PIABA BAR JOURNAL

VOLUME 29, NO. 2 • 2022

a publication of

Public Investors Advocate Bar Association

PIABA BAR JOURNAL

VOLUME 29 2022 NO. 2

Generally published three times per year by PIABA, 1225 W. Main St., Ste. 126, Norman, Oklahoma 73069. Subscriptions, copies of this issue and/or all back issues may be ordered only through PIABA. Inquiries concerning the cost of annual subscriptions, current and/or back issues should be directed to PIABA.

It is our policy that unless a claim is made for nonreceipt of a *Bar Journal* number within six months after the mailing date, PIABA cannot be held responsible for supplying such number without charge.

The *PIABA Bar Journal* is interested in receiving submissions from PIABA members and non-members including experts, mediators, arbitrators, securities regulators and educators. Manuscripts are reviewed prior to publication and are accepted for publication based on, *inter alia*, quality, timeliness and the subject's importance to PIABA and the arbitration/investor-attorney community. Individuals interested in contributing should contact the PIABA office at 888.621.7484. Comments and contributions are always welcome.

PIABA BAR JOURNAL

VOLUME 29 2022 NO. 2

In this Issue

PIABA BAR JOURNAL

VOLUME 29 2022 NO. 2

FORM CRS IN PRACTICE: HOW THE SEC FAILS TO PROTECT RETAIL INVESTORS

*Zev T. Chabus**

INTRODUCTION

The Securities and Exchange Commission (SEC) adopted Regulation Best Interest (Reg BI) on June 5, 2019, as part of a push to improve "transparency . . . [regarding] retail investors' relationships with investment advisers and broker-dealers."[1] As part of this new rule, broker-dealers and investment advisers are now required to submit a Form CRS Relationship Summary ("Form CRS") if they offer certain services to retail investors.[2] The SEC has published instructions as to what information must be included in Form CRS, as well as how that information should be displayed.[3] However, not every firm has been following those instructions.[4]

Currently, four firms handle the majority of investment by retail investors: Charles Schwab, Fidelity, TD Ameritrade, and Etrade.[5] Each of these firms offers brokerage and investment adviser services, and each firm publishes its own Form CRS. Each of these firms' Form CRS contains similarities, but also several differences. These differences create inconsistencies in how

---

* Zev T. Chabus is a J.D. candidate at Cornell Law School, Class of 2022, and participated in Cornell's Securities Law Clinic during the Spring 2021 and Fall 2021 semesters. Thank you to Professor Birgitta Siegel for her assistance and advice on this Article, and the PIABA Bar Journal staff for their work.

1. *Regulation Best Interest, Form CRS and Related Interpretations*, SEC (Jan 5. 2021), https://www.sec.gov/regulation-best-interest.

2. *Form CRS Relationship Summary; Amendments to Form ADV*, SEC (Sept. 10, 2019), https://www.sec.gov/rules/final/2019/34-86032.pdf.

3. *Appendix B, Form CRS*, SEC (June 2019), https://www.sec.gov/rules/final/2019/34-86032-appendix-b.pdf (hereafter "Instructions").

4. Thompson Information Services, *Observations from Early Form CRS Reviews Offer "Lessons Learned*," 25 NO. 10 INVESTMENT MGMT. COMPLIANCE GUIDE NEWSL. 1 (Dec. 2020).

5. Sean Ross, *The Biggest Stock Brokerage Firms in the U.S.*, INVESTOPEDIA (Oct. 24, 2021), https://www.investopedia.com/articles/professionals/110415/biggest-stock-brokerage-firms-us.asp.

information is displayed, and this Article will demonstrate how the inconsistencies ultimately harm retail investors. It will be shown that the harm is due to the SEC's failure to provide adequate guidance to firms on how to structure and complete Form CRS.

The blame is not only on the firms that fail to adequately complete Form CRS. Rather, such failures are based at least partially on the SEC's lack of clear guidance. Each firm is responsible for accurately completing and submitting Form CRS by the appropriate deadline, but the SEC bears the ultimate responsibility for enforcing protections for retail investors, which includes implementing and monitoring guidelines and regulations for firms.[6] Reg BI is one of those regulations, and Form CRS is an important part of the rule. This Article will discuss the purpose and failings of the current Form CRS instructions, but a full discussion of the merits and controversies of Reg BI is outside the scope of this Article.

This Article is intended to offer observations and practical guidance for changes to Form CRS. Part I of this Article will explore the history of Reg BI, the development of Form CRS and its role in Reg BI, and investors' concerns about Form CRS. Part II will examine the SEC's current instructions for Form CRS, especially as they relate to investors' concerns, and will utilize Charles Schwab's, Fidelity's, TD Ameritrade's, and Etrade's Form CRS filings as examples of potential issues and lack of compliance with the current instructions. Finally, Part III will propose solutions to the problems with Form CRS, including revised SEC instructions or the creation of a template for Form CRS that would eliminate uncertainty and inconsistencies in the current Form CRS instructions, as well as an interactive website for investors to use.

PART I

1. History of Reg BI

On April 14, 2015, the Department of Labor (DOL) proposed the forerunner of Reg BI.[7] The DOL rule would have imposed a national, uniform fiduciary standard on people and firms, including brokers and brokerage firms,

6. *About the SEC*, SEC (Nov. 22, 2016), https://www.sec.gov/about.shtml.

7. U.S. Labor Department Seeks Public Comment on Proposal to Protect Consumers from Conflicts of Interest in Retirement Advice, U.S. DEPT. LABOR (Apr. 14, 2015), https://www.dol.gov/newsroom/releases/ebsa/ebsa20150655.

that provide retirement investment advice.[8] At the time, the Financial Industry Regulatory Authority (FINRA)[9] advocated for a fiduciary standard that would apply equally to brokers and investment advisers, which would avoid the possibility of multiple standards of conduct applying to a single scenario.[10] However, the DOL rule was delayed numerous times, including in response to pressure from investment management firms.[11] Ultimately, the Court of Appeals for the Fifth Circuit vacated the DOL rule.[12]

The SEC proposed Reg BI on April 18, 2018, and approved it on June 5, 2019.[13] The final version of the rule "retain[ed] its overall structure and scope" but contains several modifications in response to comment letters from the financial industry and investors.[14] Reg BI does not impose a fiduciary standard. Instead, firms "must act in the best interest of their retail customers" when they make certain recommendations.[15]

Reg BI contains four components that govern how firms must deal with retail investors: Disclosure; Care; Conflict of Interest; and Compliance.[16] The rule applies to broker-dealers that make "recommendation[s] to a retail

---

8. Katelyn Peters, *Everything You Need to Know About the DOL Fiduciary Rule*, INVESTOPEDIA (July 14, 2021), https://www.investopedia.com/updates/dol-fiduciary-rule/.

9. FINRA is a not-for-profit organization authorized by Congress to regulate the broker-dealer industry. *About FINRA*, FINRA, https://www.finra.org/about (last visited Dec. 8, 2021).

10. Sara Hanley, Joe Wojciechowski & Bradley Stark, Investors Cornered: Regulation Best Interest – It's Not a Fiduciary Duty, but the Industry Hopes Investors Think It Is, 27 PIABA B.J. 237, 242 (2020).

11. *Id.*

12. Chamber of Commerce v. United States of America, 885 F.3d 360, 388 (5th Cir. 2018).

13. Adam Hayes, *Regulation Best Interest*, INVESTOPEDIA (Feb. 4, 2021), https://www.investopedia.com/what-is-the-sec-s-regulation-bi-best-interest-rule-4689542.

14. *See Regulation Best Interest: The Broker-Dealer Standard of Conduct*, SEC (Sept. 10, 2019) https://www.sec.gov/rules/final/2019/34-86031.pdf (hereafter "Reg BI final rule"), at 33.

15. Christine Lazaro, An Overview of the Regulation Best Interest Rule Package, 27 PIABA B.J. 357, 357 (2020).

16. *Id.* at 359.

customer of any securities transaction or investment strategy involving securities."[17] A retail customer, or retail investor, is a "natural person" who receives securities recommendations from a broker-dealer and then uses that recommendation "primarily for personal, family, or household purposes."[18] Reg BI does not apply to "self-directed or otherwise unsolicited transactions by a retail customer."[19]

Before the SEC introduced Reg BI, the brokerage side of the industry followed FINRA's suitability rule. The suitability rule requires broker-dealers to consider several factors about customers[20] before making a "suitable"

---

17. Reg BI final rule, *supra* note 14.

18. *Id.* at 109. The SEC agreed with SIFMA that the definition should be limited. *See* SIFMA, *infra* note 31, at 16.

19. Reg BI final rule, *supra* note 14, at 299. Accordingly, platforms like Robinhood would be exempt from Reg BI. Robinhood notes that it does not provide recommendations, *see Open Account, Get Free Stock*, ROBINHOOD, https://robinhood.com/us/en/support/articles/open-account-get-free-stock/ (last visited Nov. 20, 2021), but it does make available an abbreviated Form CRS on its website: *Form CRS Customer Relationship Summary Responses to "Conversation Starters*," ROBINHOOD (Oct. 17, 2021, https://cdn.robinhood.com/assets/robinhood/legal/RHF%20Form%20CRS%20Responses%20to%20Conversation%20Starters.pdf. An internet search also turns up a full version of Robinhood's Form CRS: *Robinhood Financial LLC Form Customer Relationship Summary (CRS")*, ROBINHOOD (Oct. 18, 2021), https://cdn.robinhood.com/assets/robinhood/legal/RHF%20Customer%20Relationship%20Summary.pdf. While Robinhood maintains that it is exempt from regulatory rules governing investment advisers, the availability of a Form CRS may indicate that the company is aware that it may become subject to these rules as it increasingly focuses on wealth management. *See* Miriam Rozen, *Robinhood Tiptoes into Wealth Management with "Recommendations" Engine*, ADVISORHUB (Oct. 27, 2021), https://www.advisorhub.com/robinhood-tiptoes-into-wealth-management-with-recommendations-engine/.

20. FINRA defines "customer" for the suitability rule differently than the SEC defines retail investors for Reg BI. FINRA's definition includes anyone who is not a broker-dealer. *Suitability*, FINRA, https://www.finra.org/rules-guidance/key-topics/suitability/faq (last visited Nov. 19, 2021). For recommendations that are subject to Reg BI, both FINRA and the SEC use the SEC's definition of retail investor. REGULATORY NOTICE 20-18: FINRA AMENDS ITS SUITABILITY, NON-CASH COMPENSATION AND CAPITAL ACQUISITION BROKER (CAB) RULES IN RESPONSE TO REGULATION BEST INTEREST, FINRA, https://www.finra.org/rules-guidance/notices/20-18 (last visited Dec. 16, 2021) (hereafter "REGULATORY NOTICE 20-18").

recommendation.[21] After the SEC implemented Reg BI, FINRA modified its suitability rule so that recommendations that are subject to Reg BI are not subject to the suitability rule,[22] although the suitability rule remains in place for other entities, as they are not subject to Reg BI.[23]

Although Reg BI created a standard of best interest rather than suitability, some of the factors involved are similar, while others are different. Reg BI, similar to the suitability rule, requires brokers and investment advisers to "perform due diligence on an investment" before recommending it to an investor.[24] Whether a recommendation is in a customer's best interest "depends on the facts and circumstances of a recommendation at the time it is made,"[25] which is similar to the suitability rule.[26] However, unlike the suitability rule, Reg BI requires broker-dealers to "consider reasonably available alternatives offered by the broker-dealer" when making a recommendation.[27] Additionally, Reg BI makes it possible for a broker-dealer to be liable for excessive trading even if the broker-dealer does not have "actual or *de facto* control over a customer's account,"[28] which FINRA incorporated into its revised suitability rule.[29]

The Securities Industry and Financial Markets Association (SIFMA), a trade group that represents securities firms, supports Reg BI and opposes a fiduciary standard.[30] In a comment letter to the SEC while the agency was debating Reg BI, dated August 7, 2018, SIFMA equated the Reg BI standard "with the obligation imposed on an investment adviser when providing

---

21. *Suitability*, FINRA, *supra* note 20.

22. *Id.*

23. Regulatory Notice 20-18, *supra* note 20.

24. *See* Hanley, *supra* note 10, at 244 (2020).

25. Reg BI final rule, *supra* note 14, at 290.

26. *Suitability*, FINRA, *supra* note 20.

27. Reg BI final rule, *supra* note 14, at 283.

28. *Id.* at 297.

29. *Suitability*, FINRA, *supra* note 20; Alan Wolper, *Goodbye Suitability, Hello Best Interest. But What Does that Mean, Practically Speaking?*, ULMER ATTORNEYS (June 26, 2020), https://www.bdlawcorner.com/2020/06/goodbye-suitability-hello-best-interest-but-what-does-that-mean-practically-speaking/.

30. Kenneth E. Bentsen, Jr., *Reg BI: Raising the Bar on Investor Protection While Preserving Choice*, SIFMA (Mar. 14, 2019), https://www.sifma.org/resources/news/reg-bi-raising-the-bar-while-preserving-choice/.

personalized investment advice," yet differentiated Reg BI from a fiduciary standard based on the fact that Reg BI would apply only at the time a recommendation is made, while a fiduciary duty would be ongoing.[31] In contrast, the Public Investors Advocate Bar Association (PIABA)[32] suggested in an August 7, 2018, comment letter that financial advisers who are dually registered as investment advisers and brokers should be held to the fiduciary standard that applies to investment advisers.[33]

Reg BI also raises issues regarding federal preemption of state fiduciary laws. In a separate comment letter, dated March 29, 2019, SIFMA argued that state laws imposing fiduciary duties should be preempted by Reg BI.[34] PIABA countered that suggestion by arguing that Reg BI should be considered the minimum level of protection for investors, not the maximum, and that "states who have enacted stronger protections" should be allowed to retain them.[35] The North American Securities Administrators Association (NASAA), an organization that represents state securities regulators, took a similar position in a comment letter on March 7, 2019, regarding Nevada's attempt to strengthen its fiduciary standard for broker-dealers and investment advisers.[36] Ultimately, while it is unclear whether the SEC has the power to preempt state fiduciary laws,[37] the SEC decided that any issues involving preemption were

---

31. *Comment Letter Re: Regulation Best Interest*, SIFMA (Aug. 7, 2018), https://www.sec.gov/comments/s7-07-18/s70718-4185817-172705.pdf, at 8.

32. PIABA is an "international bar association" consisting of attorneys who "represent investors in disputes with the securities industry." *About PIABA*, PIABA, https://piaba.org/about-piaba (last visited Dec. 8, 2021).

33. *Response to Request for Comments Regarding Regulation Best Interest*, PIABA (Aug. 7, 2018), https://www.sec.gov/comments/s7-07-18/s70718-4182233-172533.pdf.

34. *Re: Federal Preemption of State Regulation under NSMIA*, SIFMA (Mar. 29, 2019), https://www.sec.gov/comments/s7-07-18/s70718-5263945-183727.pdf.

35. PIABA, *supra* note 33, at 2.

36. *RE: Notice of Draft Regulations and Request for Comment*, NASAA (Mar. 7, 2019), https://www.nasaa.org/wp-content/uploads/2019/12/NASAA-Nevada-Comment-Letter-3-7-2019.pdf.

37. Nick Thornton, *Will Reg BI Preempt State Fiduciary Rules?*, BENEFITSPRO (Feb. 13, 2019), https://www.benefitspro.com/2019/02/13/will-reg-bi-preempt-state-fiduciary-rules/; *see* Yerv Melkonyan, Note, *Regulation Best Interest and the State-Agency Conflict*, 120 COLUMBIA L. REV. 1591, 1613 (2020).

best left to the judicial system to decide "in future . . . proceedings."[38] In April 2021, Robinhood sued Massachusetts and William F. Galvin, the Secretary of the Commonwealth of Massachusetts, in response to the Commonwealth's administrative claim that Robinhood violated Massachusetts' fiduciary rule.[39] In its lawsuit, Robinhood argued that Galvin did not have authority under Massachusetts state law to enact a fiduciary rule, and that Reg BI preempts state fiduciary laws.[40] On March 30, 2022, the Massachusetts Superior Court agreed with Robinhood that Galvin lacked the authority to enact Massachusetts' fiduciary rule.[41] However, due to this ruling, the court did not address the question of whether Reg BI preempted the state's fiduciary rule.[42] Galvin appealed the decision on April 29, 2022.[43]

Reg BI has been, and continues to be, controversial among many legal scholars and practicing attorneys in the securities regulation and arbitration fields. Some attorneys prefer that firms meet a fiduciary standard, and Reg BI does not hold broker-dealers to that standard.[44] Despite what some may claim are, and what may be, extensive disclosure requirements, Reg BI does not impose a fiduciary standard and therefore "fails to adequately protect investors," especially as the rule does not "require[] an improvement in the recommendations of broker-dealers."[45] Although FINRA's suitability rule also does not impose a fiduciary standard, it does contain a clear list of factors that broker-dealers could use to decide whether a recommendation is suitable.[46] In

---

38. Reg BI final rule, *supra* note 14, at 43.

39. Heaven Chandler, Sandra Dawn Grannum & James Lundy, Robinhood vs. Massachusetts' Secretary of the Commonwealth: A Battle for the Ages over Massachusetts' New Strict Fiduciary Duty Rule, JDSUPRA (May 25, 2021), https://www.jdsupra.com/legalnews/robinhood-vs-massachusetts-secretary-of-8955842/. See note 19, supra, for a more detailed discussion of Robinhood's current brokerage practices.

40. Id.

41. Robinhood Fin., LLC v. William F. Galvin, Sec'y of the Commonwealth, No. 2184CV00884 (Mass. Super. Ct. 2022), at 26.

42. *Id.* at 3.

43. Notice of Appeal of Defendants at 1, Robinhood Fin, LLC v. William F. Galvin, Sec'y of the Commonwealth, No. 2184CV00884 (Mass. Super. Ct. 2022).

44. Hanley, *supra* note 10, at 249.

45. *Id.* at 253–54.

46. *See Suitability*, FINRA, *supra* note 20.

contrast, Reg BI does not define what "best interest" means,[47] which can potentially confuse investors who think that Reg BI is the same as a fiduciary standard,[48] especially as the Investment Advisers Act of 1940, which imposes a fiduciary standard on investment advisers, uses the same language.[49] When the SEC released the final version of Reg BI, the SEC also reaffirmed that investment advisers are subject to a fiduciary duty in a 42-page interpretive document that used the term "best interest" or "best interests" 51 times.[50]

2. History of Form CRS

Form CRS falls under the Disclosure prong of Reg BI.[51] Although Reg BI is targeted at broker-dealers, the SEC was concerned that retail investors were "confused about the services, fees . . . required standard of conduct . . . and the differences between broker-dealers and investment advisers."[52] Form CRS was designed to address this confusion.[53] Form CRS is an amendment to Form ADV, which investment advisers were already required to file with the SEC; broker-dealers who have qualifying retail customers need only file Form CRS with FINRA.[54] The SEC requires that firms include certain specific information in their Form CRS filings: a description of the services the firm

---

47. *SEC Adopts Regulation Best Interest and Other Measures for Broker-Dealers and Investment Advisers*, THOMPSON HINE (June 18, 2019), https://www.thompsonhine.com/publications/sec-adopts-regulation-best-interest-and-other-measures-for-broker-dealers-and-investment-advisers.

48. 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 (Apr. 18, 2018), https://www.sec.gov/news/public-statement/stein-statement-open-meeting-041818.

49. Investment Advisers Act of 1940, 15 U.S.C. § 80b-1, https://www.govinfo.gov/content/pkg/COMPS-1878/pdf/COMPS-1878.pdf at 33.

50. *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, SEC (July 12, 2019), https://www.sec.gov/rules/interp/2019/ia-5248.pdf.

51. Lazaro, *supra* note 15, at 368.

52. SEC, *supra* note 2, at 483–84.

53. *Id.* at 484–85.

54. *Frequently Asked Questions on Form CRS*, SEC (Mar. 5, 2021), https://www.sec.gov/investment/form-crs-faq.

offers; legal obligations of the broker-dealer or investment adviser; disciplinary history; information about fees and how the firm makes money; "conversation starters," which are specifically-worded prompts that are designed to encourage investors to ask questions of their broker or investment adviser; and additional information that the firm does not address directly in a given section.[55] All of this information is meant to increase disclosure.

To fulfill the Disclosure prong of Reg BI, any firm that makes recommendations to retail investors must complete Form CRS, file it in the appropriate place, and send it to investors who are considering opening an account with that firm.[56] In 2018, before the SEC approved the final rule implementing Form CRS, the SEC circulated a mockup Form CRS to prepare firms for the upcoming requirements.[57] As part of that preparation, the SEC organized a survey of retail investors that attempted to gauge their interest in Form CRS, as well as whether they understood its purpose and components.[58] That survey produced inconsistent results: investors reported that they liked Form CRS, but could not understand it.[59] As a result of that survey, the SEC drafted instructions for firms, which purported to address the issues that the survey revealed.[60]

Before the SEC finalized Form CRS, SIFMA proposed its own versions of Form CRS in response to the SEC's mockup. The group submitted a one-page mockup Form CRS for brokerage firms that covered most, but not all, of the information contained in the current Form CRS.[61] SIFMA argued that this

---

55. Instructions, *supra* note 3, at 10–17.

56. *Form CRS Relationship Summary; Amendments to Form ADV*, SEC (Sept. 19, 2019), https://www.sec.gov/info/smallbus/secg/form-crs-relationship-summary.

57. Dual Registrant Mock-up, https://www.sec.gov/rules/proposed/2018/34-83063-appendix-c.pdf; Broker-Dealer Mock-up, https://www.sec.gov/rules/proposed/2018/34-83063-appendix-d.pdf; Investment Adviser Mock-up, https://www.sec.gov/rules/proposed/2018/34-83063-appendix-e.pdf.

58. Angela A. Hung, Katherine G. Carman, Jennifer Cerully, Jeff Dominitz & Kathryn Edwards, *Investor Testing of Form CRS Relationship Summary*, SEC (Nov. 2018), https://www.sec.gov/comments/s7-07-18/s70718-4628415-176399.pdf (hereafter "Survey").

59. Diana Britton, *SEC Report: Investors Like Form CRS but Don't Understand It*, WEALTHMANAGEMENT (Nov. 9, 2018), https://www.wealthmanagement.com/regulation-compliance/sec-report-investors-form-crs-don-t-understand-it.

60. Instructions, *supra* note 3.

61. SIFMA, *supra* note 31, at 52.

format is "simple . . . relevant . . . focused . . . layered . . . visual . . . [and] resourceful," but, notably, it omits references to firm or individual disciplinary history and excludes a detailed breakdown of fees and costs.[62] SIFMA also submitted a second mockup form that contained two pages—with small font—and which compared services offered within a single firm instead of a comparison between brokers and investment advisers.[63] The SEC ultimately allowed firms to use a longer format than SIFMA suggested[64]—although, as this Article will demonstrate, that decision was not entirely beneficial for investors[65]—and declined to create a Form CRS solely for services offered within a firm.

3. Problems with the 2018 Mockup Form CRS

The SEC survey on the mockup Form CRS revealed several problems. First, over half of investors surveyed said that the form was too long.[66] Nearly three-quarters of investors appreciated the section that detailed firms' fees, but over a third found it hard to understand and thought that more detail would be useful.[67] Additionally, the form overall was too difficult for the average adult in the US to be able to understand: according to Deborah Bosley, an English language and communication expert, the mockup Form CRS was "written at a '14th grade' level . . . while the average adult in the U.S. reads at an 8th grade level."[68]

The SEC took some steps as a response to these problems. The agency released updated instructions to firms, replacing the mockup Form CRS with

---

62. *Id.* at 52-53.

63. *Id.* at 54-55.

64. *See id.* at 35.

65. *See* PART II.3 and text accompanying note 109, *infra*.

66. Britton, *supra* note 59. The mockup forms were four pages long, the same length as the current version examined in this Article. However, as this Article will demonstrate, the four firms' Form CRS examined in this Article include more information through smaller font sizes, making the effective length of the current Form CRS more than four pages.

67. Survey, *supra* note 58, at 34.

68. Diana Britton, *Reg BI Disclosure Does Not Pass Readability Test*, WEALTHMANAGEMENT (Sept. 19, 2018), https://www.wealthmanagement.com /regulation-compliance/reg-bi-disclosure-does-not-pass-readability-test.

detailed requirements as to what firms must include in their filings.[69] Those instructions include an exhortation to write in "plain English,"[70] as well as a link to a handbook that contains guidance for writing in plain English.[71] However, these actions did not resolve all of the problems that the survey identified. Additionally, several firms failed to file their Form CRS by the deadline, or otherwise failed to comply with the requirements, and the SEC has not stated what it will do to improve compliance.[72] As such, the current usage of Form CRS is flawed, as will be explained in Part II.

PART II

1. Problems With the Form CRS Currently in Use

The current form version and process of Form CRS filings, effective June 30, 2020, is the SEC's response to the failings of the previous version, as illustrated by the survey that the SEC conducted. The SEC rejected the mockup Form CRS in favor of detailed instructions to investment advisers and broker-dealers as to what should be included in the form.[73] However, while the SEC does require firms to include certain information that must be discussed in particular ways, it left many of the details up to the firms. This can lead to confusion for investors when different firms relay the same information differently, especially when investors frequently consider more than one firm when deciding with which firm to invest.[74] As this Article will demonstrate, the instructions are vague enough that firms can comply and still harm retail investors.[75]

---

69. Instructions, *supra* note 3.

70. *Id.* at 2.

71. *A Plain English Handbook: How to Create Clear SEC Disclosure Documents*, SEC (1998), https://www.sec.gov/pdf/handbook.pdf (hereafter "Handbook").

72. Thompson Information Services, *supra* note 4.

73. Instructions, *supra* note 3.

74. *See* Chris Davis, *Yes, You Can Have Multiple Brokerage Accounts*, NERDWALLET (Aug. 17, 2021), https://www.nerdwallet.com/article/investing/open-multiple-brokerage-accounts.

75. PART II.3, *infra*.

Additionally, although the SEC's updated instructions were purportedly a response to the concerns that retail investors had with the mockup Form CRS, the SEC did not go far enough in addressing those concerns. For example, firms must limit their Form CRS to two pages if they are either a broker-dealer or investment adviser (four pages total if they are dual registrants), but otherwise must use "reasonable paper size, font size, and margins."[76] The SEC does not provide further guidance, and as this Article will demonstrate, the firms discussed in this Article frequently use formatting and font sizes that are not reasonable.[77] Similarly, the SEC does not mandate a particular level of readability for Form CRS, and the four firms' Form CRS do not always take into account that the average American adult reads at an eighth grade level.[78] Additionally, while retail investors strongly preferred that Form CRS include detailed fee information,[79] the SEC only requires that firms "summarize" or "describe" their fees.[80] The SEC lets firms escape providing detail by allowing them to reference the exact fees on their websites.[81] Although 90 percent of retail investors indicated that they would click on links involving fees, they still preferred the firms to spell out the fee information.[82] The lack of detail does not help investors who receive physical copies of Form CRS, and nearly 40 percent of surveyed retail investors preferred to receive a physical Form CRS.[83]

Despite the SEC's awareness of some of the deficiencies with Form CRS, the SEC does not have a plan to correct them.[84] In a roundtable response to firms' first Form CRS filings after the June 30, 2020, deadline, the SEC noted that firms were not fully following the instructions in terms of content order,

---

76. Instructions, *supra* note 3, at 2.

77. PART II.2, *infra*.

78. *See* Ann Wylie, *What's the Latest U.S. Literacy Rate?*, WYLIE COMMUNICATIONS, https://www.wyliecomm.com/2021/08/whats-the-latest-u-s-literacy-rate/ (last visited Nov. 21, 2021).

79. *Survey*, *supra* note 58, at 34.

80. Instructions, *supra* note 3, at 12.

81. *Id.* at 13.

82. Survey, *supra* note 58, at 42.

83. *Id.* at 24.

84. Staff Statement Regarding Form CRS Disclosures, Press Release, SEC (Dec. 17, 2021), https://www.sec.gov/news/statement/staff-statement-form-crs-disclosures-121721 [hereafter "Statement"].

readability,[85] affiliate information, fees, disciplinary history, filing requirements, and recordkeeping.[86] The SEC "suggested" that firms should "consider" making changes in the future.[87] There was no mention of what exactly those changes might be or how or when they would be implemented. In a statement in December 2021 regarding Form CRS implementation, the SEC stated that firms have been having ongoing compliance issues with the plain English standard, formatting, and including certain required information, but this statement did not indicate any planned changes to the SEC's instructions.[88] The roundtable and statement included possible suggestions for future compliance, so adding those to the official instructions would be a good first step.

2. The Four Firms Use Disparate CRS Forms

The Form CRS filings by Charles Schwab, Fidelity, TD Ameritrade, and Etrade are examples of what the current Form CRS, as mandated by the SEC, looks like in practice.[89] Notwithstanding these firms' importance in the retail investment world, their Form CRS filings demonstrate the similarities and differences among firms' Form CRS filings to illustrate where firms comply with the SEC instructions, where they fall short, and where those shortfalls, and even their compliance, can harm investors.[90]

---

85. However, the SEC did acknowledge that the information in Form CRS "should be written for an 8th grade reader." Thompson Information Services, *supra* note 4.

86. *Id.*

87. *Id.*

88. Statement, *supra* note 84.

89. As each firm is dually registered as a broker and investment adviser, *see* INTRODUCTION, *supra*, each firm uses a Form CRS that is four pages long (except for Charles Schwab, which uses two separate forms, one for its brokerage service and one for its investment adviser offerings).

90. Each of these firms initially filed its Form CRS before the SEC released its December 2021 statement. Charles Schwab updated its Form CRS in February 2022 and TD Ameritrade and Fidelity did so in March 2022. Some of the updates were clarifications of services that each respective firm offers, while others were in response to the SEC's December statement. (As of May 2022, Etrade's most recent Form CRS was dated October 2021.) The analysis in this Article is based on the February or March version, respectively, of each firm's Form CRS (October 2021

The SEC requires that any firm that must complete a Form CRS must make it available online and send it to investors who open an account.[91] The four Form CRS filings discussed in this Article can all be found on the firms' websites. The forms are available in PDF file format, which means that investors cannot easily edit them—which is reasonable, considering that the purpose of the forms is to disclose certain information; being able to edit the form would increase the risk of an investor accidentally deleting information. However, as will be discussed in this Article, this format also makes it possible for firms to manipulate their compliance with the SEC instructions and can make it harder for investors to read the information in the form.[92]

A. Formatting

These four firms' Form CRS share certain similarities, but also contain differences. In order to fully protect retail investors and enhance disclosure, it is important that the Form CRS appear uniform.[93] For example, both Etrade's and TD Ameritrade's Form CRS contains columns to compare whether investors should select investment adviser or brokerage services, while Charles Schwab divides this information into two separate forms and Fidelity uses continuous text that starts at the top of page one and ends at the bottom of page four.[94] The SEC's survey showed that the vast majority—nearly 85 percent—of retail investors surveyed preferred that firms display this information side by side,[95] as Etrade and TD Ameritrade currently do,[96] and

---

for Etrade), but the same analysis applies to the pre-December 2021 filings, since the updates did not fix the issues discussed in this Article.

91. Instructions, *supra* note 3, at 6–7.

92. PART II.3, *infra*.

93. The SEC has implicitly acknowledged this by requiring firms to use specific wording in certain places in Form CRS. *See* PART I.2, *supra*. *See also, e.g.*, *The Benefits of Uniform Checking Account Disclosures*, PEW CHARITABLE TRUSTS (Nov. 2015), https://www.pewtrusts.org/-/media/assets/2015/11/consumerbanking_accountdisclosurebrief.pdf (asserting that uniformity increased consumers' ease of understanding). Common sense leads to a similar conclusion for Form CRS.

94. None of these four firms exceed the four-page maximum.

95. Survey, *supra* note 56, at 22.

96. *See* Figures 5–7, APPENDIX, *infra*.

which Charles Schwab and Fidelity do not.[97] Each firm's Form CRS differs noticeably when it comes to font sizes, colors, and formatting. The SEC instructions require that certain segments be made more prominent, and encourages graphics where firms find it desirable, but the exact details are left to the firms.[98] This results in vastly different Form CRS visual appearances among firms. It is important that investors not be confused about what each firm offers. When comparing firms, it is easier to look at information that is displayed in the same style, so investors know exactly where to look for the same information in each firm's filings. The SEC "expects firms to use white space and other design features," but fails to mandate uniformity or specify exactly what kinds of design features are not allowed, thus failing to prevent confusion for investors.[99]

B. Fees

The firms' Form CRS filings also differ regarding how they discuss fees and costs. TD Ameritrade is the only one of these four firms to provide a detailed breakdown of fees and costs, in the form of exact dollar amounts and value ranges for specific trades.[100] In contrast, the other firms use generic and vague statements like "Our . . . fees . . . include most transaction costs"[101] or "account- or transaction-related fees"[102] or "activity assessment fee"[103] or "a

---

97. Charles Schwab uses two forms. *See* Figures 3–4, APPENDIX, *infra*. Fidelity uses a standard paragraph format for the entire form. *See* Figure 1, PART II.3, *infra*.

98. Instructions, *supra* note 3, at 3–4.

99. *See* Statement, *supra* note 84.

100. *TD Ameritrade, Inc.: Form CRS Customer Relationship Summary*, TD AMERITRADE (Mar. 31, 2022), https://www.tdameritrade.com/content/dam/tda/retail/marketing/en/pdf/TDA101313.pdf (hereafter "TD Ameritrade Form CRS"), at 2.

101. *Relationship Summary: Investment Advisory*, CHARLES SCHWAB (Feb. 2022), https://www.schwab.com/resource/investment-advisory-relationship-summary-form-crs-ia (hereafter "Charles Schwab Form CRS IA"), at 1.

102. *Relationship Summary: Broker Dealer*, CHARLES SCHWAB (Feb. 2022), https://www.schwab.com/resource/broker-dealer-relationship-summary-form-crs-bd (hereafter "Charles Schwab Form CRS BD"), at 1.

103. *Customer Relationship Summary*, FIDELITY (Mar. 28, 2022), https://www.fidelity.com/bin-public/060_www_fidelity_com/documents/FBS-FPWA-CRS.pdf (hereafter "Fidelity Form CRS"), at 1.

sales fee called a load."[104] While each firm includes a link to their respective fee breakdowns online, these generic statements are possibly the minimum that firms can use and still claim to comply with the SEC's requirement to "describe" their fees and costs. Arguably, however, such generic statements simply acknowledge that these firms charge fees; they are not actually descriptions of the fees. The SEC's December 2021 statement noted that firms have used "boilerplate" and "vague" language, but stopped short of requiring firms to spell out their fees in detail: "Firms should not include vague and imprecise 'boilerplate' explanations . . . that could *hinder transparency or comparability between firms*."[105] The italicized language, which is open to interpretation without further guidance, allows firms to escape providing complete fee information in Form CRS. Furthermore, the SEC warned against "vague fee descriptions" but, aside from expecting firms to "summarize the principal fees and costs," does not provide clearer guidance.[106] Language requiring firms to "list the exact fees and costs associated with their products," for example, could resolve this problem.

---

104. *Relationship Summary*, ETRADE (Oct. 1, 2021), https://content.etrade.com /etrade/estation/pdf/relationshipsummary.pdf (hereafter "Etrade Form CRS"), at 3.

105. Statement, *supra* note 84 (emphasis added).

106. *Id.*

3. Compliance Can be Manipulated in Ways that Fail to Protect Retail Investors

Font size is a clear example[107] of how although firms may technically comply with the SEC instructions, such compliance actually harms investors. Most of the information in the mockup Form CRS was displayed in the Calibri font, size 12. The U.n S. Department of Health recommends font size 12 as the standard, and a larger font size if readers are older, as well as a sans-serif font such as Calibri.[108] In contrast, although each firm uses the same Calibri font as in the mockup Form CRS, Fidelity presents most of its information in font size 11, Charles Schwab and TD Ameritrade use size 9, and Etrade goes down to size 8, which is barely legible for many elderly investors or anyone with impaired vision. Such small text is undoubtedly hard for many retail investors, or anyone, to read, regardless of their age, and is not reasonable under the SEC instructions. Although each firm keeps its Form CRS to the four-page maximum, increasing the font size, while keeping the same amount of text, would increase the page length. As such, the small font size violates the requirement that the form be "easy to read."[109]

Each firm does something similar regarding emphasis in required areas. The SEC requires that compared to most information in Form CRS, firms make "noticeable and prominent in relation to other . . . text" information related to conversation starters, additional services, fees, and conflicts of interest.[110] Firms can meet this requirement in a number of ways: through bolded, italicized, or underlined text, or by offsetting the information.[111] Such

---

107. Each of these firms' Form CRS appears online in PDF format, which does not allow one to easily determine font size or typeface. To facilitate a detailed examination of font sizes and typeface, each firm's Form CRS was converted into a Microsoft Word–readable file; references to the forms' font size and typeface are based on that conversion. References to text colors, other visual qualities, and specific language in the forms are based on the original PDF files. The Word and PDF versions of each form are identical except for minor formatting discrepancies that had no effect on any of the analysis in this Article.

108. *See Display Content Clearly on the Page*, U.S. DEPT. HEALTH, https://health.gov/healthliteracyonline/display/section-3-3/ (last visited Dec. 16, 2021).

109. Instructions, *supra* note 3, at 3.

110. Instructions, *supra* note 3, at 4.

111. *Id.*

methods are not exhaustive.[112] However, Fidelity did the minimum amount that appears to be required under the guidelines: although the vast majority of the text in Fidelity's Form CRS is font size 11, the conversation starters are the same size, although bolded, italicized, and in a light gray box.[113] This is not "noticeable and prominent," despite what the SEC seems to state, especially when the rest of Fidelity's form consists entirely of black text on a white background. The only text in Fidelity's Form CRS that is larger than font size 11 is the title of the form, and the required questions in the form are the same size as the rest of the text and, therefore, easy for retail investors to miss. The following excerpt illustrates the difficulty investors face when reading Fidelity's Form CRS:

FBS brokerage accounts are also available to you when you work with a third-party adviser such as a registered investment adviser, retirement plan administrator, bank or family office ("intermediaries"). If you open your FBS brokerage account through an intermediary, you or your intermediary will make all decisions regarding the purchase or sale of investments; FBS will not provide recommendations or monitor your investment decisions, or your intermediary, for you. Some intermediaries limit the investment products and services available to you. Please contact us or your intermediary for more information on the available services and investments, conflicts of interest, and any fees you will pay.

Conversation Starters. Ask your FBS financial professional:

- ***Given my financial situation, should I choose a brokerage service? Why or why not?***
- ***How will you choose investments to recommend to me?***
- ***What is your relevant experience, including your licenses, education and other qualifications? What do these qualifications mean?***

What fees will I pay?
The fees that you will pay depend on whether you work directly with FBS or through an intermediary. If you establish a retail relationship directly with FBS, there are no commissions charged on online transactions for U.S. stocks, ETFs, options, new issue bonds and certificates of deposit ("CDs"). Online

Figure 1. The above is an excerpt from the Fidelity Form CRS brokerage section, including the conversation starter. For context, text in the body of this Article is written in font size 11; footnotes, and this text, are size 10.

Charles Schwab, Etrade, and TD Ameritrade take slightly different approaches. TD Ameritrade uses columns to display information, and the required section headers are in a separate column to the left, and in green text (the regular text is black). However, the required questions (conversation starters) are simply bolded and placed in the columns with the rest of the information.[114] The font size is usually the same, and these might not be

112. *Id.*

113. *See* Figure 1, PART II.3, *infra*.

114. *See* Figure 2, PART II.3, *infra*.

noticeable and prominent, especially since some other text is also bolded. Charles Schwab[115] and Etrade[116] both place the questions in bold and slightly larger font. However, the font is still small, and below the ideal 12-point size. This text might technically satisfy the SEC's requirements because it complies with a proffered method, but it does not meet the SEC's requirement that Form CRS be "easy to read,"[117] and is arguably not noticeable and prominent at all, thus failing to serve the purpose of providing retail investors with required information. The following excerpt of TD Ameritrade's Form CRS shows the firm's columns-based approach and the conversation starter's lack of prominence:

What fees will I pay? (cont.)	**You will pay fees and costs whether you make or lose money on your investments. Fees and costs will reduce any amount of money you make on your investments over time. Please make sure you understand what fees and costs you are paying. Actual transaction costs will be shown on the trade confirmations sent to you.** ***For additional information,*** please see our above linked Regulation Best Interest Disclosures and other applicable documents available at the following links: • TDA Pricing tdameritrade.com/pricing • Margin & Interest Rates tdameritrade.com/rates • Brokerage Fees tdameritrade.com/fees • TDAI Pricing tdainstitutional.com/tdaipricing • SDPS Pricing tdameritrade.com/sdpspricing Form CRS: • TDAIM tdameritrade.com/crstdaim ***Conversation Starter.*** Ask your financial professional— • **Help me understand how these fees and costs might affect my investments. If I give you $10,000 to invest, how much will go to fees and costs, and how much will be invested for me?**

Figure 2. The above is an excerpt from the TD Ameritrade Form CRS fees section, including the conversation starter.

A 2016 study conducted by Stanford Law School and FINRA demonstrates how these violations are harmful to the goal of investor protection.[118] Although the study was conducted before the SEC released Form CRS, the study focused on investors' preferences and responses to disclosures

115. *See* Figures 3–4, APPENDIX, *infra*.

116. *See* Figures 5–6, APPENDIX, *infra*.

117. Instructions, *supra* note 3, at 3.

118. Margaret Hagan, *Designing 21st-Century Disclosures for Financial Decision Making*, STANFORD LAW SCHOOL (Summer 2016), https://law.stanford.edu/wp-content/uploads/2016/10/Hagan-Designing-21st-Century-Disclsoures-for-Wise-Financial-Decision-Making-FINAL-2016.pdf (hereafter "Stanford study").

in the financial industry,[119] and its findings are relevant as applied to Form CRS.[120] For example, the study found that disclosures should be written for an eighth grade reader.[121] It also found that the ideal font size is 14 or 16,[122] which is larger than the Department of Health's recommendation and far larger than any of the four firms' Form CRS filings, as demonstrated in this Article.[123] The four firms' Form CRS formatting increases the likelihood that investors will not read the filings at all, since the "traditional visual designs of disclosures, with dense . . . and small-point text" indicates that the filings are not meant for the average retail investor.[124]

A. Readability Concerns

The largest compliance issue may be whether these firms' Form CRS filings are "easy to read" in the first place. The SEC's December 2021 statement noted that firms should not use "legal jargon" or "technical" terms without explanation, but did not provide a comprehensive mechanism for evaluating readability.[125] As mentioned, the average American adult reads at an eighth-grade level.[126] The SEC does not require firms to prepare Form CRS at that level, although it has acknowledged that they should do so,[127] but does require that it be written in "plain English."[128] As such, the Flesch-Kincaid scale, widely considered an accurate measure of how readable something is,[129] is a useful tool to measure whether the average American adult can understand

---

119. *Id.* at 2.

120. The Stanford study focused on "millennials," *id.* at 6, but many of the findings are still applicable to disclosures in general and Form CRS in particular.

121. *Id.* at 39.

122. *Id.* at 8.

123. *See* text accompanying notes 108-09, *supra*.

124. *See* Stanford study, *supra* note 118, at 38-39.

125. Statement, *supra* note 84.

126. *See* Wylie, *supra* note 78.

127. *See* note 86, *supra*.

128. Instructions, *supra* note 3, at 2.

129. *Flesch-Kincaid*, WEBFX, https://www.webfx.com/tools/read-able/flesch-kincaid.html (last visited Nov. 19, 2021).

these four firms' Form CRS.[130] The Flesch-Kincaid scale relies on a formula to determine how readable a piece of text is, which is displayed as the American educational grade level that someone would need to be in or have completed in order to understand the text. For example, someone who reads at an eighth-grade level would likely understand a piece of text with a grade level of 8 or lower; such a person might understand text with a higher grade level, but it would be more difficult, perhaps significantly so.[131] The SEC's Plain English Handbook warns against the use of readability formulas, such as the Flesch-Kincaid scale,[132] but as there is currently no objective evaluation of how readable each firm's Form CRS is, and no hard requirement as to how readable it must be or how to determine such readability, such formulas are a useful tool.

Fidelity's Form CRS is close to the goal of an eighth-grade reading level, but is still too complicated. The overall readability of the form is at a tenth-grade level, and the brokerage section on fees, which surveyed investors said was the most informative,[133] is readable at an eighth-grade level or slightly above. The investment adviser fees section is more difficult, with a grade level of 11.8. However, the section on brokerage services that the firm offers, which investors ranked as second most informative,[134] is more difficult to read than the form overall: intended for investors with a 15th grade reading level, it is even more difficult than the 14th grade reading level that typified the mockup Form CRS.[135] The investment adviser services section is slightly less difficult, with a grade level of 13, which is still too high.

Etrade's Form CRS readability level is similar to Fidelity's. The overall readability is appropriate for a tenth-grade reader, with the fees section having

---

130. For this analysis, each firm's Form CRS was digitally copied and pasted, in its entirety and then by section, and run through the following testing tool: *Readability Test*, WEBFX, https://www.webfx.com/tools/read-able/check.php (last visited Nov. 22, 2021).

131. *See* WEBFX, *supra* note 129. The Flesch-Kincaid scale also produces a total numerical score as a gauge of readability, with a higher score indicating that the text is easier to understand. However, since the grade level score is simpler and more intuitive, and because it is the measure that the SEC and others allude to, it is the primary indicator of readability that will be used in this Article.

132. Handbook, *supra* note 71, at 57.

133. *See* Survey, *supra* note 58, at 10.

134. *Id.*

135. *See* Britton, *supra* note 66.

a grade level of 8.7, roughly the same as Fidelity's brokerage fees section. The section on services that the firm offers is appropriate for someone with a 12th grade reading level—better than Fidelity, although the results may be skewed due to the chart format that Etrade uses; the "X" notations are considered short sentences on the Flesch-Kincaid scale and may artificially lower the readability level.[136] However, as the overall readability level shows, this form is still too complicated for the average retail investor.

Charles Schwab, which divides its Form CRS into two separate filings, one for its brokerage service and one for its investment adviser practice, has different results for each form. The investment adviser form has an overall grade level of 9.4, which is better than Fidelity and Etrade but still above the ideal eighth grade level. However, the brokerage form is intended for an investor with a reading level equal to seventh grade, which is better than the eighth-grade ideal minimum. The fees section on the brokerage firm is readable by investors with a fifth-grade reading ability, which is below the eighth-grade level but potentially too low.[137] The investment adviser fees section meets the eighth-grade goal, with a grade level of 7.5. However, the services section of the investment adviser form is still only appropriate for an investor with a 14th grade reading level, although the brokerage services section is in line with the goal of an investor with an eighth-grade reading level.

TD Ameritrade's Form CRS suffers from similar problems as the other firms and also raises additional issues. Overall, the firm's Form CRS is suitable for a ninth-grade reader overall. The brokerage fees section has a grade level of 5.9, while the investment adviser fees section has a grade level of 7.4. The section on brokerage services, however, is appropriate only for someone with a grade level of 12.6, and the investment adviser services section is intended for someone with a 12th grade reading level. However, TD Ameritrade's Form CRS presents other readability concerns. When TD Ameritrade released its January 2021 version of Form CRS, the form located on the firm's website was digitally locked.[138] This has repercussions for investors, such as those who

136. *See* WEBFX, *supra* note 129.

137. *See id.*

138. Initially, an unlocked version of TD Ameritrade's Form CRS was located on the SEC's website. *Form CRS Customer Relationship Summary*, TD AMERITRADE (Jan. 30, 2021), https://reports.adviserinfo.sec.gov/crs/crs_7870.pdf (on file with author). This version was analyzed through conversion to Microsoft Word format. *See* note 107, *supra*. However, as of May 2022, both the version that is available on the firm's website and the version available on the SEC's website are digitally locked and

are visually impaired, who rely on screen readers to read text on computer screens: that version of TD Ameritrade's Form CRS cannot be read aloud by Adobe Acrobat Reader, a popular, free computer application for viewing PDF files downloaded from the internet,[139] while the application can read audibly each of the other firms' Form CRS filings. According to the Centers for Disease Control and Prevention, "[a]pproximately 12 million people" in the United States over the age of 40 are visually impaired.[140] This lack of accessibility automatically raises questions about whether TD Ameritrade's Form CRS is "easy to read," and may also be a violation of the Americans with Disabilities Act,[141] as well as a violation of the SEC instructions requiring that Form CRS have "machine-readable headings."[142] The March 2022 version of the form, while still locked, can be read aloud by Adobe Acrobat Reader, but investors who only have access to the January 2021 version, including investors who are not required to receive an updated version of Form CRS,[143] may be unable to find the information they need, especially if TD Ameritrade did not send them the unlocked version.

4. Investors' Remaining Concerns

Despite the changes that the SEC incorporated when it created the current instructions for Form CRS, the agency did not account for all of the concerns that investors mentioned in the 2018 survey.

---

cannot be converted to Microsoft Word format. The font size, typeface, and readability analyses were conducted on the earlier, unlocked version; from its appearance, the March 2022 version does not contain font size, typeface, or material wording differences from the January 2021 version.

139. *See Adobe Acrobat Reader*, ADOBE https://www.adobe.com/acrobat/pdf-reader.html (last visited Nov. 19, 2021). Both the locked and unlocked versions could not be read aloud by Adobe Reader.

140. *Fast Facts of Common Eye Disorders*, CENTERS FOR DISEASE CONTROL (June 9, 2020), https://www.cdc.gov/visionhealth/basics/ced/fastfacts.htm.

141. *See Effective Communication*, DEPT. JUSTICE, CIVIL RIGHTS DIVISION, DISABILITY RIGHTS SECTION (Jan. 2014), https://www.ada.gov/effective-comm.htm.

142. Instructions, *supra* note 3, at 6.

143. *See Frequently Asked Questions on Form CRS*, SEC, https://www.sec.gov/investment/form-crs-faq#delivery (last visited May 3, 2022).

A. Disciplinary History

One of the areas where the SEC failed to account for investors' concerns is disciplinary history. Only 41 percent of investors were "very comfortable" asking their broker or adviser about their disciplinary history[144]—the lowest such percentage of any of the suggested questions on the mockup Form CRS[145]—yet the SEC encourages investors to ask about it instead of requiring firms to clearly disclose any such history.[146] The instructions do not require firms to describe any disciplinary history on the form, or even include a direct link to BrokerCheck;[147] instead, firms simply indicate whether they have any disciplinary history and direct investors to where to find more information.[148] Approximately 75 percent of investors indicated that they were likely to look up that information,[149] but the purpose of Form CRS is to disclose information to investors, and disciplinary history should be disclosed as well, especially as just over a third of investors thought that such questions would be inappropriate to ask.[150]

B. Qualifications and Licensure

Investors also felt less comfortable asking about their brokers' or advisers' qualifications, licenses, experience, and education. 43 percent of surveyed investors felt "very comfortable" asking about it,[151] the second lowest percentage after the question about disciplinary history.[152] A quarter of investors considered the question inappropriate.[153] However, the SEC does not

---

144. Survey, *supra* note 58, at 17.

145. *Id.* at 18.

146. Instructions, *supra* note 3, at 16.

147. *See* PART III.3, *infra*, for a discussion of the website that firms must link to in Form CRS and how difficult it is to use.

148. Instructions, *supra* note 3, at 16.

149. Survey, *supra* note 58, at 27.

150. *Id.* at 18.

151. *Id.* at 17.

152. *Id.* at 18.

153. *Id.*

require firms to provide even general information in this area. The instructions limit this information to a "conversation starter," putting the onus on investors to ask questions that they might not feel comfortable asking and potentially limiting the information that investors have available to them.[154]

C. Length of Form CRS

The SEC only partially accounted for the preferences of investors as to the ideal length for Form CRS. Just over half of the surveyed investors thought that the four-page mockup Form CRS was too long, while 41 percent thought it was the proper length and less than two percent thought it was too short.[155] The SEC split the difference: the agency limited the current Form CRS to two pages each for broker-dealers and investment advisers, or dual registrants that file separate forms, but dual registrants that include all information in the same Form CRS are allowed to use four pages.[156] The SEC possibly relied on the majority of investors who wanted to keep each individual section the same length while downplaying the preferences of investors as to the overall length.[157] However, the survey did not ask about investors' preferences as to font sizes or certain formatting, and as this Article has demonstrated, firms fit more information into the current Form CRS than would have fit in the mockup Form CRS, making the effective length more than four pages,[158] contrary to the preferences of investors. TD Ameritrade indicates in its Form CRS that four pages is not an adequate length, since it directs investors to additional websites "as the SEC limits the length of [Form CRS] to four pages."[159]

---

154. Instructions, *supra* note 3, at 11.

155. Survey, *supra* note 58, at 21.

156. Instructions, *supra* note 3, at 2.

157. *See* Survey, *supra* note 58, at 9.

158. PART II.3, *supra*.

159. TD Ameritrade Form CRS, *supra* note 100, at 2.

PART III

1. The SEC Can Fix Its Instructions

The SEC could resolve the problems with the current Form CRS if it updates and revises its instructions. Many of the individual instructions already include enough detail that not much change would be needed. For example, instead of only requiring that the text be easy to read and emphasizing certain words, the SEC could also adopt the 12-point font size that the Department of Health suggests or the larger size that the Stanford study recommends; clearly state that certain words must be bolded, or whichever particular measure of emphasis the SEC desires; and mandate a specific color for text. Such instructions would be clearer and leave less room for interpretation and manipulation, and ultimately go further toward the goal of protecting investors.

The SEC should also more clearly account for investors' preferences. The SEC study found that investors were uncomfortable asking certain questions,[160] but the current Form CRS ignores that. Instead of requiring firms to list questions as "conversation starters" that investors might or might not ask, the SEC should require firms to answer those questions on the form itself. Admittedly, some answers may be extensive and would not fit within the page limits, but giving investors some information and allowing to them to research the rest is better than putting the onus on investors to do all the work. However, such an approach would require strict guidance so that firms do not mislead investors. The SEC could also require language on Form CRS that says that such questions should be directed to the investor's broker or adviser (TD Ameritrade and Fidelity already do this, but Charles Schwab and Etrade do not), but that still puts the onus on investors to do something that may make them uncomfortable.

A. Detailed Disciplinary History

The current Form CRS should include specific information about firms' disciplinary history. This is the area that investors felt least comfortable asking about, but simply stating that the firm has a disciplinary history does not tell investors anything. Between 2016 and 2020, FINRA filed hundreds of disciplinary actions and levied hundreds of millions of dollars in fines against

160. *See* text accompanying notes 150 and 151, *supra*.

firms and individuals;[161] it is unlikely that investors will find a firm that does not have any disciplinary history, while individual brokers within a firm may have no disciplinary history. Indeed, investors may care more about an individual broker's disciplinary history compared to a firm's,[162] but the SEC uses catch-all phrasing and does not require firms to specify the disciplinary history of any individual broker.[163] The current SEC instructions require firms to indicate that they do have a disciplinary history only in certain cases—if the firm is required, unless such information is excluded from BrokerCheck under FINRA Rule 8312, to disclose disciplinary history in Form ADV or Form BD, or disclosures on Form U4, Form U5, or Form U6—but firms are not required to provide any detail in Form CRS.[164]

The SEC's December 2021 statement picks up on this vagueness, warning firms against using boilerplate language, especially the term "may," but provides little specific advice.[165] At a minimum, the SEC should require firms to indicate which categories of disciplinary history they have been subject to, based on the current instructions.[166] Ideally, firms would spell out their disciplinary history in detail, although as in the case of answering conversation starters, there might not be enough room. Regardless, the SEC should require firms to do more than make investors attempt to find all of the relevant information.[167] The same should apply for brokers' education and qualifications. Although an extensive listing of such information would be

---

161. *Regulatory Actions and Corporate Financing Review 2016-2020*, FINRA, https://www.finra.org/media-center/statistics#more (last visited Dec. 11, 2021).

162. *See* Study and Recommendations on Improved Investor Access to Registration Information About Investment Advisers and Broker-Dealers, SEC (Jan. 2011), https://www.sec.gov/files/919bstudy.pdf, at 22-23, for a discussion of the total amount of BrokerCheck searches between 1999 and 2009. FINRA could not determine how many searches were conducted by retail investors as opposed to regulators or industry members, but given that there were over 20 million searches in 2009, id. at 23, it is likely that a significant percentage were conducted by retail investors who were researching brokers.

163. Instructions, *supra* note 3, at 16 ("Do you *or* your financial professionals have legal or disciplinary history?") (emphasis added).

164. *Id.*

165. Statement, *supra* note 84.

166. *See id.*

167. *Id.* ("Direct the *retail investor* to visit Investor.gov/CRS for a free and simple search tool to research you and your financial professionals") (emphasis in original).

unlikely to fit within the page limits, investors should at least be told where to find such information on the firm's website. If firms do not list their financial professionals, they should do so, in a manner that is easy for retail investors to understand.

B. Detailed Breakdown of Fees

One of the most important areas where the SEC needs to implement clear and specific instructions is the fees section. Retail investors prefer when firms provide detailed fee information. TD Ameritrade is the only firm discussed in this Article that does so. The SEC guidance in this area is limited and does not take into account the basic fact that investors are trusting brokers and advisers with their money with the hope of earning more, and that it is important for investors to know how much of their money will be lost to fees. Depending on the products and services that each firm offers, it may be feasible to include specific fee information in Form CRS, perhaps displayed in a table format. At the very least, the SEC should require firms to display fees as a percentage if that is how they are calculated, but the more specific this information is, the more useful it will be for investors.

2. The SEC Can, and Should, Create a Template

The SEC can also create a template for Form CRS, which would resolve many of the issues that are raised by unclear instructions. Firms would have little to no flexibility in terms of information that must be included and how to display it, but the tradeoff for investors would be a uniform Form CRS that would make it easier for investors to compare firms. If the SEC wishes for firms to have flexibility, it can create new instructions or revise the existing ones to reflect the content that would appear in the template, in line with the suggestions discussed above.[168] A template would also resolve the problems that are inherent when trying to draft instructions for firms, which, as discussed, have led to manipulation of the current instructions.[169] With a template, the SEC holds more control over the substance and format of Form CRS.

---

168. PART III.1, *infra*.

169. PART II.3, *supra*.

The SEC's existing instructions lend themselves to creating a template. For example:

1. The SEC's instructions requiring firms to use certain specific language and display information in a particular order can be converted to a template format.
2. Since investors preferred that firms display information in a side-by-side format, a template can include two columns, similar to the format of the mockup Form CRS. The agency can build on the feedback that it received from investors in its 2018 survey.
3. A template can also resolve the visual differences between various firms' Form CRS. Since some firms, such as Charles Schwab, includes graphics in the middle of a page while other firms do not, a template can resolve these visual differences by allowing firms to display logos or other graphics above or below the substantive content, where such graphics would be less likely to distract investors from the information in the form. Alternatively, the SEC can limit graphics to those that help investors understand the text.[170]
4. The SEC can also mandate a particular color for text, which would resolve the confusion that is inherent when each firm is allowed to use a different color.[171]
5. Finally, a template can force firms to comply with a particular grade-level standard for readability. Instead of suggesting that firms rely on a plain English handbook that does not directly address the information that firms must include, and which leaves firms to determine what constitutes plain English,[172] a template can include specific language, as the SEC already does for conversation starters, and indicate where it must be located.

If the SEC made changes to the existing instructions to address visual formatting, it would have to come up with language to prevent firms from complying with the letter of the law, but not the spirit. A template with hard rules regarding formatting would prevent this. The SEC could also draft its own language and include it in updated instructions, but once the SEC is taking the time to draft language, it makes sense to maintain control over where it is displayed in Form CRS and how firms can use it, which is easier with a template than with an instruction manual.

---

170. *See* Stanford study, *supra* note 118, at 42.

171. *See, e.g.*, Figures 1–2, PART II.3, *supra*; Figures 3-6, APPENDIX, *infra*.

172. *See* Instructions, *supra* note 3, at 2; Handbook, *supra* note 71.

Moreover, the SEC already uses template formats for other types of disclosure. For example, Form 10-K has a cover page with different options for companies to select.[173] Although the majority of the form allows each company to craft its answers to the various items, the cover page shows that the SEC can design a form to elicit specific information and limit the responses through specific prompts.

However, even the best template does not fully address the problems that are inherent with disclosure, although it does meet other goals, such as uniformity and ease of access. In light of the problems that are inherent with traditional disclosures, the Stanford study recommended new forms of disclosure "that have greater interactivity, more transparency, and more visual and story-based presentations."[174] This can include an interactive website.[175]

3. The SEC Can Modify Its Investor Education Website

Today, with an unlimited amount of information on the internet, it makes sense for investors to be able to find relevant information online. The SEC tries to make this possible through a dedicated website that contains general educational information about investments, beyond the firm-specific information that firms report in Form CRS.[176] The SEC directs firms to mention this website in Form CRS.[177] The main page of the Investor.gov/CRS website includes a search function to allow investors to find more detail about a firm, including locating a firm's Form CRS;[178] this search feature is the only way to find firm-specific information via this website. However, the search function requires multiple steps and is not intuitive, as it requires an investor to know the exact name of the firm,[179] and must select the option to search for

173. *Form 10-K*, SEC (May 2021), http://www.sec.gov/about/forms/form10-k.pdf, at 6.

174. Stanford study, *supra* note 118, at 8.

175. *See* PART III.3, *infra*.

176. *Welcome to Investor.gov/CRS*, SEC, https://www.investor.gov/CRS (last visited Nov. 20, 2021).

177. Instructions, *supra* note 3, at 10.

178. SEC, *supra* note 176.

179. Searching for a firm pulls up a list of brokerage and investment adviser firms with similar names, including subsidiaries and affiliates, as well as firms that are not currently registered with the SEC.

a firm as opposed to an individual. When an investor wishes to learn more about a firm, the Investor.gov/CRS website redirects to another website, where investors can find the firm's Form CRS, although it is labeled differently depending on the agency: it is "Part 3 Relationship Summary" on the SEC's website[180] and "Relationship Summary" on FINRA's website.[181] If a firm is registered with FINRA, the Investor.gov/CRS search function will link to BrokerCheck, where investors can find the firm's disciplinary history, if it has one.[182]

Instead, the SEC can add functionality to the existing website to make it similar to the one that is used for Medicare plan comparisons.[183] Investors can answer a few questions based on, for example, their investment knowledge, preference for fees, and what kind of investment relationship or products they are looking for, and the website will show them which firms meet their criteria. Multiple large companies in the private sector also offer comparison or filtering tools on their websites.[184] These tools, if used in the brokerage context, would allow investors to decide what is important when selecting a broker or investment adviser and would eliminate the jargon and inconsistencies between different firms' Form CRS filings, as well as provide a centralized location for investors to find relevant information. Additionally, this would enable investors to compare multiple services offered by the same firm, which SIFMA suggested in its comment letter on Reg BI.[185]

---

180. *See, e.g.*, TD Ameritrade Investment Adviser Firm Summary, https://adviserinfo.sec.gov/firm/summary/7870 (last visited May 3, 2022).

181. *See, e.g.*, TD Ameritrade, Inc., https://brokercheck.finra.org/firm/summary/7870 (last visited Dec. 16, 2021).

182. *See* PART II.4.A, *supra*, for a discussion of how investors do not receive clear information on firms' disciplinary history.

183. *Find a 2022 Medicare Plan*, U.S. CENTERS MEDICARE & MEDICAID SERVICES, https://www.medicare.gov/plan-compare/ (last visited Nov. 20, 2021).

184. *See, e.g.*, *Compare Products*, HOME DEPOT, https://www.homedepot.com/compare?item1=314024432&item2=314145556&item3=308743988 (comparison of three refrigerators) (last visited Dec. 11, 2021); *All Laptops*, BESTBUY, https://www.bestbuy.com/site/laptop-computers/all-laptops/pcmcat138500050001.c?id=pcmcat138500050001(allowing users to limit a search for laptops to ones containing specific items) (last visited Dec. 11, 2021); *Checked Suitcases*, WALMART, https://www.walmart.com/browse/clothing/checked-suitcases/5438_1045799_3768420_8675023_2334062 (allowing users to search for checked suitcases meeting specific parameters) (last visited Dec. 11, 2021).

185. SIFMA, *supra* note 34, at 35.

The brokerage industry would undoubtedly argue that this type of format is expensive. The industry was willing to accept Form CRS even though it was expensive,[186] and the SEC and firms already possess the information that could be used to create a website of this kind. Indeed, the SEC could modify the existing website to add a questionnaire and searchable database and change nothing else. SIFMA opposes a "one size fits all" model, such as a template, but may be willing to support a website that provides flexibility to firms and investors regarding the kind of information that is displayed.[187] A website does not fully account for the preferences of investors who prefer to receive a physical Form CRS,[188] but it does provide another option.

4. A Fiduciary Rule, While Beneficial for Investors, Would not Fix Form CRS

A fiduciary rule, while beneficial for investors overall, would likely not resolve all of the problems with Form CRS. It would resolve at least some of the problems created by Reg BI and FINRA's revision of the suitability rule, but investors would still need to have certain information available to them, and a fiduciary rule does not offer that. Notwithstanding the problems associated with disclosures in general, and lengthy, text-based disclosures in particular, investors would still need to be informed about fees, disciplinary history, and even the differences between a brokerage account and an investment adviser. The SEC was correct to be concerned about this, although its solution is lacking.

5. The SEC Should Conduct a New Survey in Order to Best Implement Solutions

In order to determine which of the above solutions, alone or combined, is best, the SEC would first need to ensure that investors would be satisfied with it and that it would serve the purpose of protecting investors. At a minimum, the SEC must conduct a new survey of retail investors, similar to the one that it conducted in 2018, but with an emphasis on the effectiveness of the current

---

186. *See id.* at 7.

187. *See id.* at 5.

188. *See* text accompanying note 83, *supra*.

Form CRS.[189] The previous survey was a good attempt at gauging investors' opinions, but the SEC failed to follow up on investors' reactions to the current, then-new, Form CRS, which was the primary purpose for conducting the survey in the first place.[190] There are many issues with the current Form CRS, as this Article demonstrated, as well as ongoing concerns that investors raised in the 2018 survey but that the SEC did not address with the current Form CRS. A new survey should evaluate the issues with the current Form CRS as well as investors' remaining concerns from the initial survey. Since protecting investors is the core mission of the SEC, it is especially important to know whether investors are satisfied with the current Form CRS and whether they would approve of any changes.

The SEC should pay special attention to the length of Form CRS. Although the SEC capped the length at four pages, there is more than four pages' worth of material in each of these four firms' Form CRS.[191] This condensation of information is the root of many problems with the current Form CRS,[192] and the SEC must evaluate whether having investors read four pages of small text and dense material is beneficial, as well as whether investors are reading the entire form in the first place. A template may reduce the overall amount of information in the form, but it provides a method for the SEC to determine what information is truly important for investors to know and allows firms to provide that information in a way that is easier for investors to read and understand compared to the current format.

CONCLUSION

The implementation of the current Form CRS based on the SEC's instructions raises questions about whether Form CRS is serving its intended purpose. The SEC failed to fully accommodate the feedback of investors from its 2018 survey, and it left too much discretion to brokerage firms and investment advisers on how to complete Form CRS. If the purpose of Form CRS is to increase disclosure, and the purpose of the SEC is to enforce

---

189. Investment advisers would support this action. Melanie Waddell, *Biggest Advisor Compliance Challenge: SEC's New Ad Rule*, BENEFITSPRO (Sept. 14, 2021), https://www.benefitspro.com/2021/09/14/biggest-advisor-challenge-secs-new-ad-rule-412-121164/.

190. Survey, *supra* note 58, at 1.

191. PART II.3, *supra*.

192. *See* PART II.2.A, *supra*, and PART II.3, *supra*.

protections for investors, the SEC needs to evaluate whether Form CRS is doing its job. The SEC's December 2021 statement shows that the SEC is aware of several issues with Form CRS, but the statement is reminiscent of the instructions for Form CRS: the vague language and lack of specificity fail to provide adequate guidance for firms and can harm retail investors.

The way that firms have chosen to comply with Form CRS raises questions about whether this is the best method to increase disclosure. As legal scholars and practicing lawyers have argued,[193] and as the Stanford study noted, "traditional lengthy, text-based means of disclosures are not effective communications to most lay consumers."[194] Before the SEC proposed Form CRS, the agency already knew that four pages of text, which is the general format that the four firms discussed in this Article adopted, was not the best way to encourage investors to read disclosures.[195] Although a template is, perhaps, an extension of the revised instructions discussed in Part III.1, and may suffer from the problems that plague textual disclosure, it offers the SEC a choice: allow firms some flexibility but accept the responsibility of creating clear guidance and enforcing compliance—possibly on a case-by-case basis—or eliminate flexibility but mandate specific language and content with a goal of uniformity. The SEC can also improve investors' access to information by looking to solutions that the federal government and private sector have already implemented in order to provide better service to consumers.

Ultimately, the SEC's response to the problems with Form CRS may indicate the future of Reg BI. A November 2021 report by NASAA did not find much positive change in firm behavior following Reg BI's

---

193. Mary Jo White, *The Path Forward on Disclosure*, National Association of Corporate Directors - Leadership Conference 2013 in National Harbor, Md. (Oct. 15, 2003), https://www.sec.gov/news/speech/spch101513mjw. Charles R. Korsmo, writing about public company disclosures, has questioned the wisdom of tailoring disclosures to retail investors in the first place. He argues that requirements to write in plain English, while well-intentioned, inevitably require firms to leave out important information. Charles R. Korsmo, *The Audience for Corporate Disclosure*, 102 IOWA L. REV. 1581 (2017). Although Korsmo ultimately concludes that it is unwise to cater disclosures to retail investors in the public company context, where "sophisticated" investors may be the primary target, *id.*, in the context of Form CRS, where retail investors are the sole target, it is important to provide information in a format that they can access and understand.

194. Stanford study, *supra* note 118, at 11.

195. *See* Stein, *supra* note 48.

implementation.[196] As Christopher Tarver Robertson observes, "When regulators impose substantive controls, the financial industry simply innovates again to create new mechanisms to exploit their financial interests."[197] Additionally, the SEC has yet to produce a clear plan to enforce compliance with even the current SEC instructions, let alone make changes to them. Given that the effectiveness of Reg BI depends on firms complying with each of its four components—including the Disclosure prong, of which Form CRS is an essential part—any SEC decision regarding improving the instructions may foreshadow the future success or failure of the rule as a whole.

APPENDIX

What fees will I pay?

If you place a trade, you will pay a commission or transaction fee in some cases. There can also be expenses built into the trade price or the investment itself.

- ✓ The fee you pay is the same whether we recommend an investment to you or not. We earn money from third parties or affiliates on certain products, so we have an incentive to encourage investment in those products.
- ✓ You may also pay account- or transaction-related fees.
- ✓ *You will pay fees and costs whether you make or lose money on your investments. Fees and costs will reduce any amount of money you make on your investments over time. Please make sure you understand what fees and costs you are paying.*

To see more information about our fees, go to www.schwab.com/transparency **and read our Best Interest Disclosure or go to** www.schwab.com/pricing-guide**.**

Questions to Ask

- Help me understand how these fees and costs might affect my investments.
- If I give you $10,000 to invest, how much will go to fees and costs, and how much will be invested for me?

Figure 3. The above is an excerpt from the Charles Schwab Form CRS BD fees section, including the conversation starter.

196. NASAA Report Finds that Many Broker-Dealer Firms Still Place Their Financial Interests Ahead of Their Customers Despite Implementation of Regulation Best Interest, NASAA (Nov. 4, 2021), https://www.nasaa.org/60748/nasaa-report-finds-that-many-broker-dealer-firms-still-place-their-financial-interests-ahead-of-their-customers-despite-implementation-of-regulation-best-interest/?qoid=current-headlines.

197. Christopher Tarver Robertson, *Biased Advice*, 60 EMORY L. J. 653, 661 (2011).

What fees will I pay?

We charge a fee for some, but not all, of our advisory services, including asset-based fees and fixed one-time and recurring fees. Some of these fees may be negotiable.

✓ Our asset-based or wrapped fees are calculated based on the amount of assets in the account and usually billed on a quarterly basis. These fees include most transaction costs, and could be higher than fees charged for advisory services that do not include such costs. There are other fees that will apply to your account, such as mutual fund and ETF operating expenses (including management fees paid to CSIM for funds managed by them), costs for trades executed at a firm other than Schwab, and account services fees.

✓ The more assets in your accounts, the more money Schwab and its affiliates earn, so we have an incentive to encourage you to invest more assets. We earn money from third parties or affiliates on certain products, including cash, mutual funds, and ETFs held in your accounts, so we have an incentive to encourage such investments.

✓ *You will pay fees and costs whether you make or lose money on your investments. Fees and costs will reduce any amount of money you make on your investments over time. Please make sure you understand what fees and costs you are paying.*

Relationship Summary: Investment Advisory (Continued) Page 2 of 2

To learn more about specific fees for each program, go to www.schwab.com/advisory to access the relevant sections of each program Disclosure Brochure: (1) Fees and Compensation; or (2) Services, Fees and Compensation.

Questions to Ask

- Help me understand how these fees and costs might affect my investments.
- If I give you $10,000 to invest, how much will go to fees and costs, and how much will be invested for me?

Figure 4. The above is an excerpt from the Charles Schwab Form CRS IA fees section, including the conversation starter.

What fees will I pay?

For a detailed list of fees and pricing, visit etrade.com/fees. Below is a summary of the types of fees charged by E*TRADE Securities and E*TRADE Capital Management. Fees are negotiable and depend on such considerations as the following: the aggregate assets contained in all of your ETS and ETCM accounts; the amount of time you have had the aforementioned accounts; the total amount of business the you conduct with ETS, ETCM, and their affiliates; and other factors.

E*TRADE Securities (ETS)	E*TRADE Capital Management (ETCM)
In many cases, ETS will not charge you a fee to buy or sell US-listed stocks, ETFs, or options when you use our online platforms. There are exceptions, such as over-the-counter (**OTC**) stock trades, options contracts, foreign stock trades, large block trades requiring special handing, futures trades, fixed income trades, trades placed through a representative, and stock plan account trades. In addition, ETS will also charge a fee for online secondary trades of bonds (other than US Treasuries). *Secondary* means any trade that occurs after a security is issued and sold for the first time. Additional regulatory and exchange fees also apply depending on the transaction as noted at etrade.com/fees.	ETCM will charge you a single fee for investment advice and the brokerage, custodial, administrative, and technological services ETS provides on behalf of ETCM. In the industry, this is referred to as a "wrap fee," and ETCM's Advisory Programs offering is a wrap fee program. The wrap fee is assessed based on the market value of all assets, including cash balances, in the account. The wrap fee could cost more or less than paying for these services individually, depending on how often you trade, the types of securities you trade, and other factors. Each Advisory Program offering has its own wrap fee schedule and is listed at etrade.com/fees. Please also see our Wrap Fee Programs Brochure at etrade.com/programsbrochure.

Figure 5. The above is a partial excerpt from the Etrade Form CRS fees section showing columns side by side.

If you purchase shares in a mutual fund, depending on the fund or share class selected, E*TRADE will charge you a transaction fee. Some mutual funds offered by E*TRADE do not charge transaction fees when you buy the fund, but you will be charged if you sell or exchange your shares before a certain amount of time has passed. With some mutual funds, you pay a sales fee called a *load*, which you may pay when you buy the fund or when you sell it. ETS may retain a portion of the load when a load is applied. If a fund has a load, it is indicated on the fund's information page on our website in the Fund Details section under the "Sales Charge" category.

ETS will also charge interest for the use of margin (borrowing from us). Margin rates depend on how much you borrow—see more at etrade.com/fees.

ETS also charges a variety of fees for certain account activities such as outgoing wire and account transfers, paper and duplicate statements, overnight mail, or changes to a position that result from a corporate reorganization. For a list of ETS fees, see etrade.com/fees and etrade.com/408b2.

In addition to the above fees charged by ETS, investors will pay indirect fees and costs for their mutual fund investments, and these benefit ETS and/or affiliates. These fees include Rule 12b-1 distribution fees, shareholder servicing fees, and other types of revenue sharing. When you buy no-transaction-fee mutual funds, ETS receives some money (revenue sharing) from the fund or its affiliate. You can see these types of fees in the Fees and Expenses tab on the fund's information page and also in the E*TRADE Regulation Best Interest Relationship Guide. ETS will also receive payments from third parties based on customer trading activity. For more information, see us.etrade.com/l/quarterly-order-routing-report.

The wrap fee does not cover every cost or fee that you may pay for your investments. For example, a mutual fund or ETF that you hold in your ETCM account will charge its own management and advisory fees, which are represented in the fund's expense ratio. Neither ETCM nor ETS receives payments from Rule 12b-1 fees, shareholder servicing fees, cash sweeps, or other types of revenue sharing for funds held in ETCM accounts; however, its affiliates who offer proprietary products used as ETCM investments will benefit and receive certain fees, such as investment advisory fees.

Certain administrative costs are not covered by the wrap fee. These include fees for such account activities as outgoing wire and account transfers, paper and duplicate statements, and overnight mail as noted at etrade.com/fees. For a complete list of fees, etrade.com/fees and etrade.com/408b2.

You will pay fees and costs whether you make or lose money on your investments. Fees and costs will reduce any amount of money you make on your investments over time. Please make sure you understand what fees and costs you are paying.

Questions to ask

- *Help me understand how these fees and costs might affect my investments. If I give you $10,000 to invest, how much will go to fees and costs, and how much will be invested for me?*

Figure 6. The above is the remainder of the excerpt from the Etrade Form CRS fees section, including the conversation starter.

What fees will I pay?	• Our retail brokerage customers pay no commissions on online U.S. exchange listed stock, ETF and options trades. They pay a $0.65 per contract fee for options trades. • They pay a commission of $6.95 for online trades of over-the-counter stocks. They also pay $5 for IVR Phone System trades and $25 for broker-assisted trades. • All trades are through third parties. Retail accounts pay certain small fees for account services and for regulatory fees we pass on. • Even with zero commissions, TDA makes money on your trades, such as from order routing revenue. The more you trade, the more money we make.	The mark-up/down is the difference between the cost of the product to the firm, vs the price we show to the client. It is often expressed as a percentage over the cost. A mark-up/down is added(or subtracted) to the total cost incurred by the customer in order to cover the costs of doing business and to create a profit for the firm. You can do secondary fixed income trades on a self-directed basis online at less cost. Our retail investor AD clients pay no fee to TDAI for its AD advisor referral service. Rather, the referred RIA will pay a referral fee to TDAI on a sliding scale basis, starting at 25 basis points for client assets up to $2 million. The referred RIA will charge the retail investor client its applicable investment management fee and will

Figure 7. The above excerpt from the TD Ameritrade Form CRS shows the firm's columns-based approach.

UNDERSTANDING INVESTMENT ADVISER DISCLOSURE REQUIREMENTS: WHAT ARE YOU NOT SEEING?

Courtney Werning, Esq.

The Securities and Exchange Commission ("SEC") encourages investors to check the background of their financial professional to help investors identify, be aware of, and be cautious of, those that may have a history of misconduct. Studies have shown that advisers with prior misconduct on their records are far more likely to engage in new misconduct as the average financial professional[1]. The SEC states that, "[a]nyone registered to sell securities or provide investment advice generally must disclose certain customer complaints, lawsuits and arbitrations, regulatory actions, employment terminations, bankruptcy filings, and certain other criminal or civil legal proceedings.[2]"

While clear and full disclosures enable a prospective client to screen advisers based on disciplinary history, nothing in the SEC's guidance, alerts, or website warns investors that they are likely not getting the full picture of their investment advisers' backgrounds. What investment advisers are required to disclose generally falls far short of the bright-line requirements set forth for FINRA-registered broker-dealers and registered representatives, which mandate disclosure of all arbitration awards, regulatory actions, pending customer disputes, written customer complaints that allege sales practice violations and damages of greater than $5,000 in the last two years, and customer disputes that were settled for more than $15,000.[3]

Investment advisors have a principals-based disclosure scheme, which gives them unilateral discretion to either voluntarily report customer disputes (whether won or lost), regulatory actions, and other disciplinary events – or not. This article will first discuss what SEC-registered and state-registered investment advisers are required to disclose on both the firm and the

---

1. Mark Egan, Gregor Matvos & Amit Seru, *The Market for Financial Adviser Misconduct*, January 2017, available at https://www.kellogg.northwestern.edu /docs/pdf/2017/egan-matvos-seru.pdf.

2. *Check Out Your Financial Professional*, SEC (June 11, 2014), https://www.sec.gov/oiea/investor-alerts-bulletins/ia_checkfinpro.html.

3. Albert Copeland, & Christine Lazaro, *An Overview of BrokerCheck and the Central Registration Depository*, 28 PIABA Bar Journal 425, 428 (2021).

representative levels and then examine the overall trend of the top fee-only investment advisers choosing non-disclosure of disciplinary events – to the detriment of both the investing public and regulators.

I. What Are Investment Advisers Required to Disclose?

SEC-Registered Investment Advisers

The current disclosure requirements for SEC-registered investment advisers[4] are set forth in the Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010). Form ADV is the uniform form used by investment advisers to register with both the SEC and state securities authorities[5]. The form consists of two parts, both of which are available to the public on the SEC's Investment Adviser Public Disclosure (IAPD) website[6].

Part 1 of Form ADV requires information about the investment adviser's business, ownership, clients, employees, business practices, affiliations, and any disciplinary events of the adviser or its employees. This section is organized in a check-the-box, fill-in-the-blank format. The SEC reviews the information from this part of the form to manage its regulatory and examination programs.

Added in 2010, Part 2 of Form ADV requires investment advisers to prepare narrative brochures that include plain language disclosures of the adviser's business practices, fees, conflicts of interest, and disciplinary information. Part 2 of Form ADV was implemented by the SEC to require

---

4. Advisers that have $100 million or more of assets under management or that provide advice to investment company clients are required to register with the Commission. Smaller advisers register under state law with state securities authorities. 15 U.S.C. § 80b-3a(2)(B)(ii) (2019).

5. Form ADV is also used by state securities regulators to register investment advisers. It includes certain items and instructions to Part 2 (*e.g.*, Item 19 of Part 2A, Item 10 of Appendix 1 to Part 2A, and Item 7 of Part 2B) that apply only to state-registered advisers. State-registered advisers are required by state, rather than federal, law to respond to these items.

6. *Investment Advisor Public Disclosure Website*, SEC (May 15, 2022), https://adviserinfo.sec.gov/ at 5.

advisers to disclose to their clients and prospective clients meaningful information in a clearer format[7].

Part 2A, as adopted, contains 18 separate items, each covering a different disclosure topic. Item 9 of Form ADV Part 2 is "Disciplinary Information," which requires that an adviser disclose in its brochure material facts about any legal or disciplinary event that occurred within the last 10 years and is "material to a client's (or prospective client's) evaluation of the integrity of the adviser or its management personnel.[8]" These requirements mirror the disciplinary information disclosures required by Rule 206(4)-4 under the Advisers Act codified at 17 CFR § 275.206(4)-4(a)(2).

The following is the list of disciplinary events that are presumptively material[9]:

A. A criminal or civil action in a domestic, foreign or military court of competent jurisdiction in which your firm or a management person
   1. was convicted of, or pled guilty or nolo contendere ("no contest") to (a) any felony; (b) a misdemeanor that involved investments or an investment-related business, fraud, false statements or omissions, wrongful taking of property, bribery, perjury, forgery, counterfeiting, or extortion; or (c) a conspiracy to commit any of these offenses;
   2. is the named subject of a pending criminal proceeding that involves an investment-related business, fraud, false statements or omissions, wrongful taking of property, bribery, perjury, forgery, counterfeiting, extortion, or a conspiracy to commit any of these offenses;
   3. was found to have been involved in a violation of an investment-related statute or regulation; or
   4. was the subject of any order, judgment, or decree permanently or temporarily enjoining, or otherwise limiting, your firm or a management person from engaging in any investment-related activity, or from violating any investment-related statute, rule, or order.

---

7. Amendments to Form ADV, Investment Advisers Act Release No. 2711, 92 S.E.C. Docket 2278 (Mar. 3, 2008) at 5.

8. Amendments to Form ADV, Investment Advisers Act Release No. 3060, 98 S.E.C. Docket 3502 (July 28, 2010) at 22.

9. *Id*. at 4.

B. An administrative proceeding before the SEC, any other federal regulatory agency, any state regulatory agency, or any foreign financial regulatory authority in which your firm or a management person
   1. was found to have caused an investment-related business to lose its authorization to do business; or
   2. was found to have been involved in a violation of an investment-related statute or regulation and was the subject of an order by the agency or authority
      (a) denying, suspending, or revoking the authorization of your firm or a management person to act in an investment-related business;
      (b) barring or suspending your firm's or a management person's association with an investment-related business;
      (c) otherwise significantly limiting your firm's or a management person's investment-related activities; or
      (d) imposing a civil money penalty of more than $2,500 on your firm or a management person.

C. A self-regulatory organization (SRO) proceeding in which your firm or a management person
   1. was found to have caused an investment-related business to lose its authorization to do business; or was found to have been involved in a violation of the SRO's rules and was: (i) barred or suspended from membership or from association with other members, or was expelled from membership; (ii) otherwise significantly limited from investment-related activities; or (iii) fined more than $2,500.

While the SEC indicates the list is not exhaustive, conspicuously missing is anything regarding arbitration cases against investment advisers, including cases in which customer won an arbitration against his investment adviser. It is well-known that investment advisers regularly force their clients into various arbitration forums to resolve disputes with mandatory arbitration clauses in their contracts,[10] and yet those actions fall completely under the radar.

10. *See, e.g.*, David Cosgrove, *Is Your Investment Adviser's Arbitration Clause Enforceable?*, NAT'L LAW REV. (June 27, 2010), https://www.natlawreview.com/article/your-investment-adviser-s-arbitration-clause-enforceable.

Moreover, the adviser may rebut this presumption of materiality, in which case no disclosure to clients is required[11]. The SEC provides an adviser with a list of four factors he or she should consider when assessing whether the presumption can be rebutted[12]:

(1) the proximity of the person involved in the disciplinary event to the advisory function;
(2) the nature of the infraction that led to the disciplinary event;
(3) the severity of the disciplinary sanction; and
(4) the time elapsed since the date of the disciplinary event.

If an adviser concludes that the materiality presumption has been overcome, he or she must prepare and maintain a file memorandum of that determination and keep it in his or her records. This too could include any arbitrations or even civil cases that a customer won against the investment adviser, as well as any regulatory actions or criminal events the adviser deemed to be immaterial to a prospective client's evaluation of his integrity. And, if a serious disciplinary event against an investment adviser took place more than 10 years ago, an adviser is not required to disclose it. The investing public and securities regulators are kept completely in the dark.

The drafters of the Form ADV questionnaire clearly intended to exclude customer arbitrations against investment advisers and the questionnaire suggests itself, by omission, that no customer arbitration could be considered material under the disclosure rules.

Item 11 of the SEC Form ADV asks only the following questions for civil cases[13]:

(1) Has any **domestic or foreign court**:
   a. In the past ten years enjoyed you or any advisory affiliate in connection with any investment-related activity?
   b. Ever found that you or any advisory affiliate were involved in a violation of investment-related statues or regulations?
   c. Ever dismissed, pursuant to a settlement agreement, an investment-related civil action brought against you or any advisory affiliate by a state or foreign financial regulatory authority?

---

11. Amendments to Form ADV, Investment Advisers Act Release No. 3060, 98 S.E.C. Docket 3502 (July 28, 2010), at 23.

12. *Id*. at 5.

13. *Form ADV (Paper Version)*, SEC (Sept. 2019), https://www.sec.gov/about/forms/formadv-part1a.pdf (emphasis added).

An adviser filling out the SEC Form ADV would not even have an opportunity to address customer arbitrations that might be material to client's evaluation of an adviser's integrity.

There is no other guidance or directives on what is material to a client's (or prospective client's) evaluation of the integrity of the adviser. The SEC has declined to further define and clarify what disciplinary information is material in these circumstances[14], although the SEC notes that "a prior disciplinary event involving an adviser would be important to clients for many reasons, including how it may reflect upon the adviser's integrity and the effect it may have on the degree of trust and confidence a client would place in the adviser.[15]"

These Amendments to Form ADV went into effect in 2010 despite heavy criticism from the North American Securities Administrators Association ("NASAA")[16], who urged the SEC to require the disclosure of arbitration awards and claims as part of Item 9 and to eliminate the adviser's ability to rebut the presumption that a particular disclosure event is material.

Nothing Rises to the Level of Materiality

Investors are not getting comprehensive disciplinary disclosures from their investment advisers. A review of the most recently filed Form ADVs for the top ten fee-only investment advisers[17] shows that not a single adviser made a single disciplinary or legal disclosure. Just among the top ten, they are managing $608 billion for over 94,000 clients.

---

14. Amendments to Form ADV, Investment Advisers Act Release No. 3060, 98 S.E.C. Docket 3502 (July 28, 2010) at 23.

15. *Id*. at 23-24.

16. Karen Tyler, *NASAA Comment Letter to Release No. IA-2711*, N. AM. SEC. ADM'RS ASS'N, (May 16, 2008), https://www.nasaa.org/wp-content/uploads/2011/07/30-ADVPart2.051608.pdf.

17. *RIA Data Center*, InvestmentNews (July 2021), https://data.investmentnews.com/ria; all Form ADVs pulled from https://adviserinfo.sec.gov/ on March 15, 2022.

Rank	Firm	Clients	Advisers	Assets Under Management	Event Disclosures
1	Cambridge Associates	509	440	$239 Billion	0
2	Fisher Asset Management	84,394	1,113	$160 Billion	0
3	Hall Capital Partners	182	28	$48 Billion	0
4	Silvercrest Asset Management Group	1,263	57	$27 Billion	0
5	Jasper Ridge Partners	47	31	$27 Billion	0
6	Moneta Group Investment Advisors	5,444	140	$27 Billion	0
7	Comprehensive Financial Management	39	13	$22 Billion	0
8	BBR Partners	1,490	70	$20 Billion	0
9	Pathstone	1,015	131	$19 Billion	0
10	Summit Rock Advisors	62	32	$18 Billion	0

By allowing investment advisers to pick and choose their own disclosures and define for themselves what is "material" for an investor's consideration, regulators are putting the blinders on themselves and the investing public. Arbitration filings are not publicly available, and there is no source available for tracking investor complaints, arbitration claims, the use of arbitration, arbitration forum selection, costs and fees of arbitration, award outcomes, and/or payment of awards. Indeed, many investment advisers utilize private arbitration forums like the American Arbitration Association (AAA) or the Judicial Arbitration and Mediation Services (JAMS). Those forums have no publicly available database of arbitration awards (compared to FINRA dispute resolution, which does allow the public access to final arbitration awards). In most cases, the investing public and regulators do not even have the chance to search and find the outcome of the disputes themselves. And the glaring lack of any voluntary disclosures within the Form ADV system by our country's

largest investment advisers shows how easy it is to paper over a disclosure event with a creation of a file memorandum that will never see the light of day.

State-Registered Investment Advisers

The disclosure requirements for a state-registered investment adviser are more robust. If an investment adviser is registering or are registered with one or more state securities authorities, they must respond to an additional item on the Form ADV, which requires disclosure of the following for the adviser or any of its "management" people:[18]

1. An award or otherwise being found liable in an arbitration claim alleging damages in excess of $2,500, involving any of the following:
   (a) an investment or an investment-related business or activity;
   (b) fraud, false statement(s), or omissions;
   (c) theft, embezzlement, or other wrongful taking of property;
   (d) bribery, forgery, counterfeiting, or extortion; or
   (e) dishonest, unfair, or unethical practices.
2. An award or otherwise being found liable in a civil, self-regulatory organization, or administrative proceeding involving any of the following:
   (a) an investment or an investment-related business or activity;
   (b) fraud, false statement(s), or omissions;
   (c) theft, embezzlement, or other wrongful taking of property;
   (d) bribery, forgery, counterfeiting, or extortion; or
   (e) dishonest, unfair, or unethical practices.[19]

This section is only applicable to state-registered investment advisers. It is the only disciplinary disclosure section of the Form ADV that does not require a determination of materiality before triggering the disclosure requirement.

---

18. Management Persons are defined in the Form ADV Glossary, Item 23, as "anyone with the power to exercise, directly or indirectly, a controlling influence over your firm's management or policies, or to determine the general investment advice given to the clients of your firm.".

19. Amendments to Form ADV, Investment Advisers Act Release No. 3060, 98 S.E.C. Docket 3502 (July 28, 2010) at 163.

II. Investment Adviser Representatives

An investment adviser representative ("IAR") generally is a person who, for compensation (1) makes any recommendations regarding securities; (2) manages accounts of clients; (3) determines which recommendation or advice regarding securities should be given; (4) solicits or sells investment advisory services, or (5) supervises employees who perform any of the foregoing.[20] The definition of an IAR, especially with respect to soliciting, can vary significantly from state to state, and so the rules of each state securities regulator should be consulted in determining whether a person qualifies as an IAR within that state. Disclosure requirements for IARs are more robust than for investment advisers and generally come from the requirements of states, rather than the SEC.

Federal Rules of IAR Disclosure

Part 2B of Form ADV is called the "Brochure Supplement," which includes information for each individual that an investment adviser supervises who: (1) formulates investment advice for that client and has direct client contact; or (2) makes discretionary investment decisions for that client's assets, even if the supervised individual has no direct client contact.[21] These brochure supplements are not filed with the SEC but are required to be delivered to clients.[22]

The brochure supplements contain information about the educational background, business experience, and any disciplinary history of the specific individuals who provide advisory services to the client[23]. However, the brochure supplements require the same level of disclosure for their individual investment adviser representatives as they do themselves – they must only disclose legal or disciplinary events that are "material to a client's or

20. *See* 17 C.F.R. § 275.203A-3(a)(1) (2011); *See also* Uniform Securities Act (1956), § 401(g).

21. Amendments to Form ADV, Investment Advisers Act Release No. 3060, 98 S.E.C. Docket 3502 (July 28, 2010) at 52.

22. *See General Instructions for Part 2B of Form ADV*, SEC (Sept. 2019), https://www.sec.gov/about/forms/formadv-part2.pdf.

23. *Id.* at 5.

prospective client's evaluation of the supervised person," and any presumption of materiality may be rebutted by the investment adviser[24].

Even if an investment adviser determines that a material disciplinary event took place for supervised person, the instructions for Part 2B of Form ADV provide that the adviser may deliver the Brochure Supplement to clients *electronically* – and in that case the Brochure Supplement only needs to say that a supervised person has a disciplinary event and provide a hyperlink to either the BrokerCheck or the IAPD systems[25]. The prospective client must know to use the BrokerCheck or IAPD systems themselves to go find out what it is.

State Rules of IAR Disclosure

If an individual meets the state's definition of an IAR and maintains a place of business within a state or has a certain number of clients within the state, then all state securities regulators will require the individual to register as an IAR[26]. This includes associated persons of an SEC-registered investment adviser that fall within the applicable state's definition of an IAR.

An individual seeking to register as an IAR with a state securities regulator will file an initial Form U4, the Uniform Application for Securities Industry Registration or Transfer, via the IAPD/Web CRD system[27]. Whenever there is a material change to information that must be disclosed, the IAR is required to file an amended Form U4[28]. Thus, on an individual level, state-registered investment adviser representative disclosure requirements are very similar to FINRA-member registered representatives.

---

24. Amendments to Form ADV, Investment Advisers Act Release No. 3060, 98 S.E.C. Docket 3502 (July 28, 2010) at 57.

25. *See General Instructions for Part 2B of Form ADV*, SEC (Sept. 2019), https://www.sec.gov/about/forms/formadv-part2.pdf.

26. *See State Investment Advisor Registration Information*, N. AM. SEC. ADM'RS ASS'N, (Aug. 2019), https://www.nasaa.org/industry-resources/investment-advisers/state-investment-adviser-registration-information/.

27. *Form U4 Uniform Application for Securities Industry Registration or Transfer*, FINRA, (May 2009), https://www.finra.org/sites/default/files/AppSupportDoc/p015111.pdf at 1.

28. *Id.*

The Form U4 contains certain disclosure questions which require detailed answers. Section 14 requires disclosure of felonies, crimes involving investments, regulatory actions by federal and state entities and self-regulatory organizations, civil litigations involving investments, customer-initiated arbitration, and written customer complaints that allege sales practice violations and damages of greater than $5,000 with the past two years, as well as any written or oral customer complaints that have settled for $15,000 or more[29]. Information obtained from the Form U4 appears within the CRD and IAPD systems.

III. Conclusion

Investment advisers manage the wealth of Americans on a discretionary basis. There is a lot of important information about them that is simply not available to the investing public and securities regulators, despite the SEC acknowledging the importance of allowing investors to screen potential advisers for disciplinary history. Understanding the nuances of what the disclosure rules require of registered investment advisers and investment adviser representatives is critical to assessing whether the public information that is out there is not telling the entire story.

29. *Form U4*, FINRA (May 2009), https://www.finra.org/sites/default/files/form-u4.pdf at § 14.

ALL OR NOTHING—CONFINING MATERIALITY AND ACTIONABLE DUTIES TO DISCLOSE: WHY ITEM 303 CANNOT ESTABLISH AN AFFIRMATIVE DUTY TO DISCLOSE UNDER RULE 10B-5

James Barnscum

I. INTRODUCTION

Investing in capital markets involves the risk than an investment will yield a positive return. Unfortunately, that is not always the result. When there are volatile changes in a company's stock price, securities class action lawsuits are often filed against companies, officers, directors, and accountants claiming they should have known negative information and disclosed it sooner. In reality, the plaintiffs in these lawsuits are often considered "professional plaintiffs," who own a few shares in various companies and sue when sudden changes in their share prices occur.[1] These factors are relevant when examining whether to expand securities fraud liability.

As a multi-trillion dollar industry, the nation's securities markets are highly regulated by the Securities and Exchange Commission ("SEC"), whose regulations subject companies to a wide array of disclosure requirements.[2] Examples of this disclosure regime include three different reports companies must file; an annual Form 10-K, quarterly Form 10-Qs, and current Form 8-Ks.[3] Those reports include financial statements and management's discussion and analysis of the company's finances and operations, as required by Regulation S-K Item 303 ("Item 303").[4]

While Congress has charged the SEC with regulating the securities industry,[5] the Supreme Court has discerned implied private rights of action to enforce specific securities laws, such as Section 10(b) of the Securities Exchange Act of 1934 ("1934 Act").[6] This means securities fraud claims may

1. H.R. REP. NO. 104-50, pt. 1, at 16 (1995).

2. *See generally* 15 U.S.C. § 78d (2021) (establishing the SEC to regulate the securities industry); 17 C.F.R. §§ 229.10-229.802 (2021).

3. *See* 15 U.S.C. § 78m (2021).

4. 17 C.F.R. § 229.303(b)(2)(ii) (2021).

5. *See* 15 U.S.C. § 78d (2021).

6. *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 37 (2011).

be brought by the SEC and private investors. However, over time, the Supreme Court recognized that implied private rights to bring securities fraud claims had morphed into a "judicial oak" from a "legislative acorn" that exceeded the express remedies Congress had provided under the federal securities laws.[7] Then, to further restrict these private rights of action, Congress passed the Private Securities Litigation Reform Act of 1995 ("PSLRA"), which mandates more exacting pleading requirements for claims brought under Section 10(b) and Rule 10b-5.[8]

Claims brought under Rule 10b-5(b) must be based either on an affirmative statement or an omission.[9] However, in the context of omissions, private actions under Rule 10b-5 exist "only when" an omission renders a previously-made affirmative statement misleading.[10] Thus, as a general rule, there can be no liability for pure omissions under Rule 10b-5, unless that omission causes an affirmative statement that is actually made to be misleading[11] or another duty to disclose that runs to investors exists.[12] Over time, long-standing examples of private rights of actions for omissions liability have been confined to two instances.[13] First, companies are subject to a duty not to mislead, which is actionable under Section 10(b) "only when" an omission renders an affirmative statement misleading.[14] Second, there is a "duty to disclose [that] aris[es] from a relationship of trust and confidence between parties to a transaction[,]"[15] such as insider trading transactions. This fiduciary duty to disclose is the only duty that the Supreme Court has

---

7. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

8. *See* 15 U.S.C. § 78u–4(b)(1) (2021).

9. 17 C.F.R. § 240.10b-5(b) (2021). As this Note concerns whether a failure to disclose under Item 303 establishes a duty to disclose under Rule 10b-5, the principal focus of this topic is omissions liability.

10. *Matrixx*, 563 U.S. at 44.

11. *Id.* Notably, there is an open question as to the extent which Section 10(b) and Rule 10b-5 require statements that were accurate when they were made to be updated.

12. *Basic, Inc. v. Levinson*, 485 U.S. 224, 240 n. 17 (1988) ("[A]bsent a duty to disclose, [silence] is not [actionable] under Rule 10b-5.").

13. There is a duty not to mislead and a duty for fiduciaries to disclose. *Basic*, *supra* note 20; *Chiarella v. United States*, 445 U.S. 222, 230 (1980).

14. *Matrixx*, *supra* note 18.

15. *Chiarella*, *supra* note 21.

recognized where a company has made no affirmative statement.[16] Thus, aside from these two duties to disclose, if no affirmative statement is made by a company, there can be no omissions liability.[17]

Separate from Section 10(b) and Rule 10b-5, Item 303 of Regulation S-K is one of many reporting requirements promulgated by the SEC.[18] While private individuals lack standing to sue companies for failing to disclose information required by Item 303, federal circuit courts disagree on whether violations of Item 303 can establish private rights of action under Section 10(b) and Rule 10b-5. Significantly, the Second and Ninth Circuits, which hear the majority of the nation's securities fraud claims, disagree on this issue.[19] Consistent with the Supreme Court's precedent concerning private rights of action, duties to disclose, and materiality, the Ninth Circuit has held that Item 303's disclosure requirements are not actionable under Section 10(b) and Rule 10b-5.[20] Alternatively, the Second Circuit has held that Item 303's affirmative duty to disclose can serve as the basis for a securities fraud claim under Section 10(b) and Rule 10b-5.[21]

As an area of federal law that regulates a multi-trillion dollar industry where individuals across the nation invest their money, there is a great need for uniformity in the federal courts on this particular issue. Otherwise, plaintiffs will sue companies in courts bound by Second Circuit precedent, while companies will seek to remove such cases to courts bound by Ninth Circuit precedent. The Supreme Court granted certiorari on this particular issue in 2017 in *Ind. Pub. Ret. Sys. v. SAIC, Inc.* ("*Leidos*"),[22] however, it never

---

16. Still, this duty is not based on a mere omission, but rather, the fraudulent use of material information, which is actionable under Rule 10b-5(a) or (c) rather than Rule 10b-5(b). *See Chiarella*, *supra* note 21, at 226.

17. 17 C.F.R. § 240.10b-5 (2021); *Basic*, *supra* note 20.

18. *See* 17 C.F.R. §§ 229.10-229.802 (2021).

19. *Compare Cohen v. NVIDIA Corp.*, 768 F.3d 1046, 1055 (9th Cir. 2014) (finding disclosure duty under Item 303 not to be actionable under Rule 10b-5) *with Stratte-McClure v. Morgan Stanley*, 776 F.3d 94 (2d. Cir. 2016) (holding that Item 303 may be the basis for a duty to disclose under Rule 10b-5).

20. *Cohen v. NVIDIA Corp.*, 768 F.3d 1046, 1055 (9th Cir. 2014).

21. *Stratte-McClure*, *supra* note 21.

22. *Ind. Pub. Ret. Sys. v. SAIC, Inc.*, 818 F.3d 85 (2d Cir. 2016) (Lohier, J.), *cert. granted sub nom*. *Leidos, Inc. v. Ind. Pub. Ret. Sys.*, 137 S. Ct. 1395 (2017) (No. 16-581).

resolved the issue, because the parties settled the lawsuit prior to their oral argument.[23] As such, this issue is still alive and relevant.

This Note seeks to demonstrate that the Ninth Circuit's holding that violations of Item 303's disclosure requirements are not actionable under Rule 10b-5 is correct. Part II examines the background and mechanics of these regulations, as well as the Second, Third, and Ninth Circuits' holdings on this issue. Part III analyzes the lack of private enforcement rights under the SEC's reporting requirements, the distinct disclosure duties of Item 303 and Rule 10b-5, the differing standards for materiality under those rules, and public policy considerations to conclude that the failure to disclose information under Item 303 should not be actionable under Rule 10b-5. Part IV suggests that courts should adopt the Ninth Circuit's holding in *Cohen v. NVIDIA* on this issue and that the SEC expand the Rule 3b-6 safe harbor to specify that pure omissions under Item 303 are not actionable "fraudulent statements" under Rule 10b-5. Finally, Part V will conclude this Note.

II. ITEM 303, SECTION 10(B), RULE 10B-5, AND THE CURRENT CIRCUIT SPLIT

To determine whether plaintiffs should be permitted to sue companies under Section 10(b) and Rule 10b-5 for a violations of Item 303, the background and mechanics of each of those laws must first be examined. When companies file Form 10-Ks, 10-Qs, and 8-Ks, they must comply with the rules of Regulation S-K, such as Item 303.[24] Then, if an event causes their stock price to fall, they are likely to be sued by investors under Section 10(b) and Rule 10b-5, claiming that a failure to disclose information required under Item 303 was materially misleading and constituted fraud. Yet, when analyzing precedent from the Courts of Appeals dealing the interplay between these rules, there is disagreement as to whether plaintiffs may state claims under Section 10(b) and Rule 10b-5 based on violations of Item 303.

---

23. *See generally* Turk & Woody, The *Leidos* Mixup: The Misunderstood Duty to Disclose in Securities Law, 75 Wash. & Lee L. Rev. 957, 957 (2018).

24. *See supra* note 11 and accompanying text; *see also* 17 C.F.R. §§ 229.10-229.802 (2021).

A. *Item 303 of Regulation S-K*[25]

Under the SEC's disclosure regime, issuing companies must comply with Regulation S-K, which requires certain disclosures in documents must be filed under the 1934 Act.[26] Item 303 of Regulation S-K ("Item 303") sets forth the "Management's discussion and analysis of financial condition and results of operations." ("MD&A").[27] As it pertains to whether an omission of information required under Item 303 can establish an affirmative duty to disclose under Section 10(b) and Rule 10b-5, Item 303 states, in pertinent part, that companies must:

> "[d]escribe any known trends or uncertainties that have had or that are reasonably likely to have a material . . . impact on net sales or revenues or income from continuing operations. If the registrant knows of events that are reasonably likely to cause a material change in the relationship between costs and revenues . . . , the change in the relationship must be disclosed."[28]

Thus, Item 303 establishes an affirmative duty for companies to disclose trends or uncertainties that they "reasonably expect[]" to have a material impact on their net sales, revenues, or income.[29]

To determine when a trend or uncertainty is "reasonably likely to have a material effect" on the company's continuing operations, companies must, of course, identify the "trend" or "uncertainty" and predict the likelihood that it will come to fruition.[30] Companies must then disclose the "trend" or "uncertainty" unless management concludes that a material effect on operations "is not reasonably likely to occur[.]"[31] This standard is a threshold

---

25. 17 C.F.R. § 229.303(b)(2)(ii).

26. 17 C.F.R. §§ 229.10-229.802 (2021).

27. 17 C.F.R. § 229.303(b)(2)(ii).

28. *Id.* Plaintiffs alleging that violations of Item 303 can be privately enforced through Rule 10b-5 normally sue companies alleging fraud under this particular subsection of Item 303.

29. *Id.* Item 303's "*reasonably likely* to have a material . . . impact" language is a far less stringent standard than the test for materiality set forth in *Basic v. Levinson*–"if there is a *substantial likelihood* that a reasonable shareholder would consider it important in their vote.".

30. SEC Guidance, 1989 WL 1092885, at *6 n. 27 (May 24, 1989); Cox, *supra* note 11, at 588.

31. SEC Guidance, 1989 WL 1092885, at *6 n. 27 (May 24, 1989).

"lower than 'more likely than not.'"[32] To illustrate Item 303's disclosure requirements, three examples show when and what companies are required to disclose under this regulation:

> **Example 1:** If a manufacturer's product is defective, and the company incurs significant costs to cover its warranty, repair, return, and replacement costs, those facts are "known trends" that must be disclosed under Item 303.
>
> **Example 2:** If a bank owns loans on its balance sheet, the fact that those loans are subject to price fluctuations due to potential interest rate changes would constitute a "known . . . uncertaint[y]" that must be disclosed under Item 303.
>
> **Example 3:** If a company enters into a contract with a city and its employees overbill the city under a kickback scheme, Item 303 requires the company to disclose the "known . . . uncertaint[y]" that there might be legal liability.

While Item 303's disclosure rules may be somewhat general, the SEC believes these disclosure obligations let investor see the company through the eyes of management.[33]

---

32. As a threshold "lower than a 'more likely than not' [standard]" whether a trend or uncertainty is material for purposes of Item 303 depends on a standard that is less than fifty percent. Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations, 67 Fed. Reg. 3,746, 3,748 (Jan. 25, 2002). Accordingly, materiality for purposes of Item 303 is much less stringent standard than materiality for Rule 10b-5. Rule 10b-5 requires companies to balance the probability that an event will occur and the anticipated magnitude of the event. *Basic*, 485 U.S. 224, 238 (1988). As such, highly unlikely events may be material under Rule 10b-5 if the magnitude of their potential impact is great enough, demonstrating potentially expansive materiality.

33. Management's Discussion & Analysis of Financial Condition and Results of Operations, 1989 WL 1092885, at *3 (May 18, 1989). With respect to Example 2, the nature of banks is to make loans, so reasonable investors should be aware of the risk of price fluctuations without any disclosure. Thus, Example 2 illustrates why private plaintiffs should not be able to sue under Rule 10b-5 for violations of Item 303.

B. *Section 10(b)*[34] *and Rule 10b-5*

Under Section 10(b) of the 1934 Act, it is unlawful "[t]o use or employ . . . any manipulative or deceptive device or contrivance in contravention of such rules . . . the [SEC] may prescribe . . . in the public interest or for the protection of investors."[35] Thus, Congress sought to prevent manipulation and deception in securities transactions, and it gave the SEC the authority to promulgate rules to carry out that purpose. In 1942, the SEC adopted Rule 10b-5 to implement Section 10(b).[36] In contrast to Item 303, Rule 10b-5 sets forth three bases of liability for companies whose securities trade in the public markets:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security."[37]

Rule 10b-5(b) specifies that companies cannot be liable for omissions unless they have already disclosed a statement of fact that is misleading.[38] Thus, companies are not subject to an actionable duty to disclose based on pure omissions.[39] Instead, the outer limits of their Rule 10b-5(b) obligations are to correct, and possibly update, statements of fact already made.

---

34. 15 U.S.C. § 78j(b) (2021).

35. *Id.*

36. *See* 17 C.F.R. § 240.10b-5 (2021); SEC *v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 847 (2d. Cir. 1968).

37. 17 C.F.R. § 240.10b-5 (2021). Interestingly, Rule 10b-5 is considered to be the most prominent antifraud provision under federal securities laws. This regulation provides the SEC with the authority to prosecute individuals for insider trading violations. *See SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 887 (2d. Cir. 1968).

38. 17 C.F.R. § 240.10b-5(b) (2021).

39. 17 C.F.R. § 240.10b-5(b) (2021). *Oran*, *NVIDIA*, *Stratte-McClure*, and *SAIC* each involved lawsuits brought under Rule.

Alternatively, Rules 10b-5(a) and 10b-5(c) pertain broadly to fraud and deceit.[40] The language of those rules is arguably broad enough to impose liability for pure omissions. However, plaintiffs have only sued for the failure to disclose information required by Item 303 under Rule 10b-5(b), alleging liability for a failure to disclose, instead of Rules 10b-5(a) and (c).[41] One explanation is that Rules 10b-5(a) and (c) apply in cases involving intentional misleading practices. Specifically, "manipulation" and "deceit," for purposes Rule 10b-5, refer generally to "practices, such as wash sales, matched orders, or rigged prices . . . that artificially affect market activity[,]"[42] rather than mere failures to comply with Item 303.

While omissions could fall within the more expansive language of Rules 10b-5(a) and (c), plaintiffs must prove the defendant acted with an intent to mislead when suing under Rule 10b-5.[43] Because defendants are unlikely to have such intent when merely failing to comply with reporting requirements, plaintiffs would likely always fail to sue under Rule 10b-5 as a surrogate for Item 303. Additionally, while the letter of Rule 10b-5(a) and (c) is broader than Rule 10b-5(b), judicial hesitancy to create new private causes of action under the securities laws means the Supreme Court is unlikely to allow private plaintiffs to sue to enforce Item 303 and other reporting requirements. Therefore, it would be unlikely for the Court to allow private plaintiffs to use Rules 10b-5(a) and (c) as backdoor mechanisms for private plaintiffs to sue for violations of Item 303.

To further contrast these rules, Rule 10b-5 creates an implied private right of action for individuals to sue companies for securities fraud, while Item 303 does not.[44] Since the 1970s, the Court has taken a restrictive view of implied private rights of action, and it is unlikely to permit private investors to sue companies for violations of reporting requirements, such as Item 303. The

---

40. *See* 17 C.F.R. § 240.10b-5(a) and (c) (2021).

41. *Oran*, 226 F.3d at 281; *NVIDIA*, 768 F.3d at 1054; *Stratte-McClure*, 776 F.3d at 100.

42. *Id.*

43. 15 U.S.C. § 78j(b) (2021); 15 U.S.C. § 78u-4 (2021); *In re Time Warner Sec. Litig.*, 381 F. Supp. 2d 192, 217 (S.D.N.Y. 2004) (citing *Santa Fe Indus.*, 430 U.S. at 476.).

44. *In re NVIDIA*, 768 F.3d at 1051–52 (quoting *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 37 (2011)) ("[T]here is an 'implied [] private cause of action' in Section 10(b)."). In contrast to Rule 10b-5, no implied private action has been found to exist under Item 303.

disagreement between the Second and Ninth Circuit relates to whether an omission of information required to be disclosed under Item 303 can establish a violation of Section 10(b) and Rule 10b-5. As follows, to state a valid claim under Rule 10b-5, plaintiffs must prove: (1) a material misstatement or omission by the defendant under the *Basic* test; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance by the plaintiff; (5) economic loss; and (6) loss causation.[45] As the decisions of the Second and Ninth Circuits reveal, plaintiffs typically cannot prove the materiality and scienter elements when companies merely omit information required by Item 303.

C. *Circuit Split*

Only three Circuits have answered whether a violation of Item 303's disclosure requirements can allow private plaintiffs to sue a company under Rule 10b-5. However, the true circuit split exists between the Ninth and Second Circuits. First, to lay the foundation for the Ninth and Second Circuit decisions, a Third Circuit opinion written by now-Justice Samuel Alito must be examined. From there, this section discusses the Ninth Circuit's analysis for holding that Item 303's disclosure duty is not actionable under Rule 10b-5. Lastly, this section explores the Second Circuit's holdings that omissions from Item 303's disclosure requirements can be actionable under Rule 10b-5 if the omission is material under *Basic*'s probability/magnitude test.

i. Oran v. Stafford[46]

In 2000, the Third Circuit was confronted with the issue of whether a violation of Item 303's disclosure requirements would permit private plaintiffs to sue under Rule 10b-5 in *Oran v. Stafford*.[47] There, the defendant corporation withdrew its prescription drugs from the market after reports surfaced that they caused medical side effects.[48] Plaintiff stockholders alleged

---

45. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 157 (2008).

46. 226 F.3d 275 (3d. Cir. 2000).

47. *Id.* at 281.

48. *Id.* at 279.

the company violated Item 303's requirement to disclose "known trends and uncertainties" and that this violation could support a claim under Section 10(b) and Rule 10b-5.[49]

Now-Justice Samuel Alito, writing for the Third Circuit, acknowledged that it was an issue of first impression whether violations of Item 303 create a cause of action for private plaintiffs, but ultimately held that they do not.[50] Justice Alito reasoned that neither Item 303 nor the SEC's interpretative releases construing it suggest it was intended to establish a private right of action.[51]

Next, he addressed whether violations of Item 303 could constitute a material omission under Rule 10b-5.[52] By referencing the SEC's interpretation of a company's disclosure obligations under Item 303, Justice Alito explained that companies must make a two-part assessment when determining whether to disclose information under Item 303.[53] First, if a trend, event, or uncertainty is known, management must first determine whether the trend, event, or uncertainty is likely to come to fruition.[54] If it is not *reasonably likely* to occur, disclosure is not required. Second, if management cannot determine that the trend, event, or uncertainty is not reasonably likely to occur, it must objectively evaluate the consequences of the trend, event, or uncertainty, on the assumption that it will come to fruition.[55]

Justice Alito then explains that the test for materiality under Item 303 "varies considerably from" the test set out in *Basic, Inc. v. Levinson*.[56] He explains that the *Basic* test for materiality is "premised on forward-looking disclosure 'upon a balancing of both the indicated probability that the event will occur and [its] anticipated magnitude[.]'"[57] Further, he recognizes that

---

49. *Id.* at 281 and 287.

50. *Id.* at 287.

51. *Id.*

52. *Id.*

53. *Id.* at 286–87 (citing Management's Discussion and Analysis of Financial Condition and Results of Operations, Exchange Act Release No. 34-26831, 54 Fed. Reg. 22427, 22430 (May 24, 1989)).

54. *Id.*

55. *Id.*

56. *Id.*

57. *Oran*, 226 F.3d 275, 287 (quoting *Basic*, 485 U.S. 224, 237 (1988) (quoting *Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d. Cir. 1968) (en banc))).

the SEC has noted that the *Basic* test for materiality . . . is inapposite to Item 303 disclosure[,]" as Item 303 "extends considerably beyond" Rule 10b-5."[58] After stressing the distinctions for materiality between Rule 10b-5 and Item 303, Justice Alito holds that "a violation of [Item 303]'s reporting requirements does not automatically give rise to a material omission under Rule 10b-5."[59] Finding that the plaintiffs failed to plead any actionable omission under Rule 10b-5, he concludes that "[Item 303] cannot provide a basis for liability" under that Rule in this particular case.[60]

ii. Cohen v. NVIDIA Corp.[61]

In 2014, the Ninth Circuit was confronted with the issue of whether a failure to disclose under Item 303 would allow a private plaintiff to sue under Rule 10b-5.[62] In *Cohen v. NVIDIA*, the defendant corporation, a semiconductor manufacturer, experienced defects in its products.[63] It disclosed to investors that it would suffer expenses of over $150 million as a result, which led its stock price to fall thirty-one percent, shrinking its market capitalization by $3 billion.[64]

Plaintiff stockholders sued the company, alleging it should have disclosed the defects sooner.[65] They argued that, by not disclosing the defects, the

---

58. *Oran*, 226 F.3d at 228 (citing Exchange Act Release No. 34-26831, 54 Fed. Reg. at 22430 n. 27).

59. *Oran*, 226 F.3d at 228. Because Justice Alito's reasoning centered on the differing materiality standards, he arguably assumes, without deciding, that Item 303 may establish a duty to disclose that might sometimes be actionable under Rule 10b-5. However, such a reading of *Oran* would improperly omit consideration of whether Item 303 establishes a duty to disclose that *runs to the investors*. Therefore, because Item 303 is a reporting requirement that only the SEC can enforce, Item 303 create no duty that runs to private individuals.

60. *Id.*

61. *Cohen v. NVIDIA Corp. (In re NVIDIA Corp. Sec. Litig.)*, 768 F.3d 1046 (9th Cir. 2014).

62. *Id.*

63. *Id.* at 1048.

64. *Id.*

65. *Id.*

company's intervening statements regarding its finances were misleading to investors in violation of Rule 10b-5. The District Court dismissed their amended complaint without leave to amend, reasoning that the plaintiff failed to plead scienter under Rule 10b-5, and on appeal, the plaintiffs argued the disclosure duty under Item 303 is actionable under Rule 10b-5, so long as the company acted with scienter. The Ninth Circuit held that Item 303's disclosure duty is not actionable under Rule 10b-5, reasoning that Rule 10b-5 does not create an actionable duty to disclose all material information.[66] Instead, disclosure under Rule 10b-5 is required only when necessary "to make . . . statements made, in the light of the circumstances under which they were made, not misleading[.]"[67] The Ninth Circuit also reasoned that "Item 303's disclosure requirement 'varies considerably from'" the *Basic* materiality test.[68] Similarly, it explained the two-step process companies must use to determine whether disclosure is required under Item 303.[69] From there, the it held that a violation of Item 303 does not inevitably require disclosure under Rule 10b-5."[70]

This reasoning extends further than the Third Circuit's, as it distinguishes Second Circuit precedent[71] holding that the failure to disclose information under Item 303 could violate Sections 11 and 12(a)(2) of the Securities Act of 1933 ("1933 Act").[72] The Ninth Circuit noted that Section 10(b) of the 1934 Act differs dramatically from Sections 11 and 12(a)(2) of the 1933 Act.[73] Specifically, Sections 11 of the 1933 Act imposes liability for "omitt[ing] to state a material fact required to be stated[,]"[74] while omissions liability under

---

66. *Id.* at 1054.

67. *Id.* at 1054 (quoting *Matrixx Initiatives,* 563 U.S. 27, 37 (2011)).

68. *Id.* at 1054–55 (quoting *Oran*, 226 F.3d at 288).

69. *Id.* at 1055 (citing Management's Discussion and Analysis of Financial Condition and Results of Operations, Exchange Act Release No. 34-26831, 54 Fed. Reg. 22427, 22430 (May 24, 1989)).

70. *Id.* In fact, the Ninth Circuit correctly goes a step further to hold that violations of Item 303 can never establish an actionable duty to disclose under Section 10(b) and Rule 10b-5.

71. *Litwin v. Blackstone Group, L.P.*, 634 F.3d 706 (2d. Cir. 2011).

72. *NVIDIA*, 768 F.3d at 1055.

73. *NVIDIA*, 768 F.3d at 1055 (citing *Steckman v. Hart Brewing, Inc.*, 143 F.3d 1293, 1296 (9th Cir. 1998)).

74. *Id*. (citing 15 U.S.C. §§ 77k(a) (2021).

Rule 10b-5(b) may arise only when necessary to make an affirmative statement actually made not misleading.[75]

Thus, by emphasizing the different materiality standards for Item 303 and Rule 10b-5, as well as the fact that Rule 10b-5(b) only imposes liability for omissions when necessary "to make . . . statements made . . . , not misleading[,]" the Ninth Circuit firmly held that Item 303 does not establish a duty to disclose under Rule 10b-5.[76] Instead, disclosure obligations under Rule 10b-5 must be separately proven under the principles stated by the Supreme Court in *Basic*.[77]

iii. Stratte-McClure v. Morgan Stanley[78]

A year after the Ninth Circuit's holding in *NVIDIA*, the Second Circuit faced the same issue in *Stratte-McClure v. Morgan Stanley*.[79] There, investors alleged that Morgan Stanley failed to disclose its exposure to losses from the subprime mortgage market, as required under Item 303 in its Form 10-Q filings.[80] They claimed substantial financial losses when the company's stock price dropped after it disclosed losses caused by owning subprime mortgages.[81] The plaintiffs appealed to the Second Circuit after the Southern District of New York dismissed their claims.[82]

When analyzing whether a failure to disclose information required under Item 303 can establish an actionable duty to disclose under Rule 10b-5, the Second Circuit first recognized that "[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5."[83] Relying on its prior decisions, the Court explained that omissions are actionable only when the corporation is subject

---

75. 17 C.F.R. § 240.10b-5(b) (2021).

76. *Id.* at 1056. This Note asserts that the Ninth Circuit's holding in this case is correct and argues that other courts should similarly adopt it.

77. *Id.* The Ninth Circuit seemingly indicates that it is irrelevant whether Item 303 has been violated when attempting to sue under Rule 10b-5.

78. *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94 (2d. Cir. 2015).

79. *Id.* at 96.

80. *Id.* at 96, 100.

81. *Id.* at 96.

82. *Id.*

83. *Id.* at 100–01 (citing *Basic*, 485 U.S. at 239 n. 17; *Chiarella*, 445 U.S. at 230).

to a duty to disclose the omitted fact.[84] Relying on those principles, the Court goes on to explain that Item 303 requires disclosures of certain "known trends or uncertainties" when companies file SEC-mandated reports and it holds that Item 303's duty to disclose can serve as the basis for a securities fraud claim under Section 10(b).[85]

The Court acknowledges that it had previously held that a failure to disclose under Item 303 is actionable under Sections 11 and 12(a) of the 1933 Act.[86] While Section 11 establishes liability for "omit[ting] to state a material fact required to be stated therein[,]" Section 12(a)(2) and Rule 10b-5(b) "require[] disclosure of 'material fact[s] necessary in order to make . . . statements made . . . not misleading.'"[87] Recognizing that prior precedent in the Second Circuit has found that a duty to disclose under Section 10(b) can derive from statutes or regulations that obligate a party to speak, the Court concludes that omitting an item required to be disclosed can render a statement misleading.[88]

Yet, although the Court held that violations of Item 303 *can* establish a duty to disclose under Rule 10b-5, it still holds that a failure to disclose under Item 303 is not sufficient by itself to state a securities fraud claim under Section 10(b).[89] Rather, claims for violations of Item 303 are sustainable under Rule 10b-5 only if the omitted information satisfies *Basic*'s materiality test."[90] In noting that it's holding is counter to *NVIDIA*, the Second Circuit essentially follows a five-step approach for plaintiffs to plead that a violation of Item 303

---

84. *Id.* at 101 (internal citations and quotations omitted) (recognizing that such a duty to disclose exists "when there is a corporate insider trad[ing] on confidential information, a statute or regulation requiring disclosure, or a corporate statement that would otherwise be inaccurate, incomplete, or misleading.").

85. *Id.* at 101.

86. *Id.* at 101 (citing *Panther Partners*, 681 F.3d at 120; *Litwin*, 634 F.3d at 716).

87. *Id.* at 102.

88. *Id.* This Second Circuit's reasoning must be incorrect. Rule 10b-5 only establishes omissions liability when companies omit material facts necessary to make *the statements made*, not misleading. 17 C.F.R. § 240.10b-5 (2021) (emphasis added). A failure to disclose under Item 303 is not an affirmative, misleading statement.

89. *Id.*

90. *Id.* at 103. This Note argues that the Second Circuit's holding in this case is incorrect and should be overruled in favor of the Ninth Circuit's holding in *Cohen v. NVIDIA Corp.*

can establish a duty to disclose under Rule 10b-5.[91] Essentially, plaintiffs must (1) allege that the defendant company failed to comply with Item 303, which would establish that it had a duty to disclose; (2) allege that the omitted information was material under *Basic*'s probability/magnitude test; (3) sufficiently plead scienter; (4) rely on the omission; and (5) suffer an economic loss caused by that reliance.[92]

Applying this approach, the Court found that the plaintiffs adequately alleged a violation of Item 303's disclosure requirements.[93] However, it ultimately affirmed the dismissal of the lawsuit, finding that the plaintiffs failed to plead scienter under Rule 10b-5.[94]

Accordingly, after *Stratte-McClure* refuted the Ninth Circuit's holding in *In re NVIDIA*, a clear circuit split was born as to whether violations of Item 303 could be actionable under Rule 10b-5. As a result, securities fraud plaintiffs now either sue in the Second Circuit or argue for other Circuits to adopt the holding of *Stratte-McClure*.

iv. Ind. Pub. Ret. Sys. v. SAIC, Inc.[95]

After *Stratte-McClure*, the Second Circuit confronted this issue again in *Ind. Pub. Ret. Sys. v. SAIC, Inc.* ("*Leidos*").[96] In *Leidos*, investors in SAIC alleged that certain SAIC employees overbilled the City of New York in connection with their contract work.[97] The plaintiffs alleged that the company failed to disclose trends or uncertainties in violation of Item 303–namely that the company could be subject to legal liability.[98] The District Court granted

91. *Stratte-McClure*, 776 F.3d at 103.

92. *Id.* While the Court does not call its holding a "multi-prong approach," that is effectively what it establishes.

93. *Stratte-McClure*, 776 F.3d at 103.

94. *Id.* at 104 The dismissal of this case illustrates just how rare it would be for a violation of Item 303 to be accompanied with scienter to establish a claim under Rule 10b-5.

95. *Ind. Pub. Ret. Sys. v. SAIC, Inc.*, 818 F.3d 85 (2d. Cir. 2016).

96. *Id.*

97. *Id.* at 88.

98. *Id.*

SAIC's motion to dismiss these claims and denied the plaintiffs' motion to amend their complaint.[99]

On appeal, relying on its approach for Rule 10b-5 claims in *Stratte-McClure*, the Second Circuit found that the plaintiffs adequately plead a failure to disclose information required by Item 303, which established a duty to disclose under Rule 10b-5.[100] Additionally, it found that they adequately plead materiality under *Basic*'s test,[101] scienter,[102] and the other requisite elements to state a claim under Rule 10b-5.[103] As such, the Court reversed the District Court's holding and allowed the plaintiffs to amend their complaint to include the failure to disclose under Item 303.[104]

The company then appealed the Second Circuit's judgment, and the Supreme Court granted certiorari to resolve whether a company's failure to disclose in violation of Item 303 creates an actionable duty to disclose under Section 10(b) and Rule 10b-5.[105] However, on the night before their oral arguments, the parties settled the case,[106] leaving this issue alive and controversial.

III. PREVENTING THE EXTENSION OF LIABILITY UNDER SECTION 10(B) AND RULE 10B-5 FROM ENCOMPASSING THE FAILURE TO DISCLOSE UNDER ITEM 303

The issue of whether a failure to disclose under Item 303 can establish an actionable duty to disclose under Section 10(b) and Rule 10b-5 is still alive and relevant because it has still not been answered by the Supreme Court.

---

99. *Id.* at 91–92.

100. *Id.* at 95–96. Again, the Second Circuit incorrectly holds that mere silence can be misleading.

101. *Id.*

102. *Id.* at 96–97.

103. *Id.* at 97.

104. *Id.*

105. *Ind. Pub. Ret. Sys. v. SAIC, Inc.*, 818 F.3d 85 (2d Cir. 2016) (Lohier, J.), *cert. granted sub nom. Leidos, Inc. v. Ind. Pub. Ret. Sys.*, 137 S. Ct. 1395 (2017) (No. 16-581).

106. *See generally* Turk & Woody, *The Leidos Mixup: The Misunderstood Duty to Disclose in Securities Law*, 75 Wash. & Lee L. Rev. 957 (2018).

There is a clear circuit split between the Second and Ninth Circuits on this issue, which prohibits uniformity in federal securities regulation. Ultimately, the Ninth Circuit's holding in *NVIDIA* that violations of Item 303 do not establish an actionable duty to disclose under Rule 10b-5 is the correct approach. First, there are no private rights of action for individuals to enforce Item 303 and other reporting requirements promulgated by the SEC, and Rule 10b-5 cannot be used as a surrogate to allow private parties to enforce Item 303's disclosure obligations. Second, Item 303's disclosure duty is much broader than the duty under Rule 10b-5. Third, "materiality" for purposes of Item 303 is a much less exacting threshold than the standard set forth in *Basic, Inc. v. Levinson* for Section 10(b) and Rule 10b-5. Finally, allowing plaintiffs to sue companies for violations of Item 303 under Rule 10b-5 runs counter to the courts' hesitancy to create new private actions, the PSLRA, and other significant policy considerations.

A. *Judicial Disfavor of Private Rights of Action*

Prior to the mid-1970s, the Supreme Court was willing to allow private investors to sue companies under the federal securities laws to supplement SEC enforcement.[107] However, since the Court's decision in *Blue Chip Stamps v. Manor Drug Stores*, federal courts are extremely hesitant to imply new private rights of action.[108] In that case, the Court held that plaintiffs must be actual purchasers or sellers of securities to have standing to sue under Section 10(b) and Rule 10b-5. It reasoned that such a rule was necessary due to the threat of vexatious litigation if individuals who did not purchase or sell the security had standing to sue. Otherwise, preventing the dismissal of a lawsuit would create settlement value for plaintiffs who are unlikely to succeed.

Thus, expanding implied private rights of action "is now a disfavored judicial activity."[109] Today, the issue of whether private rights of action exist under the federal securities laws depends on whether Congress intended for them to.[110] But by establishing more exacting pleading requirements in

---

107. *See J.I. Case Co. v. Borak*, 377 U.S. 426, 433 (1964) (implying a private right of action for proxy rules).

108. 421 U.S. 723, 730 (1975) (limiting standing to sue under Rule 10b-5 to actual purchasers and sellers).

109. *Janus Capital Grp., Inc. v. First Derivative Traders*, 564 U.S. 135, 146 (2011).

110. Cox, *supra* note 11, at 521.

securities lawsuits under the PSLRA, Congress further restricts private investors' rights to sue companies under Rule 10b-5. Thus, if a private right of action was not judicially recognized prior to 1975 before the *Blue Chip Stamps* holding, it cannot be implied by a court.[111] However, the Second Circuit has blatantly violated that principle in *Stratte-McClure* and *Leidos*.[112]

By holding that a mere failure to disclose under Item 303 can be misleading and establish a duty to disclose under Rule 10b-5, the Second Circuit has gone beyond the bounds of *Blue Chip Stamps* and the PSLRA by implying a private action for investors to enforce the SEC's reporting requirements.[113] This is true for two reasons. First, no private right of action exists to enforce a company's violation of Item 303. Second, no private right of action exists under Rule 10b-5 to enforce violations of Item 303, even if those violations are material under the *Basic* test.

First, Congress has never authorized private enforcement of the SEC's reporting requirements.[114] Instead, such requirements are for the SEC to enforce, bbecause Regulation S-K was adopted under Sections 12, 13, 14, 15(d), and 23(a) of the 1934 Act, rather than Section 10(b).[115] Alternatively, Item 303 was adopted under Sections 6, 7, 8, 10, and 19 of the 1933 Act.[116] These distinctions imply a need for different rules for regulations based upon the 1933 Act, such as Item 303, versus regulations based on the 1934 Act, such as Rule 10b-5.

---

111. *Janus Capital Grp., Inc. v. First Derivative Traders*, 564 U.S. 135, 146 (2011).

112. Not only does the Second Circuit purport to establish a new theory of liability that could not be privately enforced before the passage of the PSLRA–that omissions under Item 303 can be privately enforced if the omission meets *Basic*'s materiality test. It also ignores the text of Rule 10b-5 that omissions liability can only be established if necessary to make a statement not misleading. *Stratte-McClure*, 776 F.3d at 104.

113. *See* 15 U.S.C. § 78u–4(b)(1)(B) (2021) In fact, the Supreme Court in *Stoneridge* explained that post-PSLRA expansion of private securities causes of actions was for Congress to decide, not the courts. 552 U.S. 148, 165 (2008).

114. Brief for Petitioners *supra* note 21, at 8.

115. *Id.* at 37 (citing Adoption of Disclosure Regulation and Amendments of Disclosure Forms and Rules, 42 Fed. Reg. 65,554, 65,556 (Dec. 23, 1977)).

116. *Id.* (citing Adoption of Integrated Disclosure System, Securities Act Release No. 33-6383, 1982 WL 126544, at *1 (Mar. 16, 1982)).

Moreover, Congress has only authorized the SEC to enforce its statutory reporting requirements.[117] Therefore, as Justice Alito recognized in *Oran*, Item 303 and other reporting requirements do not provide independent private causes of action.[118] This signals that Regulation S-K can only be enforced by the SEC, and Congress seemingly believes SEC enforcement through judicial and administrative actions, such as cease-and-desist orders, is the proper remedy for violations of Regulation S-K.[119]

Next, even if an omission under Item 303 is material under *Basic*'s probability/magnitude test, Rule 10b-5 cannot be used as a surrogate for private plaintiffs to enforce Item 303. The only duty to disclose that exists with respect to registration requirements is the obligation to disclose this information *to the SEC* during the process of making its registration statement effective. No similar duty runs to the investors.

Accordingly, to sue based on a violation of Item 303 under Rule 10b-5, plaintiffs must sufficiently plead and prove that an omission was misleading because it failed to make a *previously-made statement* not misleading. The Second Circuit ignores this requirement. In fact, the its reasoning directly counters the Supreme Court's guidance in *Matrixx Initiatives* that Rule 10b-5(b) does not require the affirmative disclosure of any and all material information. Instead, "companies can control what they have to disclose under [Rule 10b-5(b)] by controlling what they say to the market."[120]

Further, while *Stratte-McClure* and *Leidos* seem to only apply to Item 303, there are many other reporting requirements within Regulation S-K. Attorneys for "professional plaintiffs" are likely to cite these Second Circuit cases to assert claims that failures to disclose under other reporting requirements can establish a private right of action under Rule 10b-5 as well. This slippery slope would have severely negative impacts, including the threat of meritless securities "fraud by hindsight" claims, excessive precautionary costs, over-

---

117. *See* 15 U.S.C. § 78m(a) (2021) (authorizing the SEC to promulgate rules and regulations concerning periodic reporting requirements); *see also Kokesh v. SEC*, No. 16-529, 2017 WL 2407471, at *4 (U.S. June 5, 2017) (acknowledging that Section 78m(a) armed the SEC with a "full panoply of enforcement tools[.]").

118. *Oran*, 226 F. 3d at 287.

119. *See* 15 U.S.C. § 78u-3(a) (2021). *But see* Harper, *supra* note 58, at 893 (arguing the SEC's cease-and-desist power is an insufficient remedy to victims of violations of Item 303).

120. *Matrixx*, 563 U.S. at 44–45.

disclosure, and chilled legitimate business activity.[121] Private actions are extremely costly and take lots of time to defend. Those costs are for Congress to weigh, not the courts, and Congress did so when it enacted the PSLRA and restricted the scope of private actions under Section 10(b) and Rule 10b-5.[122] In contrast, Congress has never endorsed private actions for the SEC's reporting requirements. As such, the Ninth Circuit's holding is the correct approach simply because there is no private right of action to enforce Item 303, regardless of whether the violation is material for purposes of Rule 10b-5.

B. *Duty To Disclose*

In *Matrixx Initiatives*, the Supreme Court emphasized that companies can control what they must disclose under Rule 10b-5 by controlling what they say in the first place.[123] Thus, companies have a duty to disclose under Rule 10b-5 only after they have spoken.[124] Examining other federal securities statutes *in pari materia* further supports the proposition that Rule 10b-5 liability cannot be imposed for pure omissions. Section 17(a) of the 1933 Act, a model for Rule 10b-5,[125] only establishes liability for "untrue statement[s] of a material fact" or for "omi[tting] to state a material fact *necessary . . . to make the statements made . . .* , not misleading."[126] This same language is used in Rule 10b-5, indicating that Rule 10b-5 is not intended to impose pure omissions liability.

Moreover, when Congress enacted the PSLRA, it ratified Rule 10b-5(b)'s command that omissions are actionable only if an affirmative statement is rendered misleading.[127] In doing so, Congress restricted the misleading statements and omissions that are sufficient to establish liability.[128] Specifically, liability under Rule 10b-5 is limited to false statements and

---

121. *See* generally Cox, *supra* note 11, at 673. This could open the door to unlimited liability for companies.

122. *Stoneridge Inv. Partners, LLC v. Sci.-Atlanta, Inc.*, 552 U.S. 148, 165 (2008).

123. 563 U.S. at 44–45.

124. *See* 17 C.F.R. § 240.10b-5(b) (2021).

125. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 213 n. 32 (1976).

126. 15 U.S.C. § 77q(a)(2) (2021).

127. *See* 15 U.S.C. § 78u-4(b) (2021).

128. *Id.* § 78u-4(b)(1)(B) (2021).

omissions only when there is a duty to disclose or to make a previous statement not misleading.[129] As such, Congress has codified Supreme Court precedent that liability under Rule 10b-5 cannot be established for pure omissions, absent a duty to disclose. Instead, omissions liability can exist only when the defendant makes an affirmative statement that is misleading and fails to render that statement "not misleading."[130] Therefore, for a plaintiff to sue under Rule 10b-5 violations of Item 303, Item 303 would have to involve a disclosure duty running to investors, akin to the duty that exists in insider trading, wash sale, matched order, or price rigging cases. However, the SEC has the sole enforcement authority with respect to Item 303 and other reporting requirements under the 1933 Act, so no duty to disclose runs from the company to its investors.

In contrast with Section 17(a), Section 10(b), and Rule 10b-5, Section 11 of the 1933 Act imposes liability on companies when their registration statements include "untrue statement[s] of a material fact or omit[] to state *a material fact required to be stated therein* or necessary to make the statements therein not misleading."[131] Thus, in a registration statement, which companies must file when registering their securities, companies cannot omit material facts and avoid liability as they can under Rule 10b-5.[132] This clear divergence under Section 11 and Rule 10b-5 is logical. At the time of a public offering, investors need as much information as possible when deciding whether to invest. When companies sell securities, investors have little information to determine their value. Therefore, it is logical to impose liability for pure material omissions when companies are more likely omit information in an attempt to sell their securities. Alternatively, in the context of claims alleging fraud based on violations of Item 303, it is far less likely that a mere omission would make a difference in the company's valuation or an investor's decision to buy or sell.

Thus, counter to the Second Circuit's holdings, it is irrelevant that Regulation S-K requires disclosure of certain information for purposes of whether any duty to disclose exists under Rule 10b-5. The mere omission of information under Item 303 does not establish an actionable duty to disclose that runs to investors, unless an omission continues to cause a previously-made

---

129. *Id.* As such, the PSLRA does not establish liability for pure omissions.

130. *Id.* § 78u-4(b)(1)(B) (2021).

131. Section 11 imposes liability for pure omissions in the Registration Statement. 15 U.S.C. § 77k (2021).

132. *See id.*

statement to misleading. In the context of violations of Item 303, where there is no previously-made statement, it is impossible for companies to be liable under the letter of Rule 10b-5(b). Instead, enforcement of Item 303 and other reporting requirements is the prerogative of the SEC.

C. *Materiality*

As each Circuit Court to address the issue has recognized, the materiality threshold for Item 303 is much lower than that of Rule 10b-5.[133] Item 303's reporting requirements depend on whether a known trend or uncertainty is "*reasonably likely* to have a material effect," which has been interpreted by the SEC to be a threshold that is "lower than 'more likely than not[.]'"[134] In contrast, a deep line of Supreme Court precedent makes clear that materiality, for purposes of Rule 10b-5 is a much higher standard.[135]

In *Basic v. Levinson*, the Court adopted a standard that omitted facts are material if there is a substantial likelihood that disclosure would have been significant to a reasonable investor for purposes of Section 10(b) and Rule 10b-5.[136] Specifically, the Court held that materiality depends upon a balancing of both the probability that the event will occur and the anticipated magnitude of the event.[137] Accordingly, the probability/magnitude test for materiality under Rule 10b-5 is a far more stringent standard than that of Item 303.

As *Stratte-McClure* and *Leidos* illustrate, courts are unlikely to engage in a meaningful application of the probability/magnitude test for materiality set forth in *Basic*.[138] If violations of Item 303 could establish private rights of action under Rule 10b-5, liability under Rule 10b-5 would be dramatically expanded to include events that are material for Item 303, but immaterial for

---

133. *Oran*, 226 F.3d at 286–87; *NVIDIA*, 768 F.3d 1054–55; *Stratte-McClure*, 776 F.3d at 102–03; *SAIC*.

134. Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations, 67 Fed. Reg. 3,746, 3,748 (Jan. 25, 2002); *see supra* note 110 and accompanying text.

135. *Matrixx Initiatives*, 563 U.S. at 30*; Basic*, 485 U.S. at 238*; TSC Industries*, 426 U.S. at 450.

136. 485 U.S. at 231.

137. *Id.* at 238 (citing *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d at 849).

138. While the Second Circuit claims to require "materiality" under the *Basic* test, it merely assumed materiality in both cases.

Rule 10b-5. This would cause the implied private right of action under Rule 10b-5 to exceed the limits set forth in the PSLRA. For that reason alone, the Ninth Circuit's approach that a failure to disclose under Item 303 cannot establish a duty to disclose under Rule 10b-5 is correct.

D. *Public Policy Considerations*

Furthermore, private enforcement of the SEC's reporting requirements would simply not be productive. Prior to *Blue Chip Stamps* in 1975, the Supreme Court held in *J.I. Case Co. v. Borak* that Section 14(a) of the 1934 Act could be enforced by private rights of action.[139] The Court reasoned that the Statute made it unlawful to solicit proxies in contravention of the SEC's regulations that are "necessary or appropriate . . . *for the protection of investors*."[140] In the context of proxy solicitations, there are more conditions for which proxies may be solicited without enough explanation for investors to cast votes, so the Court held that private enforcement was a necessary supplement to SEC action to enforce proxy rules.[141]

Unlike proxy statements, there are other sources of information that can reveal the content included in Item 303 disclosures, such as analyst reports, financial news, and macroeconomic trends. Therefore, the argument cannot be made that private enforcement is a necessary supplement to the SEC's enforcement authority pertaining to its reporting requirements. In fact, the Court's choice to stop liberally implying private rights of action in *Blue Chip Stamps* was due to the threat of frivolous litigation interrupting typical business activities if expansive private rights were permitted. Thus, if private enforcement of Item 303 were allowed, companies would be incentivized to disclose even immaterial and unnecessary information, which would be overwhelming to investors, yet seen as necessary for companies to avoid massive liability.

Even more troubling, private enforcement of the SEC's reporting requirements would encourage "fraud by hindsight" litigation.[142] Item 303

---

139. 377 U.S. 426, 433 (1964). At that time, courts liberally implied private rights of action, reasoning such actions as necessary to supplement the SEC's enforcement authority.

140. *Id.* at 432.

141. *Id.* at 431–32.

142. Cox, *supra* note 11, at 688–89.

claims, by their very nature, would require a hindsight analysis of forward-looking information. This means that if negative results occur and a plaintiff decides to sue, they can look back in time and allege that the company had enough information to identify a trend or uncertainty that would have predicted a particular current result. As private litigation is expensive and time consuming, permitting a violation of Item 303 to create a duty to disclose under Rule 10b-5 could open the floodgates to meritless lawsuits brought by disgruntled shareholders and professional plaintiffs. Accordingly, public policy considerations support the proposition that violations of Item 303 are not actionable under Rule 10b-5.

IV. JUDICIAL AND ADMINISTRATIVE MEANS TO ENSURE THAT VIOLATIONS OF ITEM 303 ARE NOT ACTIONABLE UNDER SECTION 10(B) AND RULE 10B-5

Because Rule 10b-5 is not a surrogate for enforcing the SEC's registration requirements, does not establish an affirmative disclose duty, and is subject to a higher materiality threshold, Item 303 can never establish an actionable duty to disclose under Rule 10b-5 regardless of whether an omission satisfies *Basic*'s test for materiality. To carry out this proposition, two solutions are suggested. First, courts should exercise judicial restraint and adopt the Ninth Circuit's holding in *Cohen v. NVIDIA Corp.* that violations of Item 303 cannot establish a duty to disclose under Rule 10b-5. Second, the SEC should amend Rule 3b-6 to establish that an omission of information required by Item 303 shall not be deemed fraudulent for purposes of Rule 10b-5.

A. *Judicial Adoption of the Ninth Circuit's Approach*

If this issue comes before the Supreme Court again, it should expressly hold that a failure to disclose under Item 303 cannot establish a disclosure obligation under Rule 10b-5. In doing so, the Court should make clear that it is not the judiciary's job to expand private rights of action under the federal securities laws. Doing so would help close the door against the frivolous litigation Congress is most concerned with when individuals have expansive rights to sue. In addition, other Circuit Courts of Appeals should similarly adopt the Ninth Circuit's approach.

In doing so, courts should rely on the following reasons for determining that a failure to disclose under Item 303 is not actionable under Section 10(b) and Rule 10b-5. First, it is Congress's decision whether to expand private

actions for Congress to decide. Second, the duty to disclose under Item 303 is much broader than the disclosure duties under Section 10(b) and Rule 10b-5. Third, the materiality standard under Item 303 is much less stringent than the test for materiality under Rule 10b-5. Fourth, it would be counter to public policy if private plaintiffs could sue companies for violations of Item 303, as that regulation is enforceable only by the SEC.

B. *Establishing A Safe Harbor Provision*[143]

While courts should expressly hold that a violation of Item 303 cannot establish a duty to disclose under Rule 10b-5, perfect harmony in this area of federal securities regulation cannot be achieved unless the SEC also weighs in. Already, Instruction 7 to Item 303 makes clear that "forward-looking information," such as financial projections, that are disclosed under Item 303 are within the safe harbor provision of Rule 3b-6(b)(1).[144] However, it is unclear whether Instruction 7 includes historically "known trends or uncertainties" within the safe harbor.

Nevertheless, to fill this gap and be consistent with the PSLRA's attempt to restrict the expansion of liability under Rule 10b-5, the SEC should provide updated guidance making clear that violations of Item 303 are not actionable "fraudulent statements" under Rule 10b-5. To do so, the SEC should amend Rule 3b-6 by adding a subsection (d), which could track the language of subsection (b). Subsection (b) states that Rule 3b-6's safe harbor provisions apply to *statements*.[145] Adding a subsection (d) to provide a safe harbor for particular *omissions* would be consistent with both the legislative intent of the PSLRA of 1995 and the Supreme Court's reluctance to expand the scope of liability for purposes of Section 10(b) and Rule 10b-5.

---

143. *See* Appendix 1.

144. 17 C.F.R. § 229.303, Instruction 7 (2021). Rule 3b-6 establishes a safe harbor for forward looking statements in documents filed with the SEC. *See* 17 C.F.R. § 240.3b-6 (2021).

145. *See* 17 C.F.R. § 240.3b-6 (2021).

The SEC should begin by renaming Rule 3b-6 as "Liability for Certain Statements [and Omissions] by Issuers." Then, it could add a subsection (d), stating as follows:

> "(d) Unless otherwise provided, this rule applies to the following omissions:
>
> (1) All omissions of information required to be disclosed under 17 C.F.R. § 229.303 (Item 303 of Regulation S-K) from documents filed with the Commission."

By amending the Section 3b-6 safe harbor in this manner, the SEC could later determine other instances where omissions should not be deemed "fraudulent statements," and incorporate them into a list under a Section 3b-6(d). While the scope of this potential change is dramatic in the sense that it effectively eliminates the line of precedent established by the Second Circuit, this safe harbor is consistent with the PSLRA. It conforms to the principle that liability for pure omissions cannot be imposed under Rule 10b-5, absent a duty to disclose, while still permitting the SEC to enforce Regulation S-K through cease-and-desist orders.

V. CONCLUSION

After the Supreme Court was unable to answer whether a violation of Item 303's reporting requirements can establish an actionable duty to disclose under Rule 10b-5, that very issue is still alive and controversial. With the Second Circuit holding that the failure to disclosure information required by Item 303 can establish such a duty under Rule 10b-5 and the Ninth Circuit holding otherwise, there is a lack of uniformity in this area of the law. The Ninth Circuit has correctly decided this issue for several reasons. First, the Supreme Court and Congress disfavor the expansion of implied private rights of action under the federal securities laws. Second, Rule 10b-5 imposes no duty to disclose information unless necessary to make an affirmative statement not misleading. Third, the materiality threshold for Item 303's reporting requirements is far less stringent than the threshold under Rule 10b-5. Lastly, permitting a violation of Item 303 to establish a duty to disclose under Rule 10b-5 is counter to the public policy of permitting effective disclosure regulation by the SEC and preventing hindsight-driven litigation. Consequently, this Note suggests that courts exercise judicial restraint and adopt the Ninth Circuit's holding that a failure to disclosure under Item 303 cannot establish a duty to disclose under Rule 10b-5. Additionally, the SEC should establish a safe harbor rule making clear that pure omissions shall not be deemed fraudulent for purposes of Rule 10b-5.

Appendix

This Note suggests that the SEC amend Rule 3b-6 to add the bracketed language:

"Rule 3b-6. Liability for Certain Statements [and Omissions] by Issuers

. . .

[(d) Unless otherwise provided, this rule applies to the following omissions:

(1) Omissions of information required to be disclosed under 17 C.F.R. § 229.303 (Item 303 of Regulation S-K) from documents filed with the Commission.

. . . .]"

RECENT ARBITRATION AWARDS

Melanie Cherdack, Esq. and Sara Hanley, Esq.

This issue's featured arbitration awards include a mixed bag of awards covering many investments, strategies and claims. The largest award, in excess of $26 million, was based on a market manipulation counterclaim. That outsize award was rendered based on an "adverse inference" against the Claimant/Counter-Respondent as a result of a series of discovery sanctions. Two awards gave substantial attorney's fees, a recent UBS YES award granting $965,657.33 attorney's fees under the Texas Securities Act, and another awarding $660,500 in attorney's fees under Arizona law. A third award based on a failure to execute claim gave attorney's fees under the Texas Civil Code. Two panels awarded damages under the well managed account theory. Finally, included is a favorable award for Claimants who alleged that their brokerage firm's trading platform's inadequate infrastructure prevented them from selling their GameStop position. These varied claims, securities and results are emblematic of the hodgepodge of recent cases going to hearing.

Clinton Anderson v. Morgan Stanley and Blair Louis Horne
Case No. 20-03312
Hearing Dates: March 23-24, 2022
Dallas, TX
Award Date: April 13, 2022
Counsel:
Counsel for Claimant:
Christopher W. Patton, Esq., Lynn Pinker Hurst & Schwegmann, L.L.P.
Counsel for Respondent:
John Bersin, Esq., Morgan Stanley, Roseville, California
Arbitration Panel:
Lawrence R. Maxwell, Jr., Presiding Chairperson, Andrea U. Calve, Public Arbitrator, Will Pryor, Public Arbitrator
Investments at Issue:
The causes of action relate to Respondents' failure to liquidate Claimant's expiring option position in Sabre stock (SABR) in a timely fashion after Claimant requested that the financial advisor exit the position.

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Fraud
(2) Breach of contract
(3) Negligence
(4) Breach of fiduciary duty
(5) Fraud by non-disclose
(6) Negligent misrepresentation

Relief Requested:

(1) Damages in excess of $317,788.98;
(2) Pre- and post-judgment interest;
(3) Reasonable attorney's fees;
(4) Costs; and
(5) Such other and further relief both special and general, at law or in equity, to which Claimant may show himself to be justly entitled.

Award

(1) Respondents are jointly and severally liable for and shall pay to Claimant the sum of $161,810.00 in compensatory damages.
(2) Respondents are jointly and severally liable for and shall pay to Claimant pre-award interest on the above-stated sum at the rate of 5% per annum from February 28, 2020, through and including the date of the award.
(3) Respondents are jointly and severally liable for and shall pay to Claimant post-award interest on the above-stated sum in #1 at the rate of 10% per annum from 10 days after the date of award through and including the date the award is paid in full.
(4) Respondents are jointly and severally liable for and shall pay to Claimant the sum of $50,000.00 in attorneys' fees pursuant to Section 38.001 of the Tex. Civ. Prac. & Rem. Code.
(5) Horne's request for expungement of the above-captioned arbitration (Occurrence Number 2066346) from registration records maintained by the CRD is denied.
(6) Any and all claims for relief not specifically addressed herein, including any requests for punitive damages and treble damages, are denied.

Analysis:

This Dallas based arbitration panel awarded Claimant almost half of the compensatory damages sought for the broker's failure to execute orders by the client to liquidate an expiring option position. In so doing, the panel awarded both pre- and post-judgment interest as well as statutory attorneys' fees under a Texas Statute which provides for such fees in breach of contract and other

commercial cases. The panel arguably agreed that Claimant's contract with Morgan Stanley entitled Claimant to attorney's fees under a Texas Statute allowing the imposition of such fees on the losing party to a breach of contract action.

Chad Durrance and Leslie Durrance v. Charles Schwab & Co., Inc.
Case No. 21-01181
Hearing Dates: March 22-25, 2022
Tampa, FL
Award Date: April 11, 2022
Counsel:
Counsel For Claimants:
Daniel P. Dietrich, Esq. and William J. Schifino, Jr., Esq., Gunster, Yoakley & Stewart, P.A., Tampa, Florida.
Counsel for Respondent:
Andrew J. Melnick, Esq. and Alexandra J. Marinzel, Esq., McGonigle, P.C., New York, New York
Arbitration Panel:
Jacquelyn M. Shannon, Presiding Chairperson, Philip L. Manczak, Public Arbitrator, James R. Augustine, Non-Public Arbitrator
Investments at Issue:
The causes of action relate to Respondent's failure to maintain an adequate infrastructure and trading platform preventing Claimants from entering orders to sell Claimants' entire GameStop Corporation ("GME") position; failure to timely place Claimants' trades; failure to provide proper support and resources; inadequate risk management system or controls; and failure to satisfy industry standards.
Claimants' Claims:
Causes of Action in Statement of Claim:
(1) Negligence
(2) Breach of contract and covenant of good faith and fair dealing
(3) Negligence
(4) Breach of fiduciary duty
Relief Requested:
(1) Compensatory damages including the profit that Respondent prevented Claimants from realizing;
(2) Punitive damages;
(3) Interest;
(4) Attorney's fees; and
(5) Any other relief the Panel deemed necessary or proper.

Relief Requested Post Hearing:

(1) Attorneys' fees in the amount of $174,931;
(2) Costs (including expert costs) in the amount of $23,708.

Other Motions Decided at Hearing:

Respondent orally moved for a directed verdict based on Claimants' alleged failure to prove they were entitled to relief, which the Panel denied.

Award

(1) Respondent is liable for and shall pay to Claimants the sum of $214,640.00 in compensatory damages.
(2) 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 of interest as the panel ruled in favor of Claimants in a GameStop ("GSE") related claim. The claims centered on Charles Schwab's trading platform's inadequate infrastructure which allegedly prevented Claimants from selling their GSE position. This award is significant in that many investors were shut out of trading in their GSE stock in 2021, the year this arbitration was filed. It will be interesting to see if future panels hold similarly based upon technology failures and inadequate infrastructure allegations.

Dong Fang, Xingxian Li, Qixu Wang and Jingxue Zhang v. Interactive Brokers, LLC

Case No. 19-02782
Seattle, Washington
Hearing Dates: March 21 - 25, 2022 and March 28 - April 1, 2022
Award Date: April 6, 2022
Counsel:

Counsel for Claimants:

Robert C. Rosen, Esq., John B. Wallace, Esq. and Sharan Ramchandani, Esq., Rosen & Associates, P.C., Los Angeles, California

Counsel for Respondent:

Daniel A. Spector, Esq. and Jason O. Billy, Esq., Interactive Brokers LLC, Washington, District of Columbia

Arbitration Panel:

Jonathan H. Krotinger, Presiding Chairperson, Helen Marinak Blohm, Public Arbitrator, Katherine Hendricks, Public Arbitrator

Investments at Issue:

Yangtze River Port and Logistics Limited stock

Claimants' Claims:

Causes of Action in Amended Statement of Claim:

(1) Breach of written contract
(2) Breach of implied covenant of good faith and fair dealing
(3) Negligence
(4) Professional negligence
(5) Breach of fiduciary duty
(6) Declaratory relief
(7) Violation of Cal. Civ. Code § 1632
(8) Elder abuse
(9) Conversion
(10) Unjust enrichment

Causes of Action in Respondent's Counterclaim:

(1) Common law fraud
(2) Conspiracy to commit fraud
(3) Aiding and abetting fraud
(4) Federal securities fraud
(5) Breach of contract

Relief Requested:

In the Amended Statement of Claim, Claimants requested:

(1) All contract and compensatory damages, including damages based on Cal. Civ. Code § 3300 et. seq.;
(2) Punitive and exemplary damages based on Cal. Civ. Code § 3294 in an amount sufficient to punish and deter Respondent;
(3) Reasonable attorneys' fees and costs of suit based on Cal. Civ. Code § 1717;
(4) All equitable remedies and relief, which includes declaratory and injunctive relief as follows: reforming the Customer Agreement consistent with the relief requested in this Statement of Claim;
(5) Treble damages under Cal. Civ. Code § 3345;
(6) Double damages under Cal. Probate Code § 859;
(7) Pre-judgment interest on all sums due from the first date on which each amount becomes due at the maximum legal rate;
(8) Respondent's affirmative claims for relief to be dismissed with prejudice and/or denied;
(9) Broad discovery rights; and
(10) Such other and further relief as the Panel deems just and proper.

In the Counterclaim Respondent requests:

(1) Claimants' claims be denied;
(2) Respondent's counterclaim be granted, with damages in an amount to be determined at the hearing.

In Claimants' Answer to the Counterclaim, Claimants requested:

(1) Respondent take nothing against any and all Claimants;
(2) Respondent's counterclaim be dismissed with prejudice and all relief requested by Respondent therein be denied;
(3) Reasonable attorneys' fees based on Respondent's request and statutory reciprocity; and
(4) Such other and further relief as the Panel deems just, equitable and proper.

Relief Requested Post Hearing:

Claimants requested:

(1) A total of $5,693,802.00 comprised of $575,889.00 for Dong Fang; $1,570,540.00 for Jingxue Zhang; $1,419,493.00 for Xingxian Li; $229,279.00 for Qixu Wang; and attorneys' fees in the amount of $1,897,601.00.
(2) Claimants also filed an alternative damages request on behalf of Jingxue Zhang, Xingxian Li and Qixu Wang only, along with attorneys' fees of $1,207,242.00 for a grand total of $4,426,554.00.

Respondents requested:

(1) Compensatory damages in the amount of $26,771,816.00 against all Claimants jointly and severally.

Award:

(1) Claimants' claims are denied in their entirety.
(2) Claimants are jointly and severally liable for and shall pay to Respondent the sum of $26,771,816.00 in compensatory damages.
(3) Any and all claims for relief not specifically addressed herein, including any requests for punitive damages, treble damages, and attorneys' fees, are denied.

Analysis:

This large $26 million award appears to be generally based on Claimants' discovery abuses. Following the panels' $5,000 a day sanction order, Claimants were cautioned by the Panel that if Claimants failed to fully comply, the Panel reserved the right to impose further sanctions, including (a) precluding Claimants from presenting evidence, (b) making one or more adverse inferences against Claimants and/or (c) dismissal of Claimants' Claims and/or defenses.

During the course of the evidentiary hearings, the Panel noted Claimants' failure to produce documents subject to its discovery orders. The Panel imposed further sanctions in the nature of an adverse inference such that the burden of proof was shifted to Claimants to disprove their participation in a stock manipulation conspiracy alleged in Respondent's counterclaim. Ultimately, the Panel awarded Respondent the full amount of compensatory damages sought by Respondent's Counterclaim and denied Claimants claims in their entirety.

John Oren and Elise Oren v. UBS Financial Services, Inc.
Case No.: 20-03856
Houston, Texas
Hearing Dates: March 15-18, 2022 and March 28-31, 2022
Award Date: May 5, 2022
Counsel:
Counsel for Claimants:
Jeffrey Erez, Esq. Erez Law, PLLC, Miami, Florida
Counsel for Respondent:
Rebecca K. Lindahl, Katten, Muchin, Rosenman, LLC Charlotte, North Carolina
Arbitration Panel:
Brian James Tagtmeier, Public Arbitrator, David Aaron DeSoto, Public Arbitrator, Nile Bailey Copeland, Public Arbitrator
Investments at Issue:
UBS- Yield Enhancement Strategy
Claimants' Claims:
Causes of Action in Statement of Claim:
(1) Breach of Fiduciary duty
(2) Negligence
(3) Negligent supervision
(4) Fraud
(5) Breach of contract
(6) Violation of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934
(7) Violation of the Texas Securities Act
Relief Requested:
(1) Damages between $1,000,000 and $5,000,000;
(2) Punitive damages;
(3) Interest;
(4) Costs;

(5) Attorney's fees; and
(6) Such other and further relief as the Panel deems just and proper

Relief Requested Post Hearing:

(1) Damages in a range of $2,272,227.00 (consisting of net out-of-pocket damages of $2,016,045.00 plus $255,182.00 in pre-judgment interest) to $2,896,972.00 (consisting of $2,571,485.00 benefit of the bargain damages, plus $325,487.00 in pre-judgment interest); and
(2) $2,304,038.00 pursuant to Texas Securities Act for damages/simple interest.

Award:

(1) Respondent is liable for and shall pay to Claimants the sum of $2,896,972.00 in compensatory damages.
(2) Respondent is liable for and shall pay to Claimants the sum of $965,657.33 in attorneys' fees pursuant to the Texas Securities Act.
(3) Any and all claims for relief not specifically addressed herein, including any requests for punitive damages and treble damages, are denied.

Analysis:

This recent UBS YES award is noteworthy because Claimants received full benefit of the bargain damages and pre-judgment interest, plus statutory attorneys' fees. Furthermore, of the $28,000.00 in total hearing session fees, the Panel assessed $24,500.00 to Respondent. This is a particularly favorable result for the Claimants given that UBS YES cases have gone to hearing with mixed results.

Nancy Mailhot, Ivan Mailhot, Nacy Mailhot, IRA, Ivan Mailhot, IRA v. First Allied Securities, Inc., National Planning Corporation, SagePoint Financial, Inc. [1]

Case No.: 18-01349
Phoenix, Arizona
Hearing Dates: February 14 – 18, 2022 and February 21- 24, 2022
Award Date: March 11, 2022
Counsel:
Counsel for Claimants:
Gary S. Menzer, Esq. and Michael S. Hill, Esq., Menzer & Hill, P.A., Boca Raton, Florida
Counsel for Respondent:
For Respondent First Allied Securities, Inc. Edwin A. Barkel, Esq., Lewis Roca Rothgerber Christie LLP, Phoenix Arizona, for Respondent National Planning Corporation, Chad Weaver, Esq., Freeman Mathis & Gary, LLP, Seal Beach, California, and for Respondent SagePoint Financial, Inc., Greg Curley, Esq., Advisor Group, Inc., Jersey City, New Jersey.
Arbitration Panel:
Edwin J. Buckley, Presiding Chairperson, Harold J. Merkow, Public Arbitrator, Ronald Dean Mayes, Public Arbitrator
Investments at Issue:
Ridgewood Energy; Griffin Capital Essential; Griffin-American Healthcare REIT III; American Realty Capital Healthcare Trust II; Hospitality Investors Trust, Inc,; Global Net REIT; Northstar Healthcare Income, Inc.; Cole Capital; UIT Advisors Bond Fund; Metlife Annuity; Midland Annuity; Jackson Life Annuity; and AXA Annuity.
Claimants' Claims:
Causes of Action in Statement of Claim:
(1) Negligence and gross negligence
(2) Misrepresentation
(3) Omission of a material fact
(4) Failure to supervise
(5) Breach of fiduciary duty
(6) Breach of contract

---

1. A motion to vacate this award was filed by the Respondent, First Allied. *See First Allied Securities Inc. v. Nancy Mailhot, Ivan Mailhot, Nancy Mailhot IRA and Ivan Mailhot IRA*, Arizona Superior Court in and for Maricopa County, Case No. CV2022-004515.

Relief Requested:

(1) Compensatory damages of approximately $1,000,000;
(2) Statutory damages pursuant to the Arizona Securities Act, including recission damages, lost opportunity damages, accrued statutory interest, and attorneys' fees;
(3) Costs;
(4) Punitive damages;
(5) Filing and hearing fees; and
(6) Other remedies the Panel deems proper and appropriate.

Relief Requested Post Hearing:

(1) Compensatory damages in the amount of $1,143,030.00;
(2) Market adjusted damages in the amount of $818,470.00;
(3) Costs in the amount of $40,000.00; and
(4) Attorneys' fees in the amount of $660,495.00.

Award:

(1) First Allied is liable for and shall pay to Claimants the sum of $1,961,500.00 in compensatory damages.
(2) First Allied is liable for and shall pay to Claimants the sum of $40,000.00 in costs.
(3) First Allied is liable for and shall pay to Claimants the sum of $660,500 in attorneys' fees pursuant to Arizona contract law.
(4) First Allied is liable for and shall pay to Claimants the sum of $425.00 to reimburse Claimants for the non-refundable portion of the filing fee previously paid to FINRA Dispute Resolution Services.
(5) First Allied's request on behalf of Unnamed Party Travis G. Blaser for expungement of the above-captioned arbitration from registration records maintained by the CRD is denied.
(6) First Allied's request on behalf of Unnamed Party Ronald Reed McCook for expungement of the above-captioned arbitration for registration records maintained by the CRD is denied.
(7) Any and all claims for relief not specifically addressed herein, including any requests for punitive damages, are denied.

Analysis:

This award is helpful to practitioners advancing market adjusted damage theories through an expert witness. Following Claimants' voluntary dismissal of the claims against National Planning Corporation and Sagepoint Financial, Inc., the final hearings proceeded solely against First Allied. First Allied filed a Motion in Limine to Exclude the expert report of Craig McCann. During the recorded evidentiary hearings, the Panel denied First Allied's Motion in Limine. The Panel awarded Claimants the full amount of compensatory damages, including market adjusted damages. The Panel also awarded

Claimants all of the costs sought as well as the full amount of attorneys' fees, $660,500, pursuant to "Arizona contract law."

Patrick David Ridgeway v. UBS Financial Services Inc.
Case No. 21-00312
Jackson, Mississippi
Hearing Dates: January 31 – February 5, 2022
Award Date: February 16, 2022
Counsel:
Counsel for Claimant:
Lance McCardle Esq., Jason Burge, Esq., and Lara Richards, Esq., Fishman Haygood, LLP, New Orleans, Louisiana.
Counsel for Respondent:
Carl S. Burkhalter, Esq., Maynard Cooper & Gale, PC, Birmingham, Alabama.
Arbitration Panel:
Stuart K. Furman, Presiding Chairperson, Alan E. Linden, Public Arbitrator, John G. Sciandra, Public Arbitrator
Investments at Issue:
The causes of action related to Claimant's investments in Respondent's managed accounts, as well as a high balance credit line collateralized with the securities held in his managed accounts.
Claimant's Claims:
Causes of Action in Statement of Claim:
(1) Breach of fiduciary duty
(2) Misrepresentation and non-disclosure
(3) Negligence and gross negligence
(4) Breach of contract and warranties
(5) Violations of Mississippi Securities Act
(6) Failure to supervise
(7) And control person liability
Relief Requested:
(1) Compensatory damages in an unspecified amount;
(2) Attorney's fees, cost and expenses;
(3) Exemplary, punitive, or treble damages and other penalties as allowed by law;
(4) Pre- and post-award interest; and
(5) And for all other sums that Claimant is entitled to at law or equity.

Relief Requested Post Hearing:

(1) At the hearing, Claimant requested damages ranging from $1,278,000.00 to $2,526,000.00.

Award:

(1) Respondent is liable for and shall pay to Claimant the sum of $1,100,000.00 in compensatory damages.
(2) Respondent is liable for and shall pay to Claimant interest on the above-stated sum at the prevailing Federal prime rate at date of filing plus 1% per annum from the date of filing Claimant's Statement of Claim through final payment of the award.
(3) Any and all claims for relief not specifically addressed herein, including any requests for punitive damages, treble damages and attorney's fees, are denied.

Analysis:

This case is noteworthy because the panel awarded Claimant $1.1 million in compensatory damages based upon a well-managed portfolio measure. Respondent managed the Claimant's discretionary account using a strategy involving high leverage. The accounts, which had been underperforming for a few years, were subject to a margin call in March 2020, at the outset of Covid-19 pandemic. Even though Respondent claimed that the Claimant had suffered little to no actual out-of-pocket losses during the period that they managed the account, the panel rejected the argument, finding Respondent liable for the Claimant's damages.

CASES & MATERIALS

Jason Burge and Tad Bartlett

In an 8-1 decision, the U.S. Supreme Court holds that a federal court does not look through an application to confirm, vacate, or modify an arbitral award to the underlying substantive controversy to determine jurisdiction, but only looks to the application submitted to the court.

Badgerow v. Walters, 142 S. Ct. 1310 (March 31, 2022):

While the Federal Arbitration Act provides the authority for a federal court to compel arbitration under § 4 of the FAA or to confirm or vacate an arbitral award under §§ 9 and 10 of the FAA, it does not provide federal jurisdiction, which must instead be independently established. With regard to a petition to compel arbitration under § 4, the Supreme Court held in 2009 that a federal court may look through the petition to the underlying dispute to determine if that underlying dispute is one over which the court may exercise jurisdiction; "[t]hat is so regardless whether the petition alone could establish the court's jurisdiction." *See Vaden v. Discover Bank*, 556 U.S. 49 (2009). In *Badgerow*, the Court examined the related issue of whether a similar "look-through" approach could be applied to the jurisdictional question for an application to confirm or vacate an arbitral award under §§ 9 and 10.

The Court held that the look-through approach may not be applied to applications to confirm or vacate an arbitral award. "Those sections lack Section 4's distinctive language directing a look-through, on which *Vaden* rested." 142 S. Ct. at 1314. The underlying dispute involved an employee's claims that she was improperly fired from her employment as a financial advisor for a firm run by the defendants. Because there was an arbitration clause applicable to her dispute in her employment agreement, she brought her claims in an arbitration. The arbitrators sided with the employer. Claiming fraud had tainted the arbitral proceeding, the former employee sued in Louisiana state court to vacate the arbitral award, which suit was then removed to federal court. The federal district court denied the employee's motion to remand, on the basis that a look-through to the underlying dispute showed that the underlying employment dispute raised federal-law claims. The district court then granted the employer's application to confirm the arbitral award upon finding that no fraud tainted the arbitral proceeding. The U.S. Fifth Circuit Court of Appeals affirmed. *See* 975 F.3d 469, 472-74 (5th Cir. 2020).

The Supreme Court reversed. It held that the look-through holding in *Vaden* was dependent on the particular language in § 4 of the FAA. "Under Section 4, a party to an arbitration agreement may petition for an order to compel arbitration in a 'United States district court which, save for [the arbitration] agreement, would have jurisdiction' over 'the controversy between the parties.'" The Court then noted that §§ 9 and 10 do not have similar operative language: "Most notably, those provisions do not have Section 4's 'save for' clause. They do not instruct a court to imagine a world without an arbitration agreement, and to ask whether it would then have jurisdiction over the parties' dispute. … So under ordinary principles of statutory construction, the look-through method for assessing jurisdiction should not apply." The Court refused to expand jurisdiction "by judicial decree" by importing the look-through provision from § 4 into the jurisdictional analysis for applications under §§ 9 and 10. The Court also rejected the defendant's (and the dissent's) call to impose a single jurisdictional analysis—look-through method—on all FAA actions as an easy-to-apply judicial standard. "However the pros and cons shake out, Congress has made its call. We will not impose uniformity on the statute's non-uniform jurisdictional rules."

The Supreme Court holds that ERISA plan fiduciaries can breach their fiduciary duties by offering imprudent unreasonably high-cost investment options even when they also offer plan participants lower cost alternatives.

Hughes v. Northwestern University, 142 S. Ct. 737 (January 24, 2022):

ERISA administrators have a fiduciary duty to plan participants, requiring that they discharge their duties "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." 29 U.S.C. § 1104(a)(1)(B). Included in that duty of prudence is a continuing duty of some kind to monitor the investment options offered to plan participants and to "remove imprudent ones." *Tibble v. Edison Int'l*, 575 U.S. 523, 530 (2015). The issue in *Hughes* was whether plan fiduciaries violated their fiduciaries duties where plan participants were offered prudent options alongside imprudent options, and the plan participants made the final choice.

Northwestern offered a defined-contribution plan to its employees. 142 S.Ct. at 740. Each participant maintained an individual investment account and could choose how to invest her funds from a menu of options selected by the

plan administrators. *Id.* Each investment option, such as a mutual fund or index fund, carried a management fee and a recordkeeping fee. *Id.* The plaintiffs argued that the defendant plan administrators violated their fiduciary duties in three ways: by failing to monitor and control the recordkeeping fees, resulting in unreasonably high costs; by offering a number of mutual funds in "retail" share classes that carried higher management fees than identical "institutional" class funds; and by offering too many investment options—over 400 in total—that caused confusion and poor decisions. *Id.*

The district court granted a motion to dismiss the complaint, and the Seventh Circuit affirmed. *Divane v. Nw. Univ.*, 953 F.3d 980 (7th Cir. 2020). The Seventh Circuit held in particular that allegations that some of the offered investment options had higher "retail fees," "unnecessary layers of fees," or could have been cheaper had the administrators negotiated better fees were insufficient to state a claim, because other options that met the plaintiffs' objectives were available. *Id.* at 991. The Seventh Circuit held that the fact that hundreds of options were offered made "a claim of imprudence less plausible" and "eliminat[ed] any claim that plan participants were forced to stomach an unappetizing menu." *Id.* at 991-92.

The Supreme Court reversed. The Court held that the Seventh Circuit ignored the plan administrators' duties to monitor the plan's offerings and "remove imprudent investments from the Plans' offerings." 142 S.Ct. at 741. The Court noted that even "where participants choose their investments, plan fiduciaries are required to conduct their own independent evaluation to determine which investments may be prudently included in the plan's menu of options." *Id.* at 742. Failing to "remove an imprudent investment from the plan within a reasonable period of time" is a breach of the plan administrator's fiduciary duty of prudence. *Id.* The Court noted that courts "must give due regard to the range of reasonable judgments a fiduciary may make based on her experience and expertise," but held that fiduciaries cannot satisfy their duty of prudence by foisting responsibility on to plan participants to ferret out appropriate investments from a vast array that includes imprudent investments. *Id.*

The Sixth Circuit holds that a mandatory arbitration clause in an employment agreement will not force arbitration of ERISA claims for breaches of fiduciary duty by plan administrators.

Hawkins v. Cintas Corp., --- F.4th ----, 2022 WL 1236954 (6th Cir. April 27, 2022).

Two retired employees brought a class action suit against their former employer, Cintas, alleging that the company and affiliated plan administrators had breached their fiduciary duties to the company's defined contribution retirement plan by offering participants only higher cost actively managed funds and charging excessive recordkeeping fees. The employer sought to compel individual arbitration of the employees' claims pursuant to arbitration and class action waiver provisions in the employee's employment agreements, which provided in relevant part:

> The rights and claims of Employee covered by this Section 8, including the arbitration provisions below, specifically include but are not limited to all of Employee's rights or claims arising out of or in any way related to Employee's employment with Employer, such as rights or claims arising under … the Employee Retirement Income Security Act. … [T]he impartial arbitration proceeding, as provided above in this Section 8, will be the exclusive, final and binding method of resolving any and all disputes between Employer and Employee. … Employee and Employer agree that each will not assert class action or representative action claims against the other in arbitration or otherwise; and Employee and Employer shall only submit their own, individual claims in arbitration and will not seek to represent the interests of any other person.

The Sixth Circuit found that, despite the broad arbitration provision which specifically referenced ERISA claims, the plaintiffs' breach of fiduciary duty claims were not subject to arbitration. It started by noting that an ERISA fiduciary duty claim is brought pursuant to Section 502(a)(2) of ERISA, and are "brought in a representative capacity on behalf of the plan as a whole." *Mass. Mut. Life Ins. Co. v. Russell*, 473 U.S. 134 (1985). The relevant fiduciary relationship is "between the fiduciary and the plan, not the fiduciary and the plaintiff." "§ 502(a)(2) merely codifies for ERISA participants and beneficiaries a classic trust-law process for recovering trust losses through a suit on behalf of the trust." *Graden v. Conexant Systems Inc.*, 496 F.3d 291, 296 (3d. Cir. 2007). The Sixth Circuit concluded that although ERISA allows § 502(a)(2) claims to be brought by individual plaintiffs, it is the plan that takes legal claim to the recovery, suggesting that the claim really "belongs" to the

Plan. Because § 502(a)(2) claims "belong" to the Plan, an arbitration agreement that binds only individual participants cannot bring such claims into arbitration.

Cintas sought to argue that claims by plaintiffs with defined-contribution plans should be treated differently because "any relief that the participant obtains depends on the value of her individual account and redounds entirely to her." The Sixth Circuit rejected this argument, holding that the fact that the individual Plaintiffs will indirectly benefit from a remedy accruing to the Plan as a whole does not render the claims individualized. The Sixth Circuit noted that the plaintiff's allegations of fiduciary breaches through offering higher-cost investment options and charging excessive recordkeeping fees "do not impact the Plaintiffs specifically; the harm (and the recovery) is to the Plan."

Finally, the Sixth Circuit held that even if the arbitration provision would apply to the Plaintiff's claim, compelling arbitration of a § 502(a)(2) breach of fiduciary duty claim would still be improper absent Plan consent. The Sixth Circuit found no authority suggesting that "individuals can consent to arbitration without the consent of the Plan," which would amount to an individual releasing a plan's right to recovery. The Sixth Circuit did note that there was no arbitration provision in the Plan's documents and expressed no opinion about whether an arbitration provision in the plan documents could subject § 502(a)(2) claims to arbitration.

The Fifth Circuit holds than an arbitration "has been had" for purposes of § 3 of the Federal Arbitration Act when an arbitration is terminated for non-payment of arbitration fees by one of the parties, allowing the stay of litigation to be lifted.

Noble Capital Fund Management, L.L.C. v. US Capital Global Investment Management, L.L.C., 31 F.4th 333, 2022 WL 1099006 (5th Cir. April 13, 2022):

Under § 3 of the Federal Arbitration Act, where an issue is subject to arbitration under an arbitration agreement between parties, the court shall "stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement." 9 U.S.C. § 3. In this case arising from a dispute regarding a joint real estate venture, the plaintiffs and defendants entered into two agreements with enforceable arbitration clauses. The first was a Limited Partnership Agreement between two Feeder Funds established and funded by Noble Capital Fund Management and US Capital Global Investment Management to establish the US Capital/Noble Capital Texas Real Estate Income Fund ("the Fund"), whereby US Capital would be the general partner

of the fund. The second agreement was a Management Advisory Services Agreement, between Noble, US Capital, and the Fund, in which Noble was obligated to make investments for the Fund.

In 2019, Noble and the feeder funds it established initiated a JAMS arbitration against US Capital, alleging that US Capital committed fraud and mismanagement, and that it had attempted to take Noble's client network. Contemporaneously, the Fund sued Noble in federal court in California, which was stayed and consolidated with the JAMS arbitration. The JAMS arbitrator entered an emergency order enjoining the Fund from using the Fund's money to pursue the litigation or an outside investigation into Noble. A subsequent order by the JAMS panel placed a freeze on the Fund's assets. The Fund then claimed it could not pay its share of the JAMS expenses because of the freeze. Neither Noble nor US Capital paid the Fund's share of expenses, and JAMS terminated the arbitration pursuant to the JAMS Comprehensive Arbitration Rules and Procedures, which rules had been expressly invoked in the parties' arbitration agreements, and which allowed JAMS the right to terminate arbitration proceedings upon the nonpayment of fees by any party.

Noble and the feeder funds then sued US Capital in Texas state court, which was removed to federal court. US Capital moved to stay the proceedings and compel arbitration once more, or to transfer the venue to California federal court, which motion was denied by the district court. The Fifth Circuit noted that the issue is "whether arbitration has been had and the parties may now pursue their claims in court." Noting that it was aligned with determination of the similar issue by the 9th, 10th, and 11th circuits, the Court held, "Following the lead of our sister circuits, we conclude that arbitration 'has been had.' Even though the arbitration did not reach the final merits and was instead terminated because of a party's failure to pay its JAMS fees, the parties still exercised their contractual right to arbitrate prior to judicial resolution in accordance with the terms of their agreements." Rejecting US Capital's argument that the reason for the termination of arbitration should be relevant, the Court noted that "the statute does not ask why the arbitration terminated and thus the inquiry over whether the arbitration 'has been had' does not require us to examine the cause of the arbitration's termination, only that arbitration has been had in accordance with the terms of the agreement."

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.

(This page intentionally left blank)

The following Comment Letter regarding *FINRA Regulatory Notice 22-09: FINRA Proposed Rule to Accelerate Processing of Arbitration Proceedings for Seriously Ill or Elderly Parties* was submitted to FINRA by Michael Edmiston on May 16, 2022. (prepared with the assistance of Robert Girard and Dayton Haigney).

Via email to: pubcom@finra.org
Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K. Street, NW
Washington, D.C. 20006-1506

Re: FINRA Regulatory Notice 22-09
FINRA Proposed Rule to Accelerate Processing of Arbitration Proceedings for Seriously Ill or Elderly Parties)

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 created by the Financial Industry Regulatory Authority ("FINRA"), seeking to make the arbitration process as just and fair as possible, and advocating for public education related to investment fraud, industry misconduct and the securities industry's arbitration process. Our members and their clients have a fundamental interest in the rules promulgated by FINRA that govern the arbitration process and the practices of brokers and broker-dealer firms.

PIABA welcomes the opportunity to comment on the proposed amendment to the customer Code of Arbitration Procedure described in FINRA Regulatory Notice 22-09 ("RN 22-09") and proposed rule change to "allow any party to request accelerated processing of an arbitration proceeding if they: (1) are at least 75 years old; or (2) certify that they have received a medical diagnosis and prognosis and that, based on that information, they have a reasonable belief that accelerated processing is necessary to prevent

prejudicing their interest in the arbitration." The proposed rule change codifies, in part, current FINRA guidelines regarding expedited proceeding requests, with some important differences addressed herein. The proposed rule would shorten procedural deadlines, including those related to turnaround time (10 months or less), serving an answer or third-party claim (within 30 days of filing the initial pleading), arbitrator rankings (10 days), responses to the FINRA Discovery Guide (35 days) and other discovery requests (30 days).

PIABA applauds FINRA's efforts to protect a vulnerable population of investors. For many who are elderly or seriously ill, the FINRA arbitration process is unduly burdensome and works against the investor's ability to participate meaningfully in the arbitration process. However, there are serious concerns regarding some of the proposed rule provisions that may result in a greater burden for, or act as a bias against, investors.

As noted in RN 22-09 and apparent to those who represent investors in FINRA arbitration, FINRA's current "program" allowing claimants ages 65 or older or seriously ill to request an accelerated process fails to ensure the process is, in fact, accelerated. While FINRA's program was designed to "encourage" arbitrators to bear in mind the needs of those who requested an accelerated process, it is rare that granting a request for acceleration resulted in actual acceleration of the process. Generally, PIABA members report having their request for acceleration granted, but during the IPHC, the panel regularly accept respondent counsel's representations that they are "unavailable" for hearing within the accelerated timelines and do not otherwise enforce the accelerated schedule. Some PIABA's members have experienced a complete disregard of the program after their request for acceleration was granted. One such example is in a currently pending case where a ninety-two (92) year old woman was initially granted acceleration. When she sought leave to amend her statement of claim four (4) months before the scheduled hearing, the arbitrators *sua sponte* vacated the hearing dates and demanded that the parties confer to set new dates. Neither the investor-claimant nor the brokerage-respondent requested that the hearing dates be vacated. Despite that fact, and despite granting the claimant's request for an accelerated process, the arbitrators ignored FINRA's "encouragement" to adhere to the program. Codifying the mandates of an accelerated process may circumvent this type of misconduct.

To date, it appears that arbitrators receive very little training regarding the management of a case filed by an elderly or seriously ill claimant and the

purported accelerated process.[1] Proper training and codifying the program's intent – with the deadlines clearly noted – will rightly put the responsibility on the arbitrators to maintain an accelerated process. Since FINRA anticipates that the current "program" will still be available to those who do not qualify for an accelerated process under the proposed rule change (for example, because they are age 70), sufficient arbitrator training is even more important. Training should be clear that the proposed rule change should be followed, but that, even if a claimant does not qualify (or does not formally cite the rule in a request), arbitrators have the discretion to consider age, health, and other factors when setting hearing dates and deadlines and should maintain a sensitivity to these issues.

While there is a possibility counsel and arbitrators may have difficulty adhering to the shortened deadlines due to scheduling conflicts, it should be reiterated in the proposed rule change and training that the rule should be followed absent stipulation *by all parties* to longer deadlines or date setting. This permits flexibility on the part of the claimant requesting the accelerated schedule, who may for example be willing to allow longer time for a particular response (e.g., a Statement of Answer or discovery responses), but has a critical need for the hearing date to be set on an accelerated schedule.

FINRA will need to train arbitrators to be vigilant against litigation tactics that work to delay the arbitration process, such as nonexistent scheduling conflicts, overly broad and burdensome discovery requests, and unnecessary motion practice. As an example, an opposing party may propound discovery requests that include medical records that are unrelated to the case, other than to the qualification for an accelerated process. Such an invasive request should be denied. The certification by the claimant requesting the accelerated process as described in RN 22-09 is sufficient and training for arbitrators should be clear that FINRA is not condoning discovery of medical information for purpose of qualifying for the accelerated schedule. Similarly, an opposing party may engage in motion practice to object to the application for an accelerated process based upon the claimant's medical condition in order to force a claimant to reveal medical information. Tactics such as these invade the investors' right to privacy of medical information, could intimidate investors and discourage them from applying for an accelerated process, and delay the proceedings in contravention of the purpose of the Code. These considerations must be addressed when revisiting the proposed rule change and arbitrator training materials.

---

1. FINRA's online Basic Arbitrator Training materials devote a portion of one slide to expedited procedures (Module 6, Slide 5). FINRA devotes one page to this issue in its Chairperson Training, p. 11 (June 2021).

With regard to the age threshold proposed in RN 22-09, PIABA strongly believes FINRA should maintain the current threshold of 65 years of age. There are two primary reasons: (1) most states with civil and/or criminal statutes protecting vulnerable populations from financial or physical abuse have an age threshold of 65;[2] and (2) setting the threshold at 75 may unfairly exclude or otherwise create disparities for portions of the population who may have lower life expectancies.[3]

By keeping the age threshold at 65 years old, FINRA will remain consistent most states with statutes that create a private right of action for financial elder abuse that also maintain age 65 as the threshold and be more inclusive of a broader demographic of investors. PIABA strongly urges FINRA to maintain the 65-year-old threshold for the purposes of consistency and inclusion.

With regard to qualification based on "serious illness," RN 22-09 fails to develop what would be required, and the language leaves a wide gap for interpretation. As noted above, an investor would be required to:

> Certif[y], in the manner and form required by the Director, that: (i) the party has received a medical diagnosis and prognosis and (ii) based on that medical diagnosis and prognosis, the party has a reasonable belief that accelerated processing of the case is necessary to prevent prejudicing the party's interest in the arbitration.[4]

Although the new language states that it is the party who must have a "reasonable belief" that acceleration is necessary, RN 22-09 states that it is up to the Director to determine whether a party has met the parameters for acceleration. PIABA believes that having the Director use subjective judgment to determine whether an investor is inappropriate. An investor should not be required to disclose private medical information merely to qualify for an accelerated process. PIABA urges FINRA to look carefully at this issue to balance claimant privacy with a fair and consistent process.

---

2. *States with a Civil Private Right of Action for Financial Elder Abuse and Exploitation,* J. Aidikoff, A. Rivkin, 24 PIABA Bar J. 29-46 (2017).

3. See, *The Association Between Income and Life Expectancy in the United States, 2001 – 2014* R. Chetty, M. Stepner, S. Abraham, JAMA Vol. 315, No. 16 (Apr. 26, 2016). The gap in life expectancy between the richest 1% and poorest 1% of individuals was 14.6 years.

4. FINRA, Regulatory Notice 22-09 (2022).

PIABA acknowledges and appreciates the opportunity to comment on this important issue. We thank you for the opportunity to comment and urge FINRA to continue its efforts to protect the public investor and provide investors with a fair and objective arbitration process.

Very truly yours,
Michael Edmiston,
President, PIABA

(This page intentionally left blank)

The following Comment Letter regarding *FINRA Regulatory Notice 22-08: Comment on Sales Practice Obligations for Complex Products and Options* was submitted to FINRA by Michael Edmiston on May 9, 2022. (prepared with the assistance of Daren Luma, Jason Kane, Jorge Riera, and Dave Neuman).

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K. Street, NW
Washington, D.C. 20006-1506

Re: Regulatory Notice 22-08 (Comment on Sales Practice Obligations for Complex Products and Options)

Dear Ms. Piorko Mitchell:

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 rules promulgated by the Financial Industry Regulatory Authority ("FINRA") relating to both investor protection and disclosure. As such, PIABA frequently comments upon proposed rule changes and retrospective rule reviews (like the instant one) in order to protect the rights and fair treatment of the investing public.

Regulatory Notice 22-08 requests comments regarding complex products and options. PIABA submits this comment because the bar association believes strongly that member firms' obligations for the supervision of sales of complex products and options should be strengthened. Notice 22-08 acknowledges a significant increase in the sales of these products, which should warrant closer attention.

This is not the first time that FINRA and its predecessor, the NASD, has raised concerns about complex products. In fact, since Notice 22-08 was published, FINRA also published Notice 22-11, regarding sales of mutual funds that use complex products and options within its portfolio (known as "alt funds"). FINRA also addressed the issues raised with complex products in numerous other notices, including:

a) Notice 12-03 – Heightened Supervision of Complex Products;
b) Notice 10-09 – Reverse Exchangeable Securities (Reverse Convertibles);
c) Notice 09-73 – Principal Protected Notes;
d) Notice 05-59 – Structured Products;
e) Notice 05-26 – Best Practices for Reviewing New Products;
f) Notice 03-71 – Non-Conventional Investments.

Likewise, issues related to these products are frequently raised in FINRA's Report on its Examination and Risk Monitoring Program, and previously in its annual Regulatory and Examination Priorities Letters. Despite nearly 20 years of guidance regarding complex products, the release of Notice 22-08 reveals that FINRA still has significant concerns about sales practices regarding these products.

FINRA should require heightened supervision regarding the sales of complex products and options. These products are often represented, at the point of sale, as being tools to help mitigate market risks. Instead, some of these products can exacerbate risks. A few examples should be noted:

a) In February 2018, the LJM Preservation and Growth Fund lost over 80% of its value within two days, possibly the biggest two-day drop for a mutual fund ever. This fund was overconcentrated in risky leveraged options, a far cry from its namesake "preservation" objective;
b) The Lehman Brothers Principal Protected Notes were marketed as being safe and conservative but lost most of their value after Lehman Brothers collapsed in 2008. The internal holdings of these notes were laden with complex structured products that did not withstand the market volatility of 2008; and
c) The Oppenheimer Champion Income Fund lost significant value in 2008. Despite being labeled as a "bond" fund, it had substantial exposure to commercial mortgage backed securities, done so using substantial leverage in derivatives and total return swaps. This product also lost significant value, much more than other "bond" funds.

There are numerous other examples of similar complex products. It is clear that complex products like the three discussed above can wreak havoc on

investors' portfolios in a relatively short period of time. This should be met with extra vigilance by FINRA.

Leveraged and Inverse ETFs

While Notice 22-08 details the numerous Regulatory Notices that FINRA has published addressing specific complex products, it is clear that further and more substantial regulatory actions are needed, particularly in complex products previously addressed by FINRA. Some of the products that FINRA should monitor closely are leveraged and inverse ETFs.

For example, in June 2009, FINRA published Regulatory Notice 09-31, Non-Traditional ETFs, which focused on leveraged and inverse exchange traded funds. Notice 09-31 described how "[m]ost leveraged and inverse ETFs 'reset' daily" and therefore "[d]ue to the effect of compounding, their performance over longer periods of time can differ significantly from the performance (or inverse of the performance) of their underlying index or benchmark during the same period of time." [1]

Notice 09-31 then cited two examples of situations in which leveraged ETFs declined in value, even though the underlying indexes they tracked increased in value, including one situation in which the Russell 1000 Financial Services Index gained "around 8 percent," while "an ETF seeking to deliver three times the daily return" of that index fell 53 percent.[2]

Given these clear dangers associated with holding leveraged ETPs for more than a single day, Notice 09-31 concluded that, "inverse and leveraged ETFs typically are not suitable for retail investors who plan to hold them for more than one trading session, particularly in volatile markets." FINRA also reminded firms that part of a member's suitability obligation requires the member to "fully understand the products and transactions they recommend," and that "[w]ith respect to leveraged and inverse ETFs, this means that a firm must understand the terms and features of the funds, including how they are designed to perform, how they achieve that objective, and the impact that market volatility, the ETF's use of leverage, and the customer's intended holding period will have on their performance."[3]

Despite FINRA's clear identification of the significant problem with investments in leveraged and inverse ETFs longer than a day and its clear

1. FINRA, Regulatory Notice 09-31 (2009).

2. *Id.*

3. *Id.*

warning to member firms, our members continue to see investors who have been victimized by inappropriate longer-term holding of positions in these complex products. FINRA's guidance and reminders concerning leveraged and inverse ETFs delivered in Notice 09-31 was insufficient by itself to stop these sales practice violations.

As Notice 09-31 detailed, and the issuers' own prospectuses make clear, leveraged and inverse exchange traded products ("ETPs) that are designed to reset daily should not be held for longer than a single trading day. Given this, FINRA should requite member firms to carefully scrutinize the holding of leveraged and inverse ETP positions beyond one trading day. Such scrutiny should include a written explanation from the registered representative who recommended the ETP; documented supervisory review of all such transactions, including the registered representative's written explanation; and affirmative, direct communication between firm supervisory personnel and individual investors making such investments to ensure that the individual investor understands the characteristics of leveraged and inverse ETPs that make holding them for longer than a single day inadvisable. FINRA should consider adopting a new rule within the 2300 series to explicitly address the sales practice and supervision concerns associated with these products.

In short, the current regulatory framework is not appropriately tailored to address the specific concerns and significant risk that complex products, such as leveraged and inverse ETPs pose. FINRA needs to closely examine and carefully draft new regulatory requirements that address these specific risks and fulfill the investor protection mandate of the securities laws.

Options Trading

PIABA is also concerned with the dramatic rise of options trading, which poses serious risks for retail investors who do not understand the characteristics of options and risks related to the product. Most recently, FINRA fined Berthel, Fisher & Co. Financial Services, Inc. for failing to supervise unsuitable options trading activity for a senior citizen.[4]

These same concerns are heightened when retail investors are accessing these products through self-directed platforms. PIABA believes that investor protection guardrails need to be strengthened to adequately address the risks posed by options trading through a self-directed platform.

---

4. In re: Berthel, Fisher & Co. Financial Services, Inc., Financial Industry Regulatory Authority Letter of Acceptance, Waiver, and Consent, No. 2018057425202 (Apr. 26, 2022).

Broker-dealers have adopted self-assessments as part of their approval process for opening a customer's self-directed account to trade options. While the self-assessment may meet FINRA's minimum due diligence requirements, the information collected by broker-dealers is not reasonably designed to sufficiently ascertain a retail investor's understanding of options trading or their understanding of the characteristics and risks related to options trading. For example, the self-assessments do not address whether the investor understands the risk and consequences of margin calls, or the risk of potentially unlimited losses for certain options trading. To further protect retail investors from future market volatility, PIABA believes that firms should solicit and keep a record of the amount an investor is able to and willing to put at risk.

Perhaps worse still, our members are seeing an uptick in small RIA firms using complex options strategies that the advisers themselves do not understand. These RIA firms typically use FINRA member firms to execute their strategies. The brokerage firms disclaim any responsibility for the trading, placing that responsibility on the RIA. However, investors do not understand that they are dealing with two separate entities, each of which have limited responsibilities and obligations.

Consistent with applicable fiduciary duties and Regulation Best Interest conduct standards, PIABA believes that, once a member firm has approved options trading for an account, the firm should also have an ongoing duty to monitor a customer's options trading strategy. Suitability is a constantly changing variable and the firm has a duty to continuously update the suitability profile as additional financial information becomes available. As part of any subsequent suitability assessment, the firm must reassess if the existing options trading strategy and products being used remain suitable for the investor. Therefore, a firm would have to prevent a customer from engaging in an overall risky trading strategy if it contradicts the customer's evolving suitability profile. This is especially true when the firm has reason to know that the customer does not fully understand the risks of the options trades.

In summary, PIABA supports any measure that strengthens investor protection and imposes stricter requirements regarding the sales of complex products and options.

Very truly yours,
Michael Edmiston
President, PIABA