise-y-y-revenues-costs-up-2021-04-28, last viewed June 20, 2021; Morgan Stanley: https://www. morganstanley.com/about-us-ir/shareholder/4q2020.pdf, last viewed June 20, 2021; Raymond James: https://www.raymondjames.com/-/media/rj/ dotcom/files/our-company/ news-and-media/2020-press-releases/rjf202010284q-earnings.pdf, last viewed June 20, 2021.

58. Kelly, Bruce, In face of pandemic, IBDs proved resilient in 2020, Investment News, April 26, 2021, available at: https://www.investmentnews.com/in-face-of-pandemic- ibds-proved-resilient-in-2020-205200, last viewed June 5, 2021.

(iii) CHARGE INVESTORS

While PIABA does not suggest that assessing a direct charge to investors is the best choice, a 2019 Pool would have required less than 14 cents per investor.[59] It simply defies credulity to believe that an investor would not be willing to part with 14 cents in exchange for the benefits the Pool would provide.

3. THE PROBLEM WITH INVESTMENT ADVISORS

The discussion above is focused largely on FINRA-registered brokers and firms failing to pay awards issued against them. The problem, however, is far broader than that. IAs, while fiduciaries under federal law, are not required to be members of FINRA. Accordingly, where they may maintain arbitration clauses calling for JAMS, AAA, or other private arbitration forums, there is no central repository of arbitration award data and therefore no way to quantify unpaid IA awards in a statistically meaningful manner. While PIABA members are quick to offer anecdotal reports of underfunded IAs and the futility of bringing claims where the expense of a JAMS or AAA arbitration will quickly exceed even the best recovery, it would be best to actually define the problem with objective data first. But the problem lies in obtaining that objective data. While the SEC maintains oversight over IAs registered with the Commission, smaller IAs are instead subject to regulation by the states in which they practice. There are therefore fifty-four differing governing bodies (fifty states, the District of Columbia, Puerto Rico, the US Virgin Islands, and the SEC) overseeing the universe of IAs.

The analysis has to start somewhere and PIABA suggests that, while claims made against IAs and the resolution thereof are "material events"

59. The US Census reports 255,200,373 adult Americans as of July 2019. https://www.census.gov/data/tables/time-series/demo/popest/2010s-national-detail.html, last viewed May 1, 2021. Of those Americans, Gallup found that 55% reported having some investments in the stock markets in 2019 and 2020. https://news.gallup.com/poll/266807/ percentage-americans-owns-stock.aspx, last viewed May 1, 2021. Fifty-five percent of the adult population equals 140,360,305 Americans invested in the markets. Dividing the $19 million FINRA reports as being unpaid in 2019 results in a per-person charge of 13.54 cents.

required to be disclosed on Form ADV,[60] the SEC must conduct a sweep of the advisory firms and IAs registered with the Commission and then report statistical summaries concerning where IA arbitrations are being heard, the results of those hearings, and data concerning unpaid awards: much as FINRA started to do after PIABA's first Report. PIABA recognizes that the statistics are of somewhat limited utility, since they will address only those larger firms and IAs registered with the SEC, but the data will offer some initial insight into the nature and scope of the problem.

CONCLUSION

The SEC and FINRA have demonstrated that they have long recognized the ongoing issue of unpaid arbitration awards but will not address it head-on. In fact, FINRA wants an act of Congress to require it to enact a solution. If, given a market that has consistently grown in value over the course of the last twelve years, nearly one out of four dollars awarded to investors in 2020 went unpaid even as brokerage firm profits held steady or grew to record levels, the next market downturn will likely wreak havoc on the growing population relying on their broker-managed 401(k) plans and IRAs for retirement. Protecting investors, and the taxpayers who will be required to bail them out, is simple: instituting a National Investor Recovery Pool will provide a backstop at a minimal economic cost. Either Congress, the SEC, or both must act now.

60. The SEC reminded registrants that their fiduciary duties required "full disclosure" to clients, and they were not permitted to withhold any material facts. General Instructions for Part 2 of Form ADV, available at: https://www.sec.gov/about/forms/formadv-part2.pdf, last visited June 6, 2021.

Notes & Observations

THE OBLIGATIONS AND REGULATORY CHALLENGES OF ONLINE BROKER-DEALERS AND TRADING PLATFORMS

Christine Lazaro and Teresa J. Verges[1]

Investing has been evolving for decades. On "Mayday" in 1975, the SEC abolished fixed commissions, changing the face of the brokerage industry.[2] A few months later, Charles Schwab opened its first offices, and discount brokerages were born.[3] By the mid-1980s, there were over 600 discount brokers operating.[4] By 1990, discount brokerage firms captured just under than 10% of the market, although Charles Schwab captured 40% of the discount brokerage market.[5] Throughout the 1990s, new firms entered the market, including E*Trade and AmeriTrade.[6] Online trading became more prevalent;

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2. *See* Jason Zweig, *Lessons of May Day 1975 Ring True Today: The Intelligent Investor*, WALL ST. J. (Apr. 30, 2015), https://www.wsj.com/articles/lessons-of-may-day-1975-ring-true-today-the-intelligent-investor-1430450405.

3. *See id.*

4. *See* Stephen Mihm, *The Death of Brokerage Fees Was 50 Years in the Making*, BLOOMBERGOPINION (Jan. 3, 2020), https://www.bloombergquint.com/view/how-nyse-went-from-quasi-cartel-to-zero-fee-stock-trading.

5. *See* Richard D. Hylton, *All About: Discount Brokers; Now Fewer Firms Are Chasing Small Investors Discount Brokers*, N.Y. TIMES (June 17, 1990), https://www.nytimes.com/1990/06/17/business/all-about-discount-brokers-now-fewer-firms-are-chasing-small-investors-discount.html.

6. *See* Bob Pisani, *Man Vs. Machine: How Stock Trading Got So Complex*, CNBC (Sept. 13, 2010), https://www.cnbc.com/2010/09/13/man-vs-machine-how-stock-trading-got-so-complex.html.

by 1999 25% of all trades occurred online.[7] The term "day trader" entered our vocabulary.[8] Commissions declined, until they reached zero.[9]

Investors now have more choices than ever when deciding how and with whom to invest. In addition to the large full service brokerage firms, there are independent broker-dealers, discount brokers, and online platforms and apps. Across the models, the level of service varies, as does the minimum amount needed to open an account and the ease with which an account can be opened.

Both new and experienced investors responded to these new trading models and reduced barriers to entry. 2020 witnessed a surge in new retail brokerage accounts opened on online platforms.[10] One research analyst at JMP Securities estimates that more than 10 million new online brokerage accounts were opened in 2020.[11] According to a joint study conducted by the FINRA Investor Education Foundation and NORC at the University of Chicago, 66% of survey respondents who opened a new account in 2020 were new investors, who had not previously owned a taxable investment account.[12] The FINRA/NORC study found that the new investors were younger, had lower incomes, and were more racially diverse, compared to the other groups measured, specifically experienced investors that also opened online brokerage accounts in 2020, or "holdover" account owners who owned a brokerage account but did not open a new account in 2020.[13] The FINRA/NORC study attributed the surge in new retail investors to the

7. *See* Arthur Levitt, Chair, Sec. Exch. Comm'n, Remarks to the National Press Club, Plain Talk About On-Line Investing (May 4, 1999), http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1990/1999_0429_LevittDraftT.pdf.

8. *See* Pisani, *supra* note 6.

9. *See* Mihm, *supra* note 4.

10. *See* FINRA INVESTOR EDUCATION FOUNDATION AND NORC REPORT, INVESTING 2020: NEW ACCOUNTS AND THE PEOPLE WHO OPENED THEM, at 1 (Feb. 2021) (hereinafter, "FINRA/NORC Study"), https://www.finrafoundation.org/sites/finrafoundation/files/investing-2020-new-accounts-and-the-people-who-opened-them_1_0.pdf.

11. *See* Susan Tompor, *Why New Investors Bought Stock During the COVID-19 Pandemic*, DET. FREE PRESS (Feb. 5, 2021), https://www.freep.com/story/money/personal-finance/susan-tompor/2021/02/05/how-invest-stock-market/4360276001/.

12. *See* FINRA/NORC Study, *supra* note 11 at 2.

13. *See id.*

reduction in barriers to entry for retail investing, including no-minimum and low-minimum accounts and low or zero trading commissions.[14]

In addition to lowering the barriers to the markets, the online platforms have changed how investors interface with firms and the markets. They offer a number of different design features, commonly described as "gamification." These may include games when an investor opens an account; animations, including confetti when a milestone is reached; social networking tools; prizes or rewards for activity streaks; points, badges, and leaderboards; lists of popular stocks; free stocks for referring additional customers; and push notifications.[15]

However, regulators are concerned that many new investors, prompted by gamification, have engaged in high-risk trading strategies without an appreciation of the risks. Noting the surge in online trading, including options trading, in its 2021 exam report FINRA identified emerging "digital communications risks" associated with digital platforms and mobile apps that have interactive and "game-like" features, which could mislead investors about the risks of certain trading strategies, such as options trading.[16] FINRA also recently announced that it will seek public comment on gamification

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14. *See id.* at 7-8. Another reason for the surge of new investors was the market volatility related to the COVID-19 pandemic, prompting new investors to take advantage of market dips. *See id.* at 1, 8. COVID-19 relief stimulus checks also contributed to the spike in online brokerage accounts opened by younger, new investors. *See* Jessica Menton, *Stimulus Check: Young Investors Use $1,400 COVID-19 Relief Payments to Join Stock Market Boom*, USA TODAY (Mar. 17, 2021), https://www.usatoday.com/story/money/2021/03/17/stimulus-check-young-investors-covid-relief-payments-stock-market/4693988001/.

15. *See* Robert W. Cook, President and Chief Executive Officer, FINRA, Statement Before the Financial Services Committee U.S. House of Representatives (May 6, 2021), https://www.finra.org/media-center/speeches-testimony/statement-financial-services-committee-us-house-representatives; *see also* Annie Massa and Tracy Alloway, *Robinhood's Role in the 'Gamification' of Investing*, BLOOMBERG WEALTH (Dec. 19, 2020), https://www.bloomberg.com/news/articles/2020-12-19/robinhood-s-role-in-the-gamification-of-investing-quicktake; Robinhood Financial, LLC, Docket No. E-2020-0047 (Mass. Off. of the Sec'y of the Commonwealth Sec. Div. Dec. 16, 2020), https://www.sec.state.ma.us/sct/current/sctrobinhood/MSD-Robinhood-Financial-LLC-Complaint-E-2020-0047.pdf.

16. *See* FINRA, 2021 REPORT ON FINRA'S EXAMINATION AND RISK MONITORING PROGRAM, at 22 (Feb. 2021) (hereinafter "2021 FINRA Report)", https://www.finra.org/rules-guidance/guidance/reports/2021-finras-examination-and-risk-monitoring-program.

practices utilized by these platforms, with a view towards potential new rulemaking.[17] SEC Chairman Gensler also expressed concern about the "gamification" of trading apps with features that "encourage investors to trade more," and indicated that these new models may require new rules.[18]

The concerns raised today about online trading echo concerns raised by then-SEC Chairman Arthur Levitt in 1999.[19] Chairman Levitt recognized that a firm's obligations do not change even though their platforms have changed:

> The laws regulating our markets are a product of the New Deal era. To me, their concepts are as immutable as the Constitution. They have weathered challenge after challenge, decade after decade, and are every bit as relevant and effective today as they were the day they were written. Companies offering their shares -- whether off a website or through a prospectus -- still have to disclose what they are selling and why. Brokers -- whether traditional or on-line -- still have the same obligations to their customers. And fraud -- whether perpetrated over the Internet, on the phone, or in-person -- is still fraud.[20]

Chairman Levitt raised concerns about the influx of new and inexperienced investors trading inconsistently with their goals and risk tolerances.[21] He recognized that as firms grow, their ability to provide effective customer service must keep pace.[22] He emphasized that firms have an obligation of best execution, regardless of how the trade has been placed.[23] He also raised concerns about the clarity of communications, and the accuracy of advertising.[24] These same concerns are echoed today by FINRA, the SEC and the state regulators.

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17. *See* Sarah E. Aberg, Shane J. Killeen, *Game On: FINRA Hints at Upcoming Gamification Sweep*, The Nat'l L. Rev. (June 1, 2021), https://www.natlawreview.com/article/game-finra-hints-upcoming-gamification-sweep.

18. Gary Gensler, Chair, Sec. Exch. Comm'n, Statement Before the House Committee on Financial Services, at 2 (May 6, 2021), https://financialservices.house.gov/uploadedfiles/hhrg-117-ba00-wstate-genslerg-20210506.pdf.

19. *See* Levitt, *supra* note 7.

20. *Id.*

21. *See id.*

22. *See id.*

23. *See id.*

24. *See id.*

Regulators may ultimately promulgate new rules to address unique features of these platforms or amend existing rules to address new technology and communication practices. However, as noted by Chairman Levitt, brokerage firms offering self-directed trading services through digital platforms are still subject to existing rules and standards applicable all broker-dealers. This article reviews these primary regulatory obligations.

I. DUTIES OF BROKER-DEALERS OPERATING ONLINE PLATFORMS AND TRADING APPS TO RETAIL CUSTOMERS

Digital trading platforms and mobile apps provide investors with the ability to open a brokerage account (often within minutes) and trade securities from the comfort of their homes. The platforms provide investors with the ability to trade securities for their own accounts, without the guidance or investment recommendations of an individual broker or investment adviser representative. While online broker-dealer platforms may look different from traditional broker-dealers, however, these firms still have many of the same basic obligations to their customers.

As described below, all brokerage firms have ongoing obligations in connection with approving, opening, and maintaining customer accounts, conducting appropriate due diligence in connection with certain trading approvals, and complying with “know your customer” and anti-money laundering regulations. Firms are also prohibited from making false or misleading statements to investors and are subject to rules governing communications to retail investors, some of which may be deemed an “investment recommendation” and therefore, subject to the SEC’s Regulation Best Interest or FINRA’s suitability rule. All firms are also required to implement written policies and procedures to safeguard confidential customer information, funds and assets. The very technology used by digital trading platforms requires these firms to adopt strong cybersecurity protections for their customers.

A. *Opening Customer Accounts, Due Diligence and Suitability Assessments*

(i) Opening and Maintenance of Accounts and Customer Identification Program

Regardless of its business model, FINRA rules require all firms to obtain, maintain and regularly update specific customer information in connection with the opening and maintenance of a customer account.

FINRA Rule 2090 requires firms to "use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer."[25] The "essential facts" necessary to comply with the know your customer obligation are those required to: "(a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules."[26]

The "know your customer" obligation arises at the beginning of the firm's relationship with the customer and extends throughout that relationship.[27] This makes sense, as customers' profiles, financial status, investment objectives, risk tolerance and other essential information can and will change over time. Moreover, the "know your customer" obligation does not depend on whether the broker or the firm has made a recommendation.

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25. FINRA, Rule 2090, Know Your Customer (2012). Rule 2090 is modeled after former NYSE Rule 405(1); Rule 2090 and Rule 2111 became effective on October 7, 2011. FINRA REGUL. NOTICE 11-02, SEC APPROVES CONSOLIDATED FINRA RULES GOVERNING KNOW-YOUR-CUSTOMER AND SUITABILITY OBLIGATIONS (Oct. 7, 2011), https://www.finra.org/rules-guidance/notices/11-02.

26. FINRA, Rule 2090.01, Essential Facts (2012).

27. *See* FINRA, REGUL. NOTICE 11-02, *supra* note 25; *see also Obligations to Your Customers*, FINRA (explaining the first step in serving the customer is to "know your customer" and ensure that the facts obtained are accurate and updated), (available at https://www.finra.org/registration-exams-ce/manage-your-career/obligations-your-customers) (last accessed Mar. 19, 2022). Firms typically comply with the maintenance requirement by sending periodic letters or notices to customers (either annually or upon a change in the account) reflecting the information they have for the customer and shifting the burden on the customer to contact the firm if any information is correct.

At least some (but certainly not all) of the essential facts necessary to comply with the "know your customer" rule are captured through the firm's compliance with FINRA Rule 4512, which sets forth the minimum information firms must obtain, maintain and update for every customer account.[28] For retail investor customer accounts, the firm must obtain the customer's name, residential address, tax identification or social security number, the customer's occupation and name of employer, determine whether the customer is of legal age to open a brokerage account, and if the customer is a corporation, partnership or other legal entity, obtain the names of any persons authorized to trade in the account.[29] The firm should also identify for each account the associated person(s), if any, responsible for the account and the scope of each associated person's responsibility,[30] and the name of a "trusted contact" (unless the customer refused to provide one).[31]

Regardless of business model, a firm's supervisory system must include written procedures for the review and approval of customer accounts in compliance with the firm's regulatory obligations.[32] Rule 4512 requires that

28. *See* FINRA, Rule 4512, Customer Accout Information (2019).

29. *See* FINRA, Rule 4512(a) (2019). In 2001, the SEC amended its books and records regulations to add, among other things, a new customer account record rule requiring firms to obtain similar information, but expanded the required information to include investment objectives, annual income and net worth (excluding value of primary home). 17 C.F.R. § 240.17a-3(a)(17) (2021) (eff. May 2, 2003). The SEC adopted the new customer account rule in order to provide SRO and state regulators access to the types of records they would need to determine the firm's compliance with the suitability rule. SEC. EXCH. COMM'N, REL. NO. 34-44992, BOOKS AND RECORDS REQUIREMENTS FOR BROKER AND DEALERS UNDER THE SECURITIES EXCHANGE ACT OF 1934 (Nov. 2, 2001), https://www.sec.gov/rules/final/34-44992.htm. However, the SEC exempted brokers and dealers who are not required to comply with the suitability rule. 17 C.F.R. § 240.17a-3(a)(17)(i)(D) (2021) ("this section will not be applicable to an account for which, within the last 36 months, the member, broker or dealer has not been required to make a suitability determination under the federal securities laws or under the requirements of a self-regulatory organization of which it is a member").

30. *See* FINRA, Rule 4512(a)(C) (2019).

31. *See* FINRA, Rule 4512.06, Trusted Contact Person (2019). The firm must maintain and preserve this information for a period of at least six years after the date the information is obtained or updated. *See* FINRA, Rule 4512.01, Customer Account Retention Periods (2019).

32. Under FINRA Rule 3110, Supervision, a firm's supervisory system must include written procedures to supervise the types of business in which a firm engages and its

the firm maintain a record of the signature of the supervisory principal "denoting that the account has been accepted in accordance with the member's policies and procedures for acceptance of accounts."[33]

The account approval and maintenance processes are increasingly automated, especially in the context of self-directed broker trading platforms. Retail investors, particularly younger and new investors, more frequently choose to invest through self-directed discount trading platforms and apps.[34] Investors can complete an application online or through an app, directly providing their customer information to the trading platform, and obtain trading approval in minutes.[35]

The ease with which new customer accounts can be opened and approved through automated processes, however, underscores the importance of firms developing and implementing a written Customer Identification Program in compliance with the Bank Secrecy Act ("BSA").[36] The BSA requires firms to monitor for, detect and report suspicious activity conducted or attempted to the U.S. Treasury's Financial Crimes Enforcement Network ("FinCEN").[37] A

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associated persons that are reasonably designed to achieve compliance with applicable securities laws, regulations and FINRA Rules. *See* FINRA, Rule 3110(b)(1), Supervision (2022). These rules include requirements for the opening and maintenance of every customer account.

33. FINRA, Rule 4512(a)(1)(D) (2019).

34. *See* FINRA/NORC Study, *supra* note 10, at 1.

35. *See, e.g.* Letter of Acceptance, Waiver, and Consent, FINRA Dep't of Enforcement v. Robinhood Financial, LLC, Docket No. 2020066971201 (June 30, 2021) at 17, https://www.finra.org/sites/default/files/2021-06/robinhood-financial-awc-063021.pdf (hereinafter "Robinhood 2021 AWC") (account approval "nearly instantaneously").

36. 31 U.S.C. § 5311 *et seq.* (2021). The BSA's implementing regulations require that firms "establish, document, and maintain a written Customer Identification Program . . . appropriate for [the firm's] size and business" and that the program contain "procedures for verifying the identity of each customer to the extent reasonable and practicable." 31 C.F.R. § 1023.220(a)(1) and (a)(2) (2021).

37. *See* 31 C.F.R. § 1023.320 (2021). Title 31 U.S.C. § 5318(g) authorizes the Treasury Department to issue suspicious activity reporting requirements for broker-dealers. The Treasury Department issued the implementing regulation, 31 C.F.R. § 103.19(a)(1) (2021), in July 2002, providing that with respect to any transaction after December 30, 2002, "[e]very broker or dealer in securities within the United States . . . shall file with [the Financial Crimes Enforcement Network (FinCEN)] . . . a report of any suspicious transaction relevant to a possible violation of law or regulation." FinCEN issued 31 C.F.R. § 1023.320 (2021) (the SAR Rule) (effective Jan. 3, 2011)

failure to file suspicious activity reports with FinCEN constitutes a violation of FINRA Rules 3310 and 2010.[38]

FINRA Rule 3310 requires firms "to develop and implement a written anti-money laundering program reasonably designed to achieve and monitor the member's compliance with the requirements of the [BSA]."[39] At a minimum, the firm's anti-money laundering ("AML") program must: (a) implement policies, procedures and internal controls that can reasonably detect and cause reporting of suspicious transactions; (b) provide for annual testing of the procedures; (c) designate and identify to FINRA by name, title and contact information the personnel responsible for implementing and monitoring the day-to-day operations and controls of the program; and (d) include risk-based procedures for ongoing customer due diligence, including understanding the nature and purpose of customer relationships for the purpose of developing customer risk profiles.[40]

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amending BSA regulations, requiring a broker-dealer to make SARs and supporting documentation available to any SRO that examines the broker-dealer for compliance with the requirements of the SAR Rule upon the request of the SEC. *See* FINRA, REGUL. NOTICE 12-08, SEC REQUESTS BROKER-DEALERS MAKE SARS AND SAR INFORMATION AVAILABLE TO FINRA (Jan. 2012), https://www.finra.org/rules-guidance/notices/12-08.

38. *See, e.g.,* Letter of Acceptance, Waiver, and Consent, FINRA Dep't of Enforcement v. Precision Securities, LLC, Docket No. 2020067467601 (July 19, 2021) (firm operated a trading platform used primarily by day- and swing-traders; however, firm did not reasonably design AML program to monitor and report suspicious activity in light of the firm's business model, including suspicious trading from China-based accounts for trading in excess of $200 million; FINRA fined firm $350,000); Letter of Acceptance, Waiver, and Consent, FINRA Dep't of Enforcement v. ITG, Inc., Docket No. 2017054643601 (Mar. 3, 2021) (firm failed to establish and implement AML policies and procedures reasonably designed to detect and cause the reporting of suspicious low-priced securities trading; firm failed to investigate numerous red flags in connection with trading of at least 30 low-priced securities, including a potential pump and dump scheme; firm censured and fined $450,000).

39. FINRA Rule 3310, Anti-Money Laundering Compliance Program (2018).

40. *See id.* NASD Notice to Members 02-21 was issued shortly after the NASD filed Rule 3310's predecessor rule, promulgated in response to the passage of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (PATRIOT Act), Pub. L. No. 107-56, 115 Stat. 272 (2001). Title III of the PATRIOT Act, referred to as the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 (Money Laundering Abatement Act), imposes obligations on broker/dealers under new anti-

FINRA has reminded firms about their obligations to implement AML programs to monitor and report suspicious activity. In Regulatory Notice 17-40, FINRA informed firms about additional customer due diligence requirements imposed by FinCEN, specifically, that firms identify and verify the identity of the beneficial owners of all legal entity customers at the time a new account is opened, subject to certain exclusions and exemptions.[41] FINRA has also brought enforcement actions against online trading platforms for failure to establish a Customer Identification program tailored to the firm's business model,[42] and failure to adapt its AML program to its growth sufficient to surveil suspicious money movements and investigate suspicious activity.[43]

Most recently, FINRA warned about the heightened risk for fraud during the COVID-19 Pandemic in Regulatory Notice 20-13, which stated that that

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money laundering (AML) provisions and amendments to the existing Bank Secrecy Act (BSA) requirements. 31 U.S.C. §§ 5311 *et seq.* (2021).

41. *See* FINRA, REGUL. NOTICE 17-40, FINRA PROVIDES GUIDANCE TO FIRMS REGARDING ANTI-MONEY LAUNDERING PROGRAM REQUIREMENTS UNDER FINRA RULE 3310 FOLLOWING ADOPTION OF FINCEN'S FINAL RULE TO ENHANCE CUSTOMER DUE DILIGENCE REQUIREMENTS FOR FINANCIAL INSTITUTIONS (Nov. 2017), https://www.finra.org/rules-guidance/notices/17-40. FINRA again reminded firms about their obligations to monitor and report suspicious activity, providing a series of red flags that would alert firms to issues involving: (i) customer due diligence and interactions with customers; (ii) deposits in securities; (iii) red flags in securities trading; (iv) red flags in money movement; (v) red flags in insurance products; and (vi) various other potential red flags associated with the account or account activity. *See* FINRA, REGUL. NOTICE 19-18, ANTI-MONEY LAUNDERING (AML) PROGRAM (May 2019), https://www.finra.org/rules-guidance/notices/19-18.

42. *See, e.g.,* Letter of Acceptance, Waiver, and Consent, FINRA Dep't of Enforcement v. Score Priority Corp., Docket No. 2020067466901 (Apr. 14, 2021) (FINRA imposed $250,000 fine and censure against online, self-directed broker-dealer that failed to develop and implement an AML program reasonably expected to detect and report suspicious activity from transactions and money movements in domestic and foreign-based retail accounts; firm also failed to establish a Customer Identification Program tailored to the firm's business and a due diligence program reasonably designed to detect money-laundering activities).

43. *See, e.g.,* Letter of Acceptance, Waiver, and Consent, FINRA Dep't of Enforcement v. Interactive Brokers LLC, Docket No. 2015047770301 (Aug. 10, 2020) (assessing $15 million fine and censure against Interactive Brokers, finding that the firm failed to reasonably design its AML program to match its significant growth, and that its existing AML program was deficient because it failed to surveil thousands of suspicious money movements in the hundreds of millions of dollars, and the firm failed to investigate potentially suspicious activity).

firms reported an increase in newly-opened fraudulent accounts, with fraudsters targeting online account platforms, particularly "firms that recently started offering such services."[44] FINRA warned that fraudsters were using stolen or synthetic identities to establish fraudulent accounts to divert congressional stimulus funds, unemployment payments or engage in automated clearing house (ACH) fraud.[45] For firms that opened accounts through electronic means, FINRA stressed the importance of a strong Customer Identification Program (in the opening and ongoing monitoring of customer accounts), which utilized *both* documentary and non-documentary (i.e., independent verification of customer information) methods of verifying customer identity, limited automated approval of multiple accounts opened by the same customer, and used other verification procedures for bank accounts and transfers.[46]

FINRA's 2021 enforcement action against Robinhood Financial included charges against the firm for its failure to establish and implement a reasonably designed Customer Identification Program.[47] According to the FINRA AWC, the firm approved more than 5.5 million new customer accounts between June 2016 to November 2018, relying primarily on a customer identification process that was "largely automated" and suffered from "multiple flaws."[48] Among other things, Robinhood did not have any employees whose primary job responsibilities related to the Customer Identification Program, as required by FINRA Rule 3310, Anti-Money Laundering Compliance Program, and had

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44. FINRA, REGUL. NOTICE 20-13, HEIGHTENED THREAT OF FRAUD AND SCAMS, FINRA REMINDS FIRMS TO BEWARE OF FRAUD DURING THE CORONAVIRUS (COVID-19) PANDEMIC (May 5, 2020), https://www.finra.org/rules-guidance/notices/20-13; *see also* FINRA, REGUL. NOTICE 19-18, *supra* note 41 (providing a comprehensive list of "money laundering red flags" that is not exhaustive or all-inclusive).

45. FINRA, REGUL. NOTICE 20-13, *supra* note 44.

46. *See id.* at 2-3. In addition to fraudulently opened accounts, Regulatory Notice 20-13 identified three additional scams which increased during the pandemic, including firm imposter scams (where fraudsters impersonate firms and associated persons in communicating with customers); IT Help Desk scams (fraudsters posing as persons associated with the firm to obtain new sign-on credentials from the firm's IT desk); and business email compromise schemes (fraudsters posing as manager or executive requesting payment for an invoice or other expense). *See id.*

47. *See* Robinhood 2021 AWC, *supra* note 35, at 26.

48. *See id*. at 26-27.

just one principal responsible for more than half of the new accounts.[49] The firm's automated system approved accounts even after its clearing firm flagged an account as needing "further review" due to the presence of a "fraud victim warning."[50]

Moreover, FINRA found that Robinhood ignored its own written procedures for the verification of these accounts. For example, although the clearing firm recommended thorough verification of flagged accounts, Robinhood *overrode* those alerts to approve the accounts anyway without any additional verification.[51] As a result of these failures, FINRA found that Robinhood had violated FINRA Rules 3310, Anti-Money Laundering Compliance Program and 2010, Standards of Commercial Honor and Principles of Trade.[52]

Brokerage firms' obligations to conduct customer due diligence, obtain and maintain updated customer information, and implement strong supervisory systems to monitor against fraudulent activity is also central to firms' obligations to protect customer information and assets, as discussed below.

(ii) Approving Customer Accounts for Options Trading and Margin

The 2021 Report on FINRA's Examination and Risk Monitoring Program stated that 2020 "witnessed a surge in new retail investors entering the market via online brokers, as well as an increase in certain types of trading, including options," noting the increase in "game-like" features of trading apps and other

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49. *See id.* at 27.

50. *Id.* The clearing firm flagged accounts as needing further review because, among other reasons, the customer's social security was not issued by the Social Security Administration, the customer's age could not be verified, the customer's address was a storage facility, P.O. Box or cash-checking facility, or the customer's address had been used ten times or more by individuals with different social security numbers. *Id.*

51. *See id.* Robinhood approved 90,000 accounts that had been flagged for potential fraud, without requesting additional identification (such as a driver's license or passport), ignoring its own requirements to obtain other physical verification of customer identities. *See id.*

52. *See id.* In the AWC, FINRA tied Robinhood's violations of its other conduct rules – including Rule 3310 – to Rule 2010 which requires firms maintain a high standards in the conduct of their business. FINRA explained that a violation of Rule 3310 also constitutes a violation of Rule 2010. *See id.*

communications that may encourage investors to engage in higher risk trading.[53] Robert Cook, FINRA's CEO, echoed this concern in his May 6, 2021 statement before the U.S. House of Representatives Financial Services Committee, observing that game-like features on trading Apps "may encourage investor behaviors that impact sound investment decisions."[54] Cook announced that FINRA established a cross-departmental working group to assess how broker-dealers use their trading platforms and mobile apps to influence customer behavior, and determine whether additional rulemaking or guidance is necessary.[55]

To the extent trading platforms and mobile apps are directing or facilitating higher risk trading in the form of options trading, however, these firms are required to approve each customer for a specific level of options trading (and use of margin) based on the customer's profile and experience.

FINRA Rule 2360 requires firms to conduct due diligence in approving a customer's account for options trading, including obtaining the essential facts about the customer, the customer's financial situation and investment objectives, and the customer's *investment experience* and knowledge, including the number of years and type of trading.[56]

FINRA Rule 2360(b)(16)(A)-(D) require a brokerage firm to consider the various levels of options trading (e.g., buying covered calls, uncovered writing), the risks specific to the customer in light of the customer's profile and experience, and "determin[e] whether and *to what extent* to approve the account for options trading."[57] Subsection (16)(B)(ii)(d) further requires a firm to note in the customer's account records the "[n]ature and types of transactions for which" it is approved. A firm cannot accept an options order unless it has provided the customer with an options disclosure document[58] and

53. 2021 FINRA Report, *supra* note 16, at 22.

54. Cook, *supra* note 15.

55. *See id.*

56. FINRA, Rule 2360(b)(16)(B), Diligence in Opening Accounts (2020).

57. *Id.*

58. The specific disclosure document is entitled "Characteristics and Risks of Standardized Options," a 188-page pamphlet available for download on the Options Clearing Corporation website at: https://www.theocc.com/Company-Information/Documents-and-Archives/Options-Disclosure-Document.

the customer's account has been approved for options trading by a registered Options Principal or Limited Principal – General Securities Sales Supervisor.[59]

In 2021, FINRA reminded firms that the obligations to conduct due diligence in connection with options account approvals and margin equally applies to self-directed accounts.[60] FINRA's notice was prompted by the significant increase in the number of customers opening self-directed accounts and trading options.[61] The notice explained that Rule 2360(b)(16) requires a firm to specifically approve (or disapprove) each customer for options trading and the appropriate level of options trading for that customer based upon "detailed customer information, including, among others, the customer's knowledge, investment experience, age, financial situation and investment objectives."[62] This obligation applies regardless of whether the account is self-directed or the options are recommended.[63]

Since option transactions are often required to be traded in a margin account, FINRA's notice reminded firms of margin maintenance requirements under Rule 4210, explaining that firms must also "have procedures to review the limits and types of credit extended to all customers, to review the need for higher margin requirements for individual securities and customers and to formulate their own margin requirements."[64]

Despite due diligence and supervisory approval requirements, customers frequently get "instant" approval for options trading in margin accounts when opening self-directed accounts online or through an app, like Robinhood. This is because online trading firms have largely automated the customer account opening process, which often includes an application to trade options. Firms are nevertheless required to implement supervisory reviews of any automated processes, however, to ensure that they comply with FINRA rules.

One of the charges against Robinhood in FINRA's enforcement action was its failure to establish or maintain a supervisory system to achieve compliance

59. *See* FINRA, Rule 2360(b)(16)(A), Approval Required (2020).

60. *See* FINRA, REGUL. NOTICE 21-15, FINRA REMINDS MEMBERS ABOUT OPTIONS ACCOUNT APPROVAL, SUPERVISION AND MARGIN REQUIREMENTS (Apr. 9, 2021), https://www.finra.org/rules-guidance/notices/21-15.

61. *See id.* at 1.

62. *Id.* at 2.

63. *See id.* The notice also referenced requirements under FINRA Rule 2090, Know your Customer, FINRA Rule 4512, Customer Account Information, and FINRA Rule 3310, Anti-Money Laundering (AML) Program. *See id.* at 1-2.

64. *Id.* at 4.

with FINRA Rule 2360(b)(16), because it used an automated system that did not sufficiently implement the due diligence requirements under the rule. The AWC stated that the firm had relied almost entirely on an automated system that used algorithms – known by Robinhood as "option account approval bots" – to review customer responses to eligibility questions and, based on those responses, approve or reject option applications "nearly instantaneously."[65] But the system failed to comply with Rule 2360(b)(16)'s due diligence and approval obligations in several respects:

- The bots considered only the information provided in the immediate customer application, without regard to any prior application or information provided by the customers;[66]
- The bots approved customers for level 3 trading (requiring three years of trading experience) even if the customers were under 21 years old, or had previously represented they had no options experience, or who had previously certified that they did not understand option spreads;[67]
- Robinhood's principals reviewed on a weekly basis less than 0.1% of the accounts to ensure that the bots performed as programmed; moreover, the reviews were limited only to ensuring that the bots functioned as programmed, and not whether the information provided was consistent for that customer or whether options trading was appropriate for that customer in the first place;[68] and
- Robinhood's system approved thousands of accounts where the customer had provided false information, or where the customer had revised risk tolerance information that would have made them ineligible to trade options under the firm's own criteria.[69]

As a result of these failures, FINRA found that Robinhood failed to supervise its system for approving options trading and exercise due diligence in approving customers for options trading, in violation of FINRA Rules 3110, 2360 and 2010.[70]

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65. Robinhood 2021 AWC, *supra* note 35, at 17.

66. *See id.*

67. *See id.* at 17-18.

68. *See id.* at 18.

69. *See id.* at 18-19.

70. *See id.* at 21.

B. Communications and Investment Recommendations

Brokerage firms have certain obligations when they communicate with the public. The 2200 series of the FINRA rules govern communications and disclosures. FINRA Rule 2210 broadly covers communications with the public. FINRA Rules 2220, 2264, and 2270 cover more specific types of communications relating to options trading, margin trading, and day-trading. As previously noted, these rules apply regardless of the way the firm does business – through brokers, online, or through a mobile app. Firms are obligated to ensure that all communications comply with FINRA rules.

(i) Communicating with the Public

FINRA categorizes communications as Retail, Correspondence, and Institutional.[71] A "retail communication" is "any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30 calendar-day period."[72] "Correspondence" is defined as "any written (including electronic) communication that is distributed or made available to 25 or fewer retail investors within any 30 calendar-day period."[73] An "institutional communication" is defined as "any written (including electronic) communication that is distributed or made available only to institutional investors, but does not include a member's internal communications."[74]

How a communication is defined determines the firms' approval and review obligations in connection with the communication. All retail communications must be approved by a principal of the firm either before it is first used or before it is filed with FINRA.[75] Correspondence must be reviewed and supervised as determined by FINRA Rule 3110.[76] Institutional communications must be reviewed by a principal.[77]

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71. *See* FINRA, Rule 2210, Communications with the Public (2019).

72. FINRA, Rule 2210(a)(5) (2019).

73. FINRA, Rule 2210(a)(2) (2019).

74. FINRA, Rule 2210(a)(3) (2019).

75. *See* FINRA, Rule 2210(b)(1)(A) (2019).

76. *See* FINRA, Rule 2210(b)(2) (2019).

77. *See* FINRA, Rule 2210(b)(3) (2019).

FINRA has also instituted broad content standards for all communications. Communications must be "fair and balanced," and may not omit any "material fact or qualification if the omission, in light of the context of the material presented, would cause the communications to be misleading."[78] Firms are not permitted to make "any false, exaggerated, unwarranted, promissory or misleading statement or claim in any communication."[79] Further, communications must "provide balanced treatment of risks and potential benefits."[80] Additionally, firms must consider to whom they will be making the communication, and provide appropriate details and explanations.[81]

The rules do not make any differentiation for the method of delivery. Electronic communications are captured by each definition. Accordingly, communications that take place via social media web sites or through apps are subject to the requirements of the rule. FINRA understands that firms are utilizing different means of communication, including icons, illustrations, cartoons, animations, short videos, and pictograms.[82] FINRA recognizes that these new technologies can help investors understand the firm's products and services, while also delivering required disclosures.[83]

Regardless of how the firm communicates with the public, firms are still obligated to follow FINRA rules and ensure communications are fair and balanced and not misleading.[84] FINRA has provided some guidance as to what that means for non-promotional materials:

- **Brand communications:** Brand communications that only acquaint investors with a firm's name and the fact that it offers financial services generally require no additional information in order to be fair and balanced.
- **Educational communications:** FINRA encourages members to use educational communications that promote financial literacy. For example, a member might develop a website that explains different

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78. FINRA, Rule 2210(d)(1)(A) (2019).

79. FINRA, Rule 2210(d)(1)(B) (2019).

80. FINRA, Rule 2210(d)(1)(D) (2019).

81. *See* FINRA, Rule 2210(d)(1)(E) (2019).

82. *See* FINRA, REGUL. NOTICE 19-31, ADVERTISING REGULATION (Sept. 19, 2019), https://www.finra.org/rules-guidance/notices/19-31.

83. *See id.*

84. *See id.*

types of securities and how markets work, but because it does not promote specific securities or services it may only require a simple statement noting that securities involve risks and an offer to provide additional information. Another example is educational content that only provides basic information about what mutual funds are and does not include information that relates to the desirability of a specific product; such a communication would not need to disclose the specific risks associated with a particular fund.

- **Reference resources:** Some members provide websites, apps or other reference resources that do not promote a specific product or service; instead, they provide information intended to assist investors with investment decisions. In general, investors must choose to access these resources and interact with them to find the information (e.g., by downloading an app or creating an online account on the firm's website). A resource that does not promote specific products or services might need little or no disclosure under FINRA rules.
- **Post-sale communications:** Once a sale has occurred, members may provide communications to investors that discuss the product, such as changes to its portfolio or information about how the product has responded to changes in market conditions. These subsequent communications typically do not require the same extent of disclosure as communications leading up to a sale. Of course, a post-sale communication that recommends additional purchases or another product would be a promotional communication.[85]

Promotional materials that discuss the benefits of a particular product, type of product, or service may require extensive disclosures, including a balanced discussion of the risks or drawbacks.[86]

FINRA has also provided specific guidance to firms communicating commission discounts. For example, FINRA has stated that the communications must recognize that stocks are not the only type of securities available, and discounts may vary depending on the product traded.[87] Firms

85. *Id.*

86. *See id.*

87. *See Guidance: Recommendations Concerning Advertising and Promotion of Commission Discounts*, FINRA, https://www.finra.org/rules-guidance/guidance /recommendations-concerning-advertising-and-promotion-commission-discounts.

must also acknowledge that certain products, such as mutual funds, may have sales charges that cannot be discounted.[88] Further, firms must include a description of any factors that would impact the discount, such as initial deposit requirements, minimum transaction size, or registration fee.[89] Firms must also disclose any services charges that are applicable, such as charges applicable to limit orders, safekeeping of securities, odd lot transactions, or research.[90]

Communications that recommend a particular security or investment strategy are subject to other rules and limitations.

Both FINRA and the SEC set standards of conduct that are applicable when a recommendation of a security or investment strategy is made to an investor. However, neither FINRA nor the SEC define the term "recommendation." When it enacted Reg. Best Interest, the SEC stated that it would define the term consistently with how it had been defined previously, specifically referencing FINRA's Suitability Rule and FINRA Notice to Members 01-23.[91]

FINRA Notice to Members 01-23, Online Suitability, discusses the obligations of firms when communicating with customers online.[92] FINRA explained that:

> [T]he "facts and circumstances" determination of whether a communication is a "recommendation" requires an analysis of the content, context, and presentation of the particular communication or set of communications. The determination of whether a "recommendation" has been made, moreover, is an objective rather than a subjective inquiry. An important factor in this regard is whether—given its content, context, and manner of presentation— a particular communication from a broker/dealer to a customer reasonably would be viewed as a "call to action," or suggestion that the customer engage in a securities transaction. Members should bear in mind that an analysis of the content, context, and manner of

88. *See id.*

89. *See id.*

90. *See id.*

91. *See* Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318, 33,335 (July 12, 2019) (hereinafter "Reg. Best Interest Adopting Release").

92. *See* FINRA, NOTICE TO MEMBERS 01-23, ONLINE SUITABILITY (Apr. 2001), https://www.finra.org/rules-guidance/notices/01-23.

> presentation of a communication requires examination of the underlying substantive information transmitted to the customer and consideration of any other facts and circumstances, such as any accompanying explanatory message from the broker/dealer. Another principle that members should keep in mind is that, in general, the more individually tailored the communication to a specific customer or a targeted group of customers about a security or group of securities, the greater likelihood that the communication may be viewed as a "recommendation.[93]

FINRA went on to provide examples of communications that would likely fall outside the definition, and communications that would generally fall within the definition of recommendation.[94] For example, the following types of communications are likely not recommendations:

- A website with an electronic library that contains research reports, news, quotes, and charts;
- A search tool that allows a customer to sort or filter information about securities, so long as the firm does not limit it to or prefer securities in which the firm makes a market or for which it has issued a "buy" recommendation; and
- An email or other electronic subscription service that alerts a customer to news affecting securities in the customer's portfolio or on the customer's "watch list."[95]

The following communications are more likely to be deemed recommendations:

- An email or pop-up to a targeted customer or targeted group of customers encouraging the purchase of a security;
- A list of stocks accompanied by a request that the customer purchase one or more stocks on the list;
- A portfolio analysis tool that provides a list of specific securities the customer could buy or sell to meet the investment goals the customer has inputted; and

93. *Id.*

94. *Id.*

95. *See id.*

- Sending or pushing specific investment suggestions following the firm's use of data mining technology to analyze a customer's financial or online activity.[96]

FINRA acknowledged that the examples provided were not all inclusive, and were based on then prevalent technologies.[97] It suggested that firms analyze each communication to determine whether it reasonably could be considered a "call to action," such that it would influence a customer to trade a particular security or group of securities.[98] Such analysis should take place regardless of whether the customer requested the information, or if it was a computer software program that determined the information should be sent.[99] FINRA also reminded firms that they cannot discharge or avoid their obligations by using disclaimers.[100]

FINRA also recognized that firms may communicate on social media. The fact that the communication is widely disseminated or limited to a select one or more individuals is not determinative of whether the firm has made a recommendation.[101] Firms must still consider the facts and circumstances of the communication.[102]

If the communication is deemed to be a recommendation, then firms must comply with FINRA Rule 2111, Suitability or Reg. Best Interest. FINRA Rule 2111 applies to all recommendations made to customers prior to June 30, 2020. For recommendations made on or after June 30, 2020 either FINRA Rule 2111 or Reg. Best Interest applies. Reg. Best Interest applies to recommendations made to retail investors, defined as natural persons and their legal representatives, seeking advice for personal, family, or household purposes.[103]

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96. *See id.*

97. *See id.*

98. *See id.*

99. *See id.*

100. *See id.*

101. *See* FINRA, REGUL. NOTICE 10-06, SOCIAL MEDIA WEB SITES, GUIDANCE ON BLOGS AND SOCIAL NETWORKING WEB SITES (Jan. 2010), https://www.finra.org/rules-guidance/notices/10-06.

102. *See id.*

103. Reg. Best Interest Adopting Release, *supra* note 91 at 33,343.

FINRA Rule 2111 applies to any recommendations not covered by Reg. Best Interest.[104]

If FINRA Rule 2111 applies, firms must comply with the three suitability components, reasonable-basis suitability, customer-specific suitability, and quantitative suitability. Reasonable-basis suitability requires that a firm "have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors."[105] This requires the firm to have an understanding of the recommendation's risks and rewards.[106]

The customer-specific obligation requires that a firm "have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile."[107] The customer's investment profile includes the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, and risk tolerance.[108]

Quantitative suitability requires that the firm "have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile."[109]

If the recommendation is governed by Reg. Best Interest, the firm must comply with the Disclosure, Care, Conflict of Interest, and Compliance obligations.[110] The Care obligation, in many ways, mirrors FINRA Rule 2111. It also consists of reasonable-basis, customer-specific, and quantitative obligations. Pursuant to the reasonable-basis obligation, the firm must "[u]nderstand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers."[111]

Under the customer-specific obligation, the firm must "[h]ave a reasonable basis to believe that the recommendation is in the best interest of a particular

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104. *See* FINRA Rule 2111.08 (2020).

105. FINRA, Rule 2111.05(a) (2020).

106. *Id.*

107. FINRA, Rule 2111.05(b) (2020).

108. FINRA, Rule 2111(a) (2020).

109. FINRA, Rule 2111.05(c) (2020).

110. 17 C.F.R. § 240.15l-1(a)(2) (2021).

111. 17 C.F.R. § 240.15l-1(a)(2)(ii)(A) (2021).

retail customer based on that retail customer's investment profile and the potential risks, rewards, and costs associated with the recommendation and does not place the financial or other interest of the broker, dealer, or such natural person ahead of the interest of the retail customer."[112]

The quantitative obligation requires the firm to "[h]ave a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile and does not place the financial or other interest of the broker, dealer, or such natural person making the series of recommendations ahead of the interest of the retail customer."[113]

As noted, neither FINRA nor the SEC have defined recommendation, and have not said whether they would deem gamification features to be recommendations. They have recognized that gamification or prompts that promote or encourage trading activity may be subject to Reg. Best Interest.[114]

Massachusetts filed an Administrative Complaint against Robinhood that sought to hold the firm responsible for violations of its newly enacted fiduciary regulation.[115] Like the Suitability Rule and Reg. Best Interest, the regulation imposes obligations on a firm when it makes recommendations. Massachusetts relied in part on Robinhood's communications, including push notifications of lists of stocks, in arguing that Robinhood was making recommendations.[116]

(ii) Options Communications

In addition to the general rules concerning communications, FINRA has enacted more specific rules with respect to options communications. With the increased prevelance of options trading in self-directed online accounts,

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112. 17 C.F.R. § 240.15l-1(a)(2)(ii)(B) (2021).

113. 17 C.F.R. §240.15l-1(a)(2)(ii)(C) (2021).

114. *See* Cook, *supra* note 15; *see also* Gensler, *supra* note 18.

115. Robinhood Financial, LLC, *supra* note 15.

116. *See* Defendants' Opposition Memorandum to the Plaintiff's Motion for Preliminary Injuctive Relief, Robinhood Financial v. Glavin, Civil Action No. 2184 CV 00884 BLS (May 10, 2021), https://www.masscourts.org/eservices/search.page.3?x=OWxSoK9l0j0xQ3Ar*dLG8NbPCYo0lMb4t1lMmfgHt8auP6Hex0vgfqBaVPJtlWJxUQkEfkQwmkkRr8E-vtGLgpBP6K4fVmZatR75C65DUmXZIZN5iyDlMQ2Zh8eE2vda58aECDHXC*OQrPTkUElyysGq496D0FLvTZW1zXs8kfs.

FINRA and the SEC have both voiced concerns that investors may not fully appreciate the risks involved.[117] When communicating about options, firms must meet additional standards.

There are two different standards to which communications regarding standardized options, prior to the delivery of disclosure documents, must conform.[118] If the options are not exempt by Securities Act Rule 238, and the communication is taking place prior to the prospectus delivery that "meets the requirements of Section 10(a) of the Securities Act", then the communication must "conform to Securities Act Rule 134 or 134a, as applicable."[119] However, if the communications are about options that are exempt from by Securities Act Rule 238, and are made before the delivery of disclosure documents are made, then there are five rules that must be adhered to.[120] First, the options being discussed can only be generally described.[121] Second, the communication must include contact information to enable the readers to obtain the disclosure documents.[122] Third, the communication may not contain "recommendations or past or projected performance figures, including annualized rates of return, or names of specific securities."[123] However, the communication may include any statement required by state or administrative law.[124] Finally, the communication is allowed to contain advertising devices, such as borders, logos, and graphics, provided that such devices are not misleading.[125]

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117. *See* Cook, *supra* note 15.

118. *See* FINRA, Rule 2220(d), Options Communications (2014).

119. FINRA, Rule 2220(d)(1)(B) (2014).

120. *See* FINRA, Rule 2220(d)(1)(A) (2014).

121. *See* FINRA, Rule 2220(d)(1)(A)(I) (2014) ("The text may also contain a brief description of options, including a statement that identifies registered clearing agencies for options and a brief description of the general attributes and method of operation of the exchanges on which such options are traded, including a discussion of how an option is priced.").

122. *See* FINRA, Rule 2220(d)(1)(A)(ii) (2014).

123. FINRA, Rule 2220(d)(1)(A)(iii) (2014).

124. *See* FINRA, Rule 2220(d)(1)(A)(iv) (2014).

125. *See* FINRA, Rule 2220(d)(1)(A)(v) (2014).

While FINRA Rule 2220(d)(1) deals with the substance of options communications, FINRA Rule 2220(d)(2) deals with communication standards that apply to firms. Firms are prohibited from including in their options communications any information that is false or misleading, or omits any materially relevant information.[126] Furthermore, firms may not make promises of results, nor make unwarranted claims or forecasts.[127] Firms are also prohibited from including opinions that lack any reasonable basis.[128] Additionally, if warnings or caveats are included in such communications, then they must be legible.[129] Such warnings may not be misleading or irrelevant.[130] These communications may not suggest that a secondary market for the options is available.[131] Finally, communications may not be made if they "would constitute a prospectus as that term is defined in the Securities Act, unless it meets the requirements of Section 10 of the Securities Act."[132]

Firms are further prohibited from using options communications that are deficient in certain ways. Communications must reflect the risks of options trading and the complexities of options as related to other investments.[133] The communication must contain a warning that options are not suitable for all investors.[134] Conversely, firms are prohibited from making a communication if it suggests that options are suitable to all.[135] Also, any communications must inform the reader that supporting documentation for all claims made is available upon request.[136] However, certain of these requirements do not apply

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126. *See* FINRA, Rule 2220(d)(2)(A)(i) (2014).

127. *See* FINRA, Rule 2220(d)(2)(A)(ii) (2014).

128. *See id.*

129. *See* FINRA, Rule 2220(d)(2)(A)(iii) (2014).

130. *See id.*

131. *See* FINRA, Rule 2220(d)(2)(A)(v) (2014).

132. FINRA, Rule 2220(d)(2)(A)(iv) (2014).

133. *See* FINRA, Rule 2220(d)(2)(A)(vi) (2014).

134. *See* FINRA, Rule 2220(d)(2)(A)(vii) (2014).

135. *See id.*

136. *See* FINRA, Rule 2220(d)(2)(A)(viii) (2014) (such documentation includes "comparison, recommendations, statistics, or other technical data").

to institutional communications.[137] Finally, all communications must be equally balanced between the upside benefits with the attendant risks.[138] All such risk warnings must be as specific as the statement of opportunities.[139]

So long as certain conditions are met, projections may be included in options communications.[140] First, all such communications must include or follow the options disclosure document.[141] Furthermore, "no suggestion of certainty of future performance [may be] made."[142] Additionally, parameters must be given to accompany the projection figures,[143] along with "all relevant costs, including commissions, fees, and interest charges."[144] All projections must be plausible, intended to be used as a point of reference,[145] and all material assumptions for those projections must be identified.[146] The risks for the options transaction must be disclosed.[147] Finally, "in communications relating to annualized rates of return, that such returns are not based upon any less than a 60-day experience; any formulas used in making calculations are clearly displayed; and a statement is included to the effect that the annualized returns cited might be achieved only if the parameters described can be duplicated and that there is no certainty of doing so."[148]

Similarly, options communications may include statistics of past performance of recommendations, and transactions, provided that certain requirements are met.[149] First, the disclosure document must accompany or

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137. *See* FINRA, Rule 2220(d)(2)(B) (2014); *see also* FINRA, Rule 2220(a)(1)(B) (2014) (stating institutional communications are defined by FINRA, Rule 2210(a)).

138. *See* FINRA, Rule 2220(d)(2)(C) (2014).

139. *See id.* ("[B]road generalities must be avoided.").

140. *See* FINRA, Rule 2220(d)(3) (2014).

141. *See* FINRA, Rule 2220(d)(3)(A) (2014).

142. FINRA, Rule 2220(d)(3)(B) (2014).

143. *See* FINRA, Rule 2220(d)(3)(C) (2014).

144. FINRA, Rule 2220(d)(3)(D) (2014).

145. *See* FINRA, Rule 2220(d)(3)(E) (2014).

146. *See* FINRA, Rule 2220(d)(3)(F) (2014).

147. *See* FINRA, Rule 2220(d)(3)(G) (2014).

148. FINRA, Rule 2220(d)(3)(H) (2014).

149. *See* FINRA, Rule 2220(d)(4) (2014).

precede any such information.[150] Next, the information must be presented in "a balanced manner."[151] Additionally, the statistics need to be "confined to a specific 'universe' that can be fully isolated and circumscribed and that covers at least the most recent 12-month period."[152] All recommendations or transactions must include: the initial date, the initial price at the initial date, and the "date and price of each recommendation or transaction at the end of the period or when liquidation was suggested or effected, whichever was earlier."[153] The performance must also include the relevant costs, inclusive of commissions, fees, and margin obligations.[154] If annualized rates of return are communicated, then all material assumptions used in those calculations must also be communicated.[155]

Furthermore, an overview of general market conditions during the covered periods must be made.[156] Any comparison made between the general state of the market and the performance record must be valid.[157] Also, there must be a specific warning that past performance does not guarantee future results.[158] Finally, the statistics or record must come with the initialed determination of a Registered Options Principal that they "fairly [re]present the status of the recommendations or transactions reported upon."[159]

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150. *See* FINRA, Rule 2220(d)(4)(A) (2014).

151. FINRA Rule, 2220(d)(4)(B) (2014).

152. *Id.*

153. FINRA, Rule 2220(d)(4)(C) (2014). This is further limited as follows: "provided that if the communications are limited to summarized or averaged records or statistics, in lieu of the complete record there may be included the number of items recommended or transacted, the number that advanced and the number that declined, together with an offer to provide the complete record upon request.".

154. *See* FINRA, Rule 2220(d)(4)(D) (2014).

155. *See* FINRA, Rule 2220(d)(4)(E) (2014).

156. *See* FINRA, Rule 2220(d)(4)(F) (2014).

157. *See id*.

158. *See* FINRA, Rule 2220(d)(4)(G) (2014).

159. FINRA, Rule 2220(d)(4)(H) (2014).

Communications regarding an options program[160] must include "the cumulative history or unproven nature of the program and its underlying assumptions."[161] Finally, if a firm violates any other SEC or SIPC rule related to options communications, the firm will have also violated FINRA Rule 2220.[162]

(iii) Margin Disclosure Statement

Certain communications must be made if the firm makes a certain type of trading available, regardless of whether the investor has requested it. Before opening a margin account on behalf of a customer, a firm is obligated to provide the customer with a Margin Disclosure Statement.[163] If the firm offers margin accounts, the firm must also make the statement available on its website in a clear and conspicuous manner.[164]

The statement is intended to highlight many of the risks attendant with margin trading. FINRA sets forth the required content of the statement, which includes the following sections: "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."[165] Each section contains a brief explanation. At least once a calendar year, the firm must also send to each customer with a margin account either the statement or a summary disclosure that includes each of the section headings.[166] Firms are permitted to customize

160. *See* FINRA, Rule 2220(d)(5) (2014) ("i.e., an investment plan employing the systematic use of one or more options strategies").

161. *Id.*

162. *See* FINRA, Rule 2220(d)(6) (2014).

163. *See* FINRA, Rule 2264(a), Margin Disclosure Statement (2011).

164. *See id.*

165. *Id.*

166. *See* FINRA, Rule 2264(b) (2011).

the disclosure so long as it is substantially similar to the content required by the rule.[167]

(iv) Day-Trading Disclosure Statement

If a firm promotes a day-trading strategy, whether directly or indirectly, it may not open an account for any customer unless it has provided the customer with the day-trading disclosure statement and posted the statement on its website in a clear and conspicuous manner.[168] FINRA does offer to review communications and provide guidance to firms as to whether the communication will be deemed to be "promoting a day-trading strategy."[169]

As with the Margin Disclosure Statement, the content of the statement is set forth by FINRA, and includes the following headings: "Day trading can be extremely risky;" "Be cautious of claims of large profits from day trading;" "Day trading requires knowledge of securities markets;" "Day trading requires knowledge of a firm's operations;" "Day trading will generate substantial commissions, even if the per trade cost is low;" "Day trading on margin or short selling may result in losses beyond your initial investment;" and "Potential Registration Requirements."[170]

C. Cybersecurity: Protection of Customer Information, Funds and Securities

The technology that has transformed the brokerage industry and driven the growth of online platforms and brokerage apps has also created supervisory challenges for financial firms. The use of cloud-based servers, remote access to trading platforms and customer data, email and electronic wire transfers, and even algorithms (or "bots") to open and monitor customer accounts, among other things, provide opportunities for malicious actors to steal confidential information and customer assets and to disrupt a firm's business operations.

167. *See* FINRA, Rule 2264(c) (2011).

168. *See* FINRA, Rule 2270(a), Day-Trading Risk Disclosure Statement (2013).

169. *See* FINRA, Rule 2270.01, Review by FINRA's Advertising Regulation Department (2013).

170. FINRA Rule 2270(a) (2013).

In a 2021 annual report on examinations and risk monitoring program, FINRA observed that cybersecurity "remains one of the principal operational risks facing broker-dealers" and that it expects firms "to develop reasonably designed cybersecurity programs and controls that are consistent with their risk profile, business model and scale of operations."[171]

The SEC and FINRA have increasingly focused on cybersecurity risks, issuing risk alerts and guidance to the industry about its obligations to protect confidential customer information under Rule 30 of the SEC's Regulation S-P, establish written procedures to identify and respond to "identity theft red flags" as required under Rule 201 of the SEC's Regulation S-ID, and protect against cybersecurity attacks that could result in disruption of operations and services to customer, implicating FINRA Rule 4370.

(i) SEC Regulation S-P Rule 30: The Safeguard Rule

The SEC's Rule 30 under the SEC's Regulation S-P, adopted in 2000 and known as "the Safeguard Rule," requires every broker-dealer to adopt and maintain "written policies and procedures that address administrative, technical, and physical safeguard for the protection of customer records and information."[172] The policies and procedures must be reasonably designed to "(1) insure the security and confidentiality of customer records and information; (2) protect against any anticipated threats or hazards to the

171. 2021 FINRA Report, *supra* note 16.

172. Privacy of Consumer Financial Information (Regulation S-P), 65 Fed. Reg. 40,334 (June 29, 2000) (codified at17 C.F.R. § 248.30(a)). The SEC promulgated Regulation S-P pursuant to Title V of the Gramm-Leach-Bliley Act ("GLBA"), passed in 1999, which directed federal agencies with oversight over financial institutions to establish standards for the protection of customer information. 15 U.S.C. § 6801(b) (2010). Title V governs imposed upon financial institutions "an affirmative and continuing obligation . . . to protect the security and confidentiality of [customer] nonpublic personal information." 15 U.S.C. § 6801(a) (2010). It further directed federal agencies with oversight over the financial industry to promulgate rules that "establish appropriate standards for the financial institutions subject to their jurisdiction relating to administrative, technical, and physical safeguards . . ." 15 U.S.C. § 6801(b) (2010). The SEC adopted amendments to the Safeguard Rule, effective January 2005, to require that the policies and procedures adopted be in writing. SEC. EXCH. COMM'N, REL. NOS. 34-50781, IA-2332, IC-26685, DISPOSAL OF CONSUMER REPORT INFORMATION (Dec. 2, 2004), https://www.sec.gov/rules/final/34-50781.htm.

security or integrity of customer records and information; and (3) protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer."[173]

After Regulation S-P Rule 30 was initially adopted, firms' security policies generally focused on administrative and physical risks to customers' personally identifiable information ("PII"), rather than risks related to changing technology.[174] FINRA Regulatory Notice 05-49 reminded firms that their policies and procedures to protect against unauthorized access to or use of customer records or PII that could result in substantial harm or inconvenience to customers should "adequately reflect changes" in technology or alternative work arrangements.[175]

FINRA acknowledged that there can be no "one-size-fits-all" policy or procedure, but stressed that members should consider at a minimum whether: (1) the firm's existing policy adequately addresses the technology it currently uses; (2) the firm has taken appropriate technological precautions to protect customer information; (3) the firm is providing training to its employees about its available technology, its use and the steps necessary to protect customer information; and (4) the firm is conducting periodic audits to detect vulnerabilities and ensure the systems are, in practice, protecting customer records and information from unauthorized access.[176]

Despite their increasing reliance on technology, many financial firms have not adequately adapted their written policies and procedures to new technology or have otherwise failed to address new vulnerabilities in their systems. In 2015, the SEC's Office of Compliance Examinations and Inspections ("OCIE") issued a risk alert after a cybersecurity examinations sweep found

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173. 15 U.S.C. § 6801(b) (2010).

174. Jeffrey Taft, Matthew Bisanz, and Leslie Cruz, *The SEC's Regulation S-P in the Age of Cybersecurity*, THE INVESTMENT LAWYER, Vol. 9, No. 9 (Sept. 2019), https://www.mayerbrown.com/-/media/files/perspectives-events/publications /2019/09/il_0919_taftbisanzcruz.pdf (observing that when Regulation S-P was first adopted many safeguarding procedures "focused on administrative and physical safeguards, and to a lesser extent on technical safeguards").

175. FINRA, NOTICE TO MEMBERS 05-49, SAFEGUARDING CONFIDENTIAL CUSTOMER INFORMATION at 1 (July 2005), https://www.finra.org/rules-guidance/notices/05-49. Regarding the use of wireless networks, FINRA stressed the importance of using appropriate safeguards, such as encryption, to prevent unauthorized parties from accessing customer information, and the use of firewalls to mitigate risks of outside intrusion by hackers.

176. *Id.* at 4.

that while most of the firms examined had adopted written security policies and procedures, 88% of broker-dealers and 74% of registered investment advisers had experienced cyber-attacks (directly or through one or more of their vendors) or had security gaps.[177]

The SEC's early enforcement cases under Regulation S-P Rule 30 focused on administrative and physical risks to PII, such as handling customer information when winding down business operations.[178] More recently, the SEC has charged brokerage firms and investment advisers with violations of Regulation S-P Rule 30 for failures to adopt, implement or enforce written policies and procedures applicable to the firm's use of technology, including, the use of email addresses not affiliated with the firm's domain name to receive over 4,000 faxes containing customer PII (in violation of written policies),[179] storing customer PII on a third-party web server without adopting written policies and procedures regarding the security and confidentiality of that information and the protection of that information from threats or unauthorized access,[180] and failing to ensure the reasonable design and operation of two web-based applications on the firm's Intranet that organized customer data and PII, to limit access to the PII, or to conduct any audits or testing of its applications to guard against unauthorized access.[181]

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177. *See* SEC. EXCH. COMM'N OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, NATIONAL EXAM PROGRAM RISK ALERT, CYBERSECURITY EXAMINATION SWEEP SUMMARY, at 2-3 (Feb. 3, 2015), https://www.sec.gov /about/offices/ocie/cybersecurity-examination-sweep-summary.pdf.

178. *See, e.g.,* David C. Levine, SEC. EXCH. COMM'N, REL. NO. 34-64222, 100 SEC Docket 3049, 2011 WL 1325568, *5 (Apr. 7, 2011) (finding brokerage firm violated, and its senior officer aided and abetted the firm's violations, of Rule 30(a) of Regulation S-P because firm failed to adopt policies and procedures to protect customer information while firm was winding down its business).

179. *See* Craig Scott Capital, LLC, SEC. EXCH. COMM'N, REL. NO. 34-77595 (Apr. 12, 2016) (ordering cease-and-desist and fining firm $100,000 penalty, and $10,000 penalties against individual associated persons who used personal emails in violation of written policies).

180. *See* R.T. Jones Capital Equities Management, Inc., SEC. EXCH. COMM'N, REL. NO. IA-4204 (Sept. 22, 2015) (the firm's third-party web server was hacked and the PII of more than 100,000 customers was rendered vulnerable to theft; firm fined $75,000).

181. *See* Morgan Stanley Smith Barney, SEC. EXCH. COMM'N, REL. NOS. 34-78021, IA-4415 (June 8, 2016) (for nearly three years one of the firm's associated persons exploited flaws in the applications to misappropriate data regarding 730,000

FINRA has brought enforcement actions against broker-dealers for violations of Regulation S-P Rule 30 in connection with similar security breaches due to firms' failure to adopt, implement and enforce written security policies to its current technology. A recurring problem is firms' use of third-party cloud services without adequately assessing and testing the third-party provider's security systems. FINRA charged Lincoln Financial Securities Corp. with violations of Regulation S-P Rule 30 because, commencing in 2011, one of the firm's branch offices started using a third-party cloud service provider to store records, including customer account applications that contained PII, without ensuring that the provider installed antivirus and encryption software.[182] Although hackers with foreign IP addresses had hacked into the server and gained access to PII for 4500 customers, the firm failed to implement a policy for months after the cyberattack, and failed to ensure its registered representatives and third-party vendor adequately applied the policy.[183] As a result of these supervisory failures, FINRA found that Lincoln Financial violated Regulation S-P Rule 30 and further violated FINRA's supervision rule and Rule 2010, censuring the firm and imposing a penalty of $650,000.[184]

(ii) SEC Regulation S-ID: The Identity Theft Red Flags Rule

The SEC's Rule 201 of Regulation S-ID, adopted in 2013 and known as the "Identity Theft Red Flags Rule,"[185] requires broker-dealers and investment

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customer accounts; Morgan Stanley was ordered to cease-and-desist, censured, and fined $1,000,000).

182. *See* Letter of Acceptance, Waiver, and Consent, FINRA Dep't of Enforcement v. Lincoln Financial Securities Corp., Docket No. 2013035036601 (Nov. 14, 2016).

183. *See id.*

184. *See id.* at 2-3; 5. *See also* Letter of Acceptance, Waiver, and Consent, FINRA Dep't of Enforcement v. Oak Tree Securities, Inc., Docket No. 2015043455201 (Sept. 28, 2017) (finding that for nearly two years Oak Tree used third party vendors to create and host its public website, but did not create any policies or procedures to ensure that it maintained the confidentiality of customer PII, or ensure that its vendors had procedures to protect PII; on at least seven occasions an internet search engine was able to access PII for over 700 customers).

185. SEC. EXCH. COMM'N, REL. NOS. 34-69,359, IA-3582, IC-30,456, IDENTITY THEFT RED FLAGS RULES (Apr. 10, 2013; effective May 20, 2013) (codified at 17 C.F.R. § 248.201), https://www.sec.gov/rules/final/2013/34-69359.pdf. The SEC

advisers registered (or required to be registered) with the SEC to establish and implement a written Identity Theft Prevention Program that is designed to detect, prevent and mitigate identity theft[186] in connection with the opening of a covered account or any existing covered account.[187] The SEC has explained that an Identity Theft Prevention Program "must include reasonable policies and procedures to: identify relevant red flags for the covered accounts and incorporate them into the Identity Theft Prevention Program; detect the red flags hat have been incorporated into the Identity Theft Prevention Program; respond appropriately to any red flags that are detected pursuant to the Identity Theft Prevention Program; and ensure that the Identity Theft Prevention Program is updated periodically to reflect changes in risks to customers from identity theft."[188]

In 2018, the SEC brought its first enforcement case for violations of the Identity Theft Red Flags Rule against Voya Financial Advisors, Inc. ("VFA"), finding that VFA had failed to update its Identity Theft Prevention Program despite significant changes in external cybersecurity risks, and failed to respond to cybersecurity incidents.[189] VFA, a dually registered firm with a national network of independent contractor registered representatives, provided its contractors with access to its brokerage and advisory customer information through a proprietary web portal, VPro.[190] The portal was managed and serviced by VFA's parent company, Voya, which handled

promulgated the rule (jointly issued with the CFTC) to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which amended section 615(e) of the Fair Credit Reporting Act, 15 U.S.C. § 1681, to add the SEC and CFTC to the list of entities required to promulgate rules to require financial institutions and creditors to implement identity theft protection programs. *See id.*

186. The rule defines "identity theft" as a fraud committed or attempted using the identifying information of another person without authority. 17 C.F.R. § 248.201(b)(9) (2021).

187. The rule defines a "covered account" to include an account that a broker-dealer or investment adviser offers or maintains, primarily for personal, family, or household purposes, that involves or is designed to permit multiple payments or transactions, such as a brokerage account with a broker-dealer. 17 C.F.R. § 248.201(b)(3) (2021).

188. Voya Financial Advisors, Inc., SEC. EXCH. COMM'N, REL. NOS. 34-84288, IA-5048, at 3-4 (Sept. 26, 2018).

189. *See id.*

190. *See id.* at 2.

VFA's cybersecurity functions, serviced support call centers, and responded to VFA's contractor representatives for assistance on VPro.[191]

The SEC found that during three days in April 2016, one or more persons impersonating VFA contractor representatives called the IT support team to reset their passwords, providing PII for the representatives; thereafter the callers were able to access to VPro and, thereby, gained access to the PII for approximately 5,600 customers.[192] The SEC found that VFA violated the Identity Theft Red Flags Rule by not updating its Identity Theft Prevention Program since 2009, by failing to conduct adequate identity theft training, and by failing to ensure that the Identity Theft Prevention Program included reasonable procedures designed to respond to and prevent red flags.[193]

In December 2020, FINRA charged a firm for Regulation S-ID Rule 201 violations in connection with security breaches. FINRA censured and fined Supreme Alliance $65,000 for failing to take action when the emails of its CEO (who was also the firm's chief compliance officer) was hacked.[194] The firm's CEO started receiving hundreds of notifications in his firm email account that his emails could not be delivered to certain external addresses, but he ignored the messages for four months.[195] When the CEO finally forwarded one of the notifications to the firm's outside email vendor, the vendor notified him that his email was likely compromised.[196] Despite learning this, the firm failed to implement any of the procedures of its written policies, or mitigate the risk of identity theft.[197] The AWC explained that at least 200 of the 17,000 emails

191. *See id.* at 4-5.

192. *See id.* at 7-8.

193. *See id.* at 7. During the relevant period, VFA had detected red flags prior to and after the April 2016 intrusion but did not reasonably respond to the red flags by changing security codes, or implementing other procedures to deny unauthorized persons access to VFA customer accounts. *See id.* The SEC also charged VFA with violations of the Safeguard Rule, Regulation S-P, Rule 30, because its policies and procedures were not reasonably designed to prevent and respond to cybersecurity risks. *See id.* at 3, 10.

194. *See* Letter of Acceptance, Waiver, and Consent, FINRA Dep't of Enforcement v. Supreme Alliance LLC, Docket No. 2019062898302 (Dec. 18, 2020).

195. *See id.* at 3.

196. *See id.*

197. *See id.*

blind copied to an external source contained customer PII.[198] FINRA found that Supreme Alliance did not have a program to address the identification and detection of red flags, or provide its registered representatives with any guidance in the event an identity theft had occurred; instead, the firm had written "generic policies and procedures not tailored to the firm's actual business model."[199] As a result, the firm violated Rule 201 of Regulation S-ID.[200]

(iii) Protecting Customer Funds

FINRA has long stressed the importance of implementing written policies and procedures governing the withdrawal and transmittal of customer funds and assets. In 2009, FINRA reminded firms to have written policies and procedures reasonably designed to review and monitor all instructions to transmit or withdraw assets from customer accounts.[201]

Concerns over the rising number of incidents of customer funds stolen as a result of compromised emails and fraudulent email instructions mailed to firms prompted FINRA to issue Regulatory Notice 12-05.[202] FINRA explained that a firm's supervisory control system must include policies and procedures reasonably designed to review and monitor the transmittal of funds or securities from customer accounts to third-party accounts (resulting in a change of beneficial ownership), to outside entities, to locations other than the customer's primary residence, and between customer accounts and registered

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198. *See id.*

199. *Id.* at 2.

200. *See id.* at 3. By virtue of its violation of Regulation S-ID, the firm also violated FINRA Rule 2010. *Id.*

201. *See* FINRA, REGUL. NOTICE 09-64, CUSTOMER ASSETS, VERIFICATION OF INSTRUCTIONS TO TRANSMIT OR WITHDRAW ASSETS FROM CUSTOMER ACCOUNTS (Nov. 2009), https://www.finra.org/sites/default/files/NoticeDocument/p120372.pdf. The notice also highlighted questions for firms to consider in evaluating its policies and procedures for the transmittal of funds or securities.

202. *See* FINRA, REGUL. NOTICE 12-05, CUSTOMER ACCOUNT PROTECTION, VERIFICATION OF EMAILED INSTRUCTIONS TO TRANSMIT OR WITHDRAW ASSETS FROM CUSTOMER ACCOUNTS (Jan. 2012), https://www.finra.org/rules-guidance/notices/12-05.

representatives.[203] The procedures must consider the specific risks associated with each method the firm allows for transmittal.[204] When firms accept email or other electronic wire or transfer instructions, their policies and procedures should include a method for verifying that the email or instructions were in fact sent by the customer, and they should train their employees to follow these procedures.[205]

In December 2020, FINRA charged Lincoln Investment with supervisory failures in connection with its transmittal of customer funds to malicious actors, arising from the failure of the firm to implement policies and procedures to identify and respond to "red flags" or suspicious activity.[206] First, the firm received multiple phone calls from a woman impersonating a customer and requesting transfers of funds to a bank account that was not previously associated with the customer.[207] The firm transferred funds from the customer's account despite numerous red flags, including the imposter's failure to answer security questions correctly.[208] Additionally, the firm failed to follow its own written policy concerning third-party transfer requests, transferring $30,000 to a third-party after an associated person received an email from a customer's email account which had been compromised.[209] FINRA charged Lincoln with violations of Rule 3110(a) for its failure to establish, maintain and enforce policies and procedures to safeguard customer

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203. *See id.* at 2.

204. *See id.*

205. *See id.* at 2-3. Moreover, the obligation to have supervisory procedures for the reviewing and monitoring of customer assets applies both to clearing and introducing firms, and while Rule 4311(c) permits firms to allocate responsibility for the performance of certain functions between the clearing and introducing firms when accounts are carried on a fully disclosed basis, the rule "expressly requires that the carrying firm be allocated the responsibility for the safeguarding of customer funds and securities." *Id.* at 3. For example, the introducing firm may have the responsibility to verify the customer's identity and that the instructions came from the customer and, therefore, have policies and procedures to ensure it carries out this function, but the clearing firm must still have adequate policies and procedures to review and monitor all disbursements it makes from the customer's account. *See id.*

206. *See* Letter of Acceptance, Waiver, and Consent, FINRA Dep't of Enforcement v. Lincoln Financial, Docket No. 2018056408401 (Dec. 10, 2020).

207. *See id.* at 2-3.

208. *See id.*

209. *See id.* at 4.

assets, which "includes the responsibility to identify and respond to red flags," censured the firm and imposed a $35,000 penalty.[210]

(iv) Increasing Cybersecurity Concerns in the Age of COVID-19

The COVID-19 pandemic profoundly affected many aspects of society and our daily lives, leading to millions of Americans working (and studying) from home, relying on technology to remotely access workplaces, classrooms, and other sites. The increased reliance on technology, combined with billions of stimulus checks sent to Americans, created new opportunities for financial fraud, prompting regulators to issue alerts about COVID-19 pandemic scams targeting consumers and investors.[211] According to one study, "[c]ybersecurity was the top near-term concern for independent broker-dealers" working from home or remote offices.[212]

FINRA has also issued several notices alerting members to the increased risk of fraudulent activity and the challenges for firms in safekeeping customer information and assets. On the heels of nationwide stay at home orders, FINRA reminded firms about their obligations under FINRA Rule 4370 and to consider pandemic-related business continuity plans,[213] and alerted them about

210. *Id.* at 2, 4. The AWC referenced FINRA Regulatory Notice 09-64 (Nov. 2009), which reminded members of their supervisory obligations to safeguard customer assets, which includes having policies and procedures governing the withdrawal or transmittal of funds or assets from customer accounts. *See id*. at 2.

211. *See Look Out for Coronavirus-Related Investment Scams*, SEC. EXCH. COMM'N (Feb. 4, 2020), https://www.investor.gov/introduction-investing/general-resources /news-alerts/alerts-bulletins/investor-alerts/look-out; *Fraud and Coronavirus (COVID-19)*, FINRA (Mar. 26, 2020), https://www.finra.org/investors/insights /fraud-and-coronavirus-covid-19.

212. Bruce Kelly, *Broker-dealers Brace for Cyberthreats*, INVESTMENTNEWS (Jan. 18, 2021), https://www.investmentnews.com/broke-dealers-brace-for-cyberthreats-201403.

213. *See* FINRA, REGUL. NOTICE 20-08, PANDEMIC-RELATED BUSINESS CONTINUITY PLANNING, GUIDANCE AND REGULATORY RELIEF (Mar. 9, 2020), https://www.finra.org/rules-guidance/notices/20-08. FINRA's 2021 Report explained that any cybersecurity breach that interrupts member operations or results in denials of service to customers also implicates Rule 4370 (Business Continuity Plans and Emergency Contact Information). *See* 2021 FINRA Report, *supra* note 16 at 8. Rule 4370 requires member firms to create and maintain a written business continuity plan identifying procedures relating to an emergency or significant business disruption,

addressing the increased vulnerability to cyberattacks and taking additional steps to protect customer information from being compromised on networks and mobile devices.[214]

In Regulatory Notice 20-08, which focused on providing firms with pandemic-related business continuity planning guidance, FINRA specifically addressed cybersecurity and advised firms to consider the increased risk of cyber events due to use of remote offices or telework.[215] FINRA stressed the importance that firms "remain vigilant in their surveillance against cyber threats and take steps to reduce the risk of cyber events."[216]

FINRA Regulatory Notice 20-13 outlined four common scams to which firms and their customers may be exposed during the COVID-19 pandemic.[217] First, FINRA observed the increase in new customer accounts and warned firms of an increase in fraudulent account openings and money transfers using synthetic or stolen customer identities, pointing firms to the importance of Customer Identification Programs, monitoring for fraud during the account opening process, and verifying transfers in selected circumstances – essentially the very same best practices FINRA has identified for a robust AML program.[218] Second, FINRA noted the increase of firm imposter scams, where fraudsters impersonate firms or associated persons in either communicating with customers or creating a fake online presence or website,

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and update the plan in the event of any material change to the member's operations, structure, business or location. Rule 4370(a), (b). Although member firms have flexibility to design their business continuity plan, the plan must address the following elements relevant to cybersecurity risks: (1) data back-up and recovery (hard copy and electronic); (2) all mission critical systems; (3) financial and operational assessments; (4) alternative communications between customers and the member; (5) alternative communications between the member and its employees; (6) alternate physical location of employees; and (7) how the member will assure "customers' prompt access to their funds and securities in the event the member determines it is unable to continue its business." Rule 4370(c).

214. *See Cybersecurity Alert: Measures to Consider as Firms Respond to the Coronavirus Pandemic (COVID-19)*, FINRA (Mar. 26, 2020), https://www.finra.org/rules-guidance/notices/information-notice-032620.

215. *See* FINRA, REGUL. NOTICE 20-08, *supra* note 213.

216. *Id.*

217. *See* FINRA, REGUL. NOTICE 20-13, *supra* note 44.

218. *See id.* at 2-4; *see also* FINRA, REGUL. NOTICE 19-18, *supra* note 41.

and provided guidance on how firms could mitigate those risks.[219] Third, the notice explained that the use of remote working arrangements increased opportunities for IT Help Desk scams, where fraudster pose as associated persons, and contact the firm's IT Help Desk staff for a password reset, thereby giving the fraudster access to the firm's network, confidential information and customer assets.[220] The fourth common scam the notice identified was email compromise schemes, where fraudsters taking advantage of remote working arrangements send an email posing as firm leadership or manager to request funds or a transfer.[221]

In 2021, FINRA issued Regulatory Notice 21-18, stating that it had received an increasing number of reports regarding online customer account takeovers, involving bad actors using compromised customer information (i.e., username and password), to gain unauthorized access to customers' online brokerage accounts.[222] In order to assist firms in identifying, preventing and responding to such attacks, FINRA hosted a roundtable discussion with representatives of 20 member firms of various sizes and business models to discuss approaches to mitigating account takeover risks.[223] The notice identified the relevant regulatory obligations to protect customer information and assets, listed common challenges to protecting customer accounts, and

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219. *See* FINRA, REGUL. NOTICE 20-13, *supra* note 44 at 5. FINRA specifically referred to its earlier Information Notice, *Imposter Websites Impacting Member Firms* (Apr. 29, 2019), which warned member firms about "imposter websites," where a malicious actor uses the names and/or photos of registered representatives to establish websites that look like the representatives' personal sites, and then directs the customers to enter personal information. *Id.* Several months after issuing Regulatory Notice 20-13, FINRA issued another notice warning firms and associated persons about imposter websites. *See* FINRA, REGUL. NOTICE 20-30, FRAUDSTERS USING REGISTERED REPRESENTATIVES NAMES TO ESTABLISH IMPOSTER WEBSITES (Aug. 20, 2020), https://www.finra.org/rules-guidance/notices/20-30. FINRA explained that firms could take steps to identify these pages by periodically searching the web for the names of its registered representatives or create alerts that automatically search for defined terms. *See id.* at 2.

220. *See* FINRA, REGUL. NOTICE 20-13, *supra* note 44 at 6. Another variant of the scheme is a fraudster posing as an IT Help Desk staffer who contacts the associated person to harvest his or her credentials or introduce malware. *See id.*

221. *See id.* at 7.

222. *See* FINRA, REGUL. NOTICE 21-18, CYBERSECURITY (May 12, 2021), https://www.finra.org/rules-guidance/notices/21-18.

223. *See id.* at 1.

provided a list of best practices and approaches to authenticating customer identities, monitoring accounts, implementing automated threat detection, and procedures to respond to potential or reported account takeovers.[224]

II. CONCLUSION

Technology has evolved the way investors interact with brokerage firms. These changes raise challenges for firms determining how to comply with the existing regulations in light of their new business models. However, the challenges firms face today mirror those in the early stages of online trading. While some things have changed, some have not.

Online platforms and mobile trading apps have increased the ability of investors to access the markets. Although the changes to technology have led more investors to be self-directed, they are still entitled to the protections of FINRA and SEC rules. Firms must still comply with the rules governing opening and approving accounts. Firms must confirm customer identies, even though they are only dealing with the investor virtually. Firms must comply with the communications rules, ensuring all communications are fair and balanced. And finally, firms must safeguard customer information, funds, and securities.

224. *See id.* at 4-7.

Notes & Observations

RILING UP AS RECOMMENDATION: HOW COMMISSION-FREE BROKERAGES RECOMMEND ACTIVE INVESTING TO THE PUBLIC

Travis Studdard[*]

ABSTRACT

Financial technology now rapidly changes the way retail investors interact with securities markets. Brokerages who once executed trades via pneumatic tubes for a fee now offer commission-free trades that can be completed at a finger tap from any smart phone. Robinhood and similar brokerages have removed barriers and expanded access to markets by offering commission-free trading. Commission-free trades drive profits because of payment for order flow, a practice where brokerages route customers' orders to market makers in exchange for a payment. This business model thrives on frequent trading – a practice known to be financially hazardous to inexperienced retail investors.

To increase customer trading, commission-free brokerages have focused less on financial innovation and more on behavioral manipulation. By presenting less information, Robinhood makes its application ("app") more attractive to investors who feel alienated by other, more-established brokerages. Investors already face their own internal biases that prevent them from making consistently rational investment decisions. Commission-free brokerages amplify this danger through gamification, a strategy that has regulators increasingly concerned, and biased "education" aimed at riling up customers and conditioning them to actively trade.

Unfortunately, the laws designed to protect investors have not kept pace with the technology. Before smart phones and apps, brokers had to speak with their customers on the phone or in person. Today, Robinhood and other commission-free brokerages remain in constant contact with their users through emoji-filled push notifications. This article demonstrates that retail investors need greater protection because the landscape surrounding how brokerages communicate with their customers has changed. In particular, regulators need to adopt a broader, more functional lens for the law to ensure that their definition of recommendation encompasses the kinds of stimuli brokerage firms use to induce ordinary humans to execute trades with

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increasing frequency. Brokerages now act as though they bear no responsibility for the consequences of their acts because the law has not yet recognized these innocuous communications as recommendations which push psychologically vulnerable customers toward risky investment decisions.

I. INTRODUCTION

In June 2020, Alex Kearns took his own life to spare his family from financial ruin. He had been using Robinhood for almost two years, but only recently ventured into options trading. Shortly before Alex's suicide, the company demanded he deposit nearly two-hundred thousand dollars to meet a margin call. He had never enabled margin. Despite this, Robinhood told him he owed three quarters of a million dollars. His three emails to the company pleading for them to investigate went without reply.[1] Alex typed a suicide note, saved a screenshot of his account balance, and threw himself in front of an oncoming train.[2]

Kearns was a twenty-year-old business student and ROTC cadet at the University of Nebraska. His life had been upended by the COVID-19 pandemic. He was living at his parents' home. Alex exemplifies the typical Robinhood user: young, curious, and inexperienced with securities trading.[3] The app appeals to this group with simplistic design, inviting graphics, and offers of free stock.[4] This false simplicity may have led to Alex's death. The screen showing Alex's negative cash balance was only half of an incomplete trade – lacking critical details.[5] After Alex died the company emailed him

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1. *See* Tony Dokoupil, *et al., Alex Kearns died thinking he owed hundreds of thousands for stock market losses on Robinhood. His parents have sued over his suicide.*, CBS News (Feb. 8, 2021), https://www.cbsnews.com/news/alex-kearns-robinhood-trader-suicide-wrongful-death-suit/ (discussing how Alex Kearns only received an automated reply assigning him a case number and a warning that the company's response time may be delayed) (last visited Mar. 8, 2022).

2. Hannah Levintova, *Robinhood Promises Free Trades. Did Alex Kearns Pay With His Life?*, MOTHER JONES (April 29, 2021), https://www.motherjones.com/politics /2021/04/robinhood-gamestop-free-trades-alex-kearns/ (last visited July 29, 2021).

3. *See* Dokoupil, *et al.*, *supra* note 1 (Alex's suicide note read in part "I also have no clue what I was doing now in hindsight.").

4. CNBC, *How Robinhood Captures Beginner Investors*, YouTube, (Oct. 7, 2020), https://www.youtube.com/watch?v=fjNtrraxLII&t=419s (last visited Mar. 8, 2022).

5. Levintova, *supra* note 2.

stating that he did not owe any money because his positions were covered. [6] If Robinhood had presented information differently, he might be alive today.

Robinhood and other commission-free brokerages have successfully tapped into a new and robust market. They attract young investors by portraying securities trading as a fun, riskless game with frictionless design and lofty mission statements.[7] Through biased and one-sided "education," they guide users toward frequent, aggressive and overconfident trading.

Retail traders likely suffer from the aggressive trading strategies many commission-free brokerages encourage. Yet much of their profitability depends upon driving retail trading – communications that rile up a user base getting them to tap, tap, tap their way to transactions. The Securities and Exchange Commission (SEC)[8] and Congress[9] have both called for closer examination of these practices.

The existing regulatory regime overlooks the behavioral and psychological impacts of strategies relied upon by commission-free brokerages.[10] Robinhood and others like it use gamification and biased education to rile up investors inducing more active trading instead of making traditional recommendations. They avoid responsibility because the law does not yet clearly recognize these strategies as recommendations though they have the same effect. They remain in the law's (and often arbitrators') blind spot. To take a more realistic approach, regulators need to reconsider what qualifies as a recommendation and adopt a broader, more functional lens that includes the tactics and stimuli used to induce trading.

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6. *See* Dokoupil, *et al*., *supra* note 1.

7. *See About Us*, ROBINHOOD.COM, https://robinhood.com/us/en/about-us/ (the company's mission is to "democratize finance for all.") (last visited Mar. 8, 2022).

8. Staff of the U.S. Securities and Exchange Commission (SEC), *Request for Information and Comments on Broker-Dealer and Investment Adviser Digital Engagement Practices, Related Tools and Methods, and Regulatory Considerations and Potential Approaches; Information and Comments on Investment Adviser Use of Technology To Develop and Provide Investment Advice*, 86 Fed. Reg. 49067 (Sept. 1, 2021) ("Request for Information").

9. Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide: Virtual Hearing Before the House Committee on Financial Services, 117 Cong. 10 (Feb. 18, 2021).

10. Sarah O'Brien, *SEC adopts rule to protect ordinary investors, but critics say it's too lax*, CNBC, (June 5, 2019), https://www.cnbc.com/2019/06/05/sec-adopts-rule-to-protect-ordinary-investors-critics-say-its-too-lax.html (last visited Mar. 8, 2022).

Robinhood and other commission-free brokerages dodge responsibility for their questionable practices because they avoid making what are considered "recommendations" to "reasonable" investors under the current law. Yet they put considerable effort into dubious "education" that pushes trading strategies that are not in the best interest of their customers. The abstract conception of how a reasonable investor acts may not hold up in light of reliable evidence about what actual humans do. If Robinhood researches what induces its customers to trade frequently, it is hard to say that they are not recommendations given that these prompts and similar stimuli are effective at inducing a desired behavior.

Due to forced arbitration clauses, courts lack opportunities to create binding precedent treating these tactics as de facto recommendations.[11] Arbitrators need to recognize that conditioning retail investors in this fashion should be deemed a recommendation for liability purposes. If arbitrators are unwilling to recognize these practices for what they are, a change in the law is urgently needed.

Section II describes Regulation Best Interest and how the law became what it is today. It also highlights how the law fails to protect investors by leaving terms such as "recommendation" and "best interest" undefined. Section III introduces biases and heuristics that impact both retail investors and financial professionals. The Section asserts that these factors already put rational financial decision-making at risk even without outside influence. Section IV describes various ways commission-free brokerages push customers toward active investing without triggering Regulation Best Interest. Section V concludes by summarizing the issues facing investors and advocating for increased investor protection through improvements in Regulation Best Interest.

II. REGULATION BEST INTEREST

Regulation Best Interest is the current standard that applies to brokerages "when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer."[12] The Rule bars brokerages from placing their own interests "ahead…of the retail customer."[13] Brokerages

11. Benjamin P. Edwards, *Arbitration's Dark Shadow*, 18 NEV. L.J. 427, (2018). Available at: https://scholars.law.unlv.edu/nlj/vol18/iss2/4.

12. Regulation Best Interest, 17 C.F.R. § 240.15l-1 (2019).

13. *Id.*

must also have a "reasonable basis to believe that the recommendation is in the [customer's] best interest."[14] The Rule does not require brokerages to put customers first. Instead, it leaves "best interest" undefined allowing brokerages to argue a harmful recommendation was reasonable and within the Rule's ambiguous boundaries.

The securities laws were written for a different era when brokers would merely execute trades. Today, brokerages use well-known behavioral techniques to drive and influence trading activity. These techniques have the same effect as making recommendations, but brokerages evade responsibility for the economic consequences to their customers. If legal accountability for conditioning a retail customer to actively trade only occurs when a recommendation is made, then brokerages can use all sorts of tactics to drive that activity while dodging responsibility for the negative consequences impacting investors.

This part introduces Regulation Best Interest in greater detail. Below, section II.A. describes the legal gaps Regulation Best Interest was designed to address. Section II.B. describes how the new standard of care allows brokerages to benefit at the expense of their customers. Section II.C. argues Regulation Best Interest's threshold inquiry (i.e., Did the broker make a recommendation?) is insufficient in light of practices common across commission-free brokerages.

A. A Call for Harmony

Most new investors enlist the services of either registered investment advisers (RIAs) or broker-dealers (brokerages). However, many inexperienced retail investors do not understand the difference between the two.[15] Because they provide largely the same services, many investors incorrectly assume both RIAs and brokerages are obligated to act in the retail investor's best interest.[16]

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14. *Id.*

15. *See* SEC, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT, at v (Jan. 2011) (hereinafter, the "SEC 913 Study").

16. *See id.* ("Many expect that both investment advisers and broker-dealers are obligated to act in the investors' best interests.").

The divergent standards have been a significant source of confusion for retail investors.[17]

The difference has especially been evident when either financial professional made a recommendation for a transaction or strategy. RIAs are fiduciaries for their customers and must abide by the duties of loyalty and care.[18] In contrast, brokerages were held to a less stringent standard. They could provide securities recommendations so long as they had "a reasonable basis to believe" that the recommendation was "suitable" to their customers' individual investment profiles.[19] Retail investors were afforded less protection if they received the communication from a brokerage as opposed to an RIA. Regulators and industry participants called for harmonizing the standard for brokerages and RIAs.[20]

The Suitability Rule and the Know Your Customer Rule[21] required brokerages to have a reasonable basis for recommending a transaction or investment strategy.[22] This was a less rigorous standard compared to an RIA's fiduciary responsibilities. Further, retail investors were unaware that the standard of care differed depending on who the recommendation came from. Regulation Best Interest was intended not only to offer retail investors greater protection but to align law with customer expectations. Unfortunately, the Regulation seemingly just imposes the same standard of care as the Suitability Rule using different language and falls short of ensuring brokerages do not escape liability if they take advantage of their customers. [23]

17. *See id.* at viii (discussing that "harmonization of regulation…would offer several advantages, including that it would provide retail investors the same or substantially similar services from investment advisers and broker-dealers.").

18. *See id.* at iii (describing the fiduciary standard RIAs are held to).

19. FINRA Rule 2111. Available at https://www.finra.org/rules-guidance/rulebooks/finra-rules/2111.

20. SEC 913 Study, *supra* note 15, at v-vi.

21. FINRA Rule 2090.

22. FINRA Office of General Counsel, *Suitability*, Rules & Guidance. Available at https://www.finra.org/rules-guidance/key-topics/suitability#overview (last visited March 8, 2022).

23. *See* SEC Commissioner Kara M. Stein, *Statement on Proposals Relating to Regulation Best Interest, Form CRS, Restrictions on the Use of Certain Names or Titles, and Commission Interpretation Regarding the Standard of Conduct for Investment Advisers*, Public Statement (April 18, 2018), https://www.sec.gov/news/public-statement/stein-statement-open-meeting-041818 ("[T]he lack of a definition of best interest, the use of similar terms to mean different things, the use of different

In practice, customers receive different advice from brokers and RIAs. A survey of the pre-Regulation Best Interest landscape found that brokerages offered more diverse and complex products that entailed higher commissions.[24] Under Regulation Best Interest, brokerages can continue to offer investments that generate third-party compensation, but investors are less likely to encounter them with RIAs.[25]

B. Permitting Questionable Practices

Despite the recommendation for harmonizing the standard of care, the SEC adopted Regulation Best Interest in June 2019.[26] Though the Regulation is "not intend[ed] to create a 'lower' or 'weaker' standard compared to" the SEC's recommendations, its nebulous language barely increased the standard of care above the prior Suitability Rule. [27]

Though Regulation Best Interest's care obligation has been described as "FINRA's Suitability Rule on steroids"[28] it falls short of a fiduciary standard. Regulation Best Interest simply leaves room for too many conflicts of interests.[29] It's "[s]pecific disclosure and additional mitigation requirements" were meant to address those conflicts. However, documents describing a

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terms to mean the same things, and the possibility that the SEC and FINRA interpret the same language in their suitability standards differently. All of these concerns would make it difficult for the industry to discern a clear compliance path.") (last visited Aug. 17, 2021).

24. *See* NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION (NASAA), *Regulation Best Interest: National Examination Initiative Phase One* at 3 (September 2020), https://www.nasaa.org/wp-content/uploads/2020/09/Reg-BI-Phase-1-Report.pdf (last visited September 2, 2021).

25. *Id.* at 7.

26. SEC, Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33318 (July 12, 2019) (hereinafter, the "Final Rule").

27. *See id.* at 33331.

28. FINRA, *Regulation Best Interest: Implementing a New Standard of Conduct*, FINRA UNSCRIPTED PODCAST (July 7, 2020), https://www.finra.org/media-center/finra-unscripted/reg-best-interest-implementation (last visited Mar. 8, 2022).

29. Final Rule, *supra* note 26 at 33332.

brokerage's obligations may be useful to some, but many investors "do not read long formulaic documents" so their utility in practice is questionable.[30]

With its largely rhetorical protections, Regulation Best Interest allows the brokerage to consider its own interests when making a recommendation to a customer.[31] For example, brokers are allowed to recommend products and strategies that result in greater compensation to themselves even though it may be financially risky for the investor. But if the recommendation remains consistent with the customer's investment profile, the broker would not run afoul of Regulation Best Interest.[32] Moreover, Regulation Best Interest allows brokerages to exclusively offer funds that pay kickbacks to the firm.[33] The brokerage could recommend any fund so long as its interest is not placed "ahead" of his customer's interest.[34] The tolerance of such practices undercuts the claim that Regulation Best Interest is a meaningfully heightened standard compared to the prior Suitability obligation.

Despite a legal challenge, the Regulation was upheld and persists as the current federal standard that applies when a broker makes a recommendation to a retail investor.[35] Many states believe retail investors deserve greater protection and crafted rules imposing a higher standard. For example, Massachusetts imposed a fiduciary obligation on brokers when they provide

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30. SEC, Comments on Proposed Rule: Regulation Best Interest, Release No. 34-83062, File No. S7-07-18 (William F. Galvin - Secretary of the Commonwealth of Massachusetts, Comment Letter) at 5, (Aug. 7, 2018).

31. Benjamin P. Edwards, *SEC rule merely pays lip service to investor protection*, THE HILL (June 18, 2019), https://thehill.com/opinion/finance/449094-sec-rule-merely-pays-lip-service-to-investor-protection (last visited July 23, 2021).

32. *See* Final Rule, *supra* note 26 at 33334 ("Regulation Best Interest will not necessarily obligate a broker-dealer to recommend the 'least expensive' or the 'least remunerative' security or investment strategy, provided the broker-dealer complies with the specific component obligations. In other words, Regulation Best Interest will allow a broker-dealer to recommend products that entail higher costs or risks for the retail customer, or that result in greater compensation to the broker-dealer, or that are more expensive, than other products provided that the broker-dealer…does not place the broker-dealer's interest ahead of the retail customer's interest.").

33. Edwards, *SEC rule merely pays lip service to investor protection*, *supra* note 31.

34. *See id.* ("[Regulation Best Interest] also allows firms to set the menu of options their brokers can recommend to clients, meaning the best funds that pay the least in kickbacks might not be available…The new rules don't require brokerage firms to give investors the best options available.").

35. *XY Planning Network, LLC v. SEC*, 963 F.3d 244, 253 (2d Cir. 2020).

investment advice or recommend a strategy.[36] This new Rule was the basis for the Commonwealth's lawsuit against Robinhood.[37] Similarly, Nevada explicitly imposes a fiduciary duty on brokerages when they provide advice to their customers and must disclose if the brokerage stands to gain "if the advice is followed."[38] Without a strong federal standard, victims of conflicted advice must look within their own states' laws for protection and recourse.

C. Recommendation Remains Undefined

Regulation Best Interest applies when a brokerage makes "a recommendation of any securities transaction or investment strategy involving securities…to a retail customer."[39] However, the Regulation does not define "recommendation." Instead, it interprets whether a recommendation has been made through the lens of "precedent under the anti-fraud provisions of the federal securities laws…and how the term has been applied under the rules of self-regulatory organizations (such as FINRA)."[40] As a result, Regulation Best Interest's application depends upon the interpretation of the prior Suitability Standard. This constricts the Regulation's application leaving retail investors vulnerable to conflicts of interest and biased "education" operating as a mass recommendation – an increasingly prevalent technique commission-free brokerages use.

Regulation Best Interest and the SEC's interpretative guidance do not provide a bright line definition of recommendation. Instead, the surrounding facts and circumstances determine whether a recommendation has been made.[41] The Rule asks whether a person would reasonably interpret a communication as a "call to action" or be "reasonably influenced to make a

36. 950 Mass. Code Regs. 12.207(1)(a) (2020).

37. *In the Matter of: Robinhood Financial, LLC*, *Respondent*, 2020 WL 7711667, Mass. Sec. Div. No. E-2020-0047 (Dec. 16, 2020).

38. Nev. Rev. Stat. § 628A.020.

39. Regulation Best Interest, *supra* note 12.

40. SEC, *Regulation Best Interest: A Small Entity Compliance Guide*, (September 2019), https://www.sec.gov/info/smallbus/secg/regulation-best-interest (last accessed August 17, 2021).

41. *See* Final Rule, *supra* note 26 at 33335.

securities transaction."[42] It is unclear if this inquiry is based on some abstract reasonable person or on evidence about what causes actual humans to act. For example, a recommendation can easily be found where a broker hands a retail investor a list of "popular" stocks to a customer in-person after he tells his broker that he is having difficulty picking stocks.[43] However, the digital version of this interaction seems to have escaped the Rule's scope.

Consider retail investor behavior across platforms. Robinhood customers "traded nine times as many shares as E-Trade customers, and 40 times as many shares as Charles Schwab customers" in the first quarter of 2020.[44] Though this may be due to differences in customer-base, the disparity in trading behavior is also a result of conditioning customers to trade more through veiled recommendations. In a lawsuit challenging Robinhood, Massachusetts stressed its concern with inexperienced Robinhood customers engaging in an "astronomically higher" volume of transactions than retail investors have historically executed.[45]

Unfortunately, the literature is sparse on what facts and circumstances are necessary to determine if a broker's communication approaches a "recommendation." Case law provides no guidance because most claimants

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42. *Id.*

43. *See In the Matter of: Robinhood Financial, supra* note 37 at 5 ("In an effort to encourage trading, Robinhood provides lists of securities on its application, including lists of the most-traded securities on Robinhood's platform and the most popular securities traded by Robinhood customers. This is no different from a broker-dealer agent handing a list of securities to a customer, pretending to be surprised when the customer purchases securities from that list, and then proclaiming that he made no recommendations to the customer.").

44. Nathaniel Popper, *Robinhood Has Lured Young Traders, Sometimes With Devastating Results*, THE NEW YORK TIMES (July 21, 2021). Available at https://www.nytimes.com/2020/07/08/technology/robinhood-risky-trading.html (last visited Aug. 17, 2021).

45. See Defendants' Opposition Memorandum to the Plaintiff's Motion for Preliminary Injunctive Relief, *Robinhood Financial v. Galvin*, Civil Action No. 2184-CV-00884-BLS (May 10, 2021). Available at https://www.masscourts.org/eservices/search.page.3?x=OWxSoK9l0j0xQ3Ar*dLG8NbPCYo0lMb4t1lMmfgHt8auP6Hex0vgfqBaVPJtlWJxUQkEfkQwmkkRr8E-vtGLgpBP6K4fVmZatR75C65DumXZIZN5iyDlMQ2Zh8eE2vda58aECDHXC*OQrPTkUElyysGq496D0FLvTZW1zXs8kfs.

are bound by arbitration clauses[46] forcing them into the shadowy arena of FINRA arbitration which notoriously lacks detailed information about claims and resolution reasoning in award decisions.[47]

Moreover, many arbitration claims against commission-free brokerages are brought by pro se litigants who lack the legal acumen necessary to test viable liability theories.[48] Notwithstanding litigants' absence of legal representation, different arbitrators facing the question of whether a communication was a recommendation will reach different conclusions depending upon what facts and circumstances they deem controlling. One arbitration panel may find a recommendation while another would reach an entirely different conclusion based on the same facts.

Though FINRA has never provided an exact definition of "recommendation" it emphasizes that the inquiry is objective and "based on the facts and circumstances of a particular case."[49] The likelihood a communication would be viewed as a recommendation increases proportionally to its personalization.[50] For example, "general financial and investment information," is excluded from the definition of "recommendation."[51] But if the communication is tailored to an individual or a targeted group of individuals, it is more likely the communication is a recommendation. FINRA is considering publishing a "Regulatory Notice"

46. *See* Robinhood Financial LLC & Robinhood Securities, LLC, Customer Agreement, Page 29 at #38 (describing the agreement's pre-dispute arbitration clause) (Revised June 22, 2020).

47. Edwards, *Arbitration's Dark Shadow*, *supra* note 11.

48. As of September 6, 2021, eleven (11) arbitration awards involving Robinhood Financial are available on FINRA's website; all but one resulted in a judgment in Robinhood's favor. FINRA, Search Results, *Arbitration Awards Online*, FINRA.ORG, https://www.finra.org/arbitration-mediation/arbitration-awards-online?aao_radios=all&field_case_id_text=&search=robinhood&field_forum_tax=All&field_special_case_type_tax=All&field_core_official_dt%5Bmin%5D=&field_core_official_dt%5Bmax%5D=.

49. *See* FINRA, *SEC Approves Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations*, Regulatory Notice 11-02, at 2 (October 7, 2011) ("[A] communication's content, context and presentation are important aspects of the inquiry.").

50. *See id.* ("[T]he more individually tailored the communication is to a particular customer or customers about a specific security or investment strategy, the more likely the communication will be viewed as a recommendation.").

51. *See* FINRA Rule 2111, *supra* note 19.

requesting information on new tactics brokerages employ that may eventually reshape its interpretation.[52]

It remains unclear when brokerages must abide by Regulation Best Interest because its threshold inquiry: "Has a recommendation been made?" is open to subjective interpretation. But biased education, gamification and behavioral prompts should not continue to escape regulatory scrutiny considering their objective effectiveness. These methods are not considered recommendations under the Regulation, yet they have the same effect: they push the customer toward specific investing habits.

Commission-free brokerages rely on users' active investing habits to generate revenue from payment for order flow.[53] The more a customer actively trades, the more payment the brokerage receives. Consider Robinhood which derived 75% of its 2020 revenues from these payments.[54] The payment replaces transaction fees it would otherwise charge and the zero-transaction cost to the customer obscures the conflict created by this business-model.

Commission-free trades may seem beneficial to customers, but they create the illusion of a riskless playground leading customers to treat investing more like a game and less like a tool to build wealth. Less trading friction allows investors to trade more actively which increases revenue for the brokerage but is financially risky for investors.[55]

Regulation Best Interest requires brokerages to disclose if they earn revenue from payment for order flow. This does little to protect investors from a business-model that not only thrives on but encourages customers to make

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52. *See* Virtual Hearing before the House Committee on Financial Services, *Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide Part III*, 117 Cong., U.S. House Committee on Financial Services, 117th Cong. (May 6, 2021) (Statement of Robert W. Cook, President and Chief Executive Officer, FINRA), https://www.finra.org/media-center/speeches-testimony/statement-financial-services-committee-us-house-representatives (last visited Mar. 8, 2022).

53. *See* 17 C.F.R. § 240.10b-10 (defining payment for order flow as "any monetary payment, service, property, or other benefit that results in renumeration, compensation, or consideration to a broker-dealer in return for the routing of customer orders.").

54. Robinhood Markets, Inc., Registration Statement, SEC (Form S-1) (July 1, 2021).

55. Brad M. Barber & Terrance Odean, *Online Investors: Do the Slow Die First?*, 15 REV. FIN. STUD. 455 (2002).

irrational investment decisions. [56] Most retail investors will not benefit from frequent trading, but commission-free brokerages continue to make a concerted effort to encourage aggressive strategies.

III. MISPLACED ASSUMPTIONS ABOUT INVESTORS

In crafting Regulation Best Interest, the SEC intended to protect the stringently rational, wealth-maximization-oriented investor.[57] Yet this consistently logical and "rational" investor is elusive. Already having to contend with his own innate biases and heuristics, he is constantly targeted by companies attempting to manipulate his behavior. These internal and external factors pull the investor away from rationally maximizing his wealth. No one is immune.

The first time investors enter securities markets they are inundated with noise (in contrast to information), encouraged to engage in herding behavior by social media, and risk succumbing to their own overconfidence. These factors, among others, make it difficult for the investor to make consistently rational investment choices. Moreover, most inexperienced retail investors have little understanding of their investment profile.[58] It becomes much easier for Robinhood to push active investing strategies to customers who are "learning as they go along"[59] and lack a sense of their financial goals.

Commission-free brokerages thrive by enabling customers to treat securities markets more like casinos than a place to build personal wealth. Retail investors would benefit from a regulatory model that acts as a

56. Brad M. Barber & Terrance Odean, *Trading Is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors*, 55 THE JOURNAL OF FINANCE 2 (2000) (discussing that frequent trading tends to underperform passive investing strategies).

57. Tiffany Heravi, *Regulation Best Interest: A Behavioral Analysis*, 28 PIABA B.J. 49 (2021).

58. *See Barber, Brad M. and Huang, Xing and Odean, Terrance and Schwarz, Christopher, Attention Induced Trading and Returns: Evidence from Robinhood Users* (Oct. 12, 2021), JOURNAL OF FINANCE (forthcoming). Available at SSRN: https://ssrn.com/abstract=3715077 or http://dx.doi.org/10.2139/ssrn.3715077 (discussing that 50% of Robinhood customers "are first-time investors, who are unlikely to have developed their own clear criteria for buying a stock.") (internal citation omitted).

59. *In the Matter of: Robinhood Financial, LLC*, *Respondent, supra* note 37 at 9.

counterweight to commission-free brokerages that do their best to distract customers from questioning their own judgements.[60] Casinos do not want a customer tapping buttons on a slot machine to think twice. Similarly, Robinhood has designed its business to give its users a false sense of confidence – don't ask questions, just tap away, make trades and have fun.

Meanwhile, retail investors remain unprotected by Regulation Best Interest because it assumes all investors are rational. The Regulation protects idealized, theoretical traders with odd appetites for reading dull legal documents and does not realistically consider that retail investors are already at risk for irrational behavior even absent active measures by conflicted brokerages.

This section provides a brief overview of some factors inherent in decision-making that stand in the way of rational behavior. Section III.A. will contrast genuine information (i.e., signal) with distorted chatter (i.e., noise). Section III.B. will address herding behavior. Section III.C. will discuss the innate overconfidence investors have in themselves and how commission-free brokerages leverage that to their advantage.

A. Signal & Noise

Professional and retail investors alike encounter massive amounts of information with respect to securities markets. In this context, sophisticated financial literature separates information that holds predictive value, known as signal, with information that lacks this quality, known as noise.[61] Signal holds reliable prognostic value on the future worth of a security, while noise has little relevance to the stock's price.[62] Noise can manifest as a viral news story or a popular trend. Investors who base their trading decisions on noise are less likely to see their portfolios succeed over time.[63] Indeed, all investors have some reason for executing trades, but that reason is not always based on signal.

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60. Joshua Rothman, *Why Is It So Hard To Be Rational?*, THE NEW YORKER (August 16, 2021), https://www.newyorker.com/magazine/2021/08/23/why-is-it-so-hard-to-be-rational (describing "meta-rationality" as "knowing when to let someone else do the thinking") (last visited August 19, 2021).

61. Fisher Black, *Noise,* 41 THE JOURNAL OF FINANCE 3 (1986).

62. *Id.*

63. *Id.*

Noise traders let emotion and hype drive their trades, rather than executing technical, process-based investing decisions.[64]

It remains difficult for rookie retail traders to consistently distinguish between signal and noise.[65] Moreover, they are competing with professionals who enjoy significant informational, analytical and capital advantages. Professional traders often have access to Bloomberg terminals, giving them superior access to company information and targeted research reports. Compared to retail investors, they are also more likely to have training in financial analysis and significant trading experience. Most professional traders experience comparatively faster and better execution, and more capital allows them to maintain positions longer than the typical retail investor.

By way of example, in late January 2021 GameStop (GME) and other "meme-stocks" rocketed to record highs, but these unprecedented gains were quickly followed by a significant corrective drop.[66] GameStop itself experienced changes in leadership and strategy which would explain some of the increase in their stocks' value,[67] but most observers attribute the stock's rise to it becoming a meme-stock via the Reddit discussion forum r/wallstreetbets.[68] Though the reasons the stock appeared on r/wallstreetbets were a combination of both signal and noise, a stock's popularity on the discussion board is a good signal that there is going to be some active short-term interest in the stock.

Whether trading speculatively or using shallow research, noise trading is dangerous to inexperienced retail investors. The resulting underperformance of noise traders' portfolios demonstrates the need to make retail traders aware of this mental pitfall.

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64. Will Kenton, *Noise,* INVESTOPEDIA.COM (June 24, 2021), https://www.investopedia.com/terms/n/noise.asp.

65. Black, *supra* note 61.

66. Tyler Van Dyke, *Major brokers restrict trading on GameStop and AMC amid 'short squeeze',* WASHINGTON EXAMINER (January 28, 2021), https://www.washingtonexaminer.com/news/major-brokers-restrict-trading-gamestop.

67. Sergio Alberto Gramitto Ricci & Christina M. Sautter, *Corporate Governance Gaming: The Power of Retail Investors*, 22 NEV. L.J. (forthcoming 2022) at 7. Available at SSRN: https://ssrn.com/abstract=3815088 (discussing the co-founder of Chewy acquiring 9 percent of GameStop, the company's deal with Microsoft and 2020's gaming console cycle).

68. *See Wall Street Bets,* REDDIT.COM, https://www.reddit.com/r/wallstreetbets/, which has become a popular discussion board for amateur investors to gather and talk investment strategy, meme-stocks and other financial topics.

B. Follow the Herd

The herd instinct refers to a psychological phenomenon where investors mimic the decisions of a larger, collective group.[69] Necessarily, they ignore their own investing plan and execute trades that could negatively impact their financial status. Those who succumb to the herd mentality find their rational calculations outweighed by the fear of losing money or embarrassment. The urge to avoid such outcomes is so strong that some investors will abandon their objectively sound financial plan and mimic the majority, possibly resulting in substantial losses especially if the herd was following noise rather than signal.

The events of late January 2021 are again illustrative. The retail investors who purchased GameStop (GME) and other meme-stocks likely did not sufficiently research the financials behind those companies. Instead, they bought the securities because many other similarly situated retail investors were doing the same thing. Keith Gill (aka "Roaring Kitty") posted numerous videos to YouTube and contributed to discussion forums on Reddit detailing why he thought GME was undervalued.[70] Many inexperienced retail investors followed his "buy recommendation" which caused the price of the stock to skyrocket.

These events were a near-perfect example of herd-mentality fueled by social-media. Though the urge to be a part of a group can be difficult to resist, it is dangerous to do so at the expense of individual financial plans. Following the herd can upend investment goals especially when retail investors put too much faith (or money) into plans others may not have thought through.[71]

C. Overconfidence & The Illusion of Knowledge

Overconfidence plagues investors of all types and skill level. Retail investors and professional fund managers are equally vulnerable to putting "unwarranted faith in one's intuitive reasoning, judgments, and cognitive

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69. Adam Hayes, *Herd Instinct*, INVESTOPEDIA.COM (June 17, 2021), https://www.investopedia.com/terms/h/herdinstinct.asp (last visited Aug 18, 2021).

70. Julia-Ambra Verlaine & Gunjun Banerji, *Keith Gill Drove the GameStop Reddit Mania. He Talked to the Journal.,* THE WALL STREET JOURNAL (Jan. 29, 2021) https://www.wsj.com/articles/keith-gill-drove-the-gamestop-reddit-mania-he-talked-to-the-journal-11611931696 (last visited Mar. 8, 2022).

71. CNBC, *supra* note 4 (quoting a Robinhood user: "The first day I started trading I put 50 dollars in and then bought Coca-Cola and then put another 50 dollars in and bought Live Nation...because I saw Mark Cuban do it").

abilities."[72] This can lead to irrational and risky decisions. For example, overconfident investors tend to have margin accounts and are more likely to have traded on margin.[73] They believe their ability to pick stocks will outperform the market and tend to buy and sell more often rather than passively invest. On average, those who engage in "more active, speculative trading…earn lower profits."[74]

Commission-free brokerages make education a key component of their business strategy. But even without education pushing a particular investing plan, a small amount of data can alter a retail investor who considers himself a novice into thinking that he has the abilities of a professional money manager leading to more active and speculative trading.[75]

Commission-free brokerages offer varying amounts of securities analytics. For example, TD-Ameritrade provides its users with four-hundred-eighty-nine (489) charting indicators while Robinhood only offers five (5).[76] In June 2020, Robinhood users averaged 4.3 million trades per day compared to TD-Ameritrade users who averaged 3.8 million trades.[77] Though different customer bases' habits may be some of the cause, the disparity in trading volume suggests that simplified information is partially to blame.

Robinhood provides its customers with enough data to make them feel confident in their trading decisions, but not so much that they feel alienated. However, information can only go so far. A typical user's forecast of expected return "tends to improve much more slowly than their confidence in the forecasts…lead[ing] to an illusion of knowledge and foster[ing] overconfidence."[78] Payment for order flow supported by overconfident and

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72. Michael M. Pompian, *Behavioral Finance and Wealth Management* at 51, John Wiley and Sons, 2006.

73. Brad M. Barber, *et al., Leveraging Overconfidence,* (November 30, 2020). Available at https://ssrn.com/abstract=3445660 (last visited Mar. 8, 2022).

74. *Id*.

75. *Id.*

76. *See TD Ameritrade vs. Robinhood 2021,* STOCKBROKERS.COM, (Aug 2, 2021) https://www.stockbrokers.com/compare/robinhood-vs-tdameritrade (last visited Mar. 8, 2022).

77. *See* Barber, *Attention-Induced Trading and Returns: Evidence from Robinhood Users, supra* note 58 at 4.

78. *See id.* at 6.

active trading subsidizes the commission-free business model which potentially opens retail investors to comparatively more financial harm.[79]

IV. ACTIVE MEASURES TO PUSH ACTIVE INVESTING

It is naturally difficult for rational investors to make wealth-maximizing investment decisions and commission-free brokerages understand that their customers are already on thin psychological ice. From there, they aim to rile up their customer-base and completely inhibit their ability to make rational investment choices. But they do not do so blatantly; they disguise the prodding in the form of education, gamified promotions and aggressive pushes for margin accounts.

Lawmakers and regulators have become increasingly concerned with the effects of these practices on retail investors. FINRA has recently established a group within the organization to measure the impacts of gamification and other customer-engagement methods on customers' trading behavior.[80] Further, FINRA called on member firms to evaluate whether their communications with customers constitute a recommendation that requires compliance with Regulation Best Interest.[81] Brokerages were also reminded that communications must be "fair and balanced" and should not make any "false, exaggerated or misleading" statements.[82] The SEC's Chairman sees these "digital engagement practices" as potentially harmful to investors and stresses that current rules will need to be reexamined to account for changes in brokerages' engagement practices.[83] In particular, the agency will be closely

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79. *Id* at 1-2.

80. Cook, *supra* note 52.

81. *See* FINRA, *2021 Report on FINRA's Examination and Risk Monitoring Program*, FINRA.ORG, at 22 (Feb. 2021), https://www.finra.org/rules-guidance/guidance/reports/2021-finras-examination-and-risk-monitoring-program.

82. *Id.*

83. *See* Katanga Johnson & Chris Prentice, *Exclusive: U.S. SEC to Scrutinize Firms' Digital-Engagement Practices as Investor Worries Grow,* REUTERS (August 24, 2021), https://www.reuters.com/technology/exclusive-us-sec-scrutinize-firms-digital-engagement-practices-investor-worries-2021-08-24/ (discussing Chairman Gensler's concern regarding "the data that's coming in to these data analytics, whether it be machine learning or deep learning, will represent the biases in society, as they exist already.") (last accessed August 26, 2021).

analyzing when a communication transforms from mere marketing into a recommendation subject to a heightened duty of care.[84]

This Section will describe practices common across commission-free brokerages that are used to increase customer engagement and trading. Section IV.A. will describe how brokerages use biased education to condition customers to actively trade. Section IV.B. will then introduce gamification and how it is used distract retail investors from reaching their own financial goals. Section IV.C. provides examples of how Robinhood uses gamification and psychological nudges to condition their customers to actively trade against their better judgment. Section IV.D. will describe how Robinhood aggressively pushes margin trading to increase its customers' trading activity.

A. Effects of Education

When providing financial education, commission-free brokerages act as if they are operating within the safe harbor of the prior Suitability Rule which excludes "general financial and investment information, including...basic investment concepts" from the definition of recommended strategies.[85] Robinhood, for example, has hundreds of jargon-free articles covering simple to complex financial topics.[86] The articles themselves on an isolated individual basis would likely fall within the confines of the safe harbor. However, a text box sits at the end of every article with a link asking "Ready to start investing? Sign up for Robinhood and get your first stock on us." Considering its structure, Robinhood apparently thinks a potential customer who just learned a basic investing concept is ready to start buying and trading stocks. The lack of proximity between the article and the offer appears calculated to induce a person without experience to begin trading. This offer follows each of Robinhood's educational articles and exposes their push for active investing.

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84. *Id. See also* SEC Request for Information, *supra* note 8 at 49075 (citing the possibility that digital engagement practices "may, depending on the relevant facts and circumstances, constitute a recommendation for purposes of Regulation Best Interest.").

85. FINRA Rule 2111, *supra* note 19.

86. Robinhood, *What is a Portfolio?*, ROBINHOOD.COM (2021) https://learn.robinhood.com/articles/4vaR9PkTzes8u3ibLAWrD1/what-is-a-portfolio/ (last visited Mar. 8, 2022). *See also* Robinhood, *What is the Sharpe Ratio?*, ROBINHOOD.COM (2021), https://learn.robinhood.com/articles/403DnmBe6ZeiQwhgDldXKn/what-is-the-sharpe-ratio/ (last visited Mar. 8, 2022).

Indeed, Robinhood likely has click-through metrics analyzing the effectiveness of its education at inducing trading.

Robinhood also prominently displays articles on options trading. On the company's "Learn" page just below "Investing 101" is "Options trading essentials."[87] The article readily reminds readers that options trading is not just for "adrenaline junkies" who enjoy "high-risk, short-term vices."[88] Again, the same tempting text box offering a free stock sits just below the article. It is difficult to imagine the justification for this offer unless the company is advocating for retail traders to adopt an active investing strategy. At the very least, it is a disguised recommendation outside the safe harbor.[89]

Robinhood is not the only commission-free brokerage promoting active investing under the guise of education and marketing. SoFi offers a self-directed brokerage service branded "Active Investing."[90] It touts this style of investing as superior to passive investing because it allows customers to "potentially beat average market returns...as opposed to waiting it out in the long run."[91] SoFi attempts to navigate into the safe harbor by stating they "won't be able to provide tips about which stocks you should buy or sell, or when."[92] In the aggregate, Sofi's biased "education" advocates for active investing while ignoring the advantages of passive investing.

Practices that emphasize customers can beat average market returns through active investing appear to be at odds with FINRA's prohibition on misleading statements.[93] By not informing customers that passive investing

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87. Robinhood, *Investing basics*, ROBINHOOD.COM, https://learn.robinhood.com (last visited July 27, 2021).

88. Robinhood, *Getting started with options*, ROBINHOOD.COM, (2021) https://learn.robinhood.com/articles/getting-started-with-options/ (last visited Mar. 8, 2022).

89. See Fred Reish, *Best Interest Standard of Care for Advisors #16: Compliance with PTE 2020-02: Enforcement of the Exemption,* FREDREISH.COM (Nov 7, 2019), https://fredreish.com/best-interest-standard-of-care-for-advisors-16/ (discussing how if educational conversations and materials are biased, they could be viewed as a disguised recommendation in the context of 401(k) plan rollovers) (last visited Mar. 8, 2022).

90. SoFi, *Active Investing,* SOFI.COM, https://www.sofi.com/invest/active/ (last visited Mar. 8, 2022).

91. *Id.*

92. *Id.*

93. FINRA Report, *supra* note 81.

tends to outperform active investing, it becomes difficult to conclude that these communications are "fair and balanced."[94]

Education is essential to commission-free brokerages like Robinhood[95] and SoFi because it makes their customers more confident in their investment decisions. A small amount of information presented in bite-sized articles leaves readers thinking that they fully understand what are doing.[96] Overconfidence leads to more active trading which drives revenue for commission-free brokerages.[97]

The Dunning-Kruger effect suggests that people who possess a small amount of knowledge on a subject tend to overestimate their expertise in that area.[98] Thanks to this psychological phenomenon, an inexperienced investor may feel he is ready to buy stocks and trade options after spending just a few minutes reading Robinhood's articles. The articles explain the basics of securities markets, but they fall short of giving readers the knowledge and expertise needed to "beat average market returns."[99] However, many customers are led to believe that they can, in fact, beat the market. Educational articles do not appear to be recommendations on their face, but when they are specifically targeted at inexperienced retail investors intending to make them "feel informed, confident, and knowledgeable",[100] they approach recommendation because they influence retail investors to trade more.

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94. *Id*.

95. *See* Robinhood Markets, Inc., *supra* note 54 at 162 ("Education is core to accomplishing our mission.").

96. Carmen Sanchez and David Dunning, *Research: Learning a Little About Something Makes Us Overconfident*, HARVARD BUSINESS REVIEW (March 29, 2018) https://hbr.org/2018/03/research-learning-a-little-about-something-makes-us-overconfident (last visited Mar. 8, 2022).

97. *See* Brad M. Barber and Terrance Odean, *supra* note 56 at 774 ("Our most dramatic empirical evidence supports the view that overconfidence leads to excessive trading.").

98. Jan Feld, *et al.*, *Estimating the Relationship Between Skill and Overconfidence*, IZA-INSTITUTE OF LABOR ECONOMICS, IZA Discussion Paper No. 10611 (March 2017). Available at SSRN: https://ssrn.com/abstract=2940601.

99. SoFi, *supra* note 90.

100. Robinhood, *Meeting Our Responsibilities to Customers,* UNDER THE HOOD (2021), https://blog.robinhood.com/news/2021/6/30/meeting-our-responsibilities-to-customers (last visited Mar. 8, 2022).

The articles Robinhood and SoFi offer lack personalization which removes them from under the umbrella of recommendation. However, their business-model does not require creating bespoke investment advice because retail investors can feel sufficiently overconfident from reading a couple of jargon-free articles. Robinhood and SoFi may avoid scrutiny under Regulation Best Interest because their educational materials are not personalized and each company explicitly states that it is not advocating or recommending any investment strategy.[101] But in the aggregate, these materials do advocate active trading as opposed to passive participation in the market – and the strategy is the same for all retail investors.

B. Gamification And Its Impacts

"Gamification" is the process of making activities in non-game contexts more game-like by using common game design elements such as points, badges, leaderboards, bonuses and competitions to increase user engagement.[102] Designers build "motivational affordances" into the non-game environment[103] to create game-like experiences and promote a psychological state that results in a desired behavioral outcome.[104] For example, the Boy Scouts of America use the possibility of obtaining a badge after demonstrating proficiency in a task as a motivational affordance to bring about a desired psychological and eventual behavioral outcome. Boy Scouts are motivated

101. *See* Robinhood, Form CRS (Aug 3, 2021), https://files.brokercheck.finra.org /crs_165998.pdf ("We buy and sell securities only at your direction and we do not offer recommendations of securities, or investment strategies involving securities…"); *see also* SoFi, Form CRS (June 24, 2021), https://files.brokercheck .finra.org/crs_151717.pdf ("We do not currently make securities recommendations and do not monitor accounts for our customers.").

102. *The Ultimate Definition of Gamification (With 6 Real World Examples),* GROWTH ENGINEERING (March 10, 2021), https://www.growthengineering.co.uk /definition-of-gamification/ (last visited Mar. 8, 2022).

103. Michael Sailer, *et al., How gamification motivates: An experimental study of the effects of specific game design elements on psychological need satisfaction*, 69 COMPUTERS IN HUMAN BEHAVIOR 371, 372 (2016).

104. Juho Hamari, *et al., Does Gamification Work? – A Literature Review of Empirical Studies on Gamification*, 47th Hawaii International Conference on System Sciences (Hawaii, USA, Jan 6-9, 2014).

(psychological outcome) to learn a new skill (behavioral outcome) because of the possibility of obtaining a new badge (motivational affordance).

Until the end March 2021,[105] confetti would rain down from the top of the screen after a user placed their first trade on Robinhood.[106] The confetti has since been replaced with new digital designs to acknowledge "investing milestones,"[107] but this equates to swapping one gamification-feature with another because the digital designs fit the description and purpose of badges.[108]

Regulators are increasingly concerned about the effects that gamified retail investing apps may have on individual investors and markets.[109] Gamification manipulates targeted users' behavior to reach goals that may seem like their own but are actually the developer's goals.[110] A gamified app prods individuals to act against their own best interests and pulls people away from acting rationally simply because humans like games.[111] When a challenge is overcome the brain releases dopamine which generates pleasant feelings.[112] Once we experience the rush of dopamine, we want to feel it again. This desire

105. Robinhood, *A New Way to Celebrate with Robinhood,* UNDER THE HOOD (2021) https://blog.robinhood.com/news/2021/3/31/a-new-way-to-celebrate-with-robinhood, (last visitedMar. 8, 2022).

106. Caitlin McCabe, *Robinhood to Remove Controversial Digital Confetti From Trading App*, THE WALL STREET JOURNAL (March 31, 2021), https://www.wsj.com/articles/robinhood-to-remove-controversial-digital-confetti-from-trading-app-11617195612 (last visited Mar. 8, 2022).

107. *Id*.

108. *See* Juho Hamari, *Do badges increase user activity? A field experiment on the effects of gamification*, 71 COMPUTERS IN HUMAN BEHAVIOR 469 (April 2015).

109. *See* Virtual Hearing before the House Committee on Financial Services, *Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide Part III*, 117 Cong., U.S. House Committee on Financial Services, 117th Cong. (May 6, 2021) (Testimony of Gary Gensler, Chair, Securities and Exchange Commission).

110. *See* GROWTH ENGINEERING, *supra* note 102.

111. George Akerlof and Robert Shiller, *Phishing for Phools: The Economics of Manipulation and Deception*, PRINCETON UNIVERSITY PRESS (2015).

112. *Gamification and Dopamine: Why Games Motivate Us*, PLAYMOTIVE (July 19, 2019), https://playmotiv.com/en/gamification-and-dopamine-why-games-motivate-us/ (last visited Mar. 8, 2022).

for more dopamine leads us to repeat our behaviors and continually participate in an activity that is not naturally attractive – such as retail investing.[113]

C. Gamification, Notifications & Information Within Robinhood

Much of Robinhood's success and a large source of its criticism is due to the simplicity of its app. The company took a "bare bones" approach and chose not to include elements "designed for the 1%, with complicated, confusing and often intimidating user interfaces." [114] Instead, the app focuses on ease-of-use.[115]

An interface without a steep learning curve helps keep users engaged and placing trades on the app. But a simplified interface has its costs as well; it is difficult for the typical Robinhood user (even a "Gold" user)[116] to beat professional traders with "the biggest computers, the fastest data feeds, and the most sophisticated analytics."[117] The company makes no mention of this and instead bombards its users with gamified features and behavioral nudges to keep them engaged.

i. Transforming Waitlists into Leaderboards

The promotional campaign for Robinhood's cash management service offers an example of how an innocuous feature can lead to addictive behavior. Prior to its release, interested customers were placed on a waitlist and could

113. *Id.*

114. Rich Bessel, *The Top Secret Robinhood Design Story,* (April 14, 2021), https://robinhood.engineering/the-top-secret-robinhood-design-story-a2b044812bae (last visited Mar. 8, 2022).

115. Chris Davis, *Robinhood Review 2021: Pros, Cons, and How It Compares,* NERD WALLET (July 23, 2021), https://www.nerdwallet.com/reviews/investing/brokers/robinhood (last visited Mar. 8, 2022).

116. *See* Robinhood, *Upgrading to Gold*, https://robinhood.com/us/en/support/articles/upgrading-to-gold/ (discussing the benefits of its Gold Membership including access to Level II market data) (last visited August 6, 2021).

117. Wall Street Journal, *How Robinhood Transformed Retail Trading Ahead of Its IPO,* YOUTUBE.COM (July 15, 2021), https://www.youtube.com/watch?v=qAuF4wlSQnk (quoting Larry Tabb, Head of Market Structure Research, Bloomberg Intelligence) (last visited Mar. 8, 2022).

see their position relative to others. However, these positions were not static because their place depended upon how many times they tapped a fake debit card on the screen. Each customer could tap up to 1,000 times per day and were encouraged to continue tapping the next day. However, those who did not tap daily would watch their position fall.[118] Gamifying a waitlist has proven to be an effective way to train customers to interact with the app through mindless, constant and daily tapping. Though not illegal, the practice should be examined when it changes users' behavior through manipulation.

ii. Cash and Stock Incentives

To encourage customers to join, Robinhood offers newly approved users a free share of stock that they reveal by scratching off a virtual lottery ticket.[119] This tactic offers another example of gamification.[120] Cash and stock incentives are a simple way to engage potential customers and give them a psychological nudge to produce a desired behavior.[121]

In March 2021, Robinhood offered cash to targeted users who deposited money into their trading account.[122] Selected users were offered $10 to $250 for making a deposit between $200 and $15,000.[123] This offer coincided with the release of $1,400 COVID-19 relief checks. Robinhood's campaign was designed to produce a substantial return through increased customer account balances leading to more trading. Such offers closely approach a "recommendation" because they target distinctive groups of current and potential customers and extend different incentives.

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118. *In the Matter of: Robinhood Financial, supra* note 37.

119. Nathaniel Popper, *supra* note 44.

120. *Id.*

121. Richard H. Thaler and Cass R. Sunstein, *Nudge*, YALE UNIVERSITY PRESS (April 2008).

122. Anders Melin & Annie Massa, *Robinhood Offers Users Cash for New Deposits as $1,400 Checks Arrive,* BLOOMBERG WEALTH (Mar. 17, 2021), https://www.bloomberg.com/news/articles/2021-03-17/robinhood-offers-traders-cash-for-new-deposits-as-1-400-stimulus-checks-arrive (last visitedMar. 8, 2022).

123. *See id.* (quoting Robinhood's promotional language: "This promotion is not available to the general public. In order to be eligible to receive a cash reward, you must be a direct recipient of the original email from Robinhood.").

Free money happens to be difficult to turn down. Robinhood uses this to their advantage and targets customers to encourage them to deposit more money. This is no different than a broker reaching out to its customers and offering them the same promotion. Regulators would likely view this as a recommendation because the brokerage firm is contacting targeted customers and urging them to deposit more money so they can execute more trades. The only difference in Robinhood's case is that they sent mass emails to targeted customers. Psychological nudges like this are the kinds of practices that should concern regulators. Rather than using the relief money for necessities such as food and rent, Robinhood blatantly encouraged customers to use it for securities trading. But influencing customers to deposit a few hundred dollars into their account is only half the story; Robinhood still needs to stimulate trading to generate revenue for itself.

iii. Push Notifications Push Influential Information

All smart phone users recognize the "ding" of a push notification. Each time an app demands our attention and we respond, notifications become increasingly difficult to ignore.[124] Similar to cash incentives, push notifications are used as a psychological prod to move a targeted user in a desired direction. Robinhood uses push notifications to capture its users' attention and draw them toward executing trades. It sends timely, personal and actionable notifications to various categories of its users.[125] For example, customers who have downloaded the app but have not executed any trades receive push notifications that read "Top Movers: Choosing stocks is hard [flexing bicep emoji] Get started by checking which stock prices are changing the most." The user who follows the notification is directed to a list displaying stocks whose prices are shifting the most at the time the notification is opened.[126]

The "Top Movers" list demonstrably influences customers' trading activity. A 2021 study found Robinhood customers "respond similarly to top

124. Dan Pontefract, *Push Notifications Have Become the Death of Thinking*, FORBES (Sep 26, 2017), https://www.forbes.com/sites/danpontefract/2017/09/26/push-notifications-have-become-the-death-of-thinking/?sh=1f7e679a3f6a (last visited Mar. 8, 2022).

125. KC Karnes, *Push Notification Best Practices: 35 Tips for Dramatically Better Messages*, CLEVER TAP (Nov 2, 2020), https://clevertap.com/blog/push-notification-best-practices/ (last visited Mar. 8, 2022).

126. *In the Matter of: Robinhood Financial, supra* note 37 at 14.

gainers and losers, while other retail investors buy top gainers much more aggressively than top losers."[127] These findings suggest that Robinhood users' decisions are influenced by the information presented to them. Push notifications accompanied by the list of "Top Movers" approaches a recommendation because it targets a specific group of customers and influences their investing decisions.[128] Even though the "Top Movers" list is available to all users, it still functions as a recommendation much like a broker "handing a list of securities to a customer."[129]

D. Aggressive Tactics to Push Margin Trading

To fill the vacuum left by a lack of sports betting during the COVID-19 pandemic, many bettors turned to the stock market because "investing has a ton of similarities."[130] Gamblers-turned-investors began trading stocks and some even went a step further into options trading without learning investing basics. Dave Portnoy captured this attitude in a March 30, 2020 podcast episode stating, "I have margin…I don't know what any of that means."[131] Most Americans cannot afford to make such a blind charge. However, commission-free brokerages like Robinhood aggressively pursued an opportunity with bored, stuck-at-home Millennials who had extra cash.[132]

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127. Brad M. Barber, *et al.*, *supra* note 58 at 15 (July 2021).

128. *See* Hugh D. Berkson, *Robinhood May Be Liable If You Lose Money Based On Its Recommendations,* STOCK MARKET LOSS (Feb 11, 2021), https://www.stockmarketloss.com/securities-law/robinhood-may-be-liable-if-you-lose-money-based-on-its-recommendations/ (last visited Mar. 8, 2022).

129. *In the Matter of: Robinhood Financial, supra* note 37 at 5.

130. Kate Rooney, *Gamblers pivot to stock trading during lockdowns - Barstool's Portnoy revives old E-Trade account*, CNBC (May 22, 2020), https://www.cnbc.com/2020/05/22/gamblers-pivot-to-stock-trading-during-lockdowns---barstools-portnoy-revives-old-e-trade-account.html (last visited Mar. 8, 2022).

131. Barstool Sports, *Barstool Rundown,* BARSTOOL SPORTS PODCAST (March 30, 2020), https://www.barstoolsports.com/video/2219389/barstool-rundown-march-30-2020 (last visited Mar. 8, 2022).

132. *See* Statista, *Tech Investors Rise During Pandemic,* (June 9, 2020), https://www.statista.com/chart/21947/tech-investors-rise-covid/, (discussing new user positions on Robinhood tripling between March 2020 and June 2020) (last visited August 7, 2021).

Consider Robinhood's approval of inexperienced and risk averse customers for margin trading who did not meet the company's own criteria. Yet Robinhood approved them for options trading even though the company requires some trading experience and a medium to high tolerance for risk. These practices, among other systemic failures within the company, led FINRA to impose its largest fine ever ($70 million) on a member firm.[133] Robinhood's lack of an adequate review process shows that it is more concerned with generating order flow payments rather than their customers' financial well-being. Between December 31, 2019, and December 31, 2020, Robinhood's customer margin account balances increased nearly 450%.[134] The massive uptick can be partially attributed to the company's proliferation of "false and misleading information" and its "failure to exercise due diligence before approving options accounts."[135]

i. Demonstrably False Claims

Between January 2018 and March 2021, Robinhood significantly downplayed the risk of potential losses related to options spread transactions. The company stated that "[y]ou'll never lose more than the premium you paid to enter the call debit spread."[136] This statement was simply not true because it did not account for circumstances in which it was possible for customers to suffer losses beyond the premium they paid.[137] Additionally, customers with expiring options who relied on Robinhood's statements lost money beyond what the company indicated.[138] Moreover, Robinhood represented that its default accounts were ineligible to trade on margin and that they could only "trade using unsettled funds up to the amount" in their account. However, the company failed to disclose that some trades "could and often did automatically trigger the use of margin" making them vulnerable to significant losses.[139]

133. FINRA, *Re: Robinhood Financial LLC*, Letter of Acceptance, Waiver, and Consent No. 2020066971201 , (June 22, 2021).

134. Robinhood Markets, Inc., *supra* note 54.

135. FINRA Letter, *supra* note 133.

136. *Id* at 10.

137. *Id.*

138. *See id.* at 11.

139. *Id* at 6-7.

These misrepresentations cost 630 customers over $5.73 million in losses.[140] Due to errors and delays in Robinhood's system, millions of customer accounts displayed inaccurate portfolio balances, buying power and total return.[141] Misrepresenting users' buying power and return is inapposite to empowering retail investors to make smart financial decisions.[142]

ii. Due Diligence Failures

Robinhood users who want to trade options must upgrade to "Gold." For five dollars per month, customers can access at least $1,000 of margin and Level II market research reports.[143] Once a customer attests to their experience level and risk tolerance, Robinhood uses an automated process to expedite approval. [144] But this was not without its flaws. Robinhood allowed customers who were previously denied access to "Gold" membership to change their answers. In one case, a 19-year-old user applied for "Gold" access and initially stated he had "low risk tolerance" and "did not understand options."[145] The company denied his application because he did not meet the minimum criteria. Minutes later, he changed his risk tolerance to "high" and indicated he had "three or more years" of experience trading options. Robinhood immediately approved his application ignoring the red-flag that a 19-year-old had three years of options trading experience.[146] Investors with margin accounts tend to trade more actively.[147] Enabling users to easily access margin through careless

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140. *Id* at 9.

141. *Id.*

142. *See* Robinhood, *Our Customers*, ROBINHOOD.COM, https://robinhood.com /us/en/our-customers/, (citing testimonials how information and education have "empowered" customers to make good financial decisions) (last visited Mar. 8, 2022).

143. Robinhood, *supra* note 116.

144. *In the Matter of: Robinhood Financial, supra* note 37 at 18.

145. FINRA, *supra* note 133 at 20.

146. *Id.*

147. *See* Emily Norris, *Cash Account vs. Margin Account: What Is the Difference?*, INVESTOPEDIA.COM (April 22, 2021), https://www.investopedia.com/ask/answers/ 100314/whats-difference-between-cash-account-and-margin-account.asp ("The borrowers of stocks held in margin accounts are generally active traders…") (last accessed August 7, 2021).

practices demonstrates Robinhood's push to drive revenue through active trading.

V. CONCLUSION

As it stands, brokerage firms that profit by driving active trading should bear some responsibility for the behaviors they encourage. This may mean that arbitrators, regulators and other policy makers should take a more critical look at what constitutes a recommendation and adopt a broader conception of the term or otherwise revise their oversight. There exists a worrying trend that commission-free brokerages are using their educational articles to drive active trading that harms both individuals and markets. To better protect investors the law must transform in-step with evolving digital engagement practices and data-driven business-models.

SECURITIES LITIGATION CONCERNS FOR BUYERS AND SELLERS IN THE NFT MARKET

Jean-Pierre Bado[1]

I. INTRODUCTION

Do you collect tattooed gangster birds?[2] How about warrior-turned-racer space lizards?[3] Perhaps you prefer costumed penguins[4] or dancing robots.[5] The good news is that all of these items can be yours! Each of these are examples of non-fungible tokens (NFTs) available for sale on exchanges found on the internet. Nevertheless – beware. The same anonymity and complexity that makes NFTs so popular may be a buyer's (*or* seller's) nightmare.

On September 14, 2021, the new U.S. Securities and Exchange Commission (SEC) Chair, Gary Gensler, appeared before the Senate banking Committee and described cryptocurrency markets as "the Wild West," referring to cryptocurrency investments, in particular, as "rife with fraud, scams, and abuse."[6] "We just don't have, I believe, enough investor protection in crypto finance, the issuance of these tokens, the trading, and particularly the lending," Gensler told Congress. [7]

One of the biggest questions facing the industry is whether tokens qualify as securities.[8] While the SEC has not provided definitive guidance on which

1. Jean-Pierre Bado is a Miami-based securities litigation attorney, practicing in the state of Florida.

2. Thugbirdz, https://www.thugbirdz.com/ (last visited Mar. 22, 2022).

3. Galactic Geckos, https://galacticgeckos.io/ (last visited Mar. 22, 2022).

4. Flippies NFT, https://www.flippies.art/ (last visited Mar. 22, 2022).

5. Solarians: The First On-Chain Generative NFTs on Solana, https://solarians.click/ (last visited Mar. 22, 2022).

6. Sheelah Kolhatkar, *The Challenges of Regulating Cryptocurrency,* THE NEW YORKER, Oct. 6, 2021, https://www.newyorker.com/business/currency/the-challenges-of-regulating-cryptocurrency (last visited Mar. 22, 2022).

7. Peter Feltman, *SEC seen having clear case against Coinbase's lending program*, ROLL CALL, Sep. 28, 2021, https://www.rollcall.com/2021/09/28/sec-seen-having-clear-case-against-coinbases-lending-program/ (last visited Mar. 22, 2022).

8. *Id*.

NFTs constitute securities, there is framework for determining whether an NFT is not a collectible but a security sold by an unregistered broker dealer.

While purchasing an NFT of a particularly fancy bulldog[9] for your collection may not relate to securities, NFTs sold on the expectation of profits can. What happens when those expectations are left unrealized and investors keep only losses?

In the absence of federal or state statutes or clear regulatory guidance, prudence demands caution from both the investors buying NFTs and the exchanges selling them. On the one hand, exchanges intending to offer such NFTs should set up stand-alone platforms registered in compliance with federal and state securities laws. On the other, potential investors should consider the lack of transparency associated with certain investments and additional litigation risks of getting back their investments when unregistered securities go bad. Accordingly, this paper will highlight important litigation concerns arising from the sale of NFTs.

II. AN NFT PRIMER

Non-fungible tokens maintain uniqueness, cannot be divided, and characterize the scarcity associated with cryptocurrencies.[10] They differ from regular cryptocurrencies in that each NFT is indivisible with properties that cannot be shared with other tokens.[11] Traditional cryptocurrencies like Bitcoin are divisible and are interchangeable, i.e., fungible.[12] It is practically impossible to split one NFT into new identities and owners, but entirely possible to do so with Bitcoin.[13] In contrast to NFTs, one Bitcoin can change hands over time and each Bitcoin is the same as the other.[14] Due to differing

9. Fancy Frenchies | Found in the cute and cuddly section of the metaverse, one can find 10,000 Fancy Frenchies barking all over the Solana network., https://fancyfrenchienft.com (last visited Mar. 22, 2022).

10. *The Rise of Non-Fungible Tokens (NFTs) in Web3,* SOLANA NEWS, Apr. 4, 2021, https://www.solana.news/post/cryptonomics-non-fungible-tokens-explained (last visited Mar. 22, 2022).

11. *Id*.

12. *Id*.

13. *Id*.

14. *Id*.

characteristics, NFTs can be used as unique digital assets, identification, or collectibles.[15]

Much has been written about cryptocurrency's history[16] and explosion[17], cryptocurrency exchanges[18] and NFTs[19]. To date though, the SEC has not offered interpretive guidance on the subject of NFTs. Thus, there is no bright line rule for when an NFT is actually a security. However, as more fully discussed herein, existing regulations and a line of federal case law make it apparent that certain NFTs should be deemed securities. When internet platforms offer these NFTs for sale, they therefore may actually be selling unregistered securities. Investors who fall prey to nefarious or opaque NFT creators could then be able to mitigate their losses by bringing their claims against those platforms.

III. SECURITIES LAW GOVERNING THE CRYPTOVERSE

In order to understand if an NFT is a security, the fundamental question is, "What constitutes a security?" The Securities Act of 1933, often referred to as the "Truth in Securities" Law, expansively defines the term "security" as

> any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, ***investment contract***, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other

15. *Id*.

16. *See, e.g.*, Bernard Marr, *A Short History Of Bitcoin And Crypto Currency Everyone Should Read*, FORBES, Dec. 6, 2017, https://www.forbes.com/sites/bernardmarr/2017/12/06/a-short-history-of-bitcoin-and-crypto-currency-everyone-should-read/?sh=1d6e6473f279 (last visited Mar. 22, 2022).

17. *See, e.g.*, Sarah Hansen, *Guide To Top Cryptocurrency Exchanges*, FORBES, Jun. 20, 2018, https://www.forbes.com/sites/sarahhansen/2018/06/20/forbes-guide-to-cryptocurrency-exchanges/?sh=2b99b2202572 (last visited Mar. 22, 2022).

18. *See e.g.*, Kira Ergorova, *Crypto Exchanges, Explained*, COINTELEGRAPH (Jul. 10, 2018), https://cointelegraph.com/explained/crypto-exchanges-explained (last visited Mar. 22, 2022).

19. Mitchell Clark, *NFTs, explained*, THE VERGE, Aug. 18, 2021, https://www.theverge.com/22310188/nft-explainer-what-is-blockchain-crypto-art-faq (last visited Mar. 22, 2022).

> mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a 'security'."[20]

With that foundation, some NFT owners may rightfully ask themselves: is my digital sloth[21] NFT a security? The definition of a security is, by design, broad enough to cover a vast array of products. The SEC has argued that digital assets like NFTs are investment contracts and thus, fall under the definition of a security.[22] The U.S. Supreme Court has provided the framework for

20. 15 U.S.C. § 77b(a)(1).

21. TheSlowPatrol | NFT investing on Solana blockchain, https://www.theslowpatrol.com/ (last visited Mar. 22, 2022).

22. *See e.g.*, Complaint, SEC v. Flik, et al., Case No. 1:20-cv-03739-SCJ, (N.D. Ga. Sep. 10, 2020), https://www.sec.gov/litigation/complaints/2020/comp-pr2020-207.pdf; Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, In re Kelvin Boon, LLC and Rajesh Pavithran, SEC Admin. Proc. File No. 3-19913 (Aug. 13, 2020), https://www.sec.gov/litigation/admin/2020/33-10817.pdf; Complaint, SEC v. ICOBox and Nikolay Evdokimov, Case No. 2:19-cv-08066 (C.D. Cal. Sep. 18, 2019), https://www.sec.gov/litigation/complaints/2019/comp-pr2019-181.pdf; Complaint, SEC v. Kik Interactive Inc., Case No. 1:19-cv-05244 (S.D.N.Y. Jun. 4, 2019), https://www.sec.gov/litigation/complaints/2019/comp-pr2019-87.pdf; Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order, In re Gladius Network LLC, SEC Admin. Proc. File No. 3-19004 (Feb. 20, 2019), https://www.sec.gov/litigation/admin/2019/33-10608.pdf; Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order, In re Floyd Mayweather, Jr., SEC Admin. Proc. File No. 3-18906 (Nov. 29, 2018), https://www.sec.gov/litigation/admin/2018/33-10578.pdf; Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order, In re Khaled Khaled, SEC Admin. Proc. File No. 3-18907 (Nov. 29, 2018), https://www.sec.gov/litigation/admin/2018/33-10579.pdf; Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing Penalties and a Cease-and-Desist Order, In re Paragon Coin, Inc., SEC Admin. Proc. File No. 3-18897 (Nov. 16, 2018), https://www.sec.gov/litigation/admin/2018/33-10574.pdf; Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing Penalties and a Cease-and-Desist

determining which NFTs are more likely to fall under the 1933 Act's definition of a security.

Specifically, in *Securities and Exchange Commission v. W J. Howey Co.*, the United States Supreme Court held that an investment contract is a contract, transaction, or scheme involving (1) an investment of money, (2) in a common enterprise, (3) with the expectation that profits will be derived from the efforts of others.[23] Under *Howey*, "form [is] disregarded for substance and the emphasis [is] on economic reality."[24] The Supreme Court further explained that that the term security "embodies a flexible rather than a static principle"

Order, In re CarrierEQ, Inc., d/b/a AirFox, SEC Admin. Proc. File No. 3-18898 (Nov. 16, 2018), https://www.sec.gov/litigation/admin/2018/33-10575.pdf; Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order, In re Zachary Coburn, SEC Admin. Proc. File No. 3-18888 (Nov. 8, 2018), https://www.sec.gov/litigation/admin/2018/34-84553.pdf; Complaint, SEC v. Blockvest*, LLC, et al.*, Case no. 3:18-cv-02287-GPC-BLM (S.D. Cal. Oct. 3, 2018), https://www.sec.gov/litigation/complaints/2018/comp-pr2018-232.pdf; Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Sections 15(b) and 21C of the Securities Exchange Act of 1934, and Section 9(b) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desists Order, In re TokenLot LLC, Lenny Kugel, and Eli Lewitt, SEC Admin. Proc. File No. 3-18739 (Sep. 11, 2018), https://www.sec.gov/litigation/admin/2018/33-10543.pdf; Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, In re Tomahawk Exploration LLC and David Thompson Laurance, SEC Admin. Proc. File No. 3-18641 (Aug. 14, 2018), https://www.sec.gov/litigation/admin/2018/33-10530.pdf; Complaint, SEC v. Titanium Blockchain Infrastructure Services Inc., et al., Case No. 2:18-cv-04315-DSF-JPR (C.D. Cal. May 22, 2018), https://www.sec.gov/litigation/complaints/2018/comp-pr2018-94.pdf: Complaint, SEC v. Sohrab ("Sam") Sharma and Robert Farkas, Case No. 18-cv-02909) (S.D.N.Y. Apr. 2, 2018), https://www.sec.gov/litigation/complaints/2018/comp-pr2018-53.pdf; Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order, In re Munchee, Inc., SEC Admin. Proc. File No. 3-18304 (Dec. 11, 2017), https://www.sec.gov/litigation/admin/2017/33-10445.pdf; Complaint, SEC v. REcoin Group Foundation, LLC, et al., Case No. 1:17-cv-05725 (E.D.N.Y. Sep. 29, 2017), https://www.sec.gov/litigation/complaints/2017/comp-pr2017-185.pdf.

23. Securities and Exchange Commission v. W J. Howey Co., 328 U.S. 293 (1946).

24. *Id.* at 298.

in order to meet the "variable schemes devised by those who seek the use of the money of others on the promise of profits."[25]

Applying *Howey* to NFTs, the first prong is satisfied if the purchase of an NFT is in return for consideration.[26] To satisfy the second prong of the *Howey* test, there must be either "horizontal commonality"[27] or "vertical commonality."[28] Simply put, an NFT will likely meet the "common enterprise test" if investors' contributions are pooled together, with each investor subsequently receiving a pro-rata share of the pool ***or*** if the investors' fortunes are linked to the NFT promoter's efforts or fortunes.

The third prong of the *Howey* test is in and of itself a multi-part test. Initially, whether an investor's expectation of profits is reasonable derives from if the offer and sale of the NFT was simply for the use or consumption

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25. *Id.* at 299.

26. *See, e.g*., Uselton v. Commercial Lovelace Motor Freight, Inc., 940 F.2d 564, 574 (10th Cir. 1991) ("[I]n spite of *Howey's* reference to an 'investment of money,' it is well established that cash is not the only form of contribution or investment that will create an investment contract.").

27. The concept of "horizontal commonality" focuses on the relationship among investors and requires a pooling of investors' contributions and distribution of profits and losses on a pro-rata basis among investors. *See* Stenger v. R.H. Love Galleries, Inc., 741 F.2d 144 (7th Cir. 1984); Newmyer v. Philatelic Leasing, Ltd., 888 F.2d 385, 394 (6th Cir. 1989); Revak v. SEC Realty Corp., 18 F.3d 81, 87-88 (2d Cir. 1994) (discussing horizontal commonality as "the tying of each individual investor's fortunes to the fortunes of the other investors by the pooling of assets, usually combined with the pro-rata distribution of profits" and two variants of vertical commonality, which focus "on the relationship between the promoter and the body of investors").

28. The concept of "vertical commonality" requires the fortunes of the investor to be "interwoven with and dependent on the efforts and success of those seeking the investment or of third parties." Villeneuve v. Advanced Bus. Concepts Corp., 698 F.2d 1121, 1124 (11th Cir. 1983), *affd en banc*, 730 F.2d 1403 (1984). Vertical commonality comes in two varieties: "broad" and "strict." Broad vertical commonality focuses on the relationship between an investor and the promoter and requires the investor's dependence on the promoter's expertise. Courts adhering to this view consider whether the investor's realization of profits is inextricably tied to the promoter's effectiveness and skill. To establish "broad vertical commonality," the fortunes of the investors must be linked only to the *efforts* of the promoter. *See* Long v. Shultz Cattle Co., 881 F.2d 129, 140-41 (5th Cir. 1989). To establish "strict vertical commonality" requires that the fortunes of investors be tied to the *fortunes* of the promoter. *See* Brodt v. Bache & Co., 595 F.2d 459, 461 (9th Cir. 1978).

of the digital item by the purchaser.[29] Subsequently, this prong requires investor receipt of earnings by either capital appreciation of the initial investment or based on the use of the investors' funds.[30] Lastly, the third prong under *Howey* requires that investor earnings must also be derived from the efforts of others. The central issue is "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[31] An NFT enterprise that assigns "nominal or limited responsibilities to the [investor] does not negate the existence of an investment contract."[32] If the NFT creator, sponsor or promoter provides efforts that are "the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise," and is not merely performing ministerial or routine tasks, then there likely is an investment contract.[33]

IV. SECURITIES LAW GOVERNING NFT PLATFORMS

If an NFT is a security, then internet platform where the NFT is bought or sold may have to register as an exchange under the Securities Exchange Act of 1934. The Exchange Act defines the term 'exchange' as:

> any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or ***provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood***, and includes the market place and the market facilities maintained by such exchange.[34]

Further the rules and regulations under the 1934 Act state that an organization shall constitute an exchange if it (1) brings together the orders for

29. United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852-53 (1975) (where a purchaser is not "'attracted solely by the prospects of a return' on his investment . . . [but] is motivated by a desire to use or consume the item purchased . . . the securities laws do not apply.").

30. *Id.* At 852.

31. SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir. 1973).

32. SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 484 n.15 (5th Cir. 1974).

33. *See Turner*, 474 F.2d at 482.

34. 15 U.S.C. § 78c(a)(1).

securities of multiple buyers and sellers; and, (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade.[35] The SEC notes that "any entity or person engaging in the activities of an exchange must register as a national securities exchange or operate pursuant to an exemption from such registration."[36] Thus, any platform that brings together multiple buyers and sellers by using non-discretionary methods will likely need to register if the NFTs they offer are deemed securities. Registration contemporaneously requires the full and fair disclosure of certain information to investors, and that information must not be materially misleading.[37]

V. POTENTIAL PITFALLS FOR NFT PLATFORMS

As discussed above, crypto marketplaces may conflict with federal securities law if products they sell are in fact unregistered securities. At first glance, several current practices marketed throughout the cryptoverse may put these platforms at risk under *Howey*.

"Staking" is the practice of pooling a crypto asset for a specified period of time in order to earn a return on the amount the investor puts in the pool.[38] The lockup period may vary from one day to several months.[39] When the lockup period expires, the investor receives the original quantity of the digital asset in

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35. 17 C.F.R. § 240.3b-16(a).

36. SEC, No. 81207, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (Jul. 25, 2017), https://www.sec.gov/litigation/investreport/34-81207.pdf.

37. *See* Tsc Indus. v. Northway, 426 U.S. 438, 449 (1976) (a fact is material "if there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision or if it "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available" to the shareholder).

38. Ahamdi Abarikwu, *Cryptonomics: Earning Passive Income with Crypto Explained*, SOLANA NEWS, Apr. 24, 2021, https://www.solana.news/post/cryptonomics-earning-passive-income-with-crypto-explained (last visited Mar. 22, 2022).

39. *Id*.

addition to any returns earned over that period.[40] Staking improves the network by validating transactions on the blockchain based on the number of crypto assets the investor holds.[41]

"Airdrops" are distributions of crypto assets in return for very easy marketing tasks or as rewards for early adoption.[42] Airdrops are traditionally associated with new blockchain projects who use them to promote the platform, but may also be used by established crypto promoters to reward loyal community members.[43] Airdrops are popular in the cryptoverse because they are of mutual benefit to the blockchain projects and the recipients.[44] Airdrops create awareness and quickly raise a community of crypto asset users while being a source of passive income to recipients since many airdropped assets already have a market value at the time of distribution.[45] Generally, a very large percentage of the recipients quickly sell off airdropped crypto assets; thousands of people seek out airdrop opportunities daily.[46] Accordingly, crypto platforms often use airdrops as a means of starting and growing a business within a specific user community.[47] Airdrop returns can vary wildly – from being worthless (e.g., when the business fails to gain traction) to spectacular.[48] Decentralized finance platforms UNI and 1Inch each airdropped crypto assets worth thousands of dollars to their respective early adopters.[49]

Several crypto exchanges, (*e.g.* Binance or KuCoin) also maintain automated lending systems.[50] These platforms allow investors to deposit

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40. *Id*.

41. *Id*.

42. *Id*.

43. Ahamdi Abarikwu, *How Does a Cryptocurrency Airdrop Work?*, BSC NEWS, Oct. 14, 2021, https://www.bsc.news/post/how-does-a-cryptocurrency-airdrop-work (last visited Mar. 22, 2022).

44. *Id*.

45. *Id*.

46. *Id.*

47. Abarikwu, *supra* note 38.

48. *Id*.

49. *Id*.

50. *Id*.

crypto assets into a pool of funds from which loans are made.[51] After expiration of a lockup period, investors recover their crypto assets together with interest.[52]

"Yield Farming" is also a form of lending available on crypto platforms.[53] A yield farmer deposits crypto assets into the platform's liquidity pool to support the platform's activities, such as exchanging tokens, and is rewarded by the platform.[54] These rewards can come from the platform's native tokens or a portion of the platform's fees.[55] The main reason why it is one of the trending sectors is the promise of huge returns, whether real or imaginary, that are associated with it by many.[56] Rather than just keeping one's crypto assets idle in one's wallet, yield farmers choose to offer those assets to a service provider and earn some form of interest.[57] Decentralized finance started on the Ethereum network, so it is no surprise that yield farming from the outset was exclusive to the Ethereum blockchain, with the rewards being in the form of Ethereum-based tokens.[58] The "De-Fi" space has now rapidly expanded, as other blockchain platforms with yield farming capability now exist and are competing with Ethereum, especially the Binance Smart Chain (BSC).[59]

VI. NFTS IN THE MARKETPLACE

NFTs can be anything digital (*e.g.* drawings, music, GIFs) but the current excitement surrounds using the tech to sell digital art.[60] Recently, NFTs have skyrocketed in mainstream popularity, leading a digital flower to sell for $20,000, a looping video clip for $26,128, a sock for $60,000 and a LeBron

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51. *Id*.

52. *Id*.

53. *Id*.

54. *Id*.

55. *Id*.

56. *Yield Farming Explained,* SOLANA NEWS, Feb. 1, 2022, https://www.solana.news/post/cryptonomics-yield-farming-explained (last visited Mar. 22, 2022).

57. *Id*.

58. *Id*.

59. *Id*.

60. *See* Clark, *supra,* note 19.

James video clip for $99,999.[61] However, many other less well-known NFTs exist and may or may not be in conflict with *Howey*.

From publicly available data, we can review how NFT creators are marketing their digital assets and determine which, if any, may fall under *Howey's* definition of investment contracts:

"Solarians" market themselves as the "OG robots on Solana originating from Solaria Prime."[62] They can be purchased on the Digital Eyes[63] or FTX US[64] platforms. Since July 2021, according to the road map listed on its website, Solarians will provide "an escrow marketplace" where "holders earn a share of transaction fees."[65] In other words, Solarians buyers are purchasing digital assets that are being pooled together to generate transaction fees, or profits, a portion of which will then be returned to those holding the robot NFTs. At first glance, this may run afoul of *Howey*. Assuming a purchase for consideration, Solarians' website suggests a common enterprise through the pooling of digital assets. Of course, further investigation is necessary to determine if the third prong is met but advertising future passive income earnings to investors is a fair start down the path leading to Solarians being deemed a security. Such a finding would likely cause legal concerns for Digital Eyes, FTX US, or any other platforms that trade Solarians.

"Thugbirdz" market themselves as digital "birds… that are thugs."[66] Their website's roadmap consists of a plan to list these digital birds on all available marketplaces, launch an 8-bit game, sell custom merchandise and ultimately, "get thugbirdz in a rap song."[67] It would appear that Thugbirdz purchasers are consuming these digital assets rather than investing in them. Further, the website does not evidence the pooling of purchaser funds or offering income

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61. Mark Stenberg, *The ABCs of NFTs: A Guide to Non-Fungible Tokens, the Cryptomedia Trend Bringing Ownership to the Internet*, ADWEEK, Mar. 2, 2021, https://www.adweek.com/media/nfts-guide-nonfungible-tokens-cryptomedia-trend-ownership-internet/ (last visited Mar. 22, 2022).

62. Solarians: The First On-Chain Generative NFTs on Solana, https://solarians.click (last visited Mar. 22, 2022).

63. DigitalEyes Market, https://digitaleyes.market/collections/Solarians (last visited Mar. 22, 2022).

64. FTX US, https://ftx.us/nfts/collection/Solarians/25/1 (last visited Mar. 22, 2022).

65. Solarians: The First On-Chain Generative NFTs on Solana, https://solarians.click /roadmap (last visited Mar. 22, 2022).

66. Thugbirdz, https://www.thugbirdz.com/#roadmap (last visited Mar. 22, 2022).

67. *Id*.

on the basis of the promoter's efforts. Absent additional information, they likely would not meet the definition of an investment contract.[68] Upon initial review, Thugbirdz do not appear to meet the definition of a security.

Other NFT creators provide just enough publicly available information to warrant investigation into whether or not these digital assets are securities. For example, Cyber Pharmacy states, without more, that Phase 2 of its rollout will include a "Special Airdrop."[69] Frakt, a "generative art collection" NFT, reveals on its roadmap that purchasers can "Stake your frakts and you will be eligible to … earn yields from collection royalties and fraktionalizer fees."[70]

VII. PRACTICAL CONSIDERATIONS

Where can an NFT creator selling an unregistered security, or a platform on which these unregistered securities are sold, expect to defend an investor's lawsuit? The response is, of course, it depends. However, there are real risks to NFT creators and their marketplaces that the answer may be anywhere or everywhere. The Securities Act and the Securities Exchange Act share identical language benefitting purchasers over defendants. "The district courts of the United States and United States courts of any Territory shall have jurisdiction of offenses and violations under this title… Any such suit or action may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took place, if the defendant participated therein….[71] If claims are made under both the Exchange Act and the Securities Act, proper venue can be determined according to the Exchange Act because its broader provisions "permit an action to be brought where any act or transaction connected with the alleged violation occurred."[72]

However, the Judicial Procedure Act may offer some aid to defendants in these cases. "For the convenience of parties and witnesses, in the interest of justice, a district court may transfer any civil action to any other district or division where it might have been brought or to any district or division to

68. *Forman*, 421 U.S. at 852.

69. Cyber Pharmacy, https://cyberpharmacy.io/ (last visited Mar. 22, 2022).

70. FRAKT | A NFT-DeFi ecosystem on Solana, https://frakt.art/#roadmap (last visited Mar. 22, 2022).

71. *See* 15 U.S.C. § 77v and 15 U.S.C. § 78aa, respectively.

72. Pioneer Props., Inc. v. Martin, 557 F. Supp. 1354, 1358 (D. Kan. 1983).

which all parties have consented."[73] Section 1404(a) gives "discretion [to] the district court to adjudicate motions for transfer according to an individualized, case-by-case consideration of convenience and fairness."[74] While plaintiffs may not like the idea of being transferred to the Defendant's home state in an unregistered securities case, it is a preferable alternative to dismissal. Courts "enjoy greater discretion to transfer a cause pursuant to § 1404(a) than to dismiss the action based upon *forum non conveniens*."[75]

VIII. RECENT NEWS

On December 22, 2020, the SEC charged Ripple Labs, Inc. and two of its executives with conducting $1.3 billion in unregistered securities offering of digital tokens.[76] Purchasers allege that the tokens lost $15 billion in value when crypto exchanges in the U.S., including Coinbase, delisted or suspended trading after the SEC sued.[77] According to the agency's complaint, the digital asset is a security, and the company should have registered its offering and sale to the public with the SEC.[78] Ripple argues that the digital asset is a currency, which would make it subject to different laws and regulations overseen by different Treasury Department agencies (*e.g.* the Office of the Comptroller of the Currency or the Financial Crimes Enforcement Network).[79] Currently still in the discovery phase, the lawsuit is expected to continue well into 2022.

On September 7, 2021, Coinbase announced in a blog post that the SEC had threatened to sue the company over its proposed offering, Coinbase Lend,

73. 28 U.S.C. § 1404(a).

74. Stewart Org., Inc. v. Ricoh Corp., 487 U.S. 22, 29 (1988).

75. Chrysler Credit Corp. v. Country Chrysler, Inc., 928 F.2d 1509, 1515 (10th Cir. 1991).

76. Press Release, SEC, SEC Charges Ripple and Two Executives with Conducting $1.3 Billion Unregistered Securities Offering (Dec. 22, 2020), https://www.sec.gov/news/press-release/2020-338 (last visited Mar. 22, 2022).

77. Jody Godoy, *Judge in Ripple cryptocurrency case wants token holders' views,* REUTERS, Oct. 5, 2021, https://www.reuters.com/legal/transactional/judge-ripple-cryptocurrency-case-wants-token-holders-views-2021-10-04/ (last visited Mar. 22, 2022).

78. Kolhatkar, *supra*, note 6.

79. *Id*.

alleging that the offering involved a security.[80] The product was said to offer users a high-yield alternative to traditional savings accounts, allowing them to loan their digital assets to Coinbase at 4% interest.[81] Citing *Howey,* "the investment of money encompasses cryptocurrency…with Coinbase Lend, there was to be an intermingling of crypto deposits from different customers… [and] a reasonable expectation of profit derived from the efforts of others; in this case, Coinbase offered a 4 percent profit."[82] Perhaps illuminating the need for registration and disclosure, Coinbase provided little in the way of details about how it would earn enough to pay 4 percent.[83] On September 17, 2021, Coinbase headed off a confrontation with the SEC by announcing it was scrapping its plans for Lend.[84]

IX. CONCLUSION

New concerns will arise as NFTs continue to proliferate, especially in the absence of clear regulatory guidance. However, NFTs sold on the promise of profit or passive income are likely to be considered securities. Parties on either of side of NFT transactions should be preparing for that future *now*. A less attractive alternative may await those who fail to prepare, possibly hitting them with the full force of a degenerate ape.[85]

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80. Paul Grewal, *The SEC has told us it wants to sue us over Lend. We don't know why.*, COINBASE, Sep. 7, 2021, https://blog.coinbase.com/the-sec-has-told-us-it-wants-to-sue-us-over-lend-we-have-no-idea-why-a3a1b6507009 (last visited Mar. 22, 2022).

81. Feltman, *supra*, note 7.

82. *Id*.

83. *Id*.

84. Ben Bain, *Coinbase scraps plans to launch crypto lending program after SEC pressure*, FORTUNE, Sep. 20, 2021, https://fortune.com/2021/09/20/coinbase-crypto-lending-program-sec-trading/ (last visited Mar. 22, 2022).

85. Solanart - Discover, collect and trade NFTs, https://solanart.io/collections/degenape (last visited Mar. 22, 2022).

LESSONS LEARNED FROM COVERED CALL CASES

Frederick Rosenberg, JD.[1]

INTRODUCTION

Over the past three decades, I have had the opportunity to analyze and review scores of covered call investor claims in which the financial adviser's recommended covered call strategies grossly underperformed the markets despite expectations and assurances that such a strategy would enhance returns at low risk and not reduce them. Causation for the underperformance is commonly attributed to equity market reversals and withdrawals by advisers in their defense, attributions that are provably false. Proper analysis almost always demonstrates that the equity losses in the underlying stocks are the direct and foreseeable consequence of a negligently implemented and poorly supervised covered call strategy.

A LOT OF MOVING PARTS

For most attorneys, evaluation of covered call cases typically begins and ends with a simple cash flow analysis of the entire account. This often shows little if any net-out-of-pocket (NOP) losses to recover, despite a benchmark model indicating far improved performance under identical cash flows.

A review of the cash flows may show - as it did in one recent case - that the overall account generated significant dividends and interest as well as profits in legacy stocks and securities also held in the account yet, the account broke even. Where did the dividends, interest and legacy profits go?

Analysis showed that they were cannibalized entirely by equity losses caused by assignments and trading losses incurred in the covering and

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1. Fred Rosenberg is a member of the Securities Expert Roundtable and has been a member of PIABA since 1998. He thanks PIABA Bar Journal editor David E. Robbins for editing two drafts of this article.
This article could not have been written without the cooperative efforts of counsel, Jenice Malecki, Esq.
I further want to thank David Robbins Esq, my Piaba Bar Journal editor, who makes my writing better and clearer in every way and has done so for years.

underlying stocks purchased specifically to collateralize short-side options speculation.

Additionally, investors with large positions in low-basis stock often lose shares called away at a taxable profit, but with unintended and undesired market losses caused by methodological departures from benchmarks that increased risk, lowered returns and resulted in the untimely loss of appreciated shares below market value. Replacing the lost shares will have to be at the appreciated price. Low basis stocks have the additional complication that no matter how negligent the options trading, the stocks will still report a taxable profit. For this reason, component analyses must mark-to-market all positions at the start of the analysis to assess portfolio impact.

Unfortunately, neither the account statements nor confirmations report the information needed to determine causation and impact of options component underperformance. Specifically, analyzing short options strategies requires knowing the following variables:

1. The days to expiration,
2. The closing market price of the underlying stock on every trade date,
3. Moneyness[2] (the amount by which an option is out or in the money on the trade date),
4. Volatility of the underlying stock and the Implied Volatility of the option, and
5. The repurchase cost of assigned options at parity on the trade date.

These are the principal variables required for input in options calculators using standard Black-Sholes methodology[3] for pricing and calculating the implied volatility of the option.

Lastly, every analysis should show percentage of expirations, assignments and repurchases to close. While repurchasing an in-the-money (ITM) option[4] at a loss to free the stock is expected prior to expiration, repurchasing an out-of-the-money (OTM) short option[5] with substantial time value remaining (i.e.,

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2. Will Kenton, *Moneyness*, INVESTOPEDIA (Apr. 13, 2021), https://www.investopedia.com/terms/m/moneyness.asp.

3. Adam Hayes, *Black-Scholes Model*, INVESTOPEDIA (Sept. 2, 2021), https://www.investopedia.com/terms/b/blackscholes.asp.

4. Christina Majaski, *In the Money vs. out of the Money: What's the Difference?*, INVESTOPEDIA (Feb. 20, 2022), https://www.investopedia.com/ask/answers/042715/what-difference-between-money-and-out-money.asp.

5. Cory Mitchell, *The Dangerous Lure of Cheap Out-of-the-Money Options*, INVESTOPEDIA (June 11, 2021), https://www.investopedia.com/articles/optioninvestor/10/lure-of-cheap-options.asp.

more than 30 days), evidences rolling, trading and impaired returns. When, as in one claim I reviewed, repurchased OTM options averaged 200+ days to expiration, the strategy amounted to volatility trading, not a conservative covered call strategy dependent on expiration.

Without analyzing the variables and opening and closing data, it would be impossible for supervisors to identify negligent or unsuitable recommendations or to evaluate an options strategy's risk, return and portfolio impact for any customer. The same applies to counsel and experts representing the investor.

Some Necessary Basics

Covered calls and cash secured puts are combination investments generally considered to be low-risk and suitable for most investors - when properly executed.

- Covered calls consist of owning stocks and selling (writing) an OTM call to a speculator at a strike price above the current market. The speculator (the buyer of the call) pays the seller a "premium" in exchange for the right to call the stock away at the strike price on or before the option's expiration date.
- A cash secured put consists of selling an OTM put for a premium, giving the purchaser of the put the right to "put" his stock to the seller at the strike price on or before the option's expiration date.

For most investors, keeping the stock and the premium is the typical expectation from covered call strategies promising "income" and growth. "Free money "is a term often echoed by investors induced by their financial advisers into covered call strategies. For put writers, on the other hand, keeping the premium without buying the stock is the goal of income investors supplementing portfolio return with net premium.

In both instances, the investor's goals can be accomplished only by expiration. Otherwise, options will be actively traded for a profit or loss or assigned for a market loss in the equities.

Once an option is written, sufficient margin or the covering stock must be maintained in the account to purchase assigned stock at the strike price, repurchase the ITM option, or to deliver the stock, and that collateral cannot be released as long as the option remains open.

Depending on how close to market value the strike price is, moneyness, the length of time to expiration, the speed of the market and volatility, risks and returns will vary substantially (particularly with high volatility underlying stocks). Options writers cannot exercise an option and have only three potential exits,

- expiration for a profit,
- repurchase the option for a profit or loss to free the underlying stock or
- permit assignment for a market loss in the underlying stock and retain the premium usually for a combination market loss.

The maximum return for an option writer is the premium received upon expiration. Writing options depends on time-value decay for profitability, the expectation the stock will remain out-of-the-money and the option expiring worthless. For every option written, the fewer the days to expiration and the farther out-of-the-money the option is written the faster the time value decay and greater the return.

The annualized return writing covered calls with 30-day or shorter expirations consistently exceeds the annualized return on options written with long expirations for higher premiums. For example, the risks in writing $105 calls expiring in 30 days for a 1.5% premium (18%/year max) on a $100 volatile stock rewritten monthly is exponentially less risky with higher return than writing a $105 covered call LEAPS[6] expiring in 730 days and rewritten once every two years for a single 15% premium (7.5%/yr. max) on the same, $100 stock.

In the time it takes for the LEAPS to expire, 2 years, the 30-day options would have generated 36% in gross premium at 1.5%/month, 21% more with lower risk. Generally, the same holds true across the entire spectrum of expirations, the longer the days to expiration the lower will be the annualized return.

Writing options long term effectively eliminates time decay from the strategy, a key element. Consequently, expirations decline and trading increases in both options and equities. The covering stock serves merely as collateral whose appreciation is capped on the upside for months or years until expiration with marginal cushioning on the downside. Only the broker-dealer is truly protected by the covering stock that ensures against customer default, while obviating margin requirements to facilitate the strategy.

The downside risk of a covered call is greater than a short, cash-covered put**.** In both cases the underlying or covering stock can go to zero for a total loss. The covered call writer must first purchase the stock at market, $100, ($10,000) and then write an out-of-the-money call at $110 for a $200 premium,

6. LEAPS, or long-term equity anticipation securities, are options contracts with expirations between 1 and 3 years out. James Chen, *Long-Term Equity Anticipation Securities (LEAPS)*, INVESTOPEDIA (Feb. 27, 2022).

thereby reducing the cost basis to $9,800 at risk. The short put writer, however, writes the OTM put first at $90, also taking in a $200 premium, but only acquires the stock - if assigned- at $90 a net of $8,800 at risk, $1,000 less at risk than the covered call on the downside for the same underlying stock and premium.

In both cases the option can expire worthless, close over $90 on the short put and under $110 for the covered call, both netting $200 and allowing the option to be rewritten. The put writer has zero cash outlay upon expiration, while the covered call writer remains out of pocket, $9,800 on the underlying shares and still subject to market risk. While the call writer cushions loss in the stock with the premium received, the put writer, in addition to any premium, will have $10 of downside protection before assignment.

In the event the put is assigned at $90, the call writer's option will have expired, but the writer will still suffer greater than a $10 market loss in the covering stock and a net combination loss. In the event the call is assigned and covering stock sold at the $110 strike price, there is no comparable market risk for the put writer who continues to generate premium while his portfolio grows unencumbered by covered calls. The call writer, having lost the stock, must then repurchase the stock to continue the strategy, usually at a far higher market price than initially purchased, effectively limiting if not eliminating appreciation and growth in the underlying securities.

Assignments

Once an option is in-the-money, it will be assigned to the writer if not repurchased. Depending on the length of time to expiration, volatility and the underlying stock price, the potential market loss could be massive if the option is not repurchased early to free the stock before assignment occurs, a race against the speed of the market.

Assignments prior to the option's expiration date do occur with American Style Equity options (i.e., nine months in duration), usually to capture dividends and splits on the underlying shares, losing both the stock and the dividend well in advance of expiration.

Options can only be exercised by the purchaser (never the seller), any time prior to expiration. When an option purchaser exercises an option, a notice is sent to the Options Clearing Corporation, which will assign the exercised option randomly to option writers. Assignments occur automatically without order tickets for supervisors to review.

The repurchase costs shifted to the equities on assigned options are paid by selling the underlying portfolio stock *below market on an assigned call* or by *purchasing stock above market price on an assigned put,* forcing the equities to absorb a market loss and the option to appear profitable. The repurchase cost of an assigned option is the amount that would have closed the option position versus allowing assignment. It equals the difference between the closing market price of the underlying stock on the trade date and the strike price.

The decision to allow assignment versus repurchase is an unsupervised investment decision that is rarely if ever discussed with aggrieved investors. There are no order tickets. Assignments happen automatically if allowed. This fact affords some brokers the opportunity to conceal option losses through assignments, making an option strategy appear profitable when it was not, while making the resulting equity market loss appear to be the result of market declines and withdrawals when, in fact, the loss was actually the direct result of the shifted options repurchase costs baked in. The assigned option will be zeroed out on the investor's statements as if it expired and will appear to be profitable when it is not. The shares called away disappear from the statements and the shares put to the account will reflect only market value; the actual option loss vanishes.

Since the statements and the confirmations report a profit on assigned options without netting the market losses in the underlying stock, it is impossible for anyone to quantify and prove causation for the equity market losses attributable to the options component and its negative impact on portfolio return based solely on the statements and confirmations. One thing is certain: absent proper analysis incorporating substantial unreported data, the options strategy's negligent methodologies and the component losses responsible for account underperformance would forever be opaque to investors and counsel, and, unfortunately, to arbitrators and mediators as well.

ILLUSORY PREMIUM INCOME

Covered Calls are consistently recommended as a low-risk strategy to generate supplemental income and enhance returns of equity portfolios. As benchmark indexes such as the BXM have consistently proven, properly executed, a covered call strategy will generate net premium income and improve performance over its benchmark index, except when the index spikes upward. However, when methodologies vary from proven indexes - as is common in investor claims - risks increase, returns decrease, trading increases, costs increase, expirations decrease and repurchases increase. Combined option and equity losses are the foreseeable consequence of methodological deviations from index algorithms as proper analysis will show.

Brokerage statements do not report "premium income" anywhere. They do report options trading profits and losses for capital gains treatment, but nowhere on the statements is there information for an investor to determine if the overall strategy is enhancing returns, producing income or not.

From the investor's perspective, premiums received on covered calls visibly increase cash flow (by $2.1 million in the referenced case), while, if assignments are permitted, the underlying equities will absorb the repurchase cost for a market loss in the underlying stock creating the illusion of option income.

Permitting assignments does not alter the fact that an options strategy as implemented consistently loses money without generating any net premium income whatsoever. The greater the number of assignments, the more impossible it is to assess the profitability of the options component without additional data. Rolling losses forward, paying for option losses with the premium from new options adds to the illusion and writing in-the-money options amplifies that illusion. The proof is established only by analysis.

Applying the analytical data

In a recent covered call case - summarized in the tables below- spanning more than 10 years, the traditional transaction analyses showed an options profit of $181,000 but more than $847,000 of market losses in the underlying equities. Overall, however, the account still broke even after contributions and withdrawals. There were virtually no NOP losses.

The options component analysis, however, revealed that over 9% of all closing options transactions resulted from assignments that shifted $489,000 in option repurchase costs to the underlying equities accounting directly for over 75% of net component losses. The remaining equity losses were traceable exclusively to the declines and trading losses in the underlying and covering stocks purchased solely to collateralize options speculation and unable to be sold without repurchasing the option for a loss. That repurchase risk was amplified by the time premium on LEAPS - options with expirations between 1 and 3 years out - and long-expiration short options.

Had the broker chosen to repurchase the ITM options versus allowing assignment, the options component would have reported a ($307,000) loss, versus the $181,000 post-assignment profit, clearly illuminating the failure of the strategy as implemented throughout. Shifting option repurchase costs to the equities delayed recognition of the loss, capped growth on the underlying shares and tied up assets for years, thereby adding to the false impression that losses in the equities resulted from market reversals and withdrawals as opposed to the shifted option repurchase costs baked in. Consequently, the options component was neither profitable nor an enhancement, but, instead, was a high-risk drag impairing portfolio performance. It was all opaque to the investor.

Additionally, the options component analysis disclosed that only 6% of all closing transactions were expirations and that nearly 85% of all closing transactions were repurchases for a profit or loss. Regardless of covering stock, trading in and out of long-term option positions is a collateralized volatility strategy not dependent upon time decay, a major departure from benchmarks.

In the instant case, expiration as an exit strategy was clearly not the objective of the broker, a fact undisclosed to the investor, who remained unaware that the broker's methodologies were inconsistent with conservative covered call benchmarks intended to enhance portfolio return with net premium. Instead, the investor was misled by the broker into believing that assignments meant profits and income enhancement as promised, and that market corrections and withdrawals were responsible for portfolio declines or underperformance.

The analysis does not end there, however. Forty percent (40%) of opening transactions generating in excess of $1million in premium were covered LEAPS. Expiration on the LEAPS averaged more than 765 days from their opening date, eliminating expiration as an exit, amplifying risk, lowering returns and binding volatile stocks for years. Covered LEAPS take the growth out of growth stocks but not the downside. LEAPS premiums are high and provide cashflow needed to sustain trading activity. However, the impairment, costs and risks are unacceptable, unsuitable and frequently undisclosed.

Writing covered LEAPS is not simply a rookie mistake in pursuit of premium, but it actually gets LEAPS backwards. When investing long term, instead of purchasing the stock at market, an at-the-money LEAPS should have been purchased as a proxy at much lower cost and calls written covered by the LEAPS. Since American Style Options can be exercised any time before expiration, the short call is covered by the LEAPS at the lower strike price. This is known as a *synthetic covered call* since the stock is never purchased.

Since the most an option purchaser can lose is the premium paid, the downside risk with buying LEAPS is limited to the premium paid, not the stock price which could drop to zero. Buying LEAPS as covering securities is lower risk than buying the stock when writing long-term options. Writing covered call LEAPS, however, is always a "red flag," requiring supervisory intervention.

In the case at issue, non-LEAPS options averaged 300 days on open. There were multiple instances of rolling losses, paying for a loss on one option with the premium from a newly opened position in the same stock, and, in some cases, writing in-the-money options to generate sufficient premium to do so. The account was commission-based and the analysis calculated over $305,000 in commissions and costs, versus half the costs if the account were on a 1% management fee.

The monthly short position in the account averaged about – ($100,000) on average equity of $1.3 million**.** At a 3%-8% premium to market, $100,000 in monthly short option balances represented a notional $1.25 million to $3.3 million in equity trades if exercised, which was one to two times the account equity and potentially massive liability inconsistent with conservative investing. Total premiums received were $2.1 million versus $1.74 million in option repurchases for trading volume of $4.2 million and $181,000 of net premium *after $489,000 in assignments.*

The tables below summarize the options-related outcomes. Without this analysis that connects all the variables and components, there is no satisfactory method of demonstrating that nearly 75% of combined losses were directly attributable to shifted repurchase costs baked in, not withdrawals or market declines as is typically alleged successfully.

AAA Option Related Equities Summary				
		trades		Commissions
Purchase Long	$ (5,166,757)	577		$ 58,450
Sold Position	$ 4,319,355	404		$ 48,158
Trading Loss	$ (847,402)	981		$ 106,608
Statement Loss	$ (847,402)			
Assignments	$ 489,398			
Pre Assignment Losses	$ (358,004)			
Trading volume	$ 9,486,112			

AAA Options Summary				
	Trades		Avg Days	Commission
Open Short	1917	$ 2,103,921	300	$ 110,495
Close Short	1704	$ (1,922,491)	140	$ 88,611
Net Premium after Assignments		$ 181,430		$ 199,106
Statement Profit	$ 181,430			
Repo costs Assigned	$ (489,398)			
Adj P/L if repurchased	$ (307,968)	Actual Option Trading Loss		
Option Commissions	$ 199,106			
Expiration	112	6.60%		
Repurchases to close	1435	84%		
Assignments allowed	157	9.20%	$ (489,398)	
Leaps	808	Avg Expiration 765 days		
Trading volume	$ 4,026,412			

Total Options Strategy Impact				
	Statement	assign	Adj Loss	Commissions
Options	$ 181,430	$ (489,398)	$ (307,968)	$ 199,106
Equities	$ (847,402)	$ 489,398	$ (358,004)	$ 106,608
	$ (665,972)	$ -	$ (665,972)	$ 305,714

When option assignments are absent, portfolio underperformance or losses still require a methodological analysis to determine causation. If, as in the current example, only 6.6% of open positions expire for maximum return, then repurchasing 94% of open positions is indistinguishable from collateralized trading dependent on the price volatility of the underlying shares and the implied volatility of the option and not on time decay as one would expect.

Time Decay, measured by Theta,[7] is most pronounced between 120 and 30 days prior to expiration. In the recent case, option repurchases averaged nearly 200 days to expiration, well before the effect of time decay, and priced principally on volatility adding substantial risk and cost.

Broker Risk: It is common to discover that a broker is writing calls not just in the investor's account but in dozens of customer accounts on broadly diversified portfolios generating well over half of the broker's gross commissions. The investor's portfolio may have five to ten open options positions to monitor, which may, by itself, seem doable. However, multiply the open option positions by 20 to 30 individual accounts and the broker may actually be managing between 100 to 300 open positions daily on a multiple of stocks and indexes, a demanding task.

Monitoring and closing out 100 to 300 open positions for 20 to 30 unique customers, absent discretion, requires prior customer contact before order entry. It also requires discipline, attention to detail, procedural safeguards and supervisory controls for customer protection. Executions will vary from customer to customer, and "front-running," a broker trading the same security in a personal account in advance of a customer's order (a rules violation}, may also occur. It is also common to find under these conditions that some brokers exercise discretion without written authorization and required heightened supervision.

In reality, writing and rewriting 30-day calls is a practical impossibility for many retail brokers in the course of their overall business, leading to recommendations of long-expiration options to generate higher cashflow, fewer expirations and increased trading with lower annualized returns, higher cost and greater risk than is suitable for an investor agreeing to a low-risk conservative covered call strategy.

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7. James Chen, *Theta*, INVESTOPEDIA (Dec. 28, 2020), https://www.investopedia.com/terms/t/theta.asp.

Finally, it is also common to find that a retail broker maintains no models, adheres to no conservative benchmark methodologies and has no documentation of producing net premium from a strategy that measurably lowered returns and increased market risk. Yet the broker continually recommends and implements the strategy blindly if not baselessly with supervisory consent, predictably leading to customer loss.

Know the Benchmarks and Methodologies

There are many indexes based on covered calls and cash secured short puts. The most popular measuring stick is the BXM (the CBOE S&P 500 Buy/Write index that writes 30-day calls at or near the money on the S&P 500). Methodologically, all indexes rely on algorithms that write options with expiration 30 days or less, cash settle and rewritten monthly, maximizing return, while lowering risk and decreasing the impact of volatility.

The average monthly BXM premium is 1.69%.[8] Rewriting monthly allows for price movement on the underlying securities while adding potentially more than 3% to 16% to overall return if all goes well, plus cushioning on the downside[9]. The key to maximizing return is in the repetition and rewriting of low risk, low return options monthly. There are no recognized indexes or standards for covered LEAPS or options expiring beyond 30 days in great part for this very reason.

Model portfolios are not arcane comparisons, but ones commonly produced by investment advisers specializing in options strategies. Approval for covered calls reasonably presumes that the broker's recommendations be guided by and consistent with accepted methodologies and risks.

When the options analysis demonstrates substantial variance and added risk in methodologies - between the implemented strategy and conservative benchmarks, as is common in investor claims of merit - the investor needs appropriate disclosure *prior to the recommendation,* of the increased risks and reduced returns that are reasonably foreseeable. Approval for covered call

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8. *Highlights from Case Study on BXM Buy-Write Options Strategy*, IBBOTSON ASSOCIATES, https://cdn.cboe.com/resources/education/research_publications /IbbotsonAug30final.pdf (last visited Mar. 15, 2022).

9. *An Historical Evaluation of the CBOE S&P 500 BuyWrite Index Strategy*, CALLAN ASSOCIATES, INC., https://cdn.cboe.com/resources/education/research_ publications/Callan_CBOE.pdf (last visited Mar. 15, 2022).

writing is not a license for a broker to speculate on options or to trade volatility even if collateralized by stock in the customer's portfolio.

Benchmark comparisons are essential to monitor, measure, and supervise a broker's option strategy recommendations. And a broker recommending a covered call strategy must maintain a performance model, a record of his recommendations and outcomes, and documentation in support of any performance claims if supervision is to be effective and reasonably based prior to a recommendation.

Writing index calls has several advantages over covered equity calls.

1. Indexes are stable, diversified, less volatile with known characteristics and cash settle.
2. Writing Index calls frees portfolio stock to grow unencumbered, while generating premium without risk of assignment.
3. For most investors seeking enhanced returns on their equity portfolios at low risk, index options offer greater stability and portfolio growth than equity options as proven by the BXM.
4. Finally, administratively, writing index calls simplifies and unifies broker management of multiple client accounts versus tracking 100 to 300 open positions for 20 to 30 unique customer portfolios.

The failure to write index options to generate premium versus equity options is directly attributable to inadequate training and supervision.

Disclosure

All options disclosures are generic, but often the actual options trading deviates wildly from benchmark methodologies and performance in investor claims. Writing covered calls is an ongoing "strategy" and performance claims attributable to the recommended strategy should be documented and disclosed. Otherwise, the recommendation is based solely on anecdotes and supposition, not fact.

Below are three excerpts from one broker-dealer's required disclosure for just one of its "Approved Portfolio Managers" engaged in covered call writing in customer accounts[10]:

- *"…Supporting documentation for any claims (including any claims made on behalf of options programs or the options expertise of salespersons), comparisons, recommendations, statistics, or other technical data, will be supplied upon request."*

10. Marketing Brochure on file with the author and available upon request.

- "Buying back a call to close an existing position and writing another call with a different strike price and/or expiration, also known as rolling, can have an adverse impact on the profitability of the account. Rolling may result in added transaction costs which will reduce returns or add to any losses. Note: It may not be prudent to continually roll positions at a loss…"
- "The CBOE S&P 500 Buy Write Index (BXM) is a benchmark index designed to track the performance of a hypothetical buy-write strategy on the S&P 500 Index. The S&P 500 Index is an unmanaged value-weighted market index of 500 stocks generally representative of the broad stock market. An investment cannot be made directly in a market index…."

Supervision

An option loss is always a loss regardless of whether the option is repurchased with cash or paid for by delivering appreciated stock called away for a market loss or by purchasing stock put to the account above market for an unrealized loss.

A strategy that consistently loses money and has demonstrably higher risk and lower return than conservative benchmarks is unsuitable for every investor given the alternatives. With capable supervision, patterns of abuse and deviations in methodologies would be identified and appropriate safeguards, standards, training and controls initiated for customer protection if warranted as required under FINRA Rule 3120 (reprinted below).

Absent appropriate controls, supervisors are incapable of identifying suspect activity with predictable negative consequences for investors. Generic disclosures are simply inadequate customer protection when undisclosed to the investor, the broker's options trading is anything but generic and deviates wildly from conservative benchmarks, adding risk and lowering return.

Without a proper options analysis providing foundation, cross-examination of supervisors and brokers will be, and commonly is, perfunctory and unfocused, adding little causative support to an investor's claim.

It is an investor's responsibility to prove the nexus between options activity and impaired equity returns that resulted in a combination loss and portfolio underperformance. Failing to do so leaves arbitrators having to answer the question about how a recognized conservative covered call strategy that is profitable establishes a basis of recovery for claimed equity losses. Causation must be - and with proper analysis can always be - proven in meritorious customer claims.

Under FINRA Rule 2111(a) and FINRA Rule 2360, broker-dealers are responsible for determining "Reasonable Basis Suitability," a requirement that every recommended investment or strategy must at least be suitable for some investors. Covered calls are an established way to manage risk and enhance return under many market conditions and pass the reasonable basis test easily.

However, when a broker's recommendations demonstrably deviate from benchmark methodologies with greater risk, higher cost, and lower returns, the implemented strategy fails the reasonable basis suitability test. Only the supervising Registered Options Principal (ROP) is in a position to implement customer protections against deviant strategies erroneously approved as covered calls. Failure to do so has foreseeable negative consequences for the investor, as illustrated by the options analysis above.

PROVING THE IMPACT OF THE OPTIONS COMPONENT AS THE MEASURE OF DAMAGES

Often the options trading component of a portfolio can be the most significant driver of portfolio underperformance hidden in the statements, especially in accounts with little or no NOP losses or even a small overall profit.

Covered calls are most commonly recommended as an income enhancement strategy to portfolio returns and, consequently, the option's component is frequently consolidated into statements that also include cash flows in and out, margin, bonds, CDs, mutual funds, UITs, NCIs, legacy stock, interest and dividends obscuring the overall impact of the covered call strategy on the covering or underlying stock.

Analysis requires identifying the methodologies causative of underperformance and isolating the covering and underlying equities, marked to market as of the start date to assess options impact on overall portfolio market performance. The task is to determine if the strategy enhanced market returns with premium income as promised or not and why.

Absent an options analysis, it is not possible to explain negative performance in the underlying equities or to pinpoint the causative variables such as long expirations and LEAPS, rolling, commissions, "moneyness," deviations from benchmark methodologies and trading in and out of equities solely to collateralize options speculation.

1. Benefit of the Bargain/ Model Damages

In the example explained above, the investor agreed to a conservative covered call strategy to supplement her income. A benchmarked model allocated 60% bonds and 40% BXM (option component) mirrored the broker's allocation. Using identical cash flows the model produced $1.37 million more than investor's account that only broke even for the identical period and market cycles.

The analysis showed that the disparity was the foreseeable consequence of negligent methodologies that reduced return and increased risk and cost as discussed above. Had the broker implemented a conservative covered call strategy as represented, the outcome would have approached the benchmark model.

Benefit of the Bargain Damages: $1,370,000

2. Lost Income and Legacy Profit

The cash flow analysis showed the portfolio, in addition to contributions generated $606,000 in bond interest and $220,000 in cash profit on legacy stock held in the account and sold as a result of a merger. The Options Analysis demonstrates that instead of enhancing returns, nearly $826K of interest and legacy profit was cannibalized by option component losses and demonstrably, had the strategy never been implemented, outcome would have been at least $826,000 higher.

Lost Income and Legacy Profit: $826,000

3. Net Component losses

The options component consisting of all the recommended options and underlying and covering stocks, lost an aggregate of $665,000, 75% of which was attributable directly to $489,000 in shifted repurchase costs from option assignments. The option analysis showed that the overall loss was the foreseeable consequence of negligent methodologies that increased market risk, increased costs and reduced returns from conservative benchmarks.

Net Component Losses: $665,972

4. Disgorgement of Commissions

Given the length of time, the consistency of combined losses - including excessive assignments and few expirations, the intent to recommend high cost, high risk and long-term, low return option strategies, the opacity of the statements and demonstrably deficient supervision - the broker should not be permitted to offset the investor's component losses with the commissions earned from their own negligent and unsuitable recommendations.

Disgorgement of Commissions: $305,000

Final Observations

Far too often, investors with meritorious covered call option claims find retaining counsel impossible, and those who do often go through mediation based upon NOPs, not component losses. Those cases that go to a hearing relying solely on the statements and the typical profit and loss and matched trade analyses consistently fail to establish causation for equity losses and account underperformance, resulting in a denial of the claim.

Analyzing short option strategies - such as covered calls - is principally data-driven and conclusions based on that analysis rely on numbers, methodologies and identified patterns, not unsubstantiated opinion based on outcome.

An options analysis must include the options and the covering stocks in combination since a short option strategy's losses are realized most frequently in the underlying equities even if net premium is generated.

Identifying elements of negligent methodologies can be as simple as a preliminary review of the assignments, expirations and repurchases to close. That said, a complete option analysis is needed to establish causation, principally for both realized and unrealized market losses baked into the underlying and covering stocks acquired for and bound to long-expiration, volatile options.

RECENT ARBITRATION AWARDS

Melanie Cherdack, Esq. and Sara Hanley, Esq.

This issue's featured arbitration awards include the first case in which a sole FINRA arbitrator awarded damages to a Robinhood customer as a result of the trading restrictions it put in place during the January 28, 2021 "short squeeze" of meme stocks. This section also discusses an award dismissing a U5 expungement claim based upon a defamatory comment placed on the broker's CRD at the time of her termination --more than six years prior to the filing of the FINRA expungement action. Both of these arbitration awards seem to open the door to similar rulings by arbitration panels. One, seeming to invite more Robinhood trading restriction arbitrations and the other encouraging parties to raise the eligibility rule in opposition to expungement claims. Also, we discuss a large UBS YES award, signaling a big win in an environment where many similar cases have resulted in disappointing outcomes. Included in the below discussion is a paper case brought by an investor rights clinic awarding the Claimant $1 more in compensatory damages than the amount sought, as well as prejudgment interest and costs.

Jose Batista v. Robinhood Financial, LLC, Robinhood Securities, LLC and Robinhood Markets, Inc.
Case No. 21-01206
Hartford, Connecticut
Hearing Date: December 13, 2021
Award Date: January 5, 2022
Counsel:
  Counsel for Claimants:
    August M. Iorio, Esq., Iorio Altamirano LLP, New York, New York
  Counsel for Respondent Robinhood Financial, LLC and Robinhood Securities, LLC:
    Dominick F. Evangelista, Esq., Bressler, Amery & Ross, P.C., Florham Park, New Jersey
    Respondent Robinhood Markets, Inc. did not enter an appearance as it is not a member firm
Arbitration Panel:
  John James McGovern, Jr., Public Arbitrator

Investments at Issue:

The causes of action relate to Respondents placing trade restrictions on numerous stocks on January 28, 2021, including, but not limited to "KOSS" and "EXPR" on its trading platforms in the midst of an unprecedented stock rise.

Claimant's Claims:

Causes of Action in Statement of Claim:

(1) Breach of contract;
(2) Breach implied covenant of good faith and fair dealing;
(3) Negligence;
(4) Breach of fiduciary duty;
(5) Unjust enrichment;
(6) Non-disclosure or concealment;
(7) Intentional interference with prospective economic advantage;
(8) Negligence interference with prospective economic advantage;
(9) Violations of 15 U.S.C. §78

Relief Requested:

(1) Compensatory damages of at least $32,428.00;
(2) Pre- and Post-Judgment interest;
(3) Costs;
(4) Attorneys' fees;
(5) Expert fees;
(6) Forum fees; and
(7) Punitive damages

Relief Requested At Hearing:

(1) Compensatory damages in the amount of $39,761.98;
(2) Pre-judgment interest at the statutory rate in Connecticut or California of 10%;
(3) Attorneys' fees in the amount of $14,401.46;
(4) Estimated forum fees in the amount of $962.50;
(5) Post-judgment interest at the rate of 10%;
(6) Discovery sanctions; and
(7) Punitive damages

Award:

(1) Respondents Robinhood Financial, LLC and Robinhood Securities, LLC are jointly and severally liable for and shall pay to Claimant the sum of $29,460.77 in compensatory damages.
(2) Respondents Robinhood Financial, LLC and Robinhood Securities, LLC are jointly and severally liable for and shall pay to Claimant interest on the above-stated sum at the rate of 10% per annum from January 28, 2021 through and including December 10, 2021.

(3) Respondents Robinhood Financial, LLC and Robinhood Securities, LLC are jointly and severally liable for and shall pay to Claimant $150.00 to reimburse Claimant for the non- refundable portion of Claimant's filing fee previously paid to FINRA Dispute Resolution Services.
(4) Any and all claims for relief not specifically addressed herein, including any requests for punitive damages and attorneys' fees, are denied.

Analysis:

This is the first Robinhood case which awarded damages to a Claimant customer for its alleged improper placement of trading restrictions on meme stocks on January 28, 2021 as a result of the short squeeze. The one-person panel rejected the defenses raised by Robinhood, including those relating to the customer agreement or contract. This award could open up the door to many other such claims arising out of the trading restrictions imposed by Robinhood as a result of the short squeeze and meteoric rise of meme stocks.

Joel D. Zychick, Trustee of the GST Trust U/W Irving Siegel and Joel D. Zychick, Trustee of the QTIP Trust U/W Irving Siegel v. UBS Financial Services, Inc.

Case No. 20-00459
Boca Raton, FL
Hearing Dates: January 11-14, 2022; January 19, 2022
Denver, Colorado
Award Date: February 2, 2022
Counsel:
Counsel for Claimants:
Jeffrey B. Kaplan, Esq., Dimond Kaplan & Rothstein P.A., Miami, Florida.
Counsel for Respondent:
Patrick M. Smith, Esq. and Timothy White, Esq., Katten Muchin Rosenman LLP, Los Angeles, California.
Arbitration Panel:
Robert Steven Haught, Presiding Chairperson, Marsha Matson, Public Arbitrator, Randy Atlas, Public Arbitrator
Investments at Issue:
The causes of action relate to Claimants' investment in the Yield Enhancement Strategy ("YES") with Respondent.

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Fraud;
(2) Misrepresentation;
(3) Unsuitability;
(4) Unsuitable product;
(5) Breach of fiduciary duty;
(6) Negligence and breach of contract, under the federal securities laws, FINRA regulations, Florida securities statutes and applicable common law;
(7) Respondeat superior;
(8) Control person liability; and
(9) Failure to supervise

Award:

(1) Respondent is liable for and shall pay to Claimant GST the sum of $517,020.80 in compensatory damages.
(2) Respondent is liable for and shall pay to Claimant GST pre-judgment interest on the above-stated sum in the amount of $49,118.52. Post judgment interest shall accrue pursuant to the Code of Arbitration Procedure ("Code").
(3) Respondent is liable for and shall pay to Claimant QTIP the sum of $1,171,124.80 in compensatory damages.
(4) Respondent is liable for and shall pay to Claimant QTIP pre-judgment interest on the above-stated sum in the amount of $111,260.36. Post judgment interest shall accrue pursuant to the Code.
(5) Claimants' request for punitive damages is denied.
(6) Respondent is liable for and shall pay to Claimants the sum of $600.00, representing reimbursement of the non-refundable claim filing fee previously paid by Claimants to FINRA Dispute Resolution Services.
(7) Respondent is liable for and shall pay to Claimants the sum of $26,512.50 representing reimbursement of expert witness fees.
(8) Respondent's request for expungement of this matter on behalf of Unnamed Parties Monty Cerf (CRD Number 2269462) (Occurrence Number 2065855) and Matthew Buchsbaum (CRD Number 2220565) (Occurrence Number 2065245) are denied.
(9) Any and all claims for relief not specifically addressed herein, including any requests for attorneys' fees, are denied.

Analysis:

A number of UBS Yes cases have gone to hearing with mixed results. This award, giving the Claimants a large percentage of their requested compensatory damages, plus prejudgment interest and expert witness fees, is a decisive win for the Claimant investors.

Emily Jing Chang v. J.P. Morgan Securities, LLC

Case No. 21-01836

San Francisco, California

Hearing Dates: December 8, 2021 (prehearing conference)

Award Date: December 22, 2021

Counsel:

Counsel for Claimant:

Michelle Atlas, Esq. HLBS Law, Westminster, Colorado

Counsel for Respondent:

Shipra K. Rege, Esq., Ulmer & Berne LLP, Cleveland, Ohio

Arbitration Panel:

Jonathan Polland, Sole Public Arbitrator

Investments at Issue:

The cause of action was for expungement of Claimant's CRD record

Claimants' Claims:

Causes of Action in Statement of Claim:

Expungement of the Form U5 amendments corresponding with Occurrence Number 1693571, and those relevant portions of the Form U4 from Claimant's CRD records on the basis that the statement is defamatory in nature, misleading, inaccurate, and/or erroneous, to include:

(1) Amendment of the Reason for Termination entry in Section 3 of Claimant's Form U5 to read "Voluntary";
(2) Expungement of the Termination Explanation from Claimant's Form U5;
(3) Amendment of the answer to question 7F(1) on Claimant's Form U5, from a "Yes" response to "No";
(4) Deletion of the Termination Disclosure Detail (U4) from the CRD, including: deletion of the Termination Type; deletion of the Explanation for the termination; and deletion of the Allegation(s) associated with the termination;

(5) Deletion of the Termination Disclosure Detail (U5) from the CRD, including: deletion of the Termination Type; deletion of the Explanation for the termination; and deletion of the Allegation(s) associated with the termination; and
(6) Deletion of the Termination Disclosure Reporting Page accompanying Occurrence Number 1693571 from the CRD;

Relief Requested:

(1) Compensatory damages of $1; and
(2) Any and other relief that the arbitration panel deems just and equitable.

Dispositive Motion:

On September 30, 2021, Respondent filed a Motion to Dismiss pursuant to Rule 13206 of the Code of Arbitration Procedure ("Code"). On October 18, 2021, Claimant filed a response opposing the Motion to Dismiss. On October 22, 2021, Respondent filed a reply in support of the Motion to Dismiss. On December 8, 2021, the Arbitrator heard oral arguments on the Motion to Dismiss.

Award:

(1) Claimant's claims are dismissed without prejudice, pursuant to FINRA Rule 13206.

Findings:

Rule 13206(a) states: "No claim shall be eligible for submission to arbitration under the Code where six years have elapsed from the occurrence or event giving rise to the claim. The panel will resolve any questions regarding the eligibility of a claim under this rule."

The "occurrence or event giving rise to" Claimant's expungement request was the disclosure of Claimant's termination on Claimant's Form U5. This occurred on February 21, 2014, which is more than six years before Claimant filed her Statement of Claim. Therefore, based on the expressed language of Rule 13206, Claimant's expungement claim is ineligible for arbitration.

Claimant attempts to get around application of Rule 13206 to her claim by contending that either the occurrence or event is continuing because allegedly derogatory information continues to appear on the BrokerCheck website, or alternatively, that the "occurrence or event" again occurred when access to the BrokerCheck website was enhanced in 2016.

The Arbitrator does not find either argument persuasive. If the continued presence of the allegedly derogatory information on the BrokerCheck website constituted a continuing violation, then Rule 13206 would never bar expungement actions. Further, the enhancements to the BrokerCheck website in 2016 do not constitute an "event or occurrence" under Rule 13206 because Respondent took no further action in 2016 with respect to Claimant's U5.

The authorities cited in Respondent's moving papers and reply support the Arbitrator's determination that the "occurrence or event" triggering the claim for expungement in this case was the submission of the Form U5 by Respondent to the CRD records. Since that event occurred more than six years before Claimant filed this arbitration, Respondent's motion to dismiss is granted.

Analysis:

This reasoned award is of import because the sole arbitrator barred Claimant's requests for expungement under FINRA's six-year eligibility rule. The ruling was based on the fact that the arbitrator found the "occurrence or event giving rise to" Claimant's expungement request was the initial disclosure of her termination on Claimant's Form U5 on February 21, 2014--which was more than six years before Claimant filed her Statement of Claim. The arbitrator rejected Claimant's argument that the occurrence or event is continuing because the allegedly derogatory information continues to appear on the BrokerCheck website, or alternatively, that the "occurrence or event" again occurred when access to the BrokerCheck website was enhanced in 2016. This award might be used to prevent arbitrators from expunging complaints or termination comments from a broker's CRD where the initial reporting took place more than six years prior to the filing of the expungement action.

Aron Greenstein v. Steven Novick

Case No. 21-02032
New York, New York
Hearing Date: N/A (paper case)
Award Date: February 7, 2022
Counsel:
Counsel for Claimants:
Christine Lazaro, Esq., St. John's University School of Law Securities Arbitration Clinic, Queens, New York
Counsel for Respondent:
Pro se

Arbitration Panel:

Phillip Weitzman, Sole Public Arbitrator

Investments at Issue:

The causes of action relate to the overcharge in fees of $4,999 due to the switch of Claimant's account from a standard brokerage account to an investment advisory account.

Claimant's Claims:

Causes of Action in Statement of Claim:

(1) Breach of fiduciary duty;
(2) Misrepresentations and omissions;
(3) Violations of industry rules; and
(4) Violations of Connecticut state law

Relief Requested:

(1) Compensatory damages of $1,931.02, which represents the overcharge in fees due to the switch from a standard brokerage account to an investment advisory account or (b) $4,999.00, which represents most of the $5,100.00 for managerial fees from the second quarter of 2014 to fourth quarter of 2019, which were retroactively deducted, and the $275.58 for managerial fee for the first quarter of 2020, which was deducted a day before Respondent removed himself from Claimant's account;
(2) Interest pursuant to Connecticut General Statute § 37-3a;
(3) Attorney's fees;
(4) Costs;
(5) Expenses; and
(6) Forum fees

Respondent's Counterclaim:

(1) Compensatory damages in the amount of $5,110.72;
(2) Interest;
(3) Attorneys' fees;
(4) Written retraction of all of the grievances filed against Respondent and other non-parties;
(5) Such additional and further relief as deemed appropriate.
(6) On November 18, 2021, Respondent clarified the nature of relief sought and requested that Claimant pay in full to have Respondent's Form U4 expunged pursuant to FINRA Rule 2080, this claim falls under the permissible grounds for expungement as follows: (C) the claim, allegation or information is false.

Award:

(1) Respondent is liable for and shall pay to Claimant the sum of $5,000.00 in compensatory damages plus interest at the rate of 10% per annum from December 16, 2020, until date of this award.
(2) Respondent's Counterclaim is denied.
(3) Respondent's request for expungement of his CRD records is denied.
(4) FINRA Dispute Resolution Services shall retain the $175.00 filing fee that Claimant deposited previously.
(5) FINRA Dispute Resolution Services shall retain the $325.00 filing fee that Respondent deposited previously.
(6) Respondent is liable for and shall pay to Claimant $175.00 to reimburse Claimant for the filing fee previously paid to FINRA Dispute Resolution Services.
(7) Any and all relief not specifically addressed herein, including requests for retraction and attorneys' fees are denied.

Analysis:

This paper case was a home run for the St. John's Securities Arbitration Clinic. The one-person panel rejected the counterclaim raised by the Respondent awarding Claimant $1 more than the $4,999 compensatory damages sought, plus 10% percent statutory interest and the FINRA filing fee, to make the Claimant whole.

Marjorie L. Ullerich v. Independent Financial Group, LLC, Royal Alliance Associates, Inc., and Gardner Financial Services, Inc.

Case No. 21-00296

Minneapolis, Minnesota

Hearing Dates: January 10-13, 2022

Award Date: January 21, 2022

Counsel:

Counsel for Claimants:

F. Chet Taylor, Esq., Aries Legal, PLC, Minneapolis, Minnesota

Counsel for Respondent:

Benjamin J. Biard, Esq., Winget Spadafora & Schwartzberg, LLP, Miami, Florida

Arbitration Panel:

Michael S. Jordan, Public Arbitrator, Presiding Chairperson, Phyllis Karasov, Public Arbitrator, Alain Frecon, Public Arbitrator

Investments at Issue:

Fraudulent conduct and mishandled investments

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Common law claims for fraud;
(2) Conversion;
(3) Breach of fiduciary duty;
(4) Violation of Minn. Stat. § 45.026 and Minn. Rule 2876.5024;
(5) Violation of Minn. Securities Act;
(6) Violation of Minn. Stat. § 80A.68 and §80A.76;
(7) Violation of Minn. Rules 2876.5021 & 2876.5023;
(8) Violation of the Minn. Civil Theft Statute, Minn. Stat. §604.14;
(9) Violation of Minn. Prevention of Consumer Fraud, Minn. Stat. § 325F.68;
(10) Violation of Minn. Deceptive Trade Practices Act, Minn. Stat. § 325D.44 and Minn. Stat. § 8.31;
(11) Violation of Minn. Prevention of Deceptive Acts Against Vulnerable Persons Statute, Minn. Stat. §325F.71;
(12) Violation of various FINRA Conduct Rules, including FINRA Rule 2010, rules prohibiting the sale of unsuitable investments, rules requiring strong supervision of salesperson, including supervision of their outside business activities and private securities transaction, rules prohibiting "selling away" and unauthorized trading, rules banning conflict of interest, and rules requiring fair dealing with customers and respondeat superior.

Relief Requested:

(1) Compensatory damages of more than $500,000 but less than $100,000;
(2) Pre and post judgment interest;
(3) Statutory penalties;
(4) Punitive damages;
(5) Costs;
(6) Expert witness fees;
(7) Attorneys' fees; and
(8) Such other and further relief as the Panel deems to be fair and reasonable.

Relief Requested Post Hearing:

(1) Compensatory damages of $638,526.75, which included $34,444.44 for theft of monies and interest in the amount of $21,374.50 at the rate of 10% from October 27, 2015 to January 10, 2022;
(2) Civil penalties of $10,000 and $34,444.44 pursuant to Minn. Stat. § 325F.71, subd. 2(a) and §604.14, subd. 1;

(3) $119,000 for breach of contract;
(4) $100,000 for attorneys' fees; and
(5) $319,263.38 for punitive damages.

Award:

(1) IFG is liable for and shall pay to Claimant the sum of $100,000 in compensatory damages.
(2) IFG is liable for and shall pay to Claimant interest on the above-stated sum at the rate of 10% per annum from and including January 13, 2022 through the date the Award is paid in full.
(3) IFG is liable for and shall pay to Claimant the sum of $425.00 in costs as reimbursement of the non-refundable portion of the filing fee.
(4) IFG is liable for and shall pay to Claimant the sum of $70,000.00 in attorneys' fees pursuant to Minn. Stat. § 80A.76, § 325F.68-70, and § 325F.71.
(5) Any and all claims for relief not specifically addressed herein, including any requests for punitive damages and treble damages, are denied.

Analysis:

This award is noteworthy because of the large amounts awarded in excess of the compensatory damages. Claimant, a 77 year old widow, sought to recover certain sums, including $34,444.44 stolen by her broker. The firm defended the case arguing that it was not responsible, blaming the victim for the loss. In rejecting this defense, the panel awarded her compensatory damages of $100,000, as well as $70,000 in attorneys' fees, plus post-judgment interest and costs.

John Elliott v. TD Ameritrade Clearing, Inc. and TD Ameritrade, Inc.

Case No. 20-00400
Denver, Colorado
Hearing Dates: August 30-31, 2021 and September 1-3, 2021
Award Date: September 29, 2021
Counsel:

Counsel for Claimants:

Matthew R. Lewis, Esq., Kunzler Bean & Adamson, PC, Salt Lake City, Utah

Counsel for Respondent:

Eric A. Bensky, Esq. and Alexandra Marinzel, Esq., Murphy & McGonigle, P.C., Washington, District of Columbia.

Arbitration Panel:

Ruth M. Moore, Public Arbitrator, Presiding Chairperson, Marilyn R. Lewis, Public Arbitrator, Rick Gale Doty, Public Arbitrator

Investments at Issue:

Options and various securities held in Claimant's Portfolio Margin account

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Breach of contract;
(2) Breach of express warranties;
(3) Breach of covenant of good faith and fair dealing;
(4) Unauthorized trading; and
(5) Negligence

Relief Requested:

(1) Restitution;
(2) Compensatory damages; and
(3) Equitable and other relief, which could include specific performance (return of liquidated securities, cash and lost dividends), in excess of $8 million and in an amount to be proven at the hearing in this matter.

Relief Requested in Amended Statement of Claim:

(1) Compensatory damages, totaling in excess of $8 million, including:
    a. Money at the current valuation on date of judgment to repurchase Equity and ETF positions that were illegally liquidated and/or specific return of those securities, totaling $5,093,543.63 as of May 31, 2020;
    b. plus, lost dividends on the elements in item (a) to the date of judgement;(As of May 31, 2020, those actual dividends total $160,255.05)
    c. plus, money used by Respondents in its liquidation, totaling $2,953,524.54; and
    d. minus, money representing the value of options that expired in-the-money, netting out to $152,253.64 (an offsetting amount to the other values); and
(2) Punitive damages

Relief Requested Post Hearing:

(1) $10,880,456.84 on his claim for negligence;
(2) $11,843,852.72 on his claim for breach of contract;
(3) Return of cash and securities in Claimant's account on his claim for rescission; and
(4) Such other relief the Panel deems just and equitable.

Award:

(1) Respondents are jointly and severally liable and shall pay to Claimant the sum of $2,082,148.30 in compensatory damages.
(2) Respondents' Counterclaim is denied.
(3) Any and all claims for relief not specifically addressed herein, including any requests for punitive damages and attorneys' fees, are denied.

Analysis:

This award is noteworthy because Claimant sought $8-$10 million in damages as a result of an alleged improper and unauthorized liquidation of securities and exchange traded funds in his Portfolio Margin Account. The arbitrators awarded $2,082,143 versus the damages requested at the final hearing of approximately $10.8-$11.8 million dollars requested post hearing. This case is also interesting because Claimant filed a Motion for Partial Summary Judgment. The Panel heard oral arguments on Claimant's Motion and ultimately denied it. Claimant also filed a written objection to certain statements made during Respondents' closing argument and the Panel ultimately overruled Claimant's objection.

Brian Leggett and Bryson Holdings, LLC v. Wells Fargo Clearing Services, LLC and Jay Windsor Pickett III

Case No. 17-01077

Atlanta, Georgia

Hearing Dates: September 24 - 27, 2018 and June 24 - 28, 2019

Award Date: July 30, 2019

Counsel:

Counsel for Claimants:

Jeffry D. Horst, Esq., Krevolin & Horst, LLC, Atlanta, Georgia and Craig H. Kulgar, Esq., Law Office of Craig Kuglar, LLC Atlanta, Georgia

Counsel for Respondent:

Jay Windsor Pickett III, Esq., Terry R. Weiss, Esq. and Stephanie M. Wayco, Esq., DLA Piper LLP, Atlanta Georgia

Arbitration Panel:

Robert L. Lestina, Jr., Public Arbitrator, Presiding Chairperson, Charles E. White, Public Arbitrator, Scott A. Schweber, Public Arbitrator

Investments at Issue:

Claimants alleged that Respondent Wells Fargo Clearing Services, LLC failed to adequately train, monitor and supervise two of its representatives and the representatives mismanaged Claimants' account.

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Negligence;
(2) Violation of the Georgia Uniform Securities Act of 2008;
(3) Failure to Supervise;
(4) Churning;
(5) Breach of Fiduciary Duty;
(6) Breach of Contract;
(7) Breach of Implied Warranty of Good Faith and Fair Dealing;
(8) Respondeat Superior;
(9) Violation of SEC and FINRA Rules, as well as securities laws.

Relief Requested:

(1) Compensatory damages in the amount no less than $1,500,000;
(2) Interest;
(3) Attorneys' fees;
(4) Costs and expenses;
(5) Under-performance damages;
(6) Consequential damages;
(7) Punitive damages;
(8) Interest at the legal rate on all sums recovered;
(9) and such other and further relief deemed just and appropriate by the Panel.

Relief Requested Post Hearing:

(1) $1,178,446.78 in realized losses;
(2) $272,407.44 in commissions, margin interest and fees;
(3) $68,218.58 in costs and arbitration expenses; and
(4) $433,770.00 in attorneys' fees.

Award:

(1) Claimants' claims are denied in their entirety.
(2) Claimant Leggett is liable and shall pay to Respondents the sum of $51,000, representing costs incurred by Respondents in connection with this matter.
(3) Any and all claims for relief not specifically addressed herein, including Claimants' requests for punitive damages and attorneys' fees, are denied.

(4) The Panel recommends the expungement of all references to the above-captioned arbitration from registration records maintained by the CRD, for Respondent Pickett (CRD No.2041509) and Non-Party McKelvey (CRD No.5288433), with the understanding that, pursuant to Notice to Members 04-16, Respondent Pickett and Non-Party McKelvey must obtain confirmation from a court of competent jurisdiction before the CRD will execute the expungement directive.

Analysis:

This award is noteworthy because it has now been vacated by a Georgia Superior Court Judge who found that Respondents' counsel received an unfair advantage during the arbitrator ranking process in this arbitration. The outcome of this award was that Claimants' claims were dismissed and Claimants were ordered to pay Respondents' costs, despite Respondents' Motion to Amend their Statement of Answer to request Attorney's Fees and Costs being denied by the Panel. Furthermore, the claim was expunged from the record of the associated person and a FINRA registered representative who was a non-party to the case. The panel found that the losses sustained by Claimants were solely caused by the trading strategy devised, implemented, and undertaken by Claimant Leggett. The Panel found that neither Respondent Pickett nor Non-Party McKelvey engaged in any wrongful conduct. The Panel found that their decision to grant the expungement requests of Non-Party McKelvey and Respondent Pickett is buttressed by the Panel's conclusion that Claimant Leggett was not a credible witness, and his complaints about Non-Party McKelvey and Respondent Pickett were false and untrue.

Elizabeth B. Snyder, individually and as Trustee of Elizabeth B. Synder Revocable Trust U/A/D/8/18/1999 Amended and Restated 3/6/2012, as Managing Member of Linkster Holdings, LLC, and on behalf of Elizabeth Snyder IRA vs. J.P. Morgan Securities, LLC, Deutsche Bank Securities, Inc., Montecito Advisors, Inc. and Barry Snyder

Case No. 18-03816

Boca Raton, Florida

Hearing Dates: August 2-6, 2021 (partially via videoconference)

Award Date: September 27, 2021

Counsel:

Counsel for Claimants:

Robert Wayne Pearce, Esq., Robert Wayne Pearce, P.A., Boca Raton, Florida.

Counsel for Respondent:

Eugene L. Small, Esq., Eugene L. Small, P.C., New York, New York, Allan N. Taffet, Esq., Bracewell LLP, New York, New York, Neil S. Baritz, Esq., Baritz & Colman, LLP, Boca Raton, Florida.

Respondent Montecito Advisors, Inc. did not appear.

Arbitration Panel:

Sidney J. Wartel, Public Arbitrator, Presiding Chairperson, Andrea R. Jacobs, Public Arbitrator, Stephen John Gohlke, Public Arbitrator

Investments at Issue:

The causes of action related to Claimants' traded securities through the use of margin, day trading, and short sales, as well as investments in stocks, such as Habitat Restaurants, Inc. and Global Eagle Entertainment, Inc.

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Common law fraud;
(2) Constructive fraud;
(3) Negligent misrepresentation;
(4) Breach of fiduciary duty;
(5) Negligent management;
(6) Negligent supervision;
(7) Fraudulent concealment.

Relief Requested:

(1) Compensatory damages in an amount to be determined;
(2) Market-adjusted and lost opportunities damages;
(3) Interest on their claim from the time thus accrued;
(4) Punitive damages in an amount to be determined;
(5) And all other costs and expenses, including legal fees.

Relief Requested Post Hearing:

(1) During the opening presentation, Claimants requested $5,143,779 inclusive of pre-judgment interest in the amount of $1,050,712.
(2) At the conclusion of the hearing, Claimant requested that the Panel deduct from its compensatory damage award the settlement amounts (which were disclosed to the Panel) with Respondent J.P. Morgan and Deutsche.

Award:

(1) Respondent B. Snyder is liable for and shall pay to Claimants the sum of $2,554,896 in compensatory damages.
(2) Claimants' request for pre-judgment interest is denied.
(3) Respondent B. Snyder is liable for and shall pay to Claimants post-judgment interest at the Federal Reserve interest rate to commence thirty (30) days after entry of the final Award.
(4) Any and all claims for relief not specifically addressed herein, including any requests for attorney's fees, punitive damages and treble damages, are denied.

Analysis:

This award is noteworthy because the panel found the individual broker, Barry Snyder, individually liable for the losses caused to his ex-wife, Elizabeth Snyder. The panel assessed these damages even after a deduction of the settlements amounts paid by the two Respondent brokerage firms. The losses were incurred in large part as a result of an overconcentration in one stock—a restaurant chain--- that failed. The broker also day traded the action resulting in additional damages. This award highlights shows that a panel will still hold a broker liable for losses even after the brokerage firms have settled the claims on their own behalf.

CASES & MATERIALS

Jason Burge and Tad Bartlett

The Seventh Circuit holds than an arbitration award is not fundamentally unfair just because one of the parties decides not to participate, an issue often seen in FINRA arbitrations, where brokers in particular may refuse to attend hearings.

Bartlit Beck LLP v. Okada, --- F.4th ---, 2022 WL 370036 (7th Cir. Feb. 8, 2022):

Bartlit Beck represented Kazuo Okada in an underlying lawsuit between Okada and Wynn Resorts, which had settled in Okada's favor for $2.6 billion. Okada refused to pay Bartlit Beck's $50 million contingency fee, and Bartlit Beck instituted arbitration before the forum agreed on by the parties, the International Institute for Conflict Prevention and Resolution ("CPR"). After participating in the arbitral proceedings for more than one year, less than 72 hours before the evidentiary hearing was scheduled to take place before the panel Okada informed the arbitrators that he would not be attending, and that he was not authorizing his attorneys to participate. The arbitral panel held Okada in default and went forward with the evidentiary hearing based only on Bartlit Beck's submissions. It then entered a $54.6 million award in Bartlit Beck's favor, which included a $963,032 sanction for the costs and fees of the hearing.

Bartlit Beck filed a petition to affirm the arbitral award, and Okada filed a motion in that proceeding to vacate the award and remand to the CPR, contending he had been deprived of a fundamentally fair proceeding when the arbitral panel decided to hear the matter without his participation or evidence. The district court ruled in Bartlit Beck's favor, confirming the award and denying Okada's motion.

The Seventh Circuit opened its analysis with the familiar refrain that arbitral awards will be set aside "only in very unusual circumstances," deferring to arbitrators' decisions as long as they are reasonable. The only issue raised on appeal by Okada was the district court's conclusion that the CPR panel had not denied him a fundamentally fair proceeding.

The Court held that it need not decide if Chapter 1 of the Federal Arbitration Act could be used to bring an action to vacate an award issued by an arbitrator in a U.S. jurisdiction but that was governed by the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, because the issue in this case is not a close question and Okada would not prevail under a more limited review or under a Chapter 1 review for fundamental fairness. The Court held that the district court properly determined the analytical framework to conclude that the arbitral panel's "decision to proceed without Okada was fair *because* it was reasonable." (Emphasis in original). The Court held that, moreover, a more exacting review of fairness and reasonableness as separate elements would not have changed the outcome. "Okada was not denied a fundamentally fair proceeding when, after *he* unequivocally announced his refusal to participate, the Panel chose to proceed without him." The Court further rejected as unsupported in the record that there was fundamental unfairness because the arbitral panel had decided to go forward in the face of a supposed medical emergency faced by Okada.

The Eighth Circuit holds that a business partner/investor in a broker-dealer's outside business activities is not a "customer" of the broker's FINRA-member employer for purposes of invoking a FINRA arbitration against the FINRA-member for failure to adequately supervise those outside business activities.

Principal Securities, Inc. v. Agarwal, 23 F.4th 1080 (8th Cir. Jan. 31, 2022):

Parties must arbitrate a dispute under FINRA Rule 12200 if the arbitration is either required under a written agreement or is requested by a "customer" and 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[.]" In this case, the Agarwals had brought a FINRA arbitration against FINRA member Principal Securities, Inc. ("PSI") arising from failed business transactions with PSI's former registered representative, John Krohn.

The Agarwals had partnered with Krohn to start an industrial glycerin and biofuel refining plant, and had offered Krohn the position as CFO of that business. Eventually, the Agarwals lost approximately $9.3 million that they had loaned to the company. The Agarwals also made investments in and loans to another business entity in which Krohn was an owner. In their arbitration against PSI, the Agarwals claimed "that PSI failed to supervise the outside business activities of Krohn." PSI brought suit in federal court under the FAA to enjoin the Agarwals from going forward with the FINRA arbitration.

The Court first held that the Agarwals had waived any argument that the FAA does not authorize a "wrongful arbitration" suit by failing to raise that argument. "Because the issue is not jurisdictional or in the nature of a jurisdictional bar, the Agarwals have waived the cause-of-action issue and we decline to address it."

The Court then held that the Agarwals were not "customers" of PSI or of Krohn as a PSI associated person. "The information in the record makes plain that the Agarwals were business partners with Krohn," involved with funding and operating the biofuel business "in arms-length business decisions"; and that the investment in and loans to the other Krohn-related entity was "insufficient to convert what was an ongoing business partnership in various ventures into a business relationship 'related directly to investment or brokerage services[.]'" The Court concluded, "FINRA's purpose is not to make a brokerage firm the insurer of failed business ventures."

The Eleventh Circuit provides a good explainer on how motions to confirm awards and motions to vacate awards intersect, confirming that a court need not allow a losing party to wait three months to assert their arguments in favor of vacatur, but can fast-track a confirmance.

McLaurin v. Terminix International Co., LP**,** 13 F.4th 1232 (11th Cir. Sept. 17, 2021):

Two homeowners bought a house on Dauphin Island, Alabama, that had been under contract with Terminix for termite treatment, abatement, and repair. After termites were discovered and Terminix had failed to make appropriate repairs, leading to the need to completely rebuild the house, the homeowners arbitrated against Terminix and received an award of almost $2.8 million. Two days later, they brought suit to confirm the arbitration award. Terminix did not substantively respond, other than to note that it would file a motion to vacate the award within the three-month timeframe. The district court confirmed the award, on finding the suit to confirm the award to be unopposed, and struck Terminix's motion to vacate.

The FAA provides a three-month window for filing a motion to vacate, modify, or change an award, while also providing up to a year to file a motion to confirm. Before turning to the particular case before it, the Eleventh Circuit articulated a set of best practices for district courts where a motion to confirm an award is filed prior to a motion to vacate: "When a motion to confirm is filed before the time to challenge an arbitration award has lapsed, we believe that the best practice is for a district court to issue an order that sets simultaneous deadlines for a losing party to file an opposition to the motion to confirm, if any, and to file a separate motion to vacate, modify, or correct, if any. … [A] district court that follows this best practice will be on sound legal footing and ensure that all issues are fully and fairly litigated."

Turning to the case at hand, the Eleventh Circuit noted that the district court had set a deadline for Terminix to file an opposition to the motion confirm, without expressly setting a deadline for a motion to vacate. "Terminix's response was baffling." The Court noted that Terminix filed only a four-page procedural argument that the motion to confirm had been filed too soon, and then did not file any substantive argument until its motion to vacate was filed a month and a half after the district court's deadline for opposing the motion to confirm.

The Court held that the FAA does not provide an automatic three-month stay on confirmation, such that the homeowners' motion to confirm was not filed too soon. The Court also held that "the FAA does not … condition confirmation on the absence of an *expected* motion to vacate." The Court then held that the district court did not abuse its discretion in striking the later-filed motion to vacate after granting the motion to confirm, noting that nothing in the FAA prevents a court from shortening the three-month statutory window for moving to vacate. The Court alternatively held that the district court could have found the motion to vacate mooted by its ruling on the motion to confirm.

Georgia state trial court grants a motion to vacate a FINRA award, denying cross-motion to confirm award, where Wells Fargo was secretly allowed to strike certain FINRA arbitrators before the lists went out for blind selection.

Leggett v. Wells Fargo Clearing Services, LLC, Civ. Action No. 2019CV328949 (Fulton County Superior Ct., State of Ga.):

The investor claimants brought a FINRA arbitration against their brokerage firm and one of its brokers over losses incurred by the investors on investments at Wells Fargo. The investors lost the arbitration, and brought suit asking the court to vacate the award.

The court commenced by recounting a number of irregularities in the conduct of the arbitration. First, Wells Fargo's counsel responded to FINRA's circulation of the supposedly computer-generated list of proposed arbitrators by asking to remove one of the arbitrators from the list before strikes were submitted due to a perceived bias of that proposed arbitrator. The investors responded that Wells Fargo had not actually provided any proof of bias, but FINRA removed the arbitrator from the list without charging a strike against Wells Fargo. Wells Fargo's counsel then sent FINRA a letter stating that it had received a verbal representation from FINRA that a particular arbitrator group would never be on any of the lists presented in cases worked on by that counsel because of "a most unusual set of circumstances," and FINRA then sent out a re-comprised and edited slate of potential arbitrators. The parties then submitted their rankings and strikes, and after the panel was comprised, Wells Fargo objected that one of the selected arbitrators had a bias against Wells Fargo; FINRA replaced that arbitrator on the panel over the investors' objection.

The panel then issued a number of rulings against the investors with regard to timing of the hearing, document production, sequestration of witnesses, and alterations in the witnesses' testimony. Then, despite Wells Fargo having made no counter-claim for fees and costs, and despite the panel having denied a motion to amend the answer to include such a counter-claim, the panel's award not only denied the claim made by the investors, but awarded $84,000 in fees and costs against them.

Upon the competing motions for vacatur and confirmation filed by the parties with the court, the court vacated the award. First, it held that "Wells Fargo and its counsel manipulated the FINRA arbitrator selection process in violation of the FINRA Code of Arbitration Procedure, denying the Investors their contractual right to a neutral, computer-generated list of potential arbitrators. … Permitting one lawyer to secretly red line the neutral list makes the list anything but neutral, and calls into question the entire fairness of the arbitral forum."

The court also held that the panel's denial of the investors' motion to postpone the hearing after Wells Fargo "dumped thousands of pages of relevant documents" after the timeframe for discovery violated the FAA. 9 U.S.C. § 10(a)(3) provides for vacatur of an arbitration award where arbitrators are "guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown." The court found that "[t]he Arbitrators provided no basis for their decision to deny the Investors' request for a short delay—a delay necessitated not by the Investors' failure to prepare but rather due to Wells Fargo's late production of documents outside the time periods set forth by the FINRA Code of Arbitration Procedure." The court also held that the panel's evidentiary and witness testimony decisions violated the FAA, where the testimony was pertinent and material to the controversy and not merely cumulative, and prejudiced the investors' rights to a fair hearing.

The court additionally held that the record showed that the award was procured by fraud, as Wells Fargo and its counsel "procur[ed] perjured testimony, intentionally misrepresent[ed] the record, and refus[ed] to turn over a key document to the Investors until after the close of evidence." Finally, the court held that the panel violated the FAA by imposing costs and hearing session fees against the investors in the absence of any counter-claim by Wells Fargo for such relief. "[T]he Arbitrators ignored the contractual framework the parties had agreed to and imposed liability beyond that which was permitted or contemplated, thus dispensing their own brand of industrial justice in violation of the FAA."

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 Michael Edmiston at msedmiston@stocklaw.com or Robin S. Ringo at rsringo@piaba.org for assistance.

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The following Comment Letter regarding *FINRA Regulatory Notice 21-43: Proposed Amendments to FINRA Rule 3240 and Retrospective Rule Review Report* was submitted to FINRA by Michael Edmiston on February 14, 2022. (prepared with the assistance of Jason Kane).

Via email to: pubcom@finra.org
Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 21-43 (FINRA proposed amendments to FINRA Rule 3240 and Retrospective Rule Review report)

Dear Ms. Piorko Mitchell:

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 welcomes the opportunity to comment on the proposed amendments to FINRA Rule 3240 and the retrospective rule review report. In October 2019, PIABA commented on FINRA's retrospective review that, among other things, sought feedback on the effectiveness of FINRA Rule 3240 which is a prohibition on borrowing from or lending to customers. PIABA's position was, and largely remains what we previously described:

Rule 3240 has been effective in protecting investors and public interest, specifically by addressing potential misconduct relating to associated persons of broker-dealer firms borrowing from or lending money to customers. Specifically, the Rule has served to deter fraud and manipulative practices involving senior investors' retirement savings by prohibiting such conduct. PIABA believes that, in situations where one of the enumerated exceptions apply, the current rule is broad enough to cover those instances in which lending or borrowing money from customers may be acceptable. Importantly, such situations first require appropriate disclosures and pre-approval by the broker-dealer firm, which is crucial to ensuring compliance with the Rule.

In this follow-up rule review, PIABA emphasizes that the obvious conflicts of interest and possibilities for abuse when registered representatives borrow or lend money to clients are major problems. FINRA Regulatory Notice 21-43 seemingly strengthens Rule 3240 and PIABA supports the effort. In fact, the simple step of changing the name of the rule from "Borrowing from or Lending to Customer" to "Prohibition on Borrowing from or Lending to Customers" makes FINRA's position on the topic very clear. (Emphasis added). There should be no doubt that these arrangements between registered persons and customers are not allowed in the financial services industry. The name change would leave no doubt. Violators of the rule have no excuse.

More specifically, strengthening the rule to broaden it and apply it to borrowing or lending arrangements that pre-exist the broker-customer relationship is a good amendment. Conflicts of interest would exist in the relationship irrespective of whether or not a lending arrangement existed before or after the broker-customer relationship is established. PIABA supports making clear that if a broker is already in a non-exempt lending relationship with a person that said person may not become a client.

Similarly, PIABA supports extending the definition of customer to those with existing accounts and those who had accounts with a registered person in the previous six months. In fact, based on the time it takes to unwind some position a registered representative might recommend, PIABA suggests that FINRA extend the proposed cooling off period to one year or more.

It is also a good idea to make clear that the prohibition extends to not just the registered person themselves but also to a person or entity related to the registered person. The same or very similar conflict of interest is present if a registered representative's close family member obtains a loan from a registered representative's client just as if the registered representative obtained it themselves. Knowing a relative or related entity stood to potentially benefit from a client's well-being creates the potential for a conflict to arise.

Finally, PIABA is in favor of modernizing the "immediate family" definition and limiting the "personal relationship" and "business relationship" exceptions. The risk of harm here is too great to leave the potential for abuse. PIABA commends any effort to limit the exceptions and make very clear that this conduct is not allowed.

PIABA acknowledges and appreciates the opportunity to comment on this important issue. PIABA applauds FINRA's effort to root out the problem that taking loans from clients or lending money to clients presents. We thank you for the opportunity to comment and urge FINRA to continue its efforts to curb this abusive conduct.

Sincerely,

Michael Edmiston
President, PIABA

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The following Comment Letter regarding *OFR Bill Reforming Chapter 517 – Recommendation to Support Florida's Office of Financial Regulation* was submitted to Securities & Financial Services Committee by Michael Edmiston on January 3, 2022. (prepared with the assistance of Jorge Riera).

Via Electronic Submission:
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Ms. Michelle K. Suarez, Esq.
Vice Chair
Corporations, Securities & Financial Services Committee
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Ms. Toni Tsvetanova, Esq.
Second Vice-Chair
Corporations, Securities & Financial Services Committee
4707 Blue Lagoon Drive
Miami, FL 33126-2015

Re: OFR Bill Reforming Chapter 517 - Recommendation to Support Florida's Office of Financial Regulation Ch. 517 Reform Legislation

Dear Ms. Suarez and Ms. Tsvetanova:

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 falling prey to investment fraud, 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 Florida Office of Financial Regulations (the "OFR") relating to exempt offerings, the practices of brokers and broker-dealers, and investor protection.

I. Introduction

On August 4, 2021, the Ch. 517 Task Force (the "Task Force"), primarily comprised of members of the Florida Bar's Corporations, Securities & Financial Services Committee ("CSFS"), Business Law Fellows, and the OFR, approved the proposed Chapter 517 Reform Legislation (the "Proposed Legislation") that materially impacts the Florida Securities and Investor Protection Act, "creates needed capital-raising opportunities for Florida-based businesses," and "strengthens investor protection measures." Contrary to the Task Force's stated goal, it appears that the Task Force is more concerned with providing greater access to funds for exempt offering issuers than it is in providing necessary protections to public investors.

The Proposed Legislation should be narrowly tailored to address the capital formation needs of entrepreneurs and certain smaller issuers while preserving investor protections. Expanding exempt offerings in the manner proposed will do nothing to promote capital formation in the public markets, and will ultimately have negative consequences for investors. Additionally, the Proposed Legislation expands the pool of investors who may be eligible to invest in exempt offerings. The Proposed Legislation is solely focused on expanding the private markets that would unquestionably cause retail investors harm. The most likely outcome of the Proposed Legislation will be to increase private issuers, which will have the harmful effect of depriving investors in those companies of the benefits of registration.

II. Expansion of Exempt Offerings Will Undermine Investor Protection

Expansion of exempt offerings to Florida retail investors will almost certainly increase the risks to which retail investors are exposed while decreasing the information available to investors attempting to make informed decisions about potential investments. It will also substantially increase the number of instances in which Florida investors fall prey to fraudulent investment schemes. These implications are significant and must be addressed if the Task Force is to honor its mission of protecting the investing public. If the Task Force is to expand the pool of investors who may be eligible to invest in exempt offerings, it must simultaneously improve investor protections for those who are eligible to invest.

The evidence is clear that fraud and other harms occur frequently where unregistered persons promote unregistered products to retail investors. In August 2020, the SEC's Division of Economic and Risk Analysis ("DERA") published a study of fraud in the private markets based on SEC enforcement actions brought over a single year.[1] Results from DERA' study showed that the majority of offerings were fraudulent offerings that did not qualify for an exemption from registration.[2] DERA's study further states that "offerings linked to SEC enforcement actions more likely involved an unregistered intermediary or a recidivist, or solicited from unsophisticated investors."[3] DERA study showed that while Florida had the sixth largest number of Regulation D issuers compared to all the other states, Florida had most number of issuers with unregistered offerings.[4] Florida also has the highest proportion of seniors in its population and accounts for the second largest number of seniors amongst all states.[5] With more than half of financial assets in the U.S. estimated to be owned by seniors,[6] elderly investors are considered to be the most targeted and vulnerable to financial exploitation.[7]

III. Finder's Exemption

PIABA opposes the proposed registration of finders ("Finder's Exemption") for many of the same reasons PIABA opposed the U.S. Securities and Exchange Commission (the "SEC") Release Number 34-90112, Notice of Proposed Exemptive Order Granting Conditional Exemption from the Broker Registration Requirements of Section 15(a) of the Securities Exchange Act of 1934 for Certain Activities of Finders (the "Proposed Exemptive Order").[8] We strongly believe that if a finder acts as a broker with respect to the securities activities of non-reporting issuers, they should be subject to all of the

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1. Rachita Gullapalli, *Misconduct and Fraud in Unregistered Offerings: An Empirical Analysis of Select SEC Enforcement Actions*, SEC Division of Economic and Risk Analysis (Aug. 2020) ("DERA Study"), available at https://www.sec.gov/files/Misconduct%20And%20Fraud%20In%20Unregistered%20Offerings.pdf.

2. *Id*. at 33.

3. *Id*. at 11.

4. *Id*. at 19.

5. *Id*.

6. *Id*.

7. *Id*.

8. *See* Letter from PIABA President David P. Meyer to Vanessa Countryman, Re: File No. S7-13-20: https://www.sec.gov/comments/s7-13-20/s71320-8011738-225383.pdf.

requirements that would apply to a broker-dealer when acting in that same capacity.

Finders would not have to possess any minimum knowledge or competency with respect to securities to qualify for the exemption, nor would they have to pass any examinations or undergo any training or continuing education to serve as a finder. Because the exemption would allow virtually any individual to promote sales of unregistered securities so long as the individual was not statutorily disqualified, there would be no assurance to the investor, the issuer, or the securities market at large that such individuals have the knowledge, skills, integrity, or competency to serve investors or issuers in capital raising activities.

Finders would not need under the federal securities laws to notify regulatory authorities of their activities, or to keep any records of their activities, communications, or finances, making it extremely difficult for the Commission or any other regulator with jurisdiction over Finders to determine whether they were complying with the exemptive order or other applicable laws and standards. There would be no database, such as BrokerCheck, for investors to learn more about a Finder's background, including any customer complaints or past crimes or disciplinary actions that do not trigger disqualification.

The proposed exemption would not allow Finders to participate in the preparation of issuer sales materials, but in our experience, persons involved in securities sales are typically involved in the preparation of the sales materials that they will use to promote an offering. (It is not clear from the Proposal whether a Finder may provide investors with projections of the price performance of a privately offered security, which generally is not permissible for broker dealers.)

Because there would be no regular oversight of the use of these materials or standards applicable to such sales materials other than general anti-fraud laws, there remains a risk that Finders may be involved in preparing sales materials that are designed to maximize sales at the cost of compliance with standards requiring such communications to be fair and balanced.

Moreover, because Finders would not need to have any background in the securities industry or pass minimum knowledge or competency examinations, it is possible that Finders would not even recognize when they are providing misleading content to investors. The North American Securities Administrators Association ("NASAA") issues enforcement reports every year that summarize enforcement actions filed by state regulators. NASAA's recent Enforcement Report show that during 2019, state securities regulators brought 738 enforcement actions against unregistered persons, including against 57 unregistered finders or solicitors.[9]

In addition, Finders should be required to do their own due diligence before making a recommendation. Prohibiting Finders to investigate or perform reasonable diligence on an issuer or its securities may provide a shield from liability for a Finder in an investor's claim in arbitration that suffered losses from the Finder's solicitation activities. For example, a Finder could assert that the restriction from performing due diligence on the issuer, and thus any claims by an investor that the Finder should have known about any fraud or investment risk related to the investment would run counter to the Finder's obligations.

If the OFR does move forward with the Finder exemption, it should be limited only to natural persons because permitting entities to come into this space opens the door to boiler room operations and other fraudulent enterprises acting under the approval of an OFR exemption.

IV. Crowdfunding

The Task Force's reasoning to expand crowdfunding offerings is deeply flawed. As support for the proposed reform measures, the OFR states that "to date there has not been a single securities offering under Florida's crowdfunding statute."[10] As further support, the OFR states that "there have been numerous offerings in Georgia under their crowdfunding provisions that are substantially similar to the OFR's reform proposals."[11]

Despite the Task Force's assertions, Florida has had numerous crowdfunding offerings under its existing regulatory framework. In 2020, there were 1149 crowdfunding offerings in the U.S. that raised $239 million.[12] Florida was among the top five states of those crowdfunding offerings for

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9. See NASAA 2020 Enforcement Report at 5, available at https://www.nasaa.org/wp-content/uploads/2020/09/2020-Enforcement-Report-Based-on-2019-Data-FINAL.pdf.

10. *See* Ch. 517 Task Force Report at p. 3.

11. *Id*.

12. See Alois, JD, *$239 Million was Raised using Reg CF During 2020, this Amount Could Double in 2021,* Crowdfund Insider (Jan. 6, 2021), available at https://www.crowdfundinsider.com/2021/01/170982-239-million-was-raised-using-reg-cf-during-2020-amount-could-double-in-2021/ (citing a report by Crowdfund Capital Advisors ("CCA")).

issuers, investments, and investors.[13] Moreover, Georgia was not among the leading states for crowdfunding offerings. Thus, mirroring Georgia's crowdfunding provisions will not likely increase capital raising opportunities for smaller companies.

PIABA is also opposed to the growth of unregulated crowdfunded offerings. Our members often find that unsophisticated retail investors are the ones more likely to fall victims to fraudulent offerings. The OFR should not increase or waive the current annual cap on investors, accredited or not. More control and review will protect investors, therefore increasing offering document disclosure and auditing, as well as regulating or limiting promotion and advertising.

Additionally, the Task Force proposes to create a new exemption for micro-offerings under $50,000. While a micro-offering could allow small business access to investors' capital, businesses seeking relatively small amounts of capital should use traditional forms of financing, like commercial loans. The risk inherent in micro-offerings is not the type of risk that should be passed onto investors. Further, the ability of a business to issue a new micro-offering every thirty days would create a loophole for fraudsters to exploit, allowing them to raise larger amounts of capital than should be allowed under a micro-offering exemption.

PIABA members see cases where the investor is unaware of the liquidity or illiquidity of an investment which they are holding. In 2019, the SEC published the results of a study conducted by its staff on the capital formation and investor protection impacts of Regulation Crowdfunding (the "SEC Crowdfunding Report").[14] According the SEC Crowdfunding Report, the average issuer had "no revenues (just over half of the offerings were by issuers with no revenues)."[15]

Florida entities that have conducted 4(a)(6) offerings have done so under funding portals registered with the SEC and FINRA. The following make up a small sampling of the crowdfunding offerings conducted by Florida entities, with the exception of one foreign entity with its principle place of business in Florida.

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13. *Id.*

14. *See SEC 2019 Regulation Crowdfunding Report* (Jan. 18, 2019), available at https://www.sec.gov/smallbusiness/exemptofferings/regcrowdfunding/2019Report.

15. *Id*. at 17.

- Acquire Skills & Knowledge Education Inc. ("ASK Education"), Boca Raton, FL: Target raise $10,000 to $107,000, and crowdfund offering closes on November 2021.[16]
- Jinglz, Inc., Boynton Beach, FL: Funds raised to date $248,588.00, crowdfund offering closed on April 2021.[17]
- We Are Kula, LLC, Boca Raton, FL: Total funds raised $12,479.00, and crowdfund offering closed on September 2020[18]
- Janover Ventures LLC, Boca Raton, FL: Total funds raised $714,052.00, and crowdfund offering closed on December 2020.[19]
- Northstar Technologies Group, Inc., Bonita Springs, FL: Funds raised to date $400,368.00, and crowdfund offering closing date is November 1, 2021.[20]
- Stemsation International, Inc., Boca Raton, FL: Total funds raised $ 43,248.00, and crowdfund offering closed on March 2020.[21]
- Atmospheric Water Solutions, LLC ("AquaBoy") Cooper City, FL: Funds raised $194,245.00, and crowdfund offering closed on April 2021.[22]
- COI Energy Services, Inc. (Incorporated in Delaware), Tampa, FL: Total funds raised $589,026.00, and crowdfund offering closed on April 2021.[23]
- Domaselo, LLC, Key Biscayne, FL: Total funds raised $57,500.00, and crowdfund offering closed on January 2021.[24]

16. *See* Netcapital fund portal, available at https://netcapital.com/companies/ask.

17. *See* Netcapital fund portal, available at https://netcapital.com/companies/jinglz.

18. *See* Netcapital fund portal, available at https://netcapital.com/companies/kula-crate.

19. *See* Republic fund portal, available at https://republic.co/janover-ventures.

20. *See* Netcapital fund portal, available at https://netcapital.com/companies/northstar-tgi.

21. *See* Netcapital fund portal, available at https://netcapital.com/companies/Stemsation.

22. *See* Netcapital fund portal, available at https://netcapital.com/companies/aquaboy.

23. *See* Republic fund portal, available at https://republic.co/coi-energy.

24. *See* Mainvest fund portal, available at https://mainvest.com/b/domaselo-miami#updates.

V. Conclusion

Once again, PIABA appreciates the opportunity to comment on the Task Force's Proposed Legislation. We urge the OFR to remember its mission to protect investors while it tackles the legitimate goal of simplifying the exempt offering framework. Although increasing the efficiency of the capital markets and ability of companies to raise money is a laudable goal, it cannot be done at the detriment of Florida investors.

PIABA would be happy to engage with the OFR further on this issue.

Respectfully submitted,

Michael Edmiston, President
Public Investors Advocate Bar Association

The following Comment Letter regarding *Request for Comment Regarding a Proposed Model Rule for Unpaid Arbitration Awards Under the Uniform Securities Acts of 1956 and 2002* was submitted to NASAA by Michael Edmiston on November 4, 2021. (prepared with the assistance of David Neuman and Albert Copeland).

Via Email [*NASAAComments@nasaa.org*]

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Securities Division
PO Box 9033
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Mr. Patrick Costello, Project Group Chair
Massachusetts Securities Division
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Securities & Audit Division
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Project Group Chairs
North American Securities Administrators Association, Inc.
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Washington, DC 20002

Re: Request for Comment Regarding a Proposed Model Rule for Unpaid Arbitration Awards Under the Uniform Securities Acts of 1956 and 2002

Dear Ms. Standifer, Mr. Costello and Mr. Brey:

I write on behalf of the Public Investors Advocate Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in the North American Securities Administrators Association's ("NASAA's") efforts relating to investor protection.

PIABA supports the adoption of NASAA's proposed Model Rules as described in its October 5, 2021, proposal. PIABA supports the suspension or expulsion of brokerage firms, advisory firms, broker-dealer representatives, and investment advisory representatives who fail to pay arbitration awards. The proposed rules would allow the state regulators to suspend or expel a financial professional or firm if they fail to pay an arbitration award or otherwise attempt to avoid payment of any client or customer-initiated arbitration.

While the proposed Model Rules are undoubtedly a positive step and important tool for regulators, PIABA repeats its longstanding call to NASAA and the securities industry to institute an Investor Recovery Fund: the most effective solution to address the serious unpaid arbitration issue.

1. Unpaid Arbitration Award Problems Persist Over Decades

The issue of unpaid arbitration awards has long been a concern for both the investing public and PIABA. The U.S. Government Accounting Office ("USGAO") recognized this problem back in June 2000 when it analyzed NASD arbitration awards. The USGAO's conclusion in its 2000 report[1] is worth restating now, some twenty-one years after it was first published:

> The securities industry, its regulators, and Congress should be concerned about the extent to which arbitration awards are unpaid. Regardless of how effective and fair the arbitration decision process may be, unpaid awards could negatively affect investors' confidence in arbitration.[2]

The issue has not gone away. PIABA wrote a report on the issue of unpaid FINRA arbitration awards in 2016, and found that one-third of FINRA arbitration awards (valued at $62.1 million, equaling 24 cents on the dollar) from 2013 went unpaid. PIABA updated its research twice since its initial 2016 report. In 2018, PIABA reported that 36% of customer awards issued in

1. In its survey of investors who received arbitration awards during 1998, the USGAO estimated 49% of the awards went unpaid, an additional 12% were only partially paid, and nearly 80% of the total $161 million awarded to investor claimants that year went unpaid. *See* FN 2.

2. United States General Accounting Office, *Securities Arbitration: Actions Needed to Address Problems of Unpaid Awards*, June 2000. https://www.gao.gov/products/ggd-00-115.

2017 went unpaid (equaling 28 cents on the dollar). Then, in 2021, PIABA found that 30% of FINRA arbitration awards in 2020 went unpaid (equaling 24 cents on the dollar).[3]

This is not an issue limited to the securities brokerage industry. Registered representatives with adverse arbitration awards often leave the brokerage industry to join the investment advisory space regulated by the SEC (instead of FINRA), and thereby continue the same sort of misconduct that got them in trouble in the first place. The proposed Model Rules would close the loophole and allow the state regulators to revoke brokerage *and* advisory licenses of professionals who fail to pay or otherwise attempt to avoid payment of final court judgments, arbitration awards, or regulatory orders and civil penalties.

In order to most effectively enforce the proposed rules, NASAA should consider adding a provision in the Model Rules requiring that brokerage firms, investment advisory firms, and their representatives submit all applicable judgments and arbitration awards to their state regulator for review and publication. Some arbitration forums like AAA and JAMS have confidentiality clauses that limit or restrict a party from sharing or publicizing an award. These restrictions are typically for the benefit of losing party. If bad actors fail to voluntarily report the awards, state regulators are left blind. As such, NASAA should consider requiring timely disclosure of final judgments and arbitration awards by firms and representatives to close this additional loophole, and strengthen enforcement of the proposed rules.

2. The Proposed Model Rules May Incentivize Insurance Coverage, but an Investor Recovery Fund Remains the Best Solution to Increase Investor Confidence in the Arbitration Process

The proposed Model Rules may create an incentive for brokerage firms, investment advisory firms, and representatives to obtain meaningful levels of insurance to cover themselves in case of potential liability. However, investors will continue to be harmed until the securities industry addresses the unpaid award issue head-on through an Investor Recovery Pool.

Other than Oregon,[4] states do not require firms and advisers to carry insurance as a prerequisite for serving in the securities brokerage or investment

3. https://piaba.org/piaba-newsroom/piaba-report-finra-arbitrations-persistent-unpaid-award-problem-september-29-2021.

4. Oregon instituted a mandatory insurance requirement applicable to certain state investment advisers effective January 1, 2018.

advisory industries. The Model Rules, by allowing states to revoke licenses, create a significant incentive for registered representatives and investment advisory representatives to ensure that they are able to pay awards. Errors and omission insurance is the most obvious, but imperfect, potential source for such payments. While insurance will typically address standard negligence claims, PIABA members have found that policies are rife with exemptions for a variety of things common in securities disputes. For example, particular novel products, options, private placements, insurance products, and fraud claims. Policy design can also be problematic: wasting policies utilize the coverage limit to pay both the cost of defense *and* liability obligations. Defense counsel might be paid first and in full while the investor who wins their claim will not. A repeat bad actor may quickly deplete a million-dollar coverage policy within a coverage period for later-filed claims. Thus, while insurance coverage is desirable, its inherent limitations can lead to an uneven administration of justice and further undermine investors' confidence in dispute resolution and the securities industry at large.

PIABA supports the Model Rules as another important regulatory and enforcement tool, and repeats its call for the institution of an Investor Recovery Pool to most effectively address this decades-long problem. PIABA applauds the proposed Model Rules' intent and prospective investor protections, such as limiting recidivism and incentivizing good behavior. But investor confidence will continue to decline until there is a process, after going through all of the mandated steps to adjudicate claims and win a judgment or arbitration award, to ensure they are made whole for their losses caused by unlawful industry conduct. Despite decades of updated research, ongoing debate, and new regulations, the unpaid arbitration issue still persists. Investors will continue to suffer absent serious change.

3. The Current Text of the Proposed Model Rules in Exhibit B Unintentionally Excludes Awards Issued Against Investment Advisers.

There is a discrepancy in the text of the Model Rules which, as currently written, inadvertently excludes arbitration issued against investment advisers. In Exhibit B of NASAA's Request for Comment, addressing unpaid awards by Investment Advisers, the proposed language in Sections (x) and (y) contain language referencing broker-dealers "…any final judgment or arbitration award resulting from an investment-related, client or customer-initiated arbitration or court proceeding, unless alternative payment arrangements are agreed to between the client or customer *and the broker-dealer or broker-dealer agent, in writing, and the broker-dealer or broker-dealer agent*..."

To have the Model Rules apply to investment advisers, both Sections (x) and (y) need to be revised to read, "…any final judgment or arbitration award resulting from an investment-related, client or customer-initiated arbitration or court proceeding, unless alternative payment arrangements are agreed to between the client or customer *and the investment adviser or investment adviser representative, in writing, and the investment adviser or investment adviser representative*…"

Conclusion

The securities industry has long encouraged investors turn to financial professionals like broker-dealer and investment advisory representatives to help guide their finances. Investors often trust these individuals and firms with their life savings and retirement plans. Many brokers and advisers do help their clients meet their investment objectives. But unlawful conduct will always be present in a multi-trillion-dollar securities industry. Many brokerage and investment advisory firms are so thinly-capitalized that even a $100,000 adverse judgment or arbitration award would put them out of business let alone enable full payment to the harmed party. Retail investors put their trust and confidence in financial professionals who, due to current loopholes and regulatory gaps, can simply avoid financial obligations. This is not the picture of the financial services industry being marketed to the investing public.

PIABA acknowledges the hard work and considerable thought NASAA put into its proposed Model Rules, and endorses them as an important tool for state regulators to discourage bad behavior and unpaid awards that result therefrom. Accordingly, PIABA supports NASAA's proposed Model Rules to suspend or bar industry professionals who fail to pay or otherwise attempt to avoid payment of final judgments and arbitration awards from client or customer-initiated claims. PIABA encourages NASAA to consider adding additional terms to the Model Rules mandating individuals and firms to timely submit such judgments and awards to state regulators as part of their licensing requirement, with the failure to do so being another express and actionable dishonest or unethical business practice.

Very truly yours,

Michael Edmiston
President, Public Investors Advocate Bar Association

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The following Comment Letter regarding *Request for Comment on Release 34-92766 (Broker-Dealer and Investment Adviser Digital Engagement Practices, Related Tools and Methods, and Regulatory Considerations and Potential Approaches)* was submitted to the Securities and Exchange Commission by David Meyer on October 1, 2021. (prepared with the assistance of Albert Copeland).

Vanessa A. Countryman, Secretary
Securities and Exchange Commission
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rule-comments@sec.gov

Re: Request for Comment on Release 34-92766 (Broker-Dealer and Investment Adviser Digital Engagement Practices, Related Tools and Methods, and Regulatory Considerations and Potential Approaches)

Dear Secretary Countryman:

I write on behalf of the Public Investors Advocate Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, courts, and in regulatory rule-making and the legislative process, while also advocating for public education regarding investment fraud and industry misconduct.

In Release No. 34-92766, the Securities and Exchange Commission ("the Commission") requested information and public comment on matters relating to, among other things, broker-dealers' use of "digital engagement practices" ("DEPs"), the analytical and technological tools and methods used in connection with DEPs, and the potential investor protection concerns posed by DEPs. In particular, the Commission requested comment on how the use of DEPs is impacted by several existing broker-dealer obligations, such as the standard of conduct under Regulation Best Interest ("Reg BI").

While brokerage firms' adoption of new technologies can offer beneficial services to its customers, such as increased access to information, product choice, and investor education, PIABA believes that the increasingly omnipresent usage of DEPs poses a unique investor protection threat, especially considering the new wave of inexperienced and unsophisticated market participants the last eighteen months have brought. The persuasive nature encouraging trading activity by certain DEPs and the marketing of such investing platforms are two important areas for promoting investor protection.

1. DEPs Are Persuasive Calls to Action That Influence Investor Trading and Should be Subject to Reg BI

One particularly relevant concern is whether a broker-dealer's use of DEPs on its digital platforms constitutes recommendations for the purpose of Reg BI, and thus should be held to the conduct standards propounded by Reg BI. As identified in the Commission's Release, an important factor considered in determining whether a recommendation has taken place includes whether a communication reasonably could be viewed as a "call to action," and reasonably would influence an investor to trade a particular security or group of securities. The Commission cites to NASD Notice to Members 01-23 in its Request, which provides examples of activities falling within the definition of "recommendation," including:

- A member sends a customer-specific electronic communication (e.g., an e-mail or pop-up screen) to a targeted customer or group of customers encouraging the particular customer(s) to purchase a security;[1]
- A member sends its customers an e-mail stating that customers should be invested in stocks from a particular sector (such as technology) and urges customers to purchase one or more stocks from a list with "buy" recommendations;

1. This example provided in NASD Notice to Members 01-23 contains the following endnote:
Note that there are instances where sending a customer an electronic communication that highlights a particular security (or securities) will not be viewed as a "recommendation." For instance, while each case requires an analysis of the particular facts and circumstances, a member generally would not be viewed as making a "recommendation" when, pursuant to a customer's request, it sends the customer (1) **electronic "alerts"** (such as account activity alerts, market alerts, or price, volume, and earnings alerts) or (2) research announcements (e.g., a firm's "stock of the week") that are not tailored to the individual customer, **as long as neither—given their content, context, and manner of presentation—would lead a customer reasonably to believe that the firm is suggesting that the customer take action in response to the communication**.
NTM 01-23, p. 6, endnote 14 (emphasis added).

- A member provides a portfolio analysis tool that allows a customer to indicate an investment goal and input personalized information such as age, financial condition, and risk tolerance. The member in this instance then sends (or displays to) the customer a list of specific securities the customer could buy or sell to meet the investment goal the customer has indicated; and
- A member uses data-mining technology (the electronic collection of information of website users) to analyze a customer's financial or online activity—whether or not known by the customer—and then, based on those observations, sends (or "pushes") specific investment suggestions that the customer purchase or sell a security.

These gamification features on investing platforms exceed the type of suggestive actions that meet the definition of a "recommendation" and were envisioned by the examples originally set forth by the NASD in 2001. It must be noted that these are not passive or neutral actions on digital platforms but rather digital *engagement* strategies and practices. In fact, these engagement strategies, including badges, contests, leaderboards, and status lists, are inherently interactive and are specifically designed to persuade a customer to take action and/or reward a desired behavior relating to trade execution. The timing, frequency, and manner of some engagement strategies encourage risky behavior, such as frequent trading and investing in higher risk products.

PIABA has concerns that broker-dealers utilizing DEPs are doing so without supervising transactions that constitute recommendations for the purpose of compliance with Reg BI and all the other industry conduct rules. This would, of course, undermine the very purpose of Reg BI – to ensure that all recommendations made to customers are in those customers' best interests.

Some broker-dealers[2], in an effort to encourage trading, are providing customers lists of securities on their applications, including lists of the most-traded securities on the platform and the most popular securities traded. On Robinhood, for example, this list is provided on the home screen of the application and is one of the first items that a new customer sees. This is no different than a broker handing a list of securities to a customer. Such a list encourages customers to search for and make those investments and should be considered a "recommendation."[3] Despite providing these lists to all customers

2. *See, e.g., Massachusetts Division of Securities v. Robinhood Financial, LLC*, Administrative Complaint No. 2020-0047, December 16, 2020.

3. As another example, customers may receive push notifications on their mobile devices if they have opened an investment account but have yet to make any trades.

by default, these broker-dealers are not conducting an analysis under Reg BI of the securities contained in the lists for customers, which is inconsistent with their obligations as registered broker-dealers.

2. Brokerage Firm's Usage and Marketing of DEPs Should Be Fair and Balanced

PIABA agrees with the Commission that the advent of digital platforms for investing have multiplied the opportunities for retail investors to invest and trade in securities.[4] Their growth, however, has also multiplied the risks inherent in investing, and the communications about such risks. PIABA believes that FINRA Rule 2210, Communications with the Public, remains a critical regulatory solution to regulate DEPs moving forward as digital platforms and their features become more sophisticated.

For instance, consider the so-called "copy trading" offered on some social trading digital platforms. Brokerage firms should fairly communicate about this trading method, yet marketing materials often lull traders into a false sense of security. Whether touting an automated trading experience or showcasing low-risk traders to follow, member communications can oversimplify the risks of investing, and certain engagement strategies on digital platforms tend to downplay the complexity of certain investment strategies.

To promote balanced and fair communications about DEPs, brokerage firms should be encouraged to closely supervise how and to what extent their DEPs are providing recommendations, and further should incorporate investor education *directly into* the digital platform themselves. Rather than bury an informative description in fine print, digital platforms could improve interactive features to educate investors while serving a transactional need of affecting securities trading. This is especially relevant for more complex trading strategies, such as options trading, where investors are able obtain certain trading levels beyond their requisite experience.

Upon clicking the notification, they are taken to the aforementioned popular stock list.

4. *See, e.g.,* FINRA Letter of Acceptance, Waiver and Consent No. 2020066971201 (Robinhood grew users from fewer than 500,000 customers in 2015 to over 31 million as of June 2021.).

Conclusion

In sum, PIABA believes that continued scrutiny of how DEPs on digital platforms risk providing, or in many instances, do provide recommendations that would subject them to rules such as Reg BI will help promote investor protection. Moreover, we believe that FINRA Rule 2210 remains a powerful tool to ensure fair and balanced communications in the marketing and usage of DEPs on digital platforms. Combined with an increased emphasis on investor education, the securities industry – retail investors, brokerage firms, and regulators – will be better for it.

Respectfully submitted,

David P. Meyer, President
Public Investors Advocate Bar Association

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The following Comment Letter regarding *OFR Bill Reforming Chapter 517 – Recommendation to Support Florida's Office of Financial Regulation* was submitted to Securities & Financial Services Committee by David Meyer on September 27, 2021. (prepared with the assistance of Jorge Riera, Courtney Werning, Robert Girard, Michael Edmiston, and Omar Bengali)

Via Electronic Submission: Stephen.Sandiford@hklaw.com
Chairman Stephen Sandiford, Esq.
Corporations, Securities & Financial Services Committee
701 Brickell Ave, Suite 3300
Miami, Florida 33131

Re: OFR Bill Reforming Chapter 517 - Recommendation to Support Florida's Office of Financial Regulation Ch. 517 Reform Legislation

Dear Chairman Sandiford:

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 falling prey to investment fraud, 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 Florida Office of Financial Regulations (the "OFR") relating to exempt offerings, the practices of brokers and broker-dealers, and investor protection.

I. Introduction

On August 4, 2021, the Ch. 517 Task Force (the "Task Force"), primarily comprised of members of the Florida Bar's Corporations, Securities & Financial Services Committee ("CSFS"), Business Law Fellows, and the OFR, approved the proposed Chapter 517 Reform Legislation (the "Proposed Legislation") that materially impacts the Florida Securities and Investor Protection Act, "creates needed capital-raising opportunities for Florida-based businesses," and "strengthens investor protection measures." Contrary to the Task Force's stated goal, it appears that the Task Force is more concerned with providing greater access to funds for exempt offering issuers than it is in providing necessary protections to public investors.

The Proposed Legislation should be narrowly tailored to address the capital formation needs of entrepreneurs and certain smaller issuers while preserving investor protections. Expanding exempt offerings in the manner proposed will do nothing to promote capital formation in the public markets, and will ultimately have negative consequences for investors. Additionally, the Proposed Legislation expands the pool of investors who may be eligible to invest in exempt offerings. The Proposed Legislation is solely focused on expanding the private markets that would unquestionably cause retail investors harm. The most likely outcome of the Proposed Legislation will be to increase private issuers, which will have the harmful effect of depriving investors in those companies of the benefits of registration.

II. Expansion of Exempt Offerings Will Undermine Investor Protection

Expansion of exempt offerings to Florida retail investors will almost certainly increase the risks to which retail investors are exposed while decreasing the information available to investors attempting to make informed decisions about potential investments. It will also substantially increase the number of instances in which Florida investors fall prey to fraudulent investment schemes. These implications are significant and must be addressed if the Task Force is to honor its mission of protecting the investing public. If the Task Force is to expand the pool of investors who may be eligible to invest in exempt offerings, it must simultaneously improve investor protections for those who are eligible to invest.

The evidence is clear that fraud and other harms occur frequently where unregistered persons promote unregistered products to retail investors. In August 2020, the SEC's Division of Economic and Risk Analysis ("DERA") published a study of fraud in the private markets based on SEC enforcement actions brought over a single year.[1] Results from DERA' study showed that the majority of offerings were fraudulent offerings that did not qualify for an exemption from registration.[2] DERA's study further states that "offerings

1. Rachita Gullapalli, *Misconduct and Fraud in Unregistered Offerings: An Empirical Analysis of Select SEC Enforcement Actions*, SEC Division of Economic and Risk Analysis (Aug. 2020) ("DERA Study"), available at https://www.sec.gov/files/Misconduct%20And%20Fraud%20In%20Unregistered%20Offerings.pdf.
2. *Id*. at 33.

linked to SEC enforcement actions more likely involved an unregistered intermediary or a recidivist, or solicited from unsophisticated investors."[3]

DERA study showed that while Florida had the sixth largest number of Regulation D issuers compared to all the other states, Florida had most number of issuers with unregistered offerings.[4] Florida also has the highest proportion of seniors in its population and accounts for the second largest number of seniors amongst all states.[5] With more than half of financial assets in the U.S. estimated to be owned by seniors,[6] elderly investors are considered to be the most targeted and vulnerable to financial exploitation.[7]

III. Finder's Exemption

PIABA opposes the proposed registration of finders ("Finder's Exemption") for many of the same reasons PIABA opposed the U.S. Securities and Exchange Commission (the "SEC") Release Number 34-90112, Notice of Proposed Exemptive Order Granting Conditional Exemption from the Broker Registration Requirements of Section 15(a) of the Securities Exchange Act of 1934 for Certain Activities of Finders (the "Proposed Exemptive Order").[8] We strongly believe that if a finder acts as a broker with respect to the securities activities of non-reporting issuers, they should be subject to all of the requirements that would apply to a broker-dealer when acting in that same capacity.

Finders would not have to possess any minimum knowledge or competency with respect to securities to qualify for the exemption, nor would they have to pass any examinations or undergo any training or continuing education to serve as a finder. Because the exemption would allow virtually any individual to promote sales of unregistered securities so long as the individual was not statutorily disqualified, there would be no assurance to the investor, the issuer, or the securities market at large that such individuals have

3. *Id*. at 11.

4. *Id*. at 19.

5. *Id*.

6. *Id*.

7. *Id*.

8. *See* Letter from PIABA President David P. Meyer to Vanessa Countryman, Re: File No. S7-13-20: https://www.sec.gov/comments/s7-13-20/s71320-8011738-225383.pdf.

the knowledge, skills, integrity, or competency to serve investors or issuers in capital raising activities.

Finders would not need under the federal securities laws to notify regulatory authorities of their activities, or to keep any records of their activities, communications, or finances, making it extremely difficult for the Commission or any other regulator with jurisdiction over Finders to determine whether they were complying with the exemptive order or other applicable laws and standards. There would be no database, such as BrokerCheck, for investors to learn more about a Finder's background, including any customer complaints or past crimes or disciplinary actions that do not trigger disqualification.

The proposed exemption would not allow Finders to participate in the preparation of issuer sales materials, but in our experience, persons involved in securities sales are typically involved in the preparation of the sales materials that they will use to promote an offering. (It is not clear from the Proposal whether a Finder may provide investors with projections of the price performance of a privately offered security, which generally is not permissible for broker dealers.)

Because there would be no regular oversight of the use of these materials or standards applicable to such sales materials other than general anti-fraud laws, there remains a risk that Finders may be involved in preparing sales materials that are designed to maximize sales at the cost of compliance with standards requiring such communications to be fair and balanced.

Moreover, because Finders would not need to have any background in the securities industry or pass minimum knowledge or competency examinations, it is possible that Finders would not even recognize when they are providing misleading content to investors. The North American Securities Administrators Association ("NASAA") issues enforcement reports every year that summarize enforcement actions filed by state regulators. NASAA's recent Enforcement Report show that during 2019, state securities regulators brought 738 enforcement actions against unregistered persons, including against 57 unregistered finders or solicitors.[9]

In addition, Finders should be required to do their own due diligence before making a recommendation. Prohibiting Finders to investigate or perform reasonable diligence on an issuer or its securities may provide a shield from liability for a Finder in an investor's claim in arbitration that suffered losses from the Finder's solicitation activities. For example, a Finder could

9. See NASAA 2020 Enforcement Report at 5, available at https://www.nasaa.org/wp-content/uploads/2020/09/2020-Enforcement-Report-Based-on-2019-Data-FINAL.pdf.

assert that the restriction from performing due diligence on the issuer, and thus any claims by an investor that the Finder should have known about any fraud or investment risk related to the investment would run counter to the Finder's obligations.

If the OFR does move forward with the Finder exemption, it should be limited only to natural persons because permitting entities to come into this space opens the door to boiler room operations and other fraudulent enterprises acting under the approval of an OFR exemption.

IV. Crowdfunding

The Task Force's reasoning to expand crowdfunding offerings is deeply flawed. As support for the proposed reform measures, the OFR states that "to date there has not been a single securities offering under Florida's crowdfunding statute."[10] As further support, the OFR states that "there have been numerous offerings in Georgia under their crowdfunding provisions that are substantially similar to the OFR's reform proposals."[11]

Despite the Task Force's assertions, Florida has had numerous crowdfunding offerings under its existing regulatory framework. In 2020, there were 1149 crowdfunding offerings in the U.S. that raised $239 million.[12] Florida was among the top five states of those crowdfunding offerings for issuers, investments, and investors.[13] Moreover, Georgia was not among the leading states for crowdfunding offerings. Thus, mirroring Georgia's crowdfunding provisions will not likely increase capital raising opportunities for smaller companies.

PIABA is also opposed to the growth of unregulated crowdfunded offerings. Our members often find that unsophisticated retail investors are the ones more likely to fall victims to fraudulent offerings. The OFR should not increase or waive the current annual cap on investors, accredited or not. More control and review will protect investors, therefore increasing offering

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10. *See* Ch. 517 Task Force Report at p. 3.

11. *Id*.

12. See Alois, JD, *$239 Million was Raised using Reg CF During 2020, this Amount Could Double in 2021,* Crowdfund Insider (Jan. 6, 2021), available at https://www.crowdfundinsider.com/2021/01/170982-239-million-was-raised-using-reg-cf-during-2020-amount-could-double-in-2021/ (citing a report by Crowdfund Capital Advisors ("CCA")).

13. *Id.*

document disclosure and auditing, as well as regulating or limiting promotion and advertising.

Additionally, the Task Force proposes to create a new exemption for micro-offerings under $50,000. While a micro-offering could allow small business access to investors' capital, businesses seeking relatively small amounts of capital should use traditional forms of financing, like commercial loans. The risk inherent in micro-offerings is not the type of risk that should be passed onto investors. Further, the ability of a business to issue a new micro-offering every thirty days would create a loophole for fraudsters to exploit, allowing them to raise larger amounts of capital than should be allowed under a micro-offering exemption.

PIABA members see cases where the investor is unaware of the liquidity or illiquidity of an investment which they are holding. In 2019, the SEC published the results of a study conducted by its staff on the capital formation and investor protection impacts of Regulation Crowdfunding (the "SEC Crowdfunding Report").[14] According the SEC Crowdfunding Report, the average issuer had "no revenues (just over half of the offerings were by issuers with no revenues)."[15]

Florida entities that have conducted 4(a)(6) offerings have done so under funding portals registered with the SEC and FINRA. The following make up a small sampling of the crowdfunding offerings conducted by Florida entities, with the exception of one foreign entity with its principle place of business in Florida.

- Acquire Skills & Knowledge Education Inc. ("ASK Education"), Boca Raton, FL: Target raise $10,000 to $107,000, and crowdfund offering closes on November 2021.[16]
- Jinglz, Inc., Boynton Beach, FL: Funds raised to date $248,588.00, crowdfund offering closed on April 2021.[17]
- We Are Kula, LLC, Boca Raton, FL: Total funds raised $12,479.00, and crowdfund offering closed on September 2020[18]

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14. *See SEC 2019 Regulation Crowdfunding Report* (Jan. 18, 2019), available at https://www.sec.gov/smallbusiness/exemptofferings/regcrowdfunding/2019Report.

15. *Id*. at 17.

16. *See* Netcapital fund portal, available at https://netcapital.com/companies/ask.

17. *See* Netcapital fund portal, available at https://netcapital.com/companies/jinglz.

18. *See* Netcapital fund portal, available at https://netcapital.com/companies/kula-crate.

- Janover Ventures LLC, Boca Raton, FL: Total funds raised $714,052.00, and crowdfund offering closed on December 2020.[19]
- Northstar Technologies Group, Inc., Bonita Springs, FL: Funds raised to date $400,368.00, and crowdfund offering closing date is November 1, 2021[20]
- Stemsation International, Inc., Boca Raton, FL: Total funds raised $43,248.00, and crowdfund offering closed on March 2020.[21]
- Atmospheric Water Solutions, LLC ("AquaBoy") Cooper City, FL: Funds raised $194,245.00, and crowdfund offering closed on April 2021.[22]
- COI Energy Services, Inc. (Incorporated in Delaware), Tampa, FL: Total funds raised $589,026.00, and crowdfund offering closed on April 2021.[23]
- Domaselo, LLC, Key Biscayne, FL: Total funds raised $57,500.00, and crowdfund offering closed on January 2021.[24]

V. Conclusion

Once again, PIABA appreciates the opportunity to comment on the Task Force's Proposed Legislation. We urge the OFR to remember its mission to protect investors while it tackles the legitimate goal of simplifying the exempt offering framework. Although increasing the efficiency of the capital markets and ability of companies to raise money is a laudable goal, it cannot be done at the detriment of Florida investors.

PIABA would be happy to engage with the OFR further on this issue.

Respectfully submitted,
David P. Meyer, President
Public Investors Advocate Bar Association

19. *See* Republic fund portal, available at https://republic.co/janover-ventures.

20. *See* Netcapital fund portal, available at https://netcapital.com/companies/northstar-tgi.

21. *See* Netcapital fund portal, available at https://netcapital.com/companies/Stemsation.

22. *See* Netcapital fund portal, available at https://netcapital.com/companies/aquaboy.

23. *See* Republic fund portal, available at https://republic.co/coi-energy.

24. *See* Mainvest fund portal, available at https://mainvest.com/b/domaselo-miami#updates.