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PLEADING AND ADVOCATING A NEGLIGENCE CLAIM THROUGH THE REGULATION BEST INTEREST LENS

Christine Lazaro and Michael S. Edmiston[1]

On June 5, 2019, the SEC adopted the Regulation Best Interest Rule Package, consisting of (i) Regulation Best Interest: The Broker-Dealer Standard of Conduct ("Reg. BI");[2] (ii) Form CRS Relationship Summary and Amendments to Form ADV;[3] (iii) the SEC Interpretation Regarding Standard of Conduct for Investment Advisers;[4] and (iv) the SEC Interpretation Regarding the "Solely Incidental" Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser.[5] Brokers were obligated to begin compliance with Reg. BI as of June 30, 2020.

Reg. BI contains four component sections mandating duties for brokers and firms: Disclosure, Care, Conflicts of Interest, and Compliance. While it is the SEC 's position that Reg. BI does not create any new private right of action or right of rescission,[6] the Rule does set forth duties to which brokers and firms must adhere. Therefore, these obligations may be used as support for a negligence claim[7] for (i) a recommendation that is not in the investor's best interests; or (ii) failure to supervise. While this article will address how to assess the various Reg. BI obligations when pleading and advancing a potential

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1. Christine Lazaro is a Professor of Clinical Legal Education and the Director of the Securities Arbitration Clinic at St. John's University School of Law. Michael S. Edmiston is an attorney with the Law Offices of Jonathan W. Evans & Associates.

2. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318 (July 12, 2019) (to be codified at 17 C.F.R. pt. 240).

3. Form CRS Relationship Summary; Amendments to Form ADV, 84 Fed. Reg. 33,492 (July 12, 2019) (to be codified at 17 C.F.R. pts. 200, 240, 249, 275, and 279).

4. Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fe. Reg. 33,669 (July 12, 2019).

5. Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion From the Definition of Investment Adviser, 84 Fed. Reg. 33,681 (July 12, 2019).

6. *See* 84 Fed. Reg. at 33,327.

7. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng*, 697 F. Supp. 1224, 1227 (D.D.C. 1988).

negligence claim in FINRA arbitration, such conduct may also support other claims such as breach of contract, negligent or intentional misrepresentation, and state Blue Sky law violations.

I. When does Regulation Best Interest Apply?

While Reg. BI is similar to FINRA's Suitability Rule,[8] there are also some differences. For both Reg. BI and the Suitability Rule to apply a broker must make a *recommendation*. As used in Reg. BI, the term "recommendation" has the same meaning it has currently under FINRA rules.[9] It is a fact-based determination. Factors to consider are "whether the communication 'reasonably could be viewed as a 'call to action' and 'reasonably would influence an investor to trade a particular security or group of securities.'"[10]

Recommendations include: advice to purchase, sell, and exchange securities; as well as advice about investment strategies; and explicit advice to hold securities.[11] Recommendations also include advice about the type of securities account to open, as well as advice to roll over or transfer assets from one account to another.[12] Additionally, a broker may be deemed to have made an implicit hold recommendation, triggering the obligations of the Rule, if the broker has agreed to perform periodic account monitoring.[13] Communications such as general financial and investment information; descriptive information about an employer-sponsored retirement plan; certain asset allocation models; and interactive investment materials are not considered recommendations.[14]

While the recommendation language is the same, Reg. BI applies to a different subset of customers than the Suitability Rule. Brokerage firms and brokers only owe their Reg. BI obligations to "retail customers," which is defined as natural persons and their legal representatives, seeking advice for personal, family, or household purposes.[15] Significantly, Reg. BI does apply to

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8. FINRA Rule 2111.

9. 84 Fed. Reg. 33,318, 33,337.

10. *Id.* at 33,335.

11. *Id.* at 33,338.

12. *Id.* at 33,338.

13. *Id.* at 33,340.

14. *Id.* at 33,337 – 33,338.

15. *Id.* at 33,343.

recommendations to individuals regardless of their sophistication so long as the advice is for personal purposes. Under the plain language of the rule, Reg. BI does not apply to recommendations to *entities.* The Suitability Rule still applies to any accounts that are not captured by Reg. BI.[16]

II. What are the Broker's Specific Obligations?

Reg. BI is comprised of four sections: (i) the Disclosure Obligation; (ii) the Care Obligation; (iii) the Conflict of Interest Obligation; and (iv) the Compliance Obligation.[17] If a broker or firm violates any of these duties, and the investor has been damaged as a result, there may be a claim for negligence.

a. Disclosure Obligation

i. Duties Under Regulation Best Interest

The Disclosure Obligation requires that a broker or brokerage firm make full and fair disclosure in communicating the "material facts relating to the scope and terms of the relationship" with the customer; and "material facts relating to such conflicts of interest that are associated with the recommendation" prior to or at the time of the recommendation.[18] "Materiality" has the same meaning that the Supreme Court articulated in *Basic v. Levinson*: a fact is material if there is "a substantial likelihood that a reasonable shareholder would consider it important."[19]

Disclosures related to the scope and terms of the relationship will be made primarily through the account agreements, usually completed at the beginning of the relationship. Some of these initial disclosures will also now be made

16. The FINRA Suitability Rule has been amended to indicate it does not apply to recommendations subject to Regulation Best Interest. *See* FINRA Rule 2111.08.

17. 17 C.F.R. §240.15l-1(a)(2).

18. 84 Fed. Reg. at 33,347.

19. *Id. See also Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

through the Form CRS.[20] There is no requirement that these disclosures be made every time a recommendation is made.

Material facts related to the scope of the relationship must include the following types of information: (i) the capacity in which the broker is acting (as a broker-dealer or investment adviser); (ii) fees and costs associated with the transactions and the accounts more generally; and (iii) the type and scope of services the brokerage firm will offer, including any limitations on those services.[21]

Regardless of whether the firm and individual are dually registered as both brokers and investment advisers, both still have the duty to disclose the capacity in which they are acting. Reg. BI also limits who may use the term "advisor" or "adviser" in their title. A broker may be called an "advisor" or "adviser" if that broker is also registered as an investment adviser, regardless of whether they are acting in an advisory capacity with a specific client. If a broker represents that they are an "advisor" or "adviser" and that broker is not dually registered, this will likely violate their disclosure obligation.[22] It remains unclear whether the broker will need to make any further disclosures when acting as both a broker and an investment adviser with the same client or acting solely in a brokerage capacity with an investor while dually registered. If the brokerage firm is dually registered but the broker is not, the broker must disclose that they cannot offer advisory services.[23]

With respect to fees and costs, the SEC expects that brokerage firms will build on the disclosure of fees and costs that are set forth in Form CRS.[24] The obligation does not require that the brokerage firm provide "individualized" costs and fees. Instead, the firm may provide standardized or hypothetical amounts or percentage ranges.[25] Brokerage firms may also satisfy this part of their disclosure obligations by providing mandated disclosure documents, such as prospectuses, and trade confirmations.[26]

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20. While Reg. BI is triggered only if a recommendation is made, the Form CRS is required to be delivered by every brokerage firm and SEC registered investment adviser. *See* 17 C.F.R. §240.17a-14; 17 C.F.R. §275.203-1.

21. 84 Fed. Reg. at 33,349.

22. *Id.* at 33,352.

23. *Id.* at 33,357.

24. *Id.* at 33,354.

25. *Id.* at 33,355.

26. *Id.*

With respect to the type of services the brokerage firm offers, the firm must disclose whether it monitors transactions and strategies.[27] As part of this disclosure, the brokerage firm must be specific as to the frequency and duration of the services offered.[28] The brokerage firm may rely on information disclosed in the Form CRS, but it will likely need to expand on that information to meet this disclosure obligation.[29] However, the brokerage firm may rely on other documents, including account agreements, to make such disclosures.[30] As mentioned previously, the broker may be deemed to have made an implicit recommendation if the broker has agreed to periodic monitoring.

The conflicts of interest disclosure obligation should summarize how the brokerage firm and the brokers are compensated for their recommendations as well as the conflicts that the compensation arrangements create.[31] These conflicts need not be disclosed on a recommendation-by-recommendation basis.[32]

While the disclosure obligation requires that the disclosures be made in writing, the SEC recognizes that it may be necessary to supplement, clarify, or update written disclosures with oral disclosures.[33] If the brokerage firm does supplement the written disclosures, however, the brokerage firm must keep a record of the fact that an oral disclosure was provided.[34]

ii. FINRA's Perspective on Inadequate Procedures

While Reg. BI is new, guidance as to what procedures are deemed to be inadequate can be found it the 2022 Report on FINRA's Examination and Risk Monitoring Program. In that report, FINRA identified ineffective practices

27. *Id.* at 33,356.

28. *Id.*

29. *Id.* at 33,357.

30. *Id.*

31. *Id.* at 33,363.

32. *Id.*

33. *Id.* at 33,368.

34. *Id.*

found during routine exams.[35] FINRA found that some firms failed to make full and fair disclosures of material fees received as a result of the recommendation, including whether the firm received revenue sharing.[36] Brokers did not adequately disclose conflicts, including whether they were trading in the same security in their own personal account.[37] Additionally, firms did not adequately disclose material limitations in their securities offerings.[38] Brokers also improperly used the term "advisor" or "adviser" in their title even though they were not dually registered.[39]

iii. Important Considerations and Documents

Firms now have a number of affirmative disclosure obligations that did not exist under the Suitability Rule. If firms are not accurately or fully making these mandated disclosures, those failures may be evidence that the firm has not made the required changes to their policies and procedures to ensure compliance with Reg. BI. Moreover, failure to adequately disclose conflicts of interest may indicate the firm has not properly assessed its conflicts, as will be discussed in further detail below. Failures to disclose, if combined with other failures discussed below, may help support a claim for negligence if the investor has been damaged as a result.

One of the more significant aspects of Reg. BI's Disclosure Obligation is the requirement to set forth the degree to which a firm or a broker will monitor an investor's account and holdings. This information will appear in the Form CRS and may also now be included in other account documents such as the account agreement. A review of the Form CRS and other account documents will help to determine what duties a broker has assumed with respect to monitoring. Additionally, the Rule recognizes that such disclosures may be supplemented orally. Therefore, if a broker has stated to an investor that they will review the investor's account annually, this should form the basis of the

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35. *See* FINRA, 2022 Report on FINRA's Examination and Risk Monitoring Program, Communications and Sales (Feb. 9, 2022) (the "FINRA Report"), https://www.finra.org/rules-guidance/guidance/reports/2022-finras-examination-and-risk-monitoring-program/reg-bi-form-crs.

36. *Id.*

37. *Id.*

38. *Id.*

39. *Id.*

broker's obligations, regardless of whether the Form CRS states that the firm does not monitor accounts. If the broker or firm represents that the account will be monitored or reviewed periodically, the broker may be deemed to have made an implicit recommendation to hold at the timing of the review if no changes are made to the investor's account. If, at the review, circumstances have changed, and a security that was appropriate at the time of the recommendation is no longer appropriate, and the broker does not make a recommendation to sell, this may be deemed an implicit recommendation to hold, triggering the Care Obligation, to be discussed next.

The restriction on the use of the term "advisor" or "adviser" is also a new provision in Reg. BI. If a broker who is not also registered as an investment adviser has used either term in their title, such as calling themself a financial advisor, the broker will have made a misleading statement. One may therefore argue that brokers holding themselves out as advisers are therefore subject to the investment adviser's obligations, including the duty to monitor the investor's account.

Most of the Reg. BI disclosure obligations must be in writing. Therefore, when initially assessing a case, it will be important to review the Form CRS and the account agreements to determine the represented scope of the broker's duties. In discovery, it will be important to seek all documents reflecting any supplemental oral disclosures made pursuant to Reg. BI, as the brokerage firm is obligated to keep such records. To the extent oral disclosures have not been documented, the firm will have violated its recordkeeping obligations, which may be relevant to further support a negligence claim.

b. Care Obligation

i. Duties Under Regulation Best Interest

The Care Obligation, in many ways, mirrors FINRA's Suitability Rule. It contains a multi-factor test requiring that that the broker, when making a recommendation, exercise reasonable diligence, care, and skill to:

(A) Understand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers;

(B) Have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks, rewards, and costs associated with the recommendation and does not place

the financial or other interest of the broker, dealer, or such natural person ahead of the interest of the retail customer; and

(C) Have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile and does not place the financial or other interest of the broker, dealer, or such natural person making the series of recommendations ahead of the interest of the retail customer.[40]

The first prong of the Care Obligation is similar to the "reasonable basis" obligation under the Suitability Rule.[41] As a threshold issue, the broker or brokerage firm must understand the security or investment strategy recommended before determining whether the recommendation is in the best interest of a particular customer.[42] Factors that the broker or brokerage firm should consider when investigating the security or investment strategy include: "the security's or investment strategy's investment objectives, characteristics (including any special or unusual features), liquidity, volatility, and likely performance in a variety of market and economic conditions; the expected return of the security or investment strategy; as well as any financial incentives to recommend the security or investment strategy."[43]

The cost of the investment is now an explicit factor in evaluating securities or strategies, as it is always relevant when evaluating the appropriateness of a recommendation.[44] "Costs" includes both costs associated with purchasing a security, as well as future costs associated with exchanging or selling a security.[45] However, cost is just one factor and the Rule does not require that a broker recommend the lowest cost option.[46]

The second prong of the Care Obligation incorporates the "customer specific" analysis of the Suitability Rule,[47] but enhances it by replacing

40. 17 C.F.R. §240.15l-1(a)(2)(ii) (2019).

41. *See* FINRA Rule 2111.05(a).

42. 84 Fed. Reg. at 33,375 – 33,376.

43. *Id.* at 33,376.

44. *Id.* at 33,373.

45. *Id.*

46. *Id.*

47. *See* FINRA Rule 2111.05(b).

"suitable" with a best interest standard.[48] In sum, the broker must determine that a recommendation is in the customer's best interest based on that customer's investment profile. The customer's investment profile includes "age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance," and any other information that may be disclosed.[49] This is the same information that firms must currently consider as part of the investor's profile under the Suitability Rule.[50] If a customer does not provide the information, the SEC cautions that a firm may not have sufficient information to make a best interest determination.[51] Note the presumption that the lack of customer-specific information is the responsibility of the firm to either resolve or not make the recommendation.

Additionally, in evaluating whether a recommendation is in the customer's best interest, the broker must consider reasonably available alternatives offered by the broker's firm.[52] The broker need not recommend the "best" of all possible alternatives.[53] The Rule also does not require that the broker be familiar with every product available by the brokerage firm.[54] The scope of the reasonably available alternatives that are considered with respect to any particular recommendation will depend on several factors, including the broker's customer base; the products available to the broker to recommend; and specific limitations on the available products, including that products may only be available in certain geographical locations or to particular types of accounts.[55]

For dually registered brokers, the options with respect to account type must be considered as reasonably available alternatives.[56] If the broker does not also offer advisory accounts, the broker must consider the customer's

48. 84 Fed. Reg. at 33,377.

49. 17 C.F.R. §240.15l-1(b)(3) (2019).

50. *See* FINRA Rule 2111(a).

51. 84 Fed. Reg. at 33,379.

52. *Id.* at 33,381.

53. *Id.*

54. *Id.*

55. *Id.* at 33,382.

56. *Id.* at 33,383.

objectives before recommending a brokerage account.[57] For example, if the customer is requesting that the broker have unlimited discretion, a brokerage account would not be appropriate and should not be offered even if it is the only option available to the broker.[58]

When recommending that an investor rollover a retirement account into an IRA, the broker must consider a number of factors, including "fees and expenses; level of service available; available investment options; ability to take penalty-free withdrawals; application of required minimum distributions; protection from creditors and legal judgments; holdings of employer stock; and any special features of the existing account."[59] A broker may not just consider whether the rollover may offer additional investment options beyond the customer's current plan. While there is no requirement to document the basis for the recommendation, it is likely that firms will require some documentation when a broker makes a rollover recommendation.

The final component is similar to the "quantitative suitability" requirement,[60] except that the "control" element has been eliminated.[61] Previously, FINRA required that the broker have actual or de facto control of a customer account before the quantitative suitability obligation was triggered. However, after Reg. BI was adopted, FINRA also removed the "control" element from the Suitability Rule.[62] The SEC determined that it would not absolve a broker of this obligation simply because the investor has "*some* knowledge of financial markets or *some* 'control'" over their account.[63] This component is intended to prevent trading that is so excessive, colloquially defined as "churning," that a positive return is virtually impossible.[64]

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57. *Id.*

58. *Id.*

59. *Id.*

60. *See* FINRA Rule 2111.05(c).

61. 84 Fed. Reg. at 33,384.

62. *See* FINRA Rule 2111.05(c).

63. 84 Fed. Reg. at 33,384.

64. *Id.*

ii. FINRA's Perspective on Inadequate Procedures and Best Practices

In the 2022 Report, FINRA also discussed deficiencies found with respect to the Care Obligation. For example, FINRA found that brokers made recommendations that were not in the investor's best interests based on their investment profile and the potential risks, rewards, and costs associated with the investment.[65] Brokers also made trading recommendations that were excessive, violating this obligation.[66]

The FINRA Report included examples of practices that it deemed effective in implementing Reg. BI mandates discovered during its routine exams. For example, firms (i) created worksheets for the broker to compare costs and reasonably available alternatives; (ii) explicitly set forth the factors to consider when evaluating reasonably available alternatives, such as considering similar investment types from the same issuer or considering less complex or risky products at the firm; and/or (iii) updated their client relationship management (CRM) tools to automatically compare reasonably available alternatives.[67]

Other useful Reg. BI tools highlighted by FINRA in its Report included firm procedures that (i) limited high-risk or complex products or strategies to particular categories of clients; (ii) required heightened supervision of any recommendations of complex or high-risk products; and/or (iii)established new exception reports to track the sale of the same product to high numbers of clients.[68]

iii. Important Considerations and Documents

The Care Obligation is the part of Reg. BI most similar to the Suitability Rule. Thus, many of the same considerations and documents will be relevant when assessing whether there was a violation of this obligation. This section will focus on the considerations and documents that may be new under Reg. BI.

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65. *See* FINRA Report, *supra* note 35.

66. *Id.*

67. *Id.*

68. *Id.*

1. Reasonable Basis Component Considerations

Pursuant to the Rule's reasonable basis component, the broker or the brokerage firm must understand the investment in the same way as under the Suitability Rule. As a threshold issue, if the reasonable basis component is violated, the broker and the firm are not capable of performing the assessment under the customer specific component of the obligation.

The Rule sets forth relevant factors, including potential risks, rewards, and costs, to consider when assessing whether it is likely that the broker has satisfied the reasonable basis component of the obligation. In evaluating a potential case regarding a complex investment, it will be important to review the offering documents for information such as the stated objectives for the investment as well as the risks involved. Notes, e-mails, and memoranda from the brokerage firm's due diligence committee should detail the degree of understanding the firm, its officers, directors, and control persons had of the product or strategy at issue. Importantly, the broker or the firm should be aware of how the investment or strategy is likely to perform in volatile, bullish and/or bearish market conditions. The broker and the firm must also evaluate financial incentives to recommend the investment, including whether the firm or the broker receives any additional compensation from the recommendation.

If the investment is particularly complex, it may be easier to establish that the broker did not adequately understand the investment. Additionally, misrepresentations or omissions about the nature of the investment may also be evidence that the broker did not understand the investment. If the firm or the broker has done little or no due diligence with respect to a complex investment, the firm and the broker have likely violated this component of the obligation.

2. Customer-Specific Component Considerations

The customer-specific component is very similar to its corresponding component under the Suitability Rule. Once the investment is evaluated and approved, the next step is to determine whether it falls within the investor's profile. The information the firm and the broker must gather about the investor is the same as that required by the Suitability Rule: age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance.

Unlike the Suitability Rule, the Reg. BI customer-specific best interest analysis does not stop after a finding that the investment at issue was suitable for the investor. The broker must also have considered reasonably available

alternatives. While the investment need not be the "best" investment, the burden will be on the broker to establish whether the recommendation was reasonable in light of the reasonably available alternatives. This will likely be most relevant in the context of complex products. If a simpler investment with lower costs is available and aligns with the investor's profile, it will be difficult to defend the recommendation of the costly, more complex investment.

The addition of the requirement to compare reasonably available alternatives may also make it easier to support a claim for well managed account damages. Well managed account damages compare the investor's actual outcome with what the outcome would have been had they been appropriately invested. In theory, the well managed account will be a reasonably available alternative that the broker should have considered, or did consider and rejected, when making the recommendation at issue. Therefore, the comparison between the two accounts will be one the broker and the firm should have engaged in prior to making the recommendation.

3. Quantitative Component Considerations

One of the biggest differences between the Care Obligation under Reg. BI and the Suitability Rule is with respect to excessive trading under the quantitative component. The investor is no longer required to demonstrate actual or *de facto* control over the account by the broker. Rather, the investor need only establish that the frequency of the trading is excessive based on their investor profile. Cost to equity ratios and turnover will continue to be relevant in assessing whether trading is excessive.

4. Final Considerations for the Care Obligation

It is likely that firms will require their brokers to document decisions they have made throughout the recommendation process. For example, FINRA recognized that a best practice would be for the firm to utilize a worksheet to establish that the broker assessed the investment and considered alternatives.[69] Therefore, in discovery, it will be important to request documents that reflect the broker's and the firm's assessment that the investment satisfies the reasonable basis and customer-specific components of the obligation. Additionally, there may be documents setting forth the reasonably available

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69. FINRA Report, *supra* note 35.

alternatives considered. In connection with the election of account type when the firm is dually registered as a broker and an investment adviser, the firm may document why a brokerage account is more appropriate for the investor rather than an advisory account. Finally, the broker may be required to document why the rollover of a retirement account is appropriate. In discovery, a catchall document request should broadly seek all documents reflecting the rationale or basis for the recommendation at issue.

c. Conflict of Interest Obligation

i. Duties Under Regulation Best Interest

The Conflict of Interest Obligation requires a firm to adopt policies and procedures designed to identify and, at a minimum, disclose all conflicts associated with a recommendation.[70] The obligation further requires that a brokerage firm mitigate or eliminate certain types of conflicts.[71]

With respect to the content of the policies and procedures, like FINRA's Supervision Rule,[72] the SEC contemplates that brokerage firms will have the flexibility to design policies and procedures that are risk-based rather than requiring a detailed review of each recommendation.[73] The SEC suggests certain components that a brokerage firm should consider when adopting policies and procedures including:

> [P]olicies and procedures outlining how the firm identifies conflicts, identifying such conflicts and specifying how the broker-dealer intends to address each conflict; robust compliance and monitoring systems; processes to escalate identified instances of noncompliance for remediation; procedures that designate responsibility to business line personnel for supervision of functions and persons, including determination of compensation; processes for escalating conflicts of interest; processes for periodic review and testing of the adequacy and effectiveness of policies and procedures; and training on policies and procedures.[74]

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70. *Id.* at 33,385.

71. *Id.*

72. FINRA Rule 3110.

73. *Id.* at 33,386.

74. *Id.* at *note* 688.

Under this conflict of interest obligation, the brokerage firm has a duty to, at a minimum, disclose all conflicts of interest.[75] Disclosure must be full and fair; if it is not possible to fully and fairly disclose a conflict, it must be mitigated such that full and fair disclosure is possible.[76]

Brokerage firms also have a duty to identify and mitigate conflicts of interest that create an incentive for the broker to place their interests ahead of the interests of the customer.[77] The SEC has primarily chosen to limit the duty to mitigate broker-level conflicts, allowing the brokerage firms to generally deal with firm-level conflicts through disclosure.[78] The requirement to identify and mitigate broker-level conflicts applies only to incentives provided to the broker, either by the firm or third parties that are within the control of or associated with the firm.[79] Accordingly, the requirement does not create an obligation with respect to private securities transactions.[80] The SEC provides examples of conflicts that must be mitigated: (i) including fees and other charges associated with the service or recommendation provided; (ii) employment incentives, including those tied to asset accumulation, special awards, variable compensation, and compensation tied to performance reviews; and (iii) commissions, sales charges, or other fees whether paid by the customer, the brokerage firm, or a third party.[81]

Mitigation measures should be based on the nature and significance of the incentive, as well as other factors related to the brokerage firm's business model, such as the size of the firm, the types of customers, and the complexity of the security product or strategy.[82]

The SEC lists the best practices for brokerage firms developing policies and procedures for mitigation methods:

- Avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales;
- Minimizing compensation incentives for employees to favor one type of account over another; or to favor one type of product over another,

75. *Id.* at 33,388.

76. *Id.*

77. *Id.* at 33,390.

78. *Id.*

79. *Id.* at 33,391.

80. *Id.* at *note* 744.

81. *Id.* at 33,391.

82. *Id.*

proprietary or preferred provider products, or comparable products sold on a principal basis, for example, by establishing differential compensation based on neutral factors;

- Eliminating compensation incentives within comparable product lines by, for example, capping the credit that an associated person may receive across mutual funds or other comparable products across providers;
- Implementing supervisory procedures to monitor recommendations that: are near compensation thresholds; are near thresholds for firm recognition; involve higher compensating products, proprietary products or transactions in a principal capacity; or, involve the roll over or transfer of assets from one type of account to another (such as recommendations to roll over or transfer assets in an ERISA account to an IRA) or from one product class to another;
- Adjusting compensation for brokers who fail to adequately manage conflicts of interest; and
- Limiting the types of retail customer to whom a product, transaction or strategy may be recommended.[83]

If a brokerage firm materially limits its securities offerings or investment strategies, the brokerage firm must prevent such limitations from causing the firm to put its interests ahead of its customers'.[84] The SEC considers that recommending only proprietary products, products with revenue sharing arrangements, or a specific asset class would be material limitations.[85] The SEC recommends that brokerage firms offering limited menus consider establishing a "product review process" that includes evaluating the use of preferred lists; restrictions on the customers to whom a product may be sold; requiring brokers selling certain products to have minimum knowledge requirements; as well as period product reviews to further evaluate conflicts.[86]

Certain common practices are completely prohibited pursuant to this obligation. For example, brokerage firms must eliminate "sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited time."[87] Non-cash compensation includes merchandise, gifts and prizes, travel expenses,

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83. *Id.* at 33,392.

84. *Id.* at 33,393.

85. *Id.*

86. *Id.* at 33,394.

87. 17 C.F.R. §240.15l-1(a)(2)(iii)(D) (2019).

meals and lodging.[88] However, this obligation is not intended to eliminate all incentives, only those that create high-pressure situations to sell specific securities within a limited period of time.[89] Brokerage firms may also continue to hold annual conferences, so long as attendance is not premised on the sale of specific securities within a limited period of time.[90]

ii. FINRA's Perspective on Inadequate Procedures and Best Practices

In the 2022 Report, FINRA also discussed deficiencies found with respect to the Conflict of Interest Obligation. For example, certain firms did not identify conflicts, or if identified, did not adequately address them.[91] In terms of best practices, some firms flattened their commission schedules within particular product types.[92] Flattening commission schedules may work to eliminate the financial incentives for recommending certain product types or products favored by firms because of their revenue sharing or proprietary nature.

iii. Important Considerations and Documents

Pursuant to this obligation, firms will have greater documentation duties than they had previously. For example, the firm must identify conflicts of interest and then assess whether the conflict should be disclosed, mitigated, or eliminated. Therefore, firms will have to review their compensation programs, paying particular attention to any incentives offered. In addressing this component in a claim, it will be important to assess what conflicts have been disclosed and whether disclosure was appropriate. When disclosure is not appropriate, the firm must take additional steps to mitigate or eliminate the conflict. In discovery, it will be important to request any documents reflecting the identification of conflicts of interest and how the firm addressed each of the conflicts. While the SEC has not set forth specific obligations, as discussed above, it has set forth best practices. It may be appropriate to argue that if a

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88. 84 Fed. Reg. at 33,396.

89. *Id.*

90. *Id.*

91. FINRA Report, *supra* note 35.

92. *Id.*

firm's policies and procedures fell short of the best practices outlined in the release, then the firm's supervision of the conflicts was not reasonable.

Reg. BI's focus on Conflicts of Interest makes the broker's compensation structure quite relevant. Like with the Disclosure Obligations, if a firm has not made any changes to its compensation structures following Reg. BI, it may be difficult for the firm to establish that it has adequately identified and mitigated conflicts of interest, and therefore it has not adequately supervised its brokers. Additionally, under Reg. BI, disclosure and mitigation are distinct. Accordingly, the firm will have to demonstrate how it has managed those conflicts that incentivize the broker to sell particular products or otherwise put their interests ahead of its investors. Failure to do so can be further support for a claim of negligence focused on failure to supervise.

d. Compliance Obligation

i. Duties Under Regulation Best Interest

The Compliance Obligation is an overarching requirement to adopt policies and procedures that are reasonably designed to achieve compliance with the Rule as a whole.[93] The Rule does not specify which policies and procedures must be adopted. The SEC expects brokerage firms to design their own policies and procedures that "prevent violations from occurring, detect violations that have occurred, and to correct promptly any violations that have occurred."[94] Brokerage firms are expected to tailor their policies and procedures to account for the "scope, size, and risks associated with the operations of the firm and the type of business in which the firm engages."[95] The Compliance Obligation is one that is already captured by the FINRA Supervision Rule, which requires that the establishment of a supervisory system "reasonably designed to achieve compliance with applicable securities laws and regulations."[96] More robust supervisory systems will be required to comply with the new standards set out in Reg. BI.

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93. *Id.* at 33,397.

94. *Id.*

95. *Id.*

96. FINRA Rule 3110.

ii. FINRA's Perspective on Inadequate Procedures and Best Practices

In the 2022 Report, FINRA also discussed deficiencies found with respect to the Compliance Obligation. For example, FINRA found that some firms' written supervisory policies were not adequately precise because they did not identify individuals responsible for supervising compliance with Reg. BI or they had not addressed how the firm would, in practice, comply with their obligations under the Rule.[97] Some firms failed to modify their policies and procedures to reflect the new requirements of Reg. BI. For example, FINRA identified firms that did not address (i) how costs and reasonably available alternatives were to be considered when a broker makes a recommendation; (ii) recommendations of account types; and/or (iii) conflicts of interest that create incentives for the broker to place their own interests ahead of the investor's interests. Finally, some firms did not create procedures to ensure the new recordkeeping obligations were captured, and did not include testing of the policies, procedures, and controls.[98]

FINRA also found that some firms adopted new policies and procedures to comply with the Rule. For example, some firms (i) limited high-risk or complex products or strategies to particular categories of clients; (ii) required heightened supervision of any recommendations of complex or high-risk products; and/or (iii) established new exception reports to track the sale of the same product to high numbers of clients.[99]

iii. Important Considerations and Documents

At a fundamental level, the Compliance Obligation replicates the Supervision Rule's requirement that the firm adopt policies and procedures that will ensure compliance with the Rule. Firms should have explicit sections of their Compliance Manual that address the assessment and recordkeeping obligations of Reg. BI. As discussed above, required disclosures must be documented, certain Care Obligation assessments must or should be documented, and the required analysis of Conflicts of Interest should be documented. Additionally, it will be important to determine whether the firm has adopted any restrictive policies and procedures. For example, some firms have determined that certain products should not be sold to certain investors.

97. *See* FINRA Report, *supra* note 35.

98. *Id.*

99. *Id.*

If a firm has adopted such policies, then a recommendation of such an investment to that type of investor will likely be deemed to be unreasonable under the Rule.

e. The SEC's First Reg. BI Enforcement Action Focuses on the Compliance Obligation

In its first enforcement action under Reg. BI, the SEC alleged that the firm violated its Compliance Obligation because it did not adequately establish, maintain, and enforce policies and procedures designed to achieve compliance with Reg. BI.[100] The firm and the brokers charged allegedly recommended high-risk debt securities to investors, many of whom were on fixed incomes with moderate risk tolerances.[101] The issuer of the securities stated that the securities were high-risk, illiquid, and suitable for investors with substantial financial resources.[102] Therefore, the SEC has alleged that the brokers did not have a reasonable basis to believe the recommendations were in the investors' best interests.[103] The assessment in the SEC's action is very similar to the assessment that would have occurred under the Suitability Rule.

III. Conclusion

For the practitioner considering a potential case, Reg. BI's Care and Compliance Obligations will be front and center for any claims sounding in negligence. The Disclosure and Conflict of Interest Obligations will also be important and may further support claims of negligence, especially when focused on failure to supervise. The article has focused on claims based on negligence, but Reg. BI may be used to support other claims as well, including breach of contract, negligent or intentional misrepresentation, and state Blue Sky law claims. For other claims, the obligations, FINRA's perspective, and the important considerations and documents will be largely the same.

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100. *See* SEC, SEC Charges Firm and Five Brokers with Violations of Reg BI (June 16, 2022) ("SEC Action"), https://www.sec.gov/news/press-release/2022-110.

101. *Id.*

102. *Id.*

103. *Id.*

In discovery, Reg. BI's new recordkeeping obligations should lead to relevant, discoverable documents. While many of the documents may fall into one or more categories of presumptively discoverable documents enumerated in the FINRA Discovery Guide, practitioners need to be well versed in identifying and/or describing the Reg. BI specific documents. In meeting and conferring with opposing counsel, explaining the Reg. BI documents that should exist in their clients' possession, custody, and/or control should be part of the early sensitization of this new regulatory scheme and its recordkeeping requirements. In addition to reviewing what the SEC has included in the rulemaking package, many defense oriented law firms are publishing guides, which will also be useful in describing documents within a discovery request and supporting motions to compel.

Further, while Reg. BI does not directly address damages, it strengthens claims seeking well managed account damages through the Care Obligation's requirement to consider reasonably available alternatives to the investment recommended. The requirement to consider and compare similar investments that may accomplish the same investment objective gives strong support for damage theories other than Net-Out-Of-Pocket damages. Thought should be given as to how damages are presented in the pleadings and at the hearing on the merits. Moreover, it may be advantageous to retain an expert early in the process to identify reasonably available alternatives while drafting the Statement of Claim.

The Reg. BI Obligations are new for practitioners but will also be new for the arbitrators. It will be important for counsel to educate arbitrators about the new Obligations and the firms' recordkeeping obligations in the pleadings, during the discovery process, and during any hearing on the merits.

Notes & Observations

WHAT MAKES SPACS SO SPECIAL?

Scott Eichhorn[1]

I. Introduction

Special Purpose Acquisition Companies, or SPACs, also known as blank check companies, are formed for the sole purpose of acquiring a private target company to bring public. The first SPACs appeared in the 1990s in response to the Securities and Exchange Commission's (SEC) implementation of rules and regulations governing blank check issuers of penny stocks.[2] Specifically, SEC Rule 419 imposed restrictions and requirements that applied to shell companies issuing penny stock but not to larger shell companies.[3] To avoid regulation under Rule 419, but anticipating the regulatory risk of potential expansion of Rule 419, early SPACs formed as non-penny stock blank check companies—incorporating restrictions similar to those imposed by Rule 419.[4] Those features remain some of the key characteristics of today's SPACs and include requirements relating to the use of offering proceeds, the exercise of warrants, and approvals of acquisitions.[5]

Simply put, SPACs are shell companies formed solely to raise capital through an IPO on an exchange and later merge with or acquire a private operating company in an initial business combination, also known as the "deSPAC" transaction, thereby bringing the target company public.[6] Shares of the combined public company then trade on the exchange that lists the SPAC, offering private companies an alternative route to traditional IPOs. As

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1. Scott Eichhorn is the Acting Director of the Investor Rights Clinic at the University of Miami School of Law. The author would like to thank Mackenzie S. P. Connick, a second-year law student at St. John's University School of Law, for her valuable research assistance.

2. James S. Murray, The Regulation and Pricing of Special Purpose Acquisition Corporation IPOs (Jan. 30, 2014), (manuscript at 2), https://ssrn.com/abstract=1746530.

3. *Id*.

4. *Id*. at 5.

5. *Id*.

6. https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-spacs-investor-bulletin.

discussed later, several key characteristics and applicable rules and regulations, however, distinguish SPAC transactions from traditional IPOs.

The initial wave of SPACs included only 14 IPOs between 1993 and 1996.[7] SPACs initially traded on the over-the-counter (OTC) markets until AMEX became the first exchange to accept SPACs for listing in 2005.[8] SPACs later experienced a brief surge in IPOs in 2006 and 2007 ending when the overall market for IPOs declined following the 2008 financial crisis. In 2008, the NYSE and NASDAQ exchanges also began to accept SPACs for listing, subject to satisfaction of certain listing standards.[9] SPACs emerged in their current form in 2009.[10] Only in recent years, however, have SPACs seen a dramatic rise in IPOs.

During 2020, 248 SPAC IPOs raised a whopping $75.3 billion, more than all previous years combined.[11] SPAC IPOs outnumbered traditional IPOs at the end of 2020 and beginning of 2021.[12] SPACs continued to proliferate with 447 IPOs in the first three quarters of 2021.[13] At the height of the SPAC mania, celebrities from Serena Williams to Leonardo DiCaprio became involved as managers or advisors promoting SPACs, prompting the SEC to release an Investor Alert cautioning against investing in SPAC 's based on such celebrity endorsements.[14] Since their soaring popularity in late 2020 and early 2021, the market for SPAC IPOs has cooled. SPAC IPOs dropped from 298 in the first quarter of 2021 to 55 in the first quarter of 2022, falling to 15 in the second

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7. Murray, *supra* note 2, at 3.

8. *Id*. at 7.

9. *Id.* at 8-9.

10. Michael Klausner, Michael Ohlrogge & Emily Ruan, A Sober Look at SPACs (Jan. 25, 2022), (manuscript at 7-8), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3720919.

11. Minmo Gahng, Jay R. Ritter & Donghang Zhang, SPACs (December 14, 2001), (manuscript at 1), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3775847.

12. https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-ipos-fall-to-earth-a-requiem-for-spacs.

13. Gahng, *supra* note 11, at 3.

14. SEC Office of Investor Education and Advocacy – Investor Alert (Mar. 10, 2021), https://www.sec.gov/oiea/investor-alerts-and-bulletins/celebrity-involvement-spacs-investor-alert#:~:text=The%20SEC's%20Office%20of%20Investor,variety%20of%20products%20and%20services; https://www.bloomberg.com/news/articles/2021-12-16/celebrity-spacs-leave-famous-winners-looking-more-like-losers.

quarter of 2022.[15] In June 2022, business magazine Forbes and online ticket dealer SeatGeek announced termination of their respective SPAC deals.[16] In addition, companies that have gone public in recent SPAC mergers have not fared well. Online media publisher BuzzFeed lost one-third of its value by June 2022 since going public through a SPAC earlier this year.[17] A $32.6 billion SPAC deal reached in June 2022—one of the largest in SPAC history—lost 90% of its value in the days following its merger.[18]

In part, unsettled market and economic conditions have blunted investor and target company demand for SPACs. In addition, regulatory announcements have also cooled market participation. SPAC market participants have long believed that the regulations applicable to business combination—or deSPAC—transactions provide a safe harbor for forward-looking statements that is not available under traditional IPO laws.[19] However, John Coates, Acting Director of the SEC Division of Corporation Finance, released a statement in April 2021 expressing the view that the safe harbor in the PSLRA may not in fact cover SPACs.[20] Another SEC statement that month also suggested that some SPACs improperly accounted for warrants, resulting in companies like Virgin Galactic reporting an additional $49 million in expenses in 2021.[21] Both of these statements gave market participants pause to reconsider raising capital through SPACs. The SEC also warned in May 2021 that attractive business combinations may become scarcer as more

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15. https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-ipos-fall-to-earth-a-requiem-for-spacs.

16. https://www.reuters.com/business/media-telecom/forbes-seatgeek-terminate-blank-check-deals-spac-boom-fizzles-out-2022-06-01/.

17. *Id*.

18. https://www.law.com/americanlawyer/2022/06/09/miami-lawyer-john-ruiz-made-2-billion-in-the-final-days-of-spac-fever-can-he-keep-it/.

19. Gahng, *supra* note 11, at 6.

20. Statement of John Coates, Acting Director, Division of Corporation Finance, SPACs, IPOs and Liability Risk under the Securities Laws (Apr. 8, 2021), https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws.

21. Neal Newman & Lawrence J. Trautman, Special Purpose Acquisition Companies (SPACs) and the SEC (December 2, 2021), (manuscript at 16), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3905372#; https://www.sec.gov/news/public-statement/accounting-reporting-warrants-issued-spacs.

SPACs became active.[22] Most recently, in May 2022, the SEC proposed an overhaul of regulations governing SPACs to align SPAC regulation more closely with traditional IPO regulation.[23]

SPACs became wildly popular during the pandemic, raising billions of dollars from investors. They are a unique investment vehicle allowing easy raising of capital. But what makes them so special? The following sections of this article contain an overview of the characteristics of SPACs, the SPAC IPO and merger processes, current rules and regulations governing SPACs, recently proposed rule changes by the SEC, and the application of FINRA and SEC rules, including Regulation Best Interest, to SPAC recommendations.

II. What is a SPAC?

SPACs are sometimes referred to as blank check companies because they do not have any operations or purpose other than to identify and acquire one or more operating companies.[24] SPACs are formed by a sponsor, which acts as the SPAC's management responsible for identifying and acquiring a target company to bring public.[25] After a SPAC identifies an acquisition opportunity, it negotiates the terms of an initial business combination with the target. Many—but not all—SPACs are then required to hold a shareholder vote on the proposed transaction.[26] If shareholders approve the deal, the SPAC executes the business combination, often structured as a reverse merger.[27] Regardless of the structure of the transaction, the combined company following the transaction is publicly traded, taking the SPAC's place on an exchange and continuing the target company's business.[28] At the time of the merger, the SPAC will change its ticker symbol to align with the target

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22. What you need to know, *supra* note 5.

23. Special Purpose Acquisition Companies, Shell Companies, and Projections, 87 Fed. Reg. 29458 (proposed May 13, 2022).

24. *What You Need to Know About SPACs – Updated Investor Bulletin*, SEC (May 25, 2021)), Investor.gov., https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-spacs-investor-bulletin.

25. *Id.*

26. *Id.*

27. *Id.*

28. *Id.*

company.[29] Thus, the SPAC process entails two separate transactions: the IPO of the SPAC itself and the merger with the private company, or deSPAC transaction.[30]

a. SPAC Structure and Process

Sponsors create SPACs by forming a corporation and hiring an underwriter to assist in an IPO.[31] Sponsors are usually limited liability companies formed by private equity funds, venture capital funds, hedge funds, former executives of large companies, or even individuals with little relevant background.[32] The SPAC's executives and directors are selected by the sponsor and usually overlap with individuals who own and organize the sponsor.[33] Thus, the sponsor is the management team of the SPAC for all practical purposes.[34]

The first stage of the SPAC process is the IPO of the SPAC itself. Following the IPO, most SPACs have between 18 to 24 months to merge with a target company.[35] If a SPAC does not identify and merge with a target company within that time, the SPAC dissolves and returns cash and accrued interest to its public shareholders.[36] If a SPAC is successful in identifying a suitable target company, negotiating terms of a merger agreement, and obtaining any required shareholder approval, then the merger takes place. The post-merger company then replaces the SPAC's ticker symbol with a new ticker symbol, and shares of the post-merger company trade in the secondary market.[37] The following section will address SPAC structures and processes at the IPO and merger stages.

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29. Newman, *supra* note 21, at 7.

30. Klausner, *supra* note 10, at 10.

31. *Id.*

32. *Id.*

33. *Id.*

34. *Id.*

35. Gahng, *supra* note 11, at 2. Time limits are imposed by prospectus and/or exchange rules. *See, e.g.,* Lionheart Acquisition Corporation II, Prospectus (Aug. 13, 2020).

36. Gahng, *supra* note 11, at 2.

37. *Id.*

i. SPAC IPOs

Since 2010, almost all SPACs price IPO units at $10.[38] Generally, the units offered in a SPAC IPO consist of one share of common stock and a fraction of a warrant.[39] The terms of the warrants as disclosed in the IPO prospectus vary among SPACs. Those terms will determine the number of shares the investor has the right to purchase, the price of the shares, when investors may purchase shares, and when the warrants expire.[40] For example, a SPAC may issue one-quarter or one-third of a warrant with each unit, giving the holder the option to purchase additional shares of the common stock of the post-merger company at a specified price per share, usually $11.50.[41] Within a period of time after the IPO—often within six to eight weeks—the common stock and the warrant that comprise each unit offered in the IPO begin to trade independent of one another with their own respective ticker symbols.[42] Warrants can only be exercised after the completion of a merger.[43] SPACs may also have the option to redeem warrants once they become exercisable.[44]

In a traditional IPO, an issuer hires one or more underwriters to conduct thorough due diligence on the company going public.[45] As noted by the SEC in its release of the proposed new rules governing SPACs, underwriters play a critical role as gatekeepers to the public markets as intermediaries between issuers and the investing public.[46] Although SPACs work with underwriters in their initial offerings, the role of the underwriter in investigating and evaluating a SPAC IPO is far more limited than the underwriter's role in a traditional IPO. This is because a SPAC has no business operations other than seeking a target company. Financial statements in the SPAC's registration statement will be minimal, including balance sheets showing shares issued to

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38. *Id.* at 1.

39. What you need to know, *supra* note 6.

40. *Id.*

41. *Id.;* Gahng, *supra* note 11, at 1.

42. What you need to know, *supra* note 6; SPACs will file an 8-K to notify investors when separate trading may commence.

43. Murray, *supra* note 2, at 6.

44. Lionheart prospectus, *supra* note 35, at 14.

45. FINRA Regulatory Notice 08-54, Guidance on Special Purpose Acquisition Companies, at 3 (Oct. 2008).

46. SEC Release, pp. 20, 88.

sponsors, nominal consideration paid for sponsor shares, any initial financing transactions, and other nominal operating expenses incurred to that point.[47] Other disclosures in the SPAC offering document should include conflicts of interest between shareholders and sponsors and the structure and timelines of the SPAC.[48] Most SPACs pay underwriters a fee of 5.5%, with 2% paid at the IPO and 3.5% paid at the time of a successful business combination.

The SPAC sets aside most of the funds raised in the IPO in a trust for use in the acquisition of a target company.[49] During this time, the SPAC also has operating expenses associated with researching, choosing, and acquiring a target company, as well as the reporting obligations of a public company.[50] SPACs may use some of the IPO funds raised from public shareholders to cover those expenses, though most SPACs will keep at least 80 percent of the funds in escrow for the sole purpose of funding an acquisition.[51] SPACs typically invest the IPO proceeds in safe, interest-bearing investments like money market funds or treasury bonds and may use interest on investments in the trust account to pay taxes.[52] Many SPACs add additional sponsor investment or other private investment to the trust account to ensure that investors receive the full $10 per share in the event of a liquidation. The funds held in escrow are returned to public shareholders if the 18- or 24-month time limit expires to effect a merger, requiring the SPAC to liquidate.[53] SPAC IPO investors are almost always large institutional investors affiliated with hedge funds.[54] The group of hedge funds that repeatedly invest in SPAC IPOs is known as the "SPAC Mafia."[55]

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47. Newman, *supra* note 21, at 39-40.

48. *Id*. at 40-41.

49. What you need to know, *supra* note 6.

50. Newman, *supra* note 21, at 22.

51. *Id*.

52. What you need to know, *supra* note 6.

53. Newman, *supra* note 21, at 33-34.

54. Klausner, *supra* note 10, at 17.

55. *Id*. at 18.

b. Sponsor's Role Following the SPAC IPO

Following the IPO, the SPAC's sponsor is responsible for managing the SPAC, serving as or appointing directors and officers to research and identify target companies, negotiating the terms of an acquisition or merger, and obtaining shareholder approval of the proposed acquisition or merger. Sponsors may include firms or individuals with specialized knowledge and contacts in a particular industry.[56] A recent paper found that SPACs that have sponsors with better connections and networks are more likely to complete a merger and also have better post-merger returns.[57] One way that sponsors can add value to the SPAC is though bridging information gaps between the target company and the market.[58] SPAC sponsors may also offer value to the target company by joining its board after the merger.[59] Some recent SPAC sponsors are affiliated with companies that are devoted solely to formation and management of SPACs.[60] Other sponsors have been famous personalities without any apparent experience or specialized knowledge. A recent study suggested that SPACs that have large private equity funds or former senior officers of Fortune 500 companies as sponsors are more successful in attracting and retaining public and private funding.[61]

At the time of the IPO, the sponsor acquires "sponsor" or "founder" shares, usually 20 percent of the shares outstanding after the merger, for a nominal sum.[62] This form of compensation is known as the sponsor "promote." For example, a SPAC may raise $200,000,000 in IPO funds through the issuance of 20,000,000 shares at $10 per share and set the sponsor's promote at the standard 20 percent of the total outstanding shares in exchange for a nominal payment of $25,000.[63] Here, the sponsor purchases 5,000,000 sponsor shares for $25,000, or $0.005 per share.[64] Thus, the IPO investors contributed 99.9

56. Newman, *supra* note 21, at 42.

57. Chen Lin, et al., SPAC IPOs and Sponsor Network Centrality (2021)), http://dx.doi.org/10.2139/ssrn.3856181.

58. Klausner, *supra* note 10, at 31.

59. Gahng, *supra* note 11, at 11.

60. Klausner, *supra* note 10, at 3.

61. *Id*. at 30.

62. Newman, *supra* note 21, at 24.

63. Lionheart prospectus, *supra* note 35, at 15-16.

64. *Id*.

percent of the funding for 80 percent of the total outstanding shares, while the sponsor contributed 0.01 percent of the funding for 20 percent of the total outstanding shares. The significant discount that sponsors pay for their equity stakes dilutes value for public shareholders in SPACs that successfully merge.[65] Commentators have observed that this hidden cost represents an "exorbitant fee" paid to sponsors by public shareholders and have questioned why investors accept such high compensation to sponsors.[66]

Unlike public investor shares, these sponsor shares do not have an interest in the funds held in trust.[67] In the event the SPAC must liquidate after the time to execute a business combination expires, the sponsor loses the entire value of its promote, which often represents tens of millions of dollars.[68] Under the SPAC's governing documents, money in the trust can only be used for the specific purposes of funding the business combination, returning it to shareholders if a SPAC liquidates, or funding shareholder redemptions.[69] Thus, sponsors do not receive the value of the promote unless the SPAC successfully merges with an operating company. If the SPAC completes a merger, sponsor shares convert into shares of the post-merger company. As discussed further in a later section, the structure of the promote provides an incentive for sponsors to support even a bad merger, rather than lose the entire value of their sponsor shares.[70]

The promote, in effect, compensates the sponsor for organizing the SPAC and supporting its management while the SPAC seeks a business combination.[71] Some SPACs add proceeds from additional sponsor investment to the trust.[72] In 2010, many sponsors began to purchase private placement warrants or units at the fair market value at the time of the IPO.[73] This additional funding of millions of dollars was used to cover upfront underwriting fees and future operating expenses of the SPAC while it sought

65. Klausner, *supra* note 10, at 22.

66. Newman, *supra* note 21, at 30.

67. Gahng, *supra* note 11, at 1.

68. Klausner, *supra* note 10, at 23.

69. *Id*. at 11.

70. *Id*. at 23.

71. *Id*. at 11.

72. *Id*.

73. Gahng, *supra* note 11, at 12.

a target company, assuring that the IPO capital held in trust did not pay those expenses.[74] This resulted in each public investor share of the trust having an initial value at or near $10.00, rather than $9.80 net of underwriting fees.[75] Such steps help to ensure that IPO investors receive a return of at least their full investment when they redeem shares or the SPAC liquidates, including interest accrued in the trust account.[76] Other SPACs may pay expenses using interest generated in the trust account.[77] Exchange rules and SPAC charters generally require that SPACs retain in trust a minimum percent of IPO proceeds for use in a business combination.[78] For example, the minimum percent required by NASDAQ is 90% of IPO proceeds, although in practice, most SPACs that are eligible to be listed on an exchange deposit more than 90% of the IPO proceeds into the trust.[79] NASDAQ rules also require that SPACs complete a business combination with a fair market value of at least 80% of the value of the trust account at the time of signing a definitive merger agreement.[80]

Following the IPO, as the SPAC seeks its target, its shares of common stock may trade at a premium or discount to the IPO unit price.[81] Share price volatility during this time bears little relationship to the ultimate success of the SPAC, depending more on overall market conditions and investor confidence in the sponsor finding value in a target.[82] IPO investors may sell their common stock and retain their warrants during this period. Public shareholders also have the right to redeem their shares of common stock (while retaining their warrants) once the SPAC announces a proposed merger.[83]

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74. *Id*. at 1; Klausner, *supra* note 10, at 11.

75. Gahng, *supra* note 11, at 1.

76. Klausner, *supra* note 10, at 11-12.

77. FINRA Regulatory Notice 08-54, *supra* note 45, at 4.

78. Murray, *supra* note 2, at 9.

79. *Id*.

80. Lionheart prospectus, *supra* note 35, at 8.

81. What you need to know, *supra* note 6, at 2.

82. *Id*.

83. *Id*. at 3.

i. SPAC Mergers

After a merger is announced, public shareholders have the option to redeem their shares. Redemption rights are a critical feature of the SPAC structure.[84] Redeeming shareholders receive cash representing their pro rata share of the funds held in trust upon completion of the business combination.[85] The redemption right entitles investors during the SPAC period (from IPO to merger) to either become investors in a newly traded public company or receive their money back guaranteed, while retaining warrants to purchase post-merger shares of the company.[86] Given these features, some commentators describe SPAC IPO units as risk-free convertible bonds with extra warrants.[87] As a result , SPAC period investors have enjoyed very attractive risk-adjusted returns, as discussed below. Further, because most IPO investors exit SPACs before the merger by redeeming their shares, and SPACs most often engage in a second round of raising capital to fund the merger, the SPAC merger is very similar to an IPO of a private company.[88]

Prior to 2010, SPAC structures bundled redemption and merger voting rights together in one decision. A vote in favor of the merger canceled the right of redemption. Since then, SPACs have separated these decisions and permitted shareholders who vote in favor of the merger to redeem their shares.[89] Because shareholders who redeem their common stock retain the separate warrants to purchase shares of the post-merger company, they have an incentive to vote in favor of an unpromising merger, redeem their shares, and retain the value of their warrants that would otherwise be worthless in a SPAC liquidation.[90] This feature may complicate decision-making for unsophisticated retail investors who do not understand that they may be better off redeeming their shares even if a majority of shareholders approved a merger.[91]

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84. Gahng, *supra* note 11, at 11.

85. Newman, *supra* note 21, at 23.

86. Gahng, *supra* note 11, at 3.

87. *Id*.

88. Klausner, *supra* note 10, at 10.

89. Gahng, *supra* note 11, at 12.

90. *Id*.

91. Newman, *supra* note 21, at 19.

After the merger announcement, the SPAC and the target company market the merger to attract interest in the public market.[92] Increased public market interest bolsters the share price of the SPAC, encouraging IPO investors to sell rather than redeem their shares and preserving cash held in trust to use in the acquisition.[93] Another objective of marketing the proposed merger is to attract private investment.[94]

Terms of the merger are disclosed in a SPAC's proxy statement filed after the announcement of the proposed merger. Those terms will detail financing requirements and the capitalization, ownership, and management of the combined company. A minimum amount of cash to be delivered by the SPAC is a requirement of most mergers.[95] In order to satisfy conditions of a merger agreement (such as minimum amounts of cash to be delivered), and depending on the rate of redemptions, SPACs may need to raise more capital through additional sponsor investment or a private investment in public equity (PIPE).[96] Additional capital contributed by PIPE investors ensures that the SPAC meets minimum cash delivery requirements negotiated in the merger agreement with the target company.[97] Prominent PIPE investors also reassure public shareholders of the attractiveness of the proposed deal, encouraging them not to redeem shares.[98] SPACs with more redemptions will require greater amounts of PIPE financing, as redemptions reduce the amount of cash in trust that can be used for an acquisition.[99] In PIPE transactions, SPACs issue unregistered shares to private investors.[100] SPACs often offer lower prices per share to PIPE investors than the price per share that SPAC IPO investors paid, further diluting share values, as initial IPO shareholders own a smaller percentage of the company with each private share issued.[101]

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92. Klausner, *supra* note 10, at 12.

93. *Id*.

94. *Id*. at 13.

95. Gahng, *supra* note 11, at 10.

96. *Id*. at 2.

97. *Id*.

98. *Id*.

99. Newman, *supra* note 21, at 33.

100. *Id*.

101. *Id*. at 34-35.

While deSPAC transactions often lack named underwriters, underwriters commonly participate by acting as financial advisor to the SPAC and assisting in other activities related to the distribution of deSPAC securities, including identification of target companies, negotiation of merger terms, or facilitation of PIPE investments.[102] At the conclusion of the merger, public investors, private investors, and sponsors usually own a minority share of the combined public company, while target company shareholders own the majority.[103] The name and ticker symbol of the combined company will typically change to reflect the name of the newly public company.[104]

c. Conflicts of Interest and SPAC Performance

The structure of SPACs encourages their formation by sponsors. The sponsor promote structure assures that the sponsor will receive generous compensation in any merger, regardless of whether the merger is good for shareholders. Moreover, the sponsor has an incentive to characterize a merger proposal as favorable in investor presentations and the SPAC's public filings, both to encourage shareholder approval of the merger and to bolster the premerger value of SPAC shares to encourage sales instead of redemptions of shares.[105] This incentivizes sponsors to not fully disclose details regarding a merger to shareholders.[106] Likewise, because 3.5% of its 5.5% underwriting fee is conditioned on a successful merger, underwriters have an incentive to gain the approval of shareholders.[107]

While the merger deadline for SPACs helps to limit IPO investors' illiquidity costs, it also creates a misaligned incentive for the sponsor to pursue unattractive business combinations.[108] For the sponsor, a merger that is bad for shareholders is still better than no merger at all, which results in a loss of the sponsor's entire 20% equity stake.[109] Unpromising merger proposals may also

102. SEC Release, *supra* note 46, at 97.

103. Klausner, *supra* note 10, at 14.

104. Newman, *supra* note 21, at 7.

105. Klausner, *supra* note 10, at 8.

106. *Id*. at 23.

107. SEC Release, *supra* note 65, at 97; Klausner, *supra* note 10, at 28.

108. Gahng, *supra* note 11, at 6.

109. Klausner, *supra* note 10, at 23.

result in higher redemptions, enhancing the need for PIPE funding to meet minimum cash per share requirements negotiated by the target company.[110] Although the difficulties posed by high rates of redemptions—including the prospects that a sponsor may need to forfeit part of its promote or to inject its own additional capital in order to meet minimum cash per share requirements—may discourage sponsors from proposing bad deals, at least one analysis has found poorer deSPAC returns associated with higher redemptions and shorter time periods until the merger deadline. This finding suggests that sponsors propose more unfavorable mergers under pressure to consummate any business combination rather than lose their promote in a liquidation of the SPAC.[111]

The average redemption rate for SPACs that merged between January 2019 and June 2020 was 73 percent.[112] The average total divestment rate during that period for all SPAC IPO investors—including sales on the open market after a merger is announced—was 98 percent.[113] Analysis of filings by large institutional investors shows close to 100 percent turnover of their shares through redemptions or sales between the announcement and closing of a merger.[114] The almost complete exit of IPO investors and the capital raised from new investors at the time of the merger show how the SPAC IPO and the SPAC merger are independent of one another in practice.[115] This is one reason why the SEC considers the SPAC merger the functional equivalent of an IPO.[116] This feature of SPACs has also led commentators to observe that SPAC IPO investors seem to serve the role of funding the creation of a public company that will later bring a private company public through a merger funded with investment from entirely new shareholders.[117]

A recent study showed that SPAC period investors earned an average annualized return of almost 16 percent for SPAC IPOs between 2010 and

110. *Id*. at 30.

111. Gahng, *supra* note 11, at 11.

112. Klausner, *supra* note 10, at 19.

113. *Id*. at 21.

114. *Id*. at 17.

115. *Id*. at 22.

116. Statement of John Coates, *supra* note 20, at 4.

117. Klausner, *supra* note 10, at 22.

2019, reflecting the benefits of redemption rights and retention of warrants.[118] Meanwhile, deSPAC period investors, measured from the first day of trading of the merged company, earned average returns of -8.1 percent, or -24.6% worse than an overall market value-weighted index.[119] Measured another way, among shareholders for all 47 SPACs that merged between January 2019 and June 2020, the average market-adjusted return of nonredeeming shareholders was -64%.[120] Why are deSPAC and nonredeeming shareholder returns so low? The value of a SPAC is its cash, and the amount of net cash per share delivered by the SPAC is in effect the price at which the target company will sell its shares, providing a reference point for estimating the valuation of the company.[121] SPACs typically deliver less than $10 of cash per share to the target company due to high redemptions, underwriting fees, and the promote, even after PIPE investments.[122] In fact, researchers found that the median SPAC, in a sample from January 2019 to June 2020, delivered only $5.70 in cash per share in its merger transaction.[123] In addition, outstanding warrants are dilutive when a merged company is successful, resulting in a drag on deSPAC upside returns.[124] Thus, public shareholders who choose not to redeem experience dilution through the sponsor promote, redemptions by other public shareholders, and PIPE investments.[125]

Proponents of SPACs cite their lower costs and greater efficiencies for target companies compared to IPOs. Skeptics note that the common SPAC structure leads to conflicts of interest for the sponsor of the SPAC and disadvantages non-redeeming IPO shareholders through dilution and costs. In his April 2021 statement, the SEC's former Acting Director of the Division of Corporation Finance described SPAC mergers as functional equivalents of introductions to the market of traditional IPOs, noting the importance of

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118. Gahng, *supra* note 11, at 3.

119. *Id.* at 4.

120. Klausner, *supra* note 10, at 7.

121. *Id*. at 57, 72.

122. Gahng, *supra* note 11, at 4.

123. Klausner, *supra* note 10, at 7; researchers have attributed the difference between $10 and the net cash per share to costs embedded in the SPAC structure: extraction of compensation paid to sponsor, IPO investors, underwriters, and other advisors in merger.

124. Gahng, *supra* note 11, at 4.

125. Newman, *supra* note 21, at 38.

"developing law around economic substance over form."[126] Commentators have also observed that there is no policy reason to treat a SPAC merger differently than an IPO and that differing treatment of them has encouraged companies seeking to go public to engage in regulatory arbitrage.[127]

d. Current Regulations Governing SPACs

Like any other IPO registrant, the SPAC files a Form S-1 registration statement—or prospectus—with the SEC in accordance with Regulation S-K and Regulation S-X.[128] Regulation S-K governs qualitative disclosures[129], while Regulation S-X governs quantitative disclosures such as financial statements.[130] While the registration statement requires disclosure of risk factors and audited financial statements, a SPAC has no business operations or performance history to report.[131] For that reason, disclosures in a SPAC registration statement are often limited to the structure and process of the SPAC, risks associated with that structure and process, and background information on the sponsor, directors, and certain executives of the SPAC.[132] Other disclosures typically include conflicts of interest between shareholders and sponsors and conflicts of interest of underwriters created by the SPAC's compensation structure.[133]

Once a SPAC has completed the negotiation of an agreement with the target company, it announces the agreement and prepares and files a Form S-4 registration statement.[134] A Form S-4 is the form required to be filed by a company seeking to publicly issue new securities pursuant to a merger and, like a Form S-1, is governed by Regulations S-K and S-X.[135] SPACs typically

126. Statement of John Coates, *supra* note 20, at 3.

127. Klausner, *supra* note 10, at 68; Gahng, *supra* note 11, at 15.

128. Newman, *supra* note 21, at 21.

129. 17 C.F.R. § 229.

130. 17 C.F.R. § 210.

131. Newman, *supra* note 21, at 22.

132. *Id*. at 21-22.

133. See, e.g., Lionheart prospectus, *supra* note 35.

134. Gahng, *supra* note 11, at 14.

135. 17 C.F.R. § 229; 17 C.F.R. § 210.

require shareholder approval of a merger and will schedule a shareholder vote and provide shareholders with a proxy statement.[136] The proxy statement contains information regarding the target company and the capital structure of the merger, including financial statements of the target and conflicts of interest among parties to the transaction, including the sponsor.[137] SPACs are also required to file written communications regarding proposed business combinations pursuant to Rule 425 of the Securities Act and may use Form 8-K to provide that information.[138] In connection with the shareholder vote on the proposed merger, SPACs are required to file a proxy statement using Form 14A.[139]

While a company going public in an IPO would be required to have financial statements audited in accordance with PCAOB standards, the operating company in a SPAC merger does not have to meet this requirement.[140] Furthermore, registration statements in a SPAC merger generally include revenue and earnings projections—forward looking statements that the securities laws prohibit in an ordinary IPO.[141]

Although traditional securities regulations apply to SPACs at the IPO stage, SPACs, as a shell company, have little operational information to disclose. In the deSPAC stage, the governing securities regulations are those applicable to mergers, not IPOs. A key difference in merger regulations is that projections and other forward-looking statements are covered by a safe harbor from liability in private actions under the securities laws.[142]

Specifically, the Private Securities Litigation Reform Act ("PSLRA") gives certain issuers a safe harbor to make forward-looking statements in

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136. What you need to know, *supra* note 6. Some SPACs do not require approval from public shareholders because the sponsor and affiliated individuals and entities hold sufficient votes to approve the transaction. In that case, the SPAC will provide an information statement to its shareholders. *Id.* If a SPAC is not required to obtain shareholder approval at all, it will provide a tender offer statement to its shareholders. *Id.*; Newman, *supra* note 21, at 29.

137. FINRA 08-54, supra note 45, at 3.

138. 17 C.F.R. § 230.425; *see, e.g.*, Lionheart Acquisition Corp. II, 8-K.

139. SEC Release, *supra* note 46, at 11.

140. Gahng, *supra* note 11, at 13.

141. *Id*. at 14.

142. Klausner, *supra* note 10, at 52.

Section 13 of the Securities Exchange Act.[143] This safe harbor does not extend to statements made in connection with an initial public offering.[144] Section 13 also excludes from the safe harbor forward-looking statements made "in connection with an offering of securities by a blank check company."[145] Why then does the safe harbor include SPACs, which are formed for the sole purpose of acquiring an operating company?

A few years before enactment of the PSLRA, the SEC defined "blank check company" under Rule 419 as "a development stage company that has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies" and is issuing "penny stock" as defined in Rule 3a51-1(503).[146] SPAC predecessors known as "blind pools" had negative associations connected with penny-stock fraud.[147] However, because SPACs being issued in the 1990s did not meet the definition of issuers of penny stock, they were not considered to be "blank check companies" for purposes of the safe harbor exclusion. A SPAC that raises more than $5 million in an IPO is not selling "penny stock" and therefore is not a "blank check company" as the SEC currently defines those terms.[148] Thus, SPACs are not subject to liability for forward-looking statements or projections that turn out to be false (if accompanied by "meaningful cautionary language") unless the person making the statement knew it was false at the time it was made.[149] While this view is widely held among SPAC market participants, at least some legislative history of the PSLRA indicates that Congress may not have been aware of the SEC definition and intended that the safe harbor would not apply to "blank check companies" regardless of whether they are issuing penny stock.[150]

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143. 15 U.S.C. §78u-5 (2018).

144. 15 U.S.C. §78u-5(b)(2)(D) (2018).

145. 15 U.S.C. §78u-5(b)(1)(B) (2018).

146. 17 CFR §230.419 (2021). Rule 3a51-1 defines "penny stock" as stock issued by a company with stockholders' equity of less than $5,000,000. 17 CFR §240.3a51-1. The vast majority of SPACs exceed this threshold.

147. Amrith Ramkumar & Maureen Farrell, *When SPACs Attack! A New Force is Invading Wall Street*, Wall St. J., Jan. 23, 2021 https://www.wsj.com/articles/when-spacs-attack-a-new-force-is-invading-wall-street-11611378007.

148. SEC release, *supra* note 46, at 83.

149. Klausner, *supra* note 10, at 53.

150. *Id*. at 67. (citing H.R. Rep. No. 104-369, at 46 (1995)).

Nonetheless, SPACs and target companies routinely disclose projections and other forward-looking statements in investor presentations and registration statement filings.[151] Companies seeking to bridge information gaps with potential investors may find it beneficial to have the ability to make forward-looking statements.[152] Similarly, low-revenue or "pre-revenue" SPAC targets may only have future projections to share with investors.[153]

In a traditional IPO, underwriters conduct thorough due diligence and then assume liability for information disclosed in the prospectus.[154] Section 11 imposes civil liability on underwriters for untrue statements or omissions of material fact in registration statements, providing significant investor protection.[155] Current regulations do not impose the same liability on underwriters for information in the proxy statement relating to the acquisition target of a SPAC.

III. SEC Proposes Rule Change to Align SPAC Regulation with Traditional IPOs

In May 2022, the SEC published its request for comment on several proposed rule changes regarding SPACs with the express intent of enhancing investor protection at both the SPAC IPO and SPAC merger stages.[156] The overall intent of the proposed rule is to enhance disclosures and to align SPAC regulation more closely with regulations governing IPOs. This section will address several changes contained in the proposed rule that are relevant to the issues discussed herein regarding enhanced disclosures, forward-looking statements, underwriter liability, and financial statements.

With respect to SPAC IPO disclosures, the proposed rule would require certain disclosures on the prospectus cover page in plain English, including the time frame for a SPAC to reach a merger, terms of redemptions, sponsor compensation, dilution, and conflicts of interest.[157] As to SPAC merger

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151. *Id*. at 53.

152. *Id*.

153. *Id*.

154. FINRA Regulatory Notice 08-54, supra note 45, at 3.

155. SEC Release, *supra* note 46, at 89.

156. *Id*.

157. *Id*. at 42.

disclosures, the proposed rule would require disclosures regarding the fairness of the deSPAC transaction, material financing transactions, sponsor compensation and dilution, and conflicts of interest on the cover page in plain English.[158] The proposed rule would also require enhanced disclosures in the prospectus summary at both the SPAC IPO and the SPAC merger stages, including the process for identifying and merging with a target company, material terms of the trust and redemption rights, the class of shares held by the sponsor, plans for additional financing, material terms and fairness of the deSPAC transaction, financing transactions for the SPAC merger, redemption, sponsor compensation, dilution, and conflicts of interest.[159]

Significantly, the proposed rule would also modify treatment of projections and other forward-looking statements under the PSLRA. Specifically, the proposal would define "blank check company" in a manner that would eliminate the safe harbor for forward-looking statements for SPACs.[160] SEC Rule 419 currently defines "blank check company" as a development stage company that is issuing penny stock and that has no specific business plan or purpose, or a company that indicates its only purpose is to acquire an unidentified company.[161] The SEC's amended definition of "blank check company" would remove the penny stock condition.[162] Removing the penny stock language would clarify that the statutory safe harbor under the PSLRA is not available for projections and other forward-looking statements in deSPAC transactions.[163] The SEC notes that it does not see any reason to treat forward-looking statements in deSPAC transactions differently than forward-looking statements in traditional IPOs, in that both involve the introduction of private companies to the public markets.[164]

Underwriters for SPACs would also face increased liability under the proposed rule. Citing underwriters' critical role as "gatekeepers" in the offering and distribution of securities, the proposed rule would subject underwriters to Section 11 liability in the deSPAC transaction under new Rule

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158. *Id*.

159. *Id*. at 43-44.

160. *Id*. at 84.

161. Rule 419; SEC Release, *supra* note 46, at 83.

162. SEC Release, *supra* note 46, at 84.

163. *Id*. at 85.

164. *Id*. at 84.

140a of the Securities Exchange Act.[165] Specifically, the proposed new rule would provide that an underwriter involved in the SPAC IPO and the deSPAC transaction, or related financing transactions, would be deemed to have engaged in the distribution of securities of the combined public company for purposes of the Securities Exchange Act.[166] The clarification of the status of underwriters in deSPAC transactions would subject them to civil liability under Section 11.[167] This would restore the "due diligence" obligations of underwriters as an intermediary in the distribution of securities, requiring them to show as a defense to civil liability that it exercised reasonable care in verifying statements in the registration statement and had reasonable ground to believe and did believe that those statements were true and that there was no omission to state a material fact required to be stated or necessary to make the statements not misleading.[168] In support of the proposed rule, the SEC cites the financial incentive that underwriters have in seeking shareholder approval of business combinations, given that 3.5% of underwriting fees is deferred to, and conditioned upon, the completion of a merger.[169]

After the initial business combination, the financial statements of the target company become those of the registrant—in this case, the SPAC—for financial reporting purposes.[170] Expressing its view that the manner in which a company decides to go public should not result in substantially different financial statement disclosures, the SEC proposes new Article 15 of Regulation S-X to align financial statement reporting requirements in deSPAC transactions more closely with those in a traditional IPO.[171] One such requirement would be that financial statements must be audited in accordance with PCAOB standards.[172] Form S-4 currently provides that target company financial statements may be audited in accordance with GAAP.[173]

165. *Id*. at 96.

166. *Id*.

167. *Id*.

168. *Id*. at 90.

169. *Id*. at 97.

170. *Id*. at 112.

171. *Id*.

172. *Id*. at 116.

173. *Id*.

IV. FINRA Regulation of SPACs

While the SEC has proposed new rules to govern SPACs that would align SPAC mergers with traditional IPOs, increasing investor protection and reducing the incentive for regulatory arbitrage by companies seeking to go public, FINRA has issued very little guidance on recommendations of SPACs by member firms and associated persons.

In 2008, FINRA released a regulatory notice providing an overview of SPACs and SPAC processes, as well as identifying risks that firms must consider at various stages when recommending SPACs to their customers.[174] Those risks included that SPAC sponsors may be "unqualified or incompetent" and that underwriters may not perform the same level of diligence on SPAC acquisition targets as they do on companies going public in an IPO.[175] At that time, FINRA stated that firms must ensure that their brokers understand the features of SPACs and that their customers understand the risks of SPACs.[176] FINRA also noted that firms should consider adoption of special suitability guidelines for SPACs.[177] In October 2021, FINRA conducted a targeted examination—also known as a sweep—regarding activities and procedures of member firms relating to services provided to SPACs as well as SPAC retail sales practices.[178]

As evidenced by the much higher returns of SPAC IPO investors as compared to deSPAC period investors, SPACs can be a profitable investment. That depends in large part, however, on the timing of decisions to buy, sell, hold, or redeem shares prior to the SPAC combining with an operating company, which is the very purpose of a SPAC.[179]

a. Brokers' Duties When Recommending SPACs Under Reg BI

Under Regulation Best Interest (Reg BI), a broker recommending SPAC shares must have a reasonable basis to believe that this recommendation is in

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174. FINRA Regulatory Notice 08-54, supra note 45.

175. *Id*. at 2-3.

176. *Id*. at 4.

177. *Id*.

178. https://www.finra.org/rules-guidance/guidance/targeted-examination-letters/special-purpose-acquisition-companies-spacs.

179. Newman, *supra* note 21, at 38.

the best interest of the customer. The cornerstone of the care obligation is that firms and brokers may not place their own interests above those of the customer.[180] Reg BI also imposes disclosure and conflict of interest obligations.[181] Pursuant to those obligations, firms that assist a SPAC or provide services in connection with a deSPAC transaction should, at minimum, disclose those activities when recommending shares of the SPAC. The compliance obligation of Reg BI also requires firms to adopt policies and procedures reasonable designed to achieve compliance with the rule, and firms that engage in SPAC activities and/or sales should tailor their policies and procedures to account for the unique characteristics and conflicts of SPACs.[182]

With respect to the care obligation, Reg BI requires a broker making a recommendation to "[u]nderstand the potential risks, rewards, and costs associated with the recommendation" and to "[h]ave a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer."[183] Because a SPAC that has not yet announced a merger has no business operations—other than its search for a target company—a broker recommending the purchase of SPAC shares at this stage has very little information available upon which to evaluate whether the recommendation is in the best interest of the customer. The information available on a pre-merger SPAC is generally limited to the background of the SPAC's management, plans for the use of offering proceeds to purchase an unidentified company, and disclosures and balance sheets relating to the operations of the SPAC. A broker recommending a SPAC at this stage likewise has little to no information on the company (or type of company) that a SPAC will acquire or the terms of the merger. Given this absence of information, it may not be possible to understand risks, rewards, and costs associated with a SPAC recommendation sufficiently to determine a SPAC to be in a customer's best interest for all but the most speculative investor profiles. As part of the obligation to understand a security before recommending it, the SEC specified "characteristics (including any special or unusual features)" as factor that brokers and firms should consider.[184] One characteristic of SPACs that is special or unusual is the redemption feature, which firms and brokers should therefore consider, understand, and explain when recommending a SPAC to a customer. Even

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180. 17 C.F.R. §240.15 ***l*** -1(a)(1) (2019).

181. 17 C.F.R. §240.15l-1(a)(2)(i) (2019); 17 C.F.R. §240.15l-1(a)(2)(iii)(A) (2019).

182. 17 C.F.R. §240.15l-1(a)(2)(iv) (2019).

183. 17 C.F.R. §240.15l-1(a)(2)(ii) (2019).

184. 84 Fed. Reg. at 33, 375-76.

then, the conflicts of interest, costs, and share dilution of SPACs may complicate or frustrate compliance with Reg. BI, and the broker or firm will not have any basis at the time of the initial recommendation for determining whether the eventual redemption decision is in the best interest of the customer.

A customer who purchases pre-merger SPAC shares has in essence a second investment decision to make after the SPAC announces a merger and its shareholders have the opportunity to redeem their shares. In order to comply with Reg BI, a broker who recommends the purchase of a SPAC may also be required to advise the customer on whether to redeem shares after the announcement of a merger and filing of proxy statements. Because the redemption decision is an entirely separate investment decision, the absence of advice to a customer on whether to redeem shares may even be considered a hold recommendation subject to the requirements of Reg BI.

V. Conclusion

While SPACs have emerged in recent years as a competitive alternative to traditional IPOs for companies seeking to go public, the new rules proposed by the SEC would significantly alter the perceived "regulatory arbitrage" advantages of SPACs, including the safe harbor for projections and forward-looking statements. It remains to be seen how the SPAC market will adapt to the proposed rules and how that may influence the continued development of the structure and funding of SPACs. The SEC's proposed rules, if adopted, would offer significant protections to investors in SPACs. Given the complexity of SPACs and their risks, however, brokers and firms recommending SPACs should, under Reg BI, consider whether sufficient information exists to determine whether a SPAC is in the best interest of the customer and whether the firm should provide advice at the redemption stage in regard to a transaction that amounts to a second investment decision. To align with the SEC's analysis of the deSPAC transaction as the functional equivalent of a traditional IPO that warrants similar investor protections, firms and brokers should also recognize the significance of the second investment decision at the redemption stage and provide SPAC recommendations that take into account the best interest of the customer at that stage.

BOND INVESTMENT CASES: A PRIMER FOR CLAIMANTS' ATTORNEYS

Mark Conner

Securities claims involving bond investments can be quite different from typical stock investment cases. Bond cases require careful attention, and they will likely require claimants' attorneys to educate arbitrators on the important differences between the two types of cases, including the proper damages calculations.

OVERVIEW

The greatest difference between stock investing and bond investing is the nature of the respective approaches to each: passive versus active. Investment professionals generally monitor a stock portfolio to guard against the possible underperformance of the commercial entities that have issued the stocks. Should there be a stock price drop, a financial advisor may recommend that the customer sell that stock and purchase another one with better prospects. While this is the typical nature of stock investing, it is not the case with bonds. Bonds are contracts between lenders (investors) and borrowers (issuers.) Performance under these contracts is guaranteed by the issuer, so, unlike stocks, bonds' performance during their life is 100% predictable. Cash flows associated with bonds are fully predictable and are just two-fold: (1) periodic interest payments and (2) the redemption value of a bond when it reaches its maturity date. Because of these certainties, bond investing is passive investing.

It is also true that bond investing is contract-driven, while stock investing is more speculative. This is an essential difference between the investment classes of equity and debt.

Returns on bonds are pre-determined at the time of purchase and are guaranteed to be realized, regardless of market dynamics. The measure of this return performance is called "yield to maturity," which is the total return that will result based on the purchase price of the bond, the cash flows from all interest payments, and the receipt of face value at maturity (assuming the bond is held to maturity).

Yield to maturity is not a prediction; it is a mathematical *fait accompli* that is known at the time of initial investment. If a bond is held to maturity, it will only produce the advertised yield to maturity outcome, nothing more and

nothing less.[1] This certainty is the central motive investors have for choosing to invest in bonds rather than stocks – they are risk-averse investors.

CONTRAST IN RISK/REWARD

Stocks and bonds differ greatly in terms of risk and reward.[2] As such, they can be seen as having opposite investment objectives: growth versus income. Most bonds (including corporate, municipal, and federal agency bonds, among others) pay a fixed rate of interest until they reach their maturity dates, when an investor receives the full face-value of the bond, also known as maturity value or par value. While the price of a bond may rise and fall due to market factors[3] until it reaches maturity, investors will still receive only the face amount of the bond at maturity, irrespective of the original purchase price. In other words, any interim price fluctuations disappear at maturity. While investors may reap capital gains (or take losses to offset other investment gains) by selling prior to maturity, generally bond investing is a buy-and-hold-to-maturity proposition. As such, growth of principal is forgone.[4] Moreover, selling prior to maturity will modify the total return to the investor, so, in this regard, turnover in a bond account undoes the original investment recommendation made to an investor, *i.e.,* the yield to maturity promise.

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1. Many bonds are subject to redemption at a predetermined price by their issuer. The outcome of such a bond "call" is also known in advance and must be described to an investor at the time of initial investment.

2. Since 1992, the S&P 500 averaged an annual average total return of 10.72%, while investment grade corporate bonds paid an average yield to maturity of 5.41%.

3. The concept of rising and falling bond prices is often summed as "When rates go up, prices go down," but this is not so self-explanatory. It's more helpful to keep in mind that once a bond is issued and purchased by an investor, its interest rate cannot change for the life of the bond. If rates subsequently rise and a new issue comes to market, it will have a higher interest rate to reflect the new reality of interest rates, which means that the older, lower interest bond will fetch less money when sold because it holds the promise of receiving less money in the form of interest income. The reverse is true when rates decline.

4. Parties to a securities dispute may argue that interest income increases the value of an account and therefore is growth, but in the securities industry, the standard definition describes growth of invested *principal* and is associated only with stocks, not bonds. Were this not true, the investment objectives of hundreds of "Growth and Income" mutual funds would be redundant.

BONDS AND STOCKS REFLECT OPPOSITE RISK TOLERANCES

Bonds (debt) stand ahead of stocks in the order of liquidation priority in bankruptcy. Bonds are, by definition, a more conservative investment choice than stocks, if only for this difference in their liquidation preference. Beyond this priority provision, there are features of bonds that make them the most suitable recommendation for risk-averse investors.

Municipal and federal agency bonds are among the safest investments available, and investment grade corporate bonds are also superior to equity investments from a principal risk perspective. The greatest threat to bond investors is default. Bonds are deemed to be in default when the issuers fail to pay interest and/or repay principal at maturity. These are disaster scenarios for bond investors, but they are rare. Moody's Investors Service statistics from 1970 through 2020 show that investment grade municipal bonds defaulted in just 0.10% of cases, and investment grade corporate bonds only 2.24%.[5]

RECENT TRENDS

Since the last Tech Wreck, shortly after the turn of the millennium, there has been a rising tide of churning cases involving bonds (generally corporate bonds, municipal bonds, or structured notes.) Also, there has been an increase among brokers of recommendations to customers to purchase marginally investment-grade (or even outright junk bonds) to boost returns. Brokers often make these unsuitable recommendations that may be hard to detect for several reasons:

- Bond commissions are not disclosed to customers,[6] either on a trade-by-trade basis or in aggregate amounts periodically. When it comes to bond commission costs, customers are completely in the dark. And, subject to some possible guidance from traders, client-facing brokers are free to set commission rates for each trade. Mark-ups and mark-downs are almost always greater than commissions for stocks, pound for pound.

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5. *See US municipal bond defaults and recoveries, 1970-2020,* MOODY'S INVESTORS SERVICE, July 9, 2021, at Exhibit 4, *available at* https://www.moodys.com/research/US-Public-Finance-US-municipal-bond-defaults-and-recoveries-1970--PBM_1259641 (last visited August 21, 2022).

6. A small proportion of bond trades involving special conditions require the disclosure of commissions only on trade confirmations, not on customer statements, but most bond trades require no commission disclosure.

- Poor bond price performance is mitigated or even offset by interest income, at least partially masking losses in total return measures.
- Until recent months, the bond markets have largely been in bull mode since 2008 due to the Federal Reserve Bank's intervention (loosening credit and Quantitative Easing). This long-term, strong performance hides the effect of excess commission costs and unsuitable turnover. In many cases, damages are simply a matter of interest income and market gains having been converted to commission through churning. This was true for nearly the entire period from 2009 through 2020, when high-grade corporate bonds averaged annual returns of 9.6%.[7]
- Brokers often recommend bonds that carry lower investment quality ratings (not infrequently including junk bonds) to show higher return performance ("stretching for yield"), exposing customers to unsuitable risk.
- Unauthorized trading is not uncommon in some bond accounts. Because of the relatively safe nature of bonds, customers may not know or are reluctant to ask about trades that only appear to conform to their objectives.
- "Bond" simply sounds safer to unsophisticated investors, and all retail investors are unsophisticated, contrary to the arguments of respondent firms.[8]

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7. S&P Investment Grade Corporate Bond Index, December 2009 – March 2020.

8. *See* MSRB (Municipal Securities Rulemaking Board) Rule D-15, *available at* https://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/Definitional/Rule-D-15.aspx (last visited August 21, 2022):

> The term 'sophisticated municipal market professional' or 'SMMP' is defined by three essential requirements: the nature of the customer; a determination of sophistication by the broker, dealer or municipal securities dealer ("dealer"); and an affirmation by the customer; (specified as): (a) Nature of the Customer. The customer must be: (1) a bank, savings and loan association, insurance company, or registered investment company; (2) an investment adviser registered either with the Commission under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or (3) any other person or entity with total assets of at least $50 million.

DAMAGES

In determining damages in a bond case, the traditional Out-of-Pocket method should generally be avoided because it is ill-suited and meaningfully disadvantages a claimant. The primary reason for this lies in the math that underlies all bond investment recommendations.

While the concept is not necessarily fully understood by all, arbitration participants generally acknowledge that prices for bonds go up and down, as with all market-traded securities. When a bond investor has held a bond since an earlier time when their interest rate was a market rate, and when an investor contemplates selling that bond at a later time but before it matures, they must take into account rates that prevail at that contemplated time of sale.

For example, if an investor purchased a 3% bond maturing in 20 years earlier at a market rate (yield to maturity) of 3%, the customer will have paid the same value as its maturity value.[9] (It is easiest to think of bond prices as a percent of par value, *e.g.*, the base unit of any bond is $1,000, and this is also the par value. For trading short-hand purposes, a single bond that costs $1,000 is said to be priced at 100, or 100% of its par value.)

Once a bond is purchased, its interest rate cannot be adjusted (in most cases) and, therefore, when newer bonds come to market at new, higher interest rates, the older bond is priced to reflect its lower interest rate. As further example, assume the 3% bond maturing in 20 years is considered for sale 2 years after purchase, when it is then an 18-year bond. If 18-year bonds at that time are paying 5%, a potential buyer of the 3% bond will require additional compensation to get to a total return of 5%. If this buyer purchases the 3% bond at something less than what they will receive when the bond matures (100), the additional cashflow from that gain will serve to increase the total return to 5%.

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9. Par value, maturity value, redemption value, and face value are all the same concepts. It is the value an investor will receive when a bond matures and the issuer pays the principal notion due.

Here's an example using a 20-year bond that pays interest at 3%:

3% BOND PURCHASE IN 3% MARKET

Purchase date:	July 1, 2012
Par value:	$100,000
Coupon rate:	3%
Maturity date:	July 1, 2032 (20 years)
Maturity value:	100 ($100,000)
Price:	100
Price per $100 par value:	$100,000
Yield to maturity:	3.00%

3% BOND PURCHASED BY CLAIMANT IN 5% MARKET 2 YEARS LATER

Purchase date:	July 21, 2014
Par value:	$100,000
Coupon rate:	3%
Maturity date:	July 22, 2032 (now 7 years)
Maturity value:	100 ($100,000)
Price per $100 par value:	76.444
Dollar cost:	$76,444
Yield to maturity:	5.00%

The claimant is the second investor and paid $76.444 ($76,444 total) for this bond in 2014, and, further, the claimant's bond was sold 3 years after their purchase at a price of 50. To assess proper income taxation on the discounted value ($23,556 out of $100,000) over the remaining life of the bond, the discount must be spread out over the bond's remaining life. This means that about $1,309 each year in added income from the discount must be taxed ($23,556 / 18 = $1,309). This process is called "discount accretion" or simply "accretion." Over the remaining 18-year life of the bond, taxes are paid on the annual accretion. At maturity, the last tax collection occurs on that same annual discount amount.

For each year that the annual, *pro rata* share of discount is taxed, the cost basis must be increased by that accretion amount to avoid future taxation on any prior discount accretions. Therefore, in this example after Year 1, the adjusted cost basis is calculated as follows: purchase price + 1 year's accretion: $76,444 + $1,309 = $77,752 (or, in trader shorthand, $77.752). In Year 2, accreted value is again $1,024 higher - $76,444. After 3 years, the accreted value (adjusted cost basis) is $75,135 ($75.135, shorthand.)

A sale of this bond after purchase but before maturity will have tax consequences and such taxation is based upon whether the bond purchase was made at a price above par, *i.e.*, greater than 100, or below par, *i.e.*, less than

100 (a bond bought at a price above par is said to have been bought at a "premium" and bonds bought at a price below par at a "discount").

Securities attorneys must educate panels on this so that they will understand that tax treatment is taken into account by the market when it determines the price for a bond (this is especially true for tax-exempt municipal bonds). Bonds trading at a premium or discount price entail unique taxation considerations to which the market remains highly attuned. Taxation is always a factor when determining damages because taxation is at all times an integral consideration at the time of the original recommendation by a broker and for all of its remaining life.

For tax purposes that the bond markets always take into account, a premium or discount price must be adjusted during the life of the bond in order to treat the difference between the purchase price (<100 or >100) and the maturity value (100) correctly. Generally speaking, for discounted taxable interest bonds (*e.g.*, corporate and federal agency bonds), the difference between the purchase price and the maturity value is taxable as income, along with the actual interest income from the bond's coupon.

Comparing the damages calculated using the Out-of-Pocket method compared to the Accretion method helps demonstrate this point. Assume that the claimant's bond suffered a price decline after purchase due to some feature or fact that was unsuitable at the time of claimant's purchase, and further assume that the bond was sold 3 years after claimant's purchase at a price of 50. At this time, the accreted cost basis is now 80.37 ($80,370), and, therefore, the principal loss is $50,000 - $80,370, or -$30,370, using the proper industry standard method for determining bond losses.

Using the ill-suited Out-of-Pocket method, one can see that the loss is understated. Out-of-Pocket simply subtracts the original price paid from the sale price, here, $50,000 – $76,444, producing a loss of $26,444, which understates the loss to the claimant by 13%.[10]

The Out-of-Pocket method clearly disadvantages a claimant. As a bond's cost basis is adjusted using the standard accretion method, it goes up, thus, the loss also increases vs. Out-of-Pocket, summarized here:

Out-of-Pocket method: **-$26,444 loss**
Accretion method: **-$30,370 loss**

This example helps us to see that the traditional Out-of-Pocket damages calculation not only disadvantages a claimant, but it also subverts the mathematical basis for the original investment recommendation. One reason that Claimants bring disputes regarding their investment losses is because

10. While interest may serve as a credit against a respondent's damages liability, interest is *not* included in principal gain or loss calculations.

recommended investments were not suitable. Because bond investment performance is fully predictable based on the math that determines the return outcome, this math should not be subverted through the use of the Out-of-Pocket method for damages, in fairness to all parties.[11]

POTENTIAL DEFENSES

The typical "defenses" offered by financial advisors in securities arbitrations involving debt investments are generally easily rebuttable.

"The claimant made money."

This argument is most often a simple and misleading conflation of "income" and "growth." The damages reality is that any investor can easily, and, at all times, earn interest in some form of investment. These include passive interest-bearing bank accounts and money market funds, and such passive interest earnings can be just as readily achieved in safer bond choices. For this reason, it must be argued in rebuttal that an aggrieved investor is entitled to damages *at least* equal to some passive investment outcome.

It is also possible that while an investor may have had a positive income result from investment, losses from unsuitable recommendations may have diminished the income value such that it was barely positive.

In bond cases, damages can arise from the following causes (or some combination)

- Excessive aggregate commissions (undisclosed)
- Unsuitable recommendations resulting in specious losses
- Cash flow disadvantages from tax treatment of income (*e.g.*, paying state taxes on out-of-state municipal bonds)

"Churning metrics do not meet the standard"

Cost/Equity rates from bond investing equal to or greater than 2% can be shown to be excessive and unsuitable by comparing them to professionally

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11. It is noted that in the circumstance of bonds purchased at a premium (price >100), the Out-of-Pocket method favors claimants and, for this reason also, should be avoided.

managed account fees of between 0.30% and 0.50%.[12] Turnover rates on bonds greater than 0.50% can be shown to be excessive and unsuitable by comparing them to bond mutual fund portfolio turnover rates of between 0.20% and 0.75%, or comparing them to individual bond "ladders" that have turnovers of 5% to 10%.

"We had no obligation to inform the customer after the initial bond purchase."

Brokers are required to inform their clients of any material change in a feature of a bond held by a client in their account that may render the bond unsuitable. As an example, if a bond's rating is downgraded, dealers, but not their clients, are directly informed of this by the issuer. Because the dealer is then in possession of information that the client is not, the dealer must inform the client of the downgrade.

"Well-managed damages are speculative."

Portfolio benchmarks and bond fund portfolios have high correlation to customer bond accounts due to the fixed and fully predictable nature of all bond cash flows. Custom benchmarks can be devised for Well-Managed Damages that very closely mimic discrete portfolios. That is, well-constructed bond benchmarks can be used in a manner that can diminish speculation.

"Client is sophisticated"

As stated above, bonds are very complex securities. When a panel is shown these complexities in detail and as they hear a claimant's testimony about their understanding and the broker's lack of disclosures, it quickly becomes clear that the claimant lacks sophistication. The reality is that the great majority of retail investors have very little understanding of how bonds and the bond markets work. This is nearly as often true for their brokers.

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12. In churning cases where mark-ups and mark-downs (commissions) of 1.5% to 3% are repeatedly charged in the course of a 1-year period, Cost/Equity measures of 3% to 8% or more are not uncommon.

The Municipal Securities Rulemaking Board tells us that nearly all retail bond investors are clearly not sophisticated:

MSRB Rule D-15

The term "sophisticated municipal market professional" or "SMMP" is defined by three essential requirements: the nature of the customer; a determination of sophistication by the broker, dealer or municipal securities dealer ("dealer"); and an affirmation by the customer; as specified below.

(a) Nature of the Customer. The customer must be:

(1) a bank, savings and loan association, insurance company, or registered investment company;

(2) an investment adviser registered either with the Commission under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or

(3) any other person or entity with total assets of at least $50 million.

(b) Dealer Determination of Customer Sophistication. The dealer must have a reasonable basis to believe that the customer is capable of evaluating investment risks and market value independently, both in general and with regard to particular transactions and investment strategies in municipal securities.

(c) Customer Affirmation. The customer must affirmatively indicate that it:

(1) is exercising independent judgment in evaluating:

(A) the recommendations of the dealer;

(B) the quality of execution of the customer's transactions by the dealer; and

(C) the transaction price for non-recommended secondary market agency transactions as to which (i) the dealer's services have been explicitly limited to providing anonymity, communication, order matching and/or clearance functions and (ii) the dealer does not exercise discretion as to how or when the transactions are executed; and

(2) has timely access to material information that is available publicly through established industry sources as defined in Rule G-47(b)(i) and (ii).[13]

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13. MSRB Rule D-15, *supra* note 8.

While it is true that FINRA does not specifically define a "sophisticated" investor for corporate or other taxable-interest bonds, it does define "accredited investor," "qualified institutional investor," and "institutional customer." All of these definitions set forth a requirement for an investor's ability to make independent risk assessments related to recommended investments.

CONCLUSION

Since the onset of the Covid pandemic, all U.S. bond markets have suffered significant price declines and, in many cases, investors have suffered losses beyond typical market losses. As investors discover that their losses may be attributable to factors other than a rise in interest rates, there may be more claims making their way to arbitration. It is important for attorneys representing Claimants in such arbitrations to be mindful of the important differences between equity investments and debt investments, as well as the proper way to calculate damages in these cases.

Notes & Observations

FINRA AND THE SEC'S COMMUNICATION RULES FAIL TO APPROPRIATELY REGULATE COMMUNICATIONS BETWEEN FIRMS AND INVESTORS

Matthew Kipnis[1]

I. Introduction

Investors now have far more options available to them than ever before when deciding how and with whom to invest.[2] In recent years, there has been a surge of online and mobile investment platforms popping-up that have reduced many of the traditional barriers to entry such as commission fees and minimum account requirements.[3] In addition to reducing the traditional barriers to the markets, these online platforms have changed how investors interface with firms and markets.[4]

During a typical day, a retail investor utilizing one of the online/mobile trading platforms is likely to receive, as an example: (1) Push notifications for individual securities that are performing well or poorly that day; (2) In-app messages regarding upcoming IPOs; (3) Emails that encourage signing up for options trading; and (4) Emails containing algorithmically tailored news roundups. Investors must decide each day how much credence to give to each of these communications from firms and whether it will impact their investment decisions. For example, an investor who receives an email from a trading platform that includes personalized information and informs them that options trading is available, might sign up for options trading believing that the firm has already evaluated that options trading would be appropriate for them. The problem with this assumption is that no such evaluation has actually taken place.

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1. Matthew Kipnis is a graduate of St. John's University School of Law ('22). While a student, Matthew interned for two semesters with the St. John's University School of Law Securities Arbitration Clinic, and also interned with FINRA Dispute Resolution.

2. *See* CHRISTINE LAZARO & TERESA J. VERGES, THE OBLIGATIONS AND REGULATORY CHALLENGES OF ONLINE BROKER-DEALERS AND TRADING PLATFORMS 79 (2021).

3. *See id.*

4. *See id.*

Investing in securities carries inherent risk to an investor's principal and communications from firms can amplify these risks when they are unfair, biased, or flat out misleading. As such, adequate supervision of communications is imperative to ensure fairness, transparency, and accuracy so that investors are reasonably informed when making investment related decisions. Thus, communications between a firm and its clients are presently subject to extensive regulation.[5] Historically, the regulations have been geared towards the traditional methods of communication that firms have used. Recently, there has been a dynamic shift in investor demographics, with the average investor being far younger than ever before.[6] This shift has coincided with technological advancements that have affected the manner in which firms communicate with investors.[7] Further, firms have altered their communications strategies to better reach younger investors. There are various mediums and mechanisms of communication that were not in place or even conceived of at the time many of the communication regulations were drafted.[8] As a result, there are drafting gaps in the regulatory regime that can be exploited and potentially cause harm to investors. Accordingly, the current regulatory regime fails to adequately regulate marketing communications in a way that sufficiently protects investors.

II. The Current Communication Rules

The 2200 Series of the FINRA Rules govern communications and disclosures.[9] FINRA Rule 2210 ("Rule 2210") broadly covers communications with the public.[10] For the purposes of approval, review, and

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5. *See* FINRA Rule 2210, Communications with the Public. For example, communications by firms "must be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service." *Id.*

6. *See St. John's University School of Law Securities Arbitration Clinic Comment On FINRA Special Notice* - 6/30/21, FINRA (Aug 30, 2021), https://www.finra.org/rules-guidance/notices/special-notice-063021#comments.

7. *See id.*

8. *See* Lazaro and Verges, *supra* note 2 at 80–82.

9. *See* FINRA Rule 2210, Communications with the Public.

10. *See id.*

recordkeeping, FINRA categorizes communications as follows: (1) Retail; (2) Correspondence; and (3) Institutional.[11]

A "retail communication" is defined as "any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30 calendar-day period."[12] "Correspondence" is defined as "any written (including electronic) communication that is distributed or made available to 25 or fewer retail investors within any 30 calendar-day period."[13] Lastly, an "institutional communication" is defined as "any written (including electronic) communication that is distributed or made available only to institutional investors, but does not include a member's internal communications."[14]

How a communication is defined dictates the firm's approval and review obligations in connection with the communication.[15] Rule 2210 requires that retail communications be approved by a principal of the firm before the earlier date of either its first use or the date that it's filed with FINRA.[16] Rule 2210 also requires that "Correspondence" be supervised and reviewed pursuant to the requirements within FINRA Rule 3110.[17] Institutional communications have to be reviewed by a principal.[18]

FINRA's rules are not specifically tailored for the various mediums of communication,[19] although any medium or channel that a member firm uses to communicate with investors falls under the purview of Rule 2210.[20] For example, firm communications that utilize social media websites or apps are

11. *See id.*

12. FINRA Rule 2210(a)(5).

13. FINRA Rule 2210(a)(2).

14. FINRA Rule 2210(a)(3).

15. *See* FINRA Rule 2210, Communications with the Public.

16. *See* FINRA Rule 2210(b)(1)(A).

17. *See* FINRA Rule 2210(b)(2). Rule 3110 sets out that member firms must establish and maintain a system to supervise the activities of each associated person in a manner that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules. FINRA Rule 3110.

18. *See* FINRA Rule 2210(b)(3).

19. *See* Lazaro and Verges, *supra* note 2 at 91.

20. *See* FINRA Rule 2210, Communications with the Public.

covered under the rule.[21] Furthermore, "FINRA recognizes that firms utilize different means of communication, including icons, illustrations, cartoons, animations, short videos, and pictograms. FINRA recognizes that these new means can help investors understand the firm's products and services, while also delivering required disclosures."[22]

Further, FINRA has set forth broad content standards for all communications, requiring that communications must be "fair and balanced."[23] Communications need to "provide balanced treatment of risks and potential benefits."[24] Firms must consider the intended recipient of communications, and provide appropriate details and explanations.[25] "Promotional communications discussing the benefits of a particular product, type of product, or service require balancing discussions of the risks or drawbacks."[26] Promotional communications from firms, such as advertisements of investment products, pose the risk of appearing to investors as member firm endorsements of particular products and have the potential to mislead investors when the advertisements only discuss an investment product's potential upside.[27] As such, these communications are thereby required to contain the aforementioned disclosures highlighting the risk of products to remediate these concerns.[28]

Non-promotional materials pose their own set of issues. FINRA has established guidelines for categorizing non-promotional communications based on the intended recipient to determine what disclosures are necessary to satisfy the fair and balanced requirements. FINRA's guidance for non-promotional materials is as follows:

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

22. *See* Lazaro and Verges, *supra* note 2 at 91; *see also* FINRA, REGUL. NOTICE 19-31, ADVERTISING REGULATION (Sept. 19, 2019), https://www.finra.org/rules-guidance/notices/19-31.

23. FINRA Rule 2210(d)(1)(A).

24. FINRA Rule 2210(d)(1)(D).

25. FINRA Rule 2210(d)(1)(E).

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

27. *See Id.*

28. *See Id.*

- Brand communications: Brand communications that only acquaint investors with a firm's name and the fact that it offers financial services generally require no additional information in order to be fair and balanced.
- Educational communications: FINRA encourages members to use educational communications that promote financial literacy. For example, a member might develop a website that explains different types of securities and how markets work, but because it does not promote specific securities or services it may only require a simple statement noting that securities involve risks and an offer to provide additional information. Another example is educational content that only provides basic information about what mutual funds are and does not include information that relates to the desirability of a specific product; such a communication would not need to disclose the specific risks associated with a particular fund.
- Reference resources: Some members provide websites, apps or other reference resources that do not promote a specific product or service; instead, they provide information intended to assist investors with investment decisions. In general, investors must choose to access these resources and interact with them to find the information (e.g., by downloading an app or creating an online account on the firm's website). A resource that does not promote specific products or services might need little or no disclosure under FINRA rules.
- Post-sale communications: Once a sale has occurred, members may provide communications to investors that discuss the product, such as changes to its portfolio or information about how the product has responded to changes in market conditions. These subsequent communications typically do not require the same extent of disclosure as communications leading up to a sale. Of course, a post-sale communication that recommends additional purchases or another product would be a promotional communication.[29]

Nonetheless, regardless of intent to promote or not to promote, when a communication recommends a specific security or a particular investment strategy, there are additional rules and limitations that apply.[30] If a communication is considered a recommendation, then a firm must comply with either FINRA Rule 2111 ("Rule 2111"), Suitability or Regulation Best

29. *See id.*

30. *See* Lazaro and Verges, *supra* note 2 at 92.

Interest ("Reg. BI").[31] For recommendations made prior to June 30, 2020, FINRA Rule 2111 may apply. Recommendations made on or after June 30, 2020 are subject to either FINRA Rule 2111 or Reg. BI.[32] Reg. BI applies to all recommendations that are made to retail investors, "defined as natural persons and their legal representatives, seeking advice for personal, family, or household purposes."[33] In contrast, Rule 2111 applies to any recommendations that are not subject to the requirements of Reg. BI.[34] Even if the communication is found to be a recommendation and complies with the requisite requirements of 2111 and Reg. BI., it also needs to be fair and balanced.[35]

When applicable, Rule 2111 requires that firms comply with three main suitability obligations: reasonable-basis suitability, customer-specific suitability, and quantitative suitability. Reasonable-basis suitability requires that a firm "have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors." This obligation requires the firm to understand both the recommendation's risks and rewards. The customer-specific obligation requires that a firm "have a reasonable basis to believe that the recommendation is suitable for the particular customer based on that customer's investment profile." For these purposes the customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, and risk tolerance. Quantitative suitability requires that the firm "have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile."

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31. *See* FINRA, NOTICE TO MEMBERS 01-23, ONLINE SUITABILITY (Apr. 2001), https://www.finra.org/rules- guidance/notices/01-23; *see also* Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318 (July 12, 2019).

32. *See* FINRA Rule 2111.

33. *See* Lazaro and Verges, *supra* note 2 at 94; *see also* Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318, 33,335 (July 12, 2019).

34. *See* FINRA Rule 2111. Prior to June 30, 2020, FINRA Rule 2111 applied to all recommendations made to customers by firms. *Id.*

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

If Reg. BI is applicable to a recommendation, then the firm is required to comply with the Disclosure, Care, Conflict of Interest, and Compliance obligations. The Care obligation mirrors Rule 2111 in several ways as it also consists of reasonable-basis, customer-specific, and quantitative obligations. Under the reasonable-basis obligation, the firm must "[u]nderstand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers." The customer-specific obligation, requires firms to "[h]ave a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks, rewards, and costs associated with the recommendation and does not place the financial or other interest of the broker, dealer, or such natural person ahead of the interest of the retail customer." Under the quantitative obligation firms need to "[h]ave a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile and does not place the financial or other interest of the broker, dealer, or such natural person making the series of recommendations ahead of the interest of the retail customer."

Neither FINRA nor the SEC have offered a definitive definition for what a recommendation is. But if a communication from a firm is deemed a call to action, in that it urges an investor to undertake an investment related course of action or strategy, then the communication is considered to be a recommendation subject to FINRA and the SEC's recommendation rules, Rule 2111 and Reg. BI.[36] However, whether something is a call to action is a facts and circumstances inquiry.[37] Of note though is that when the SEC implemented Reg. Best Interest, the SEC stated that "it would define the term consistently with how it had been defined previously, specifically referencing FINRA's Suitability Rule and FINRA Notice to Members 01-23."

FINRA Notice to Members 01-23, Online Suitability ("NTM 01-23"), was adopted in April 2001. At the time, FINRA[38] recognized a shift in how firms communicate with investors due to the advent of the internet. FINRA also recognized that these technological advancements and digital industry shifts

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36. *See id*. FINRA suggested that firms analyze each communication to determine whether it reasonably could be considered a "call to action," whether it would influence a customer to trade a particular security or group of securities. *Id.*

37. *See id.*

38. *See id.* FINRA was still known as its predecessor the NASD at the time. *Id.*

might have regulatory implications including the application of the suitability rules to online activities.[39] Accordingly, NTM 01-23 sets forth the firm's obligations when communicating with customers online. FINRA stated that firms are using "technology to offer many new beneficial services to customers and it supports the continued development and use of technology to enhance investor education and access to information[.]"[40]

Pursuant to NTM 01-23, the suitability rules apply to all recommendations that firms make to consumers including those made via electronic means.[41] The problem is thus determining when a communication is a recommendation. To address that question, NTM 01-23 lays out the following:

> [T]he "facts and circumstances" determination of whether a communication is a "recommendation" requires an analysis of the content, context, and presentation of the particular communication or set of communications. The determination of whether a "recommendation" has been made, moreover, is an objective rather than a subjective inquiry. An important factor in this regard is whether—given its content, context, and manner of presentation— a particular communication from a broker/dealer to a customer reasonably would be viewed as a "call to action," or suggestion that the customer engage in a securities transaction. Members should bear in mind that an analysis of the content, context, and manner of presentation of a communication requires examination of the underlying substantive information transmitted to the customer and consideration of any other facts and circumstances, such as any accompanying explanatory message from the broker/dealer. Another principle that members should keep in mind is that, in general, the more individually tailored the communication to a specific customer or a targeted group of customers about a security or group of securities, the greater likelihood that the communication may be viewed as a "recommendation.[42]

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39. *See id.*("Technological advancements have provided many benefits to investors and the brokerage industry. These technological innovations, however, also have presented new regulatory challenges, including those arising from the application of the suitability rule to online activities[.]").

40. *Id* ."One of the most dramatic changes is the way in which brokerage firms use the Internet to communicate with their customers." *Id.*

41. *See id.*

42. *See id; see also* Lazaro and Verges, *supra* note 2 at 93–101.

In short, one must consider the content, context, and manner of presentation are engaged with in the facts and circumstances analysis. In terms of content, there are two relevant groupings of communications.[43] There are communications where the content is making an explicit recommendation: a communication that directly prompts the recipient to buy or sell a security.[44] Then, there are all other types of communications.[45]

Under the facts and circumstances test, whether the content of a communication encourages undertaking a course of action is significant, but not always determinative of being a recommendation.[46] The content must be considered in conjunction with the context and the manner in which it is presented.[47] The context and manner of presentation has a significant bearing on the efficacy of how a communication is received.[48] Characteristics such as: (1) the frequency with which this type of communication is sent; (2) whether the investor opted in to these communications or if they are unsolicited; (3) the tone of the language used in the communication; (4) the colors and typeface used; and (4) how the message is addressed, are all relevant considerations.[49]

A communication becomes a recommendation when the content, context, and presentation of the communication suggests the recipient take a specific course of action involving investment related activity such as a purchasing or selling a specific security or undertaking an investment strategy.[50] For example, educational content when viewed in a vacuum may not be a call to action but when presented to the investor as a push notification or on the firm's home page, may now be considered a call to action.[51] Further, if a communication's characteristics make it more likely that an investor will think it was a personalized and evaluative communication it increases the likelihood

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

44. *See id.*

45. *See id.*

46. *See id.*

47. *See id.*

48. *See id.*

49. *See id.*

50. *See id; see also* Lazaro and Verges, *supra* note 2 at 93–101.

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

of being a recommendation.[52] The threshold question thus becomes whether the content of the communication coupled with its context and manner of presentation pose a call to action.[53]

III. Concerns with the Current Communication Rules

The current communications rules do not provide a clear answer to the question of whether a communication is a recommendation. The ambiguous language in the current rules pose challenges with consistent application of the rules by both firms and regulators. The technological landscape of communications has also seen a dynamic shift in recent years, with firms employing various digital engagement practices in their communications that affect the content, context, and manner of presentation of communications in ways the rules do not specifically account for.[54] Since the rules are not being consistently applied, these regulatory gray areas cause investors to suffer harm.

A. Ambiguities in the Rule Language

The rules never define the term "recommendation."[55] The term is defined through the facts and circumstances test set forth in the guidance. However, in light of the technological advancements in communications, FINRA's guidance is not as helpful as it once was. There are far more media of communication available to firms than was anticipated when the current guidance was adopted.[56] Accordingly, regulators may expect that a regulation

52. *See id.*

53. *See id.*

54. *See St. John's University School of Law Securities Arbitration Clinic Comment On FINRA Special Notice* - 6/30/21, FINRA (Aug 30, 2021), https://www.finra.org/rules-guidance/notices/special-notice-063021#comments.

55. *See* FINRA Rule 2210(b)(1).

56. *See St. John's University School of Law Securities Arbitration Clinic Comment On FINRA Special Notice* - 6/30/21, FINRA (Aug 30, 2021), https://www.finra.org/rules-guidance/notices/special-notice-063021#comments.

will be applied a certain way, while firms may interpret it as being applicable in an entirely different sense.[57]

B. Issues Applying the Rules to Digital Engagement Practices

Many online trading platforms now generally utilize digital engagement practices on their platforms. For instance, these platforms offer a variety of different "design features, commonly described as gamification."[58] Gamification features include "games when you open your account; animations, including confetti when a milestone is reached; social networking tools; prizes or rewards for activity streaks; points, badges, and leaderboards; lists of popular stocks; free stocks for referring additional customers; and push notifications."[59] In addition to these gamification practices, firms employ marketing practices like the strategic use of certain colors, highlighting, visual cues, prompts, etc. to increase the efficacy of their communication.[60] All of these practices are relevant in determining the context and manner of presentation of the communications.[61] Accordingly, regulators have expressed concerns that many new investors, prompted by gamification and marketing practices, have engaged in high-risk trading strategies without an appreciation of the risks.[62]

FINRA and the SEC have not addressed whether they would deem gamification features to be recommendations. FINRA and the SEC have recognized that "gamification or prompts that promote or encourage trading

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

58. *See* Lazaro and Verges, *supra* note 2 at 80.

59. *Id.; see also* Annie Massa and Tracy Alloway, *Robinhood's Role in the 'Gamification' of Investing*, BLOOMBERG WEALTH (Dec. 19, 2020), https://www.bloomberg.com/news/articles/2020-12-19/robinhood-s-role-in-the-gamification-of-investing-quicktake.

60. *See St. John's University School of Law Securities Arbitration Clinic Comment On FINRA Special Notice* - 6/30/21, FINRA (Aug 30, 2021), https://www.finra.org/rules-guidance/notices/special-notice-063021#comments.

61. 01-23.

62. *See* Lazaro and Verges, *supra* note 2 at 80.

activity may be subject to Reg. Best Interest."[63] Firms generally maintain a presence across various social media platforms and utilize those channels as another way to communicate with customers.[64] Communications over social media channels can have an even more heightened sense of personalization to them when firms respond directly to investors.[65] FINRA is aware of social media communications and in 2010 stated that a "communication is widely disseminated or limited to a select one or more individuals is not determinative of whether the firm has made a recommendation."[66] Firms are still required to consider the facts and circumstances of the communication.[67] The level of engagement available to firms on social media in 2021 differs markedly though from the engagement options that existed when FINRA issued guidance in 2010.[68] These digital engagement practices and social media engagement options have further complicated the already unclear applicability of investor protections.[69]

In NTM 01-23, FINRA suggested that firms need to analyze each communication to determine whether it reasonably could pose a call to action, "whether it would influence a customer to trade a particular security or group of securities."[70] For these purposes, 01-23 includes a set of example

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63. *See* Robert W. Cook, President and Chief Executive Officer, FINRA, Statement Before the Financial Services Committee U.S. House of Representatives (May 6, 2021), https://www.finra.org/media-center/speeches-testimony/statement-financial-services-committee-us-house-representatives.

64. *See* Lazaro and Verges, *supra* note 2 at 94.

65. *See St. John's University School of Law Securities Arbitration Clinic Comment On FINRA Special Notice* - 6/30/21, FINRA (Aug 30, 2021), https://www.finra.org/rules-guidance/notices/special-notice-063021#comments.

66. *See* FINRA, REGUL. NOTICE 10-06, SOCIAL MEDIA WEB SITES, GUIDANCE ON BLOGS AND SOCIAL NETWORKING WEB SITES (Jan. 2010), https://www.finra.org/rules-guidance/notices/10-06; *see also supra* note 51 at 94.

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

68. *See St. John's University School of Law Securities Arbitration Clinic Comment On FINRA Special Notice* - 6/30/21, FINRA (Aug 30, 2021), https://www.finra.org/rules-guidance/notices/special-notice-063021#comments.

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

70. *See id*. *See* Lazaro and Verges, *supra* note 2 at 93.

communications that FINRA would deem as not being recommendations and a set of example communications that FINRA deems to be recommendations.[71] But, the examples are less relevant today than they were in 2001 at the time of 01-23's issuance. The current technological landscape has added additional layers to the analysis for firms that were not necessarily accounted for in the existing guidance.[72] The following types of communications do not fit squarely within the examples provided in NTM 01-23, which means a firm has to engage in a facts and circumstances analysis to determine whether the communication is a recommendation:[73]

1- **Push notifications for individual securities that are performing well or poorly that day**: When a firm sends a push notification containing information about whether an individual security is performing well or poorly to an investor, there is a strong argument that such a communication can be deemed a recommendation. The content of the communication–stock performance information–in a vacuum might very well not be a recommendation because stock performance information is generally displayed in many places. But, using the facts and circumstances test, when that particular content is considered in conjunction with the context and manner in which it was received by the investor, that is in a manner that alerts the investor like a notification, there becomes a greater chance that the investor will interpret the communication as a call to action. Reg. Notice 01-23 sets out that when "[a] member sends a customer specific electronic communication (e.g., an e-mail or pop-up screen) to a targeted customer or targeted group of customers encouraging the particular customer(s) to purchase a security[,]" as an example of a communication that would constitute a recommendation. A push notification that contains particular securities is similar and may thus be deemed to be recommendation. If it was a push notification that includes a prominent statement that the notification is not intended to constitute investment advice, it is

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

72. *See id.*

73. *See id.* While this paper endeavors to conduct a facts and circumstances analysis of these communications, firms and FINRA may reach different conclusions based slight differences in facts and circumstances.

less likely that the communication would be deemed a recommendation.[74]

2- **In app messages regarding upcoming IPOs**: An in-app message on a mobile trading platform that notifies an investor about an upcoming IPO can also be a recommendation when it is considered in the context and manner of presentation. A newspaper that displays information about upcoming IPOs is likely not a recommendation. However, a message directly sent to an investor may appear to the investor as the endorsing the IPO and thus prompting the investor to take a specific course of action. Such a method of personal communication conveys to the investor the sense that the information was curated directly for their benefit. In NTM 01-23, FINRA considered that when "[a] member sends its customers an e-mail stating that customers should be invested in stocks from a particular sector (such as technology) and urges customers to purchase one or more stocks from a list with "buy" recommendations," the communication would be deemed a recommendation. There may be differences in this type of communication. One that notifies an investor of an IPO, although notification does not explicitly state the customer should be invested in the IPO, the personalized nature of the notification may implicitly suggest the customer purchase the IPO. Such a notification may be viewed by the customer differently than an email. How it's interpreted may be dependent on the investor's age or other factors.[75]

3- **Emails encouraging signing up for options trading:** A web advertisement that promotes options trading is promotional material, which must be fair and balanced, but is not necessarily a call to action. When an investment platform sends an investor an email that encourages the investor to sign up for options trading, this is more likely to be considered by the investor to be a call to action, and therefore a recommendation. There are further considerations that can make communications more likely to be a recommendation. A single email encouraging signing up for options trading might not be a recommendation. When an investor receives an email with this content in the context of having received several prior emails encouraging options trading, there

74. *See id.*

75. *See id.*

becomes an increased likelihood that the investor will undertake that specific course of action and the communication would be a recommendation. Repeated emails may also convey to the investor that the platform has determined that options trading is in line with the investor's personalized information or investment goals.[76]

4- **Emails containing algorithmically tailored news roundups**: Emails containing algorithmically tailored news roundups can be recommendations when the content of the communication is considered in conjunction with its context and manner of presentation. If an investor has opted-in to news alerts about a specific market sector like energy, the email is probably not a recommendation. For an investor that has not opted-in to news alerts, a tailored news roundup about specific securities may be viewed by the investor as far more personal and evaluative and increases the likelihood of causing an investor to take a particular action. An algorithm can be used to analyze a customer's financial or online activity on the investment platform and then send specifically catered news about specific securities or market activity that it deems is likely to engage the investor. When a tailored news roundup is sent unprompted, that can make it more likely that the communication will be viewed as personally curated for the investor. In Reg. Notice 01-23, FINRA considered that when "[a] member uses data-mined technology (the electronic collection of information on Web Site users) to analyze a customer's financial or online activity—whether or not known by the customer—and then, based on those observations, sends (or "pushes") specific investment suggestions that the customer purchase or sell a security," the communication was likely to be deemed a recommendation. An email containing an algorithmically tailored news roundup is similar to the data mining previously contemplated by FINRA.

These examples may or may not be recommendations depending on how the facts and circumstances test is applied. The content, context, and manner of presentation might render the communications to be recommendations by FINRA, whereas a firm's analysis could lead it to the opposite conclusion.[77] The facts and circumstances inquiry is partially subjective rather than

76. *See id.*

77. *See id.*

objective, which means a firm could analyze these same communications and believe that the factors discussed above are not enough for the communication to be considered a recommendation.[78]Subtle changes in a communication, like changes in verbiage or even color scheme might make it more likely to be a recommendation or less likely to be a recommendation because it's a facts and circumstances test and is wholly dependent on how certain facts are interpreted and viewed.[79]

Additionally, the guidance provides that the analysis should account for what a customer would reasonably believe. There is no definition for what is a "reasonable customer.".[80] The rules do not address or explain how factors like age and familiarity with technology factor into determining what beliefs would be reasonable.[81] Millennials are far more tech savvy than senior citizens are and on a retail trading platform may be more perceptive of digital engagement practices and thus less likely to interpret a communication as a recommendation. A senior investor who is less familiar with technology might be more likely to interpret every generic in-app message or notification as a personally evaluative message being sent directly to them. Thus, the facts and circumstances test is also predicated on how relevant factors are weighted in determining whether a belief is reasonable.[82]

C. Gray Areas in the Current Regulatory Regime Cause Harm to Investors

The underlying intent behind FINRA's communication rules and FINRA's and the SEC's recommendation rules is to adequately protect investors from harm. The rules are intended to provide a uniform system of guidance and disclosures that ensures investors are able to rely on the various mediums of communications that they receive.[83] If there is ambiguity as to whether a regulation must be complied with because it is not clear whether the communication is a recommendation, investors may be left with inadequate

78. *See id.*

79. *See id.*

80. *See id.*

81. *See id.*

82. *See id.*

83. *See id.*

protections. Investors may think they are receiving advice when the firm does not believe it is giving advice.[84]

Recently, Massachusetts filed an Administrative Complaint against Robinhood seeking to hold Robinhood responsible for violations of its newly enacted fiduciary regulation.[85] Similar to Rule 2111 and Reg. BI, Massachusetts' new regulation imposes obligations on a firm when it makes recommendations.[86] In the Administrative Complaint, "Massachusetts relies in part on Robinhood's communications, including push notifications of lists of stocks, in arguing that Robinhood was making recommendations."[87]

The Massachusetts action relies on an analysis similar to FINRA's of whether a communication is a recommendation under the Massachusetts Regulatory Code.[88] The Massachusetts regulation seeks to accomplish the same goals as Rule 2111 and Reg. BI in ensuring investors are protected when recommendations are being made, and ensuring the brokers are being held to the same standard when making a recommendation.[89] Therefore, the Massachusetts action evidences that when communications are not properly treated as recommendations, investors are harmed.

This harm is due in part to the potential mismatch between the customer's expectations and the firm's intent. The demographic makeup of an investor may affect the investor's expectations. A millennial's reasonable expectations may differ from a senior's with regard to their interactions with the firm. When investor believes that a recommendation has been made and is tailored to their wants and needs, but the firm does not, the investor is not receiving the

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

85. *See id.*

86. *See id.*

87. *See* Lazaro and Verges, *supra* note 2 at 94. Massachusetts lost the case at the trial level. *See* Nate Raymond, *In win for Robinhood, judge declares Massachusetts investment advice rule invalid*, REUTERS (March 30, 2022), https://www.reuters.com/legal/litigation/win-robinhood-massachusetts-judge-declares-fiduciary-rule-invalid-2022-03-30/.

88. *See id.*

89. *See id.*

protections that either expect. Put another way, an investor may think that they are getting advice, when a firm is simply sending them what it deems educational material.

This mismatch in expectations is problematic because investors may not be receiving the protections of Rule 2111or Reg. BI. If the firm does not consider the communication a recommendation, it will not ensure the communication is appropriately tailored to the investor's needs and goals.[90] As a result, vulnerable investors may be engaging in risky trading activity that they otherwise might not have.[91]

There may also be a mismatch between regulator's expectations and the firm's intent. Regulators may think that targeted communications from online firms are recommendations, and thus expect that firms will comply with Rule 2111 or Reg BI. Firms may think they only have to comply with the fair and balanced requirements of Rule 2210 and may be unintentionally violating both FINRA and SEC rules because firms are not fully on notice as to what their obligations are. Firms also run regulatory risk as they may be subject to enforcement actions while not fully on notice of their obligations. Investors are the ones who run the risk of being harmed from this unclear communication standard. The gray area of ambiguous applicability of the current regulatory structure leaves investors exposed to varying levels of harm.

IV. Possible Solutions Available to FINRA and the SEC to Address these Regulatory Issues

There are a few different ways in which these issues can be mitigated and addressed. One such way would be to increase investor education efforts and thereby increase investor literacy and awareness of capital market risks.[92]

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90. *See* FINRA Rule 2211; *see also* Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318, 33,335 (July 12, 2019) (hereinafter "Reg. Best Interest Adopting Release").

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

92. *See St. John's University School of Law Securities Arbitration Clinic Comment On FINRA Special Notice* - 6/30/21, FINRA (Aug 30, 2021), https://www.finra.org/

Better informed investors will be less easily persuaded by digital engagement practices.[93] Better educated investors will also be better protected against misleading information in communications.[94]

There are several barriers that can potentially undermine the efficacy of a plan to increase investor education. First, a FINRA funded study found that the typical investor today is far younger than previous decades.[95] There is a wide age deviation amongst the investor pool and this age deviation means that there are varying levels of investing experience.[96] This in turn makes tailoring an education campaign far more difficult because more experienced investors may need less educational efforts than younger less experienced investors would. Even if an educational campaign is crafted to cater to the least tech savvy investor to address this issue, it could be tuned out by experienced investors who may disregard the information as not helpful to them.[97]

Further, as discussed above, familiarity with technology can shape how an investor perceives a communication received on a platform. Generally, millennials who grew up with an iPad, laptop, smartphone, or etc., are likely to have a greater comfort level with technology. They may understand push notifications and feeds differently than a senior might. Accordingly, millennials interact with the digital world differently than seniors. Therefore, the medium of communication and the framing of the message needs to be tailored based on generation because respective generations are going to process information differently.

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rules-guidance/notices/special-notice-063021#comments.

93. *See id.*

94. *See id.*

95. The FINRA funded study found that the majority of new investors were under the age of 45, had lower incomes, held smaller account balances and were more racially and ethnically diverse than investors who already owned taxable investment accounts before 2020. FINRA, INVESTOR EDUCATION FOUNDATION AND NORC REPORT, INVESTING 2020: NEW ACCOUNTS AND THE PEOPLE WHO OPENED THEM, at 1(Feb. 2021), https://www.finrafoundation.org/sites/finrafoundation/files/investing-2020-new-accounts-and-thepeople-who-opened-them_1_0.pdf2020-new-accounts-and-the-people-who-opened-them_1_0.pdf.

96. *See id.*

97. *See St. John's University School of Law Securities Arbitration Clinic Comment On FINRA Special Notice* - 6/30/21, FINRA (Aug 30, 2021), https://www.finra.org/rules-guidance/notices/special-notice-063021#comments.

Second, for any investor education initiative to be successful, time is required to achieve financial literacy.[98] During that time, harm to investors can still continue to accrue until the period when financial literacy is achieved. Third, there is going to be a substantial cost associated with cultivating and then implementing an investor education campaign. Fourth, educational methods that work for some investors may not work for others. For instance, whereas millennials may need educational material disseminated in short videos with bulleted reading materials attached to it, while seniors may benefit more from detailed reading materials. Moreover, some investors might be receptive to a social media campaign while other demographics may not be. The challenges of using an investor education plan to counteract the systematic harms that stem from the regulatory structure may very well outweigh the potential benefits of such a plan.

Another option to better protect investors is for regulators to adjust the present regulatory scheme to make it clear which digital engagement practices will be deemed to be recommendations. More specifically, either through rulemaking or guidance, regulators can create a bright line rule about when a communication will be considered a call to action. This could even include creating clear definitions for what constitutes a recommendation. This approach will have its challenges too. A clearly illustrated bright line rule means it likely will not account for further innovation in communications methods. Firms may exploit gaps in the rule in the form of future media of communication that do not directly conform to either side of the bright line rule. Additionally, if a rule was created through new regulation, it would entail a period of time for the rules adoptions process during which investors would still be at risk of harm. In contrast, for FINRA to issue updated guidance on how the present rules should be applied would take far less time. Additionally, the SEC can also issue guidance about what it deems to be a recommendation which would help provide a clearer interpretation of the rules. There is the risk that the guidance would not entirely close the gray area in the current rules, issuing new rules altogether would have greater likelihood of eliminating the gaps in the current rules. This list of possible solutions and associated challenges is by no means exhaustive.

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98. *See id.*

V. Conclusion

Since the present regulatory structure inadequately protects investors because it has ambiguous language that creates grey areas that can not only be intentionally exploited by firms, but also unintentionally violated by firms. A solution is needed to shield investors from this unnecessary harm. In an effort to address not just these concerns but several risks facing investors, FINRA is considering ways to increase its investor education efforts. A widespread investor education campaign may protect investors in the long run from market risks, but, the associated costs, time needed, and overall challenges of tailoring a plan to meet the educational needs of the entire investor pool make this a far less viable option to address the harm investors are presently facing from communications that may be recommendations. Logistical challenges aside, a larger problem with using an investor education plan to address these areas is that it shifts accountability and responsibility from market regulators and firms to the individual investor. Firms and regulators are in a far better position to address these issues on a wide scale than individual investors.

Issuing new rules for ascertaining which communications will be deemed recommendations is may eliminate ambiguity in the application of these rules. Providing rules that define the term recommendation would help eliminate further ambiguity. The substantial time required for drafting and the subsequent rule adoption process will leave investors vulnerable in the short term. A new rules structure will not capture innovation. When technological advancements or changes occur in the way that firms communicate with investors.

Issuing new guidance that not only updates the rules to illustrate how the present regulatory regime applies to the current market environment will not address all the gaps that presently exist in the rules, it presents the best option to protect investors in the short term.

The best way to protect investors is to change the present regulations to shift the onus of accountability and responsibility from individual investors to firms and regulators. New rules may be the most efficient way to protect investors in the long term, but in the short term FINRA should issue updated guidance for firms to better illustrate how to comply with the communications rules so that firms have a better understanding before disseminating a communication, if the suitability rules should be applied.

Notes & Observations

CUSTOMER ARBITRATION WITH REGISTERED INVESTMENT ADVISORS: PROBLEMS AND SOLUTIONS

Michael S. Edmiston[1]

Pre-dispute arbitration clauses in customer account agreements have been consistently enforced since the United States Supreme Court's decision in *Shearson/American Express v. McMahon*, 482 US 220 (1987). During the 1990s and early 2000s, when brokerage firms held a firm grip on retail investors, the securities brokerage industry forced its customers into arbitration through several industry-sponsored forums including FINRA's predecessor, the NASD, and other arbitration forums run by the stock exchanges.

I. TODAY'S SECURITIES ARBITRATION ENVIRONMENT

Today, FINRA is the only industry-run forum remaining and virtually all customer-broker disputes are heard in its forum. While FINRA's forum remains imperfect, customers benefit significantly from the fact that the industry subsidizes the bulk of FINRA forum fees by paying various industry fees and surcharges. FINRA rules mandate that FINRA-registered firms use the forum if requested by the customer, regardless of other forum selection language in a customer account agreement; and require clear, prominent disclosures about the presence and terms of the arbitration clause.

The retail investment services landscape is undergoing a massive shift. The number of broker-dealers are shrinking and the number of Registered Investment Advisors ("RIAs") are mushrooming.

As of 2021, FINRA reports there are 3,394 FINRA-registered broker-dealers and 612,457 registered representatives.[2] FINRA's registration numbers have been declining for the past five years.[3] By comparison, as of

1. Michael S. Edmiston is an attorney with Jonathan W. Evans and Associates in Studio City, California. He is serving as the President of the Public Investors Advocate Bar Association ("PIABA") for 2021-2022.

2. FINRA, 2021 Industry Snapshot, https://www.finra.org/rules-guidance/guidance/reports-studies/2021-industry-snapshot (last visited Jun. 12, 2022).

3. *Id.*

December 31, 2020, there are 13,880 SEC-registered RIAs[4] with 332,578 investment adviser representatives.[5] There are an additional 17,371 state-registered RIAs according to the North American Securities Administrators Association as of December 31, 2021.[6] The number of RIAs and related investment adviser representatives have grown year-over-year for the last five years.[7]

FINRA's declining numbers show, to some extent, in year-over-year arbitration filings. In 2018, there were 4,325 new filings.[8] By comparison, in 2021 there were only 2,893 arbitration cases filed.[9] Through April 2022 there have been 840 customer cases filed.[10] Annualized, this suggests the decline will continue with about 2,500 new cases filed for 2022.

There are no similar reported statistics for RIA arbitration cases. No regulator is tracking and no provider is reporting any statistics for RIA arbitration cases. NASAA enforcement statistics indicate that RIAs engage in misconduct at approximately the same rate as brokers.[11] With about 2,900 customer arbitration claims filed with FINRA in 2021, it can be estimated that there were or should have been approximately 6,000 RIA arbitration claims filed.

While the financial services industry's desire to resolve disputes through arbitration remains constant, at this point the arbitration paths diverge. FINRA is not the regulator for RIAs. Thus, all of the protections it put in place over the past 30 years to protect retail investors do not apply when an arbitration claim is brought against an RIA in a non-FINRA forum.

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4. Investment Adviser Association, Investment Adviser Industry Snapshot 2021, 2d. Ed. (Jul. 2021). https://investmentadviser.org/wp-content/uploads/2021/08/Investment_Adviser_Industry_Snapshot_2021.pdf at p. 18 (last visited Jun. 12, 2022).

5. *Id.* at p. 22.

6. NASAA, 2022 Investment Adviser Section Annual Report (Apr. 2022).

7. Investment Adviser Association, Investment Adviser Industry Snapshot 2021, 2d. Ed. (Jul. 2021) at p. 23.

8. FINRA, Dispute Resolution Statistics, https://www.finra.org/arbitration-mediation/dispute-resolution-statistics#historicalarbstats (last visited Jun. 12, 2022).

9. *Id*.

10. *Id*.

11. NASAA, 2020 Enforcement Report, https://www.nasaa.org/wp-content/uploads/2020/09/2020-Enforcement-Report-Based-on-2019-Data-FINAL.pdf (last visited Jun. 13, 2022).

II. FINRA AND RIA ARBITRATION – COMPARING THE CUSTOMER-INVESTOR PROTECTIONS

A. FINRA'S CUSTOMER PROTECTIONS

The FINRA arbitration process has been largely subsidized by fees imposed on broker-dealer disputants.[12] After paying an initial filing fee, the forum remains accessible to customer-claimants through the evidentiary hearing and final award since forum fees may be required to be paid at the conclusion of a case.[13]

FINRA prohibits the use of most choice-of-law clauses, specifying a hearing location away from the customer's place of residence, limiting the ability of an arbitrator to award damages, utilizing class action waivers, and waiving the protections of FINRA or SEC rules or laws to limit claims.[14]

The FINRA forum has grown increasingly transparent with the frequent public reporting of numerous statistics including types of claims, outcomes, awards, and even unpaid awards.

These important protections do not apply to customer-RIA arbitration claims heard outside of the FINRA forum.[15] Clients of RIAs are often forced to pursue their disputes in commercial arbitration forums, such as AAA or JAMS. In addition to being drastically and often prohibitively more expensive for customers than the FINRA forum, these commercial forums, by design, provide little to no transparency into the RIA arbitration process.

In this modern time, at least one state regulator has made the argument that utilizing pre-dispute arbitration clauses are antithetical to RIAs' fiduciary

12. Member surcharges are assessed for all customer claims filed (FINRA, Rule 12901 (2022)) and Pre-hearing Process Fees are assessed for all customer claims that reach the arbitrator appointment stage (FINRA, Rule 12903 (2022)).

13. FINRA Rule 12902.

14. FINRA Regulatory Notice 21-16 (2021).

15. FINRA will take customer-RIA cases on a voluntary basis, provided the RIA agree to pay the same fees as if it were a FINRA-registered member firm. FINRA, Guidance on Disputes between Investors and Investment Advisers that are Not FINRA Members, https://www.finra.org/arbitration-mediation/guidance-disputes-between-investors-and-investment-advisers-are-not-finra-members (last visited Jun. 16, 2022).

obligation as it is not in the best interest of clients, and thus RIAs should not even be permitted to engage in such conduct.[16]

B. COMMERCIAL ARBITRATION FEES CREATE AN ACCESS TO JUSTICE PROBLEM

The non-FINRA forums are more expensive and require the customer to make a sizable deposit to proceed with their claims. For example, it is not uncommon for a single arbitrator in JAMS (where arbitrators set their own fees in addition to what the forum charges for its administrative fees) to charge $8,000 or more for a single day's work. The arbitrator's fees alone can easily exceed $64,000 for five days of hearings and three days of pre-hearing and post-hearing work. The size of the fees and the requirement that they be paid in advance of the hearing itself serve as disincentives for customer-claimants to bring claims.

Once in an arbitration, an RIA-respondent can still thwart the arbitration process by refusing to pay its share of the arbitration fees. If the firm or adviser has not paid their share of forum fees, the forum typically gives the customer the option of paying the respondent's share of the deposit to be allowed to proceed.[17] The customer may incur the full cost of the arbitration just to be able to pursue their rights or face terminating the arbitration proceeding and starting anew in court.[18]

C. LACK OF PROTECTIONS FOR THE CUSTOMER-CLAIMANT

Commercial forums do not offer any of the protections that FINRA has instituted in its forum over the years, including requiring clear disclosure of key aspects of the arbitration clause, and prohibitions, and prohibiting firms or

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16. Vermont Commissioner of Financial Regulation and then NASAA President Michael Pieciak explained in an August 9, 2019 comment letter addressing the use of forced arbitration contract by state-registered RIAs, "Forced arbitration at the demand of an investment adviser is inimical to the basic fiduciary nature of an investment advisory relationship." NASAA, https://www.nasaa.org/wp-content/uploads/2019/08/Va.-Comment-Letter-8-9-2019.pdf (last visited Jun 12, 2022).

17. *See* JAMS Comprehensive Rules, Rule 31(C); American Arbitration Association Commercial Arbitration Rules and Mediation Procedures, R-57.

18. American Arbitration Association Commercial Arbitration Rules and Mediation Procedures, R-57(e).

brokers from designating an inaccessible venue, limiting claims, or preventing class claims from proceeding.

When arbitration forum providers apply consumer rules to customer claims, it is often at the cost of arbitrator selection, discovery processes, and hearing time. This puts the customer-claimant in the position of 1) electing a significantly curtailed arbitration process for a complex matter; 2) accepting oppressive terms in the pre-dispute arbitration agreement and advancing monies they cannot afford prior for an arbitration process designed for complex claims, or 3) electing not to bring the claim.

Even when a provider such as the American Arbitration Association makes a determination that a customer-RIA arbitration should proceed under its consumer rules, those same rules allow the RIA to challenge the determination to the arbitrator once appointed.[19] For the arbitrator deciding the issue, lurking in the background of any arguments is the difference of earning a flat fee of $2,500 per day[20] or charging his/her individual fee which will be substantially more.

D. LACK OF AVAILABLE ARBITRATION DATA HARMS CUSTOMERS AT ALL LEVELS OF RIA-CUSTOMER RELATIONSHIP

In contrast to FINRA arbitration, no one knows how many customer-RIA arbitrations there are in a given year. For SEC-registered RIA, there is no requirement to disclose the existence or results of arbitration proceedings. However, state-registered advisers filing Part 1B of Form ADV are required by state law to report arbitration claims and complete a corresponding Disclosure Reporting Page ("DRP").[21] No entity is tracking, consolidating, reporting, or verifying the accuracy of the number of arbitrations disclosed by

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19. American Arbitration Association Consumer Arbitration Rules, R-1(e): "If either the consumer or the business disagrees with the AAA's decision, the objecting party must submit the objection by the due date for filing an answer to the demand for arbitration. If an objection is filed, the arbitrator shall have the authority to make the final decision on which AAA rules will apply.".

20. American Arbitration Association Consumer Arbitration Rules, Costs of Arbitration, https://adr.org/sites/default/files/Consumer_Fee_Schedule_2.pdf (last visited Jun. 16, 2022).

21. Form ADV, Item 11. *See also*, Form ADV and IARD Frequently Asked Questions, Form ADV, Item 11, https://www.sec.gov/divisions/investment/iard/iardfaq.shtml (last visited Jun. 13, 2022).

state-registered RIAs. Ultimately, potential customer looking to do business with an RIA may have no information about the RIA's past history of arbitration claims. A lengthy and adverse arbitration history would be material information a customer would want to have prior to entering into an advisory relationship with an RIA.

Further, there is no public source of information about customer-RIA arbitration claims in commercial forums, the providers used, the identities of the arbitrators deciding claims, where the hearings take place, under what terms they take place, what the results of those arbitrations are, the forum costs, how many claims succeed, and how many unpaid awards exist.

Regulators also lack data pertaining to costs, how many customers abandon their claims due to excessive costs, or what other problems, such as "repeat player" bias,[22] may exist.

III. STUDYING THE RIA ARBITRATION ISSUE

Before considering reforms, a study or studies must assess the prevalence of forced arbitration clauses; the forums or providers selected; the arbitration rules selected; any selection of hearing location(s); the existence of any hedge clauses, types of damages limitations, class action waivers, and/or fee shifting provisions; and the per day cost of arbitration in a given forum in a range capturing the majority of fees charged by individual arbitrators in a given forum.

The studies also need to look at the actual costs of arbitrations in the past five years, the issues presented by customer claims, the defenses asserted in response to the claims, the existence of arbitration awards, the percentage of awards decided for the customer or RIA, the amount of damages awarded (if any) against the amount of damages claimed, the identity of arbitrators issuing awards, post award litigation, the time period from issuance of an award to payment of an award by an RIA, the number of and amount of any unpaid arbitration awards, and the disclosures, if any, of prior arbitration claims.

Studying the RIA-arbitration problem is not easy due to the fragmented regulatory system governing RIAs. Generally, the SEC regulates advisors with assets under management in excess of $100 million, while individual states regulate those with under $100 million. With the almost 14,000 SEC-registered advisors and more than 17,000 state-registered advisors, any study

22. "Indeed, businesses that arbitrate often in an institution perform particularly well within that institution." Andrea Cann Chandrasekher and David Horton, Arbitration Nation: Data from Four Providers, 107 Cal. L.R. 1 at 9 (2019).

or studies must involve both the federal and state regulators to obtain the most complete set of data of how arbitration clauses are being used by RIAs to best determine how to eliminate customer abuses and improve transparency.

IV. SOLUTIONS TO THE RIA ARBITRATION ISSUES

Whether voluntarily undertaken by RIAs or involuntarily imposed by regulators and/or legislators, there are three main non-exclusive solutions to resolving the RIA-arbitration conundrum.

A. POTENTIAL SOLUTION #1 – PROHIBIT RIA ARBITRATION

The state of Virginia has prohibited RIAs from using forced arbitration clauses in their account agreements by deeming their usage as dishonest or unethical business practices.[23]

Setting aside the issue whether an outright, across-the-board ban could withstand a challenge under the Federal Arbitration Act, such a prohibition would put an end to all the arbitration issues presented in the customer-RIA context.

The disadvantage to a ban is that it denies a viable dispute resolution mechanism that may be desirable by both sides of such a dispute.

B. POTENTIAL SOLUTION #2 – IMPOSE RESTRICTIONS AND TRANSPARENCY ON USE OF ARBITRATION BY RIAS

Eliminating the current set of issues and abuses already experienced and expected to be revealed after any regulator's study of the current state of customer-RIA arbitration practices would improve the current process for customers. Such an approach would require the involvement of multiple regulators and/or voluntary cooperation by the RIA industry to create a uniform standard from state to state and forum to forum. Such solutions would likely involve creating a new dispute resolution provider and/or contracting with an existing provider, plus thorough rule-making enforced by regulators and ongoing oversight.

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23. 21 Va. Admin. Code § 5-80-200(F).

1. The Costs and Fees of Arbitration Must be Shifted to the RIA

The prohibitive cost of arbitration at non-FINRA providers must be addressed first. Like the broker-dealers subsidizing FINRA arbitrations, RIAs will have to subsidize a large portion of the arbitration process to ensure access to justice. This is already common practice for arbitration forums including AAA and JAMS that hear consumer and employment claims. Those providers require the entity imposing the arbitration requirement to agree to pay the forum fees as a condition of hearing the case.

Expecting RIAs to pay all the costs of the forum they have designated in their arbitration clause, except for a nominal filing fee, is not unreasonable. This puts the cost burden on the more sophisticated party that forced arbitration, as opposed to the customer, who was forced to waive their right to pursue a claim in any other forum.

2. Prohibit Anti-Customer Practices Such as Hedge Clauses, Hearing Location Selection, Choice of Law Clauses

The three customer-claimant practices discouraging customer claims have to be addressed and removed from the RIA-arbitration process: 1) the continued use of hedge clauses limiting claims and damages despite the SEC's recent messaging case reiterating its prohibition of the same;[24] 2) selecting hearing locations geographically distant from the customer's place of residence; and 3) choice-of-law clauses that have no relationship to the customer's residence.

24. *In the Matter of Comprehensive Capital Management, Inc.*, Order Instituting Administrative and Cease-And-Desist Proceedings Pursuant to Sections 203(E) and 203(K) of the Investment Advisers Act of 1940, Making Findings and Imposing Remedial Sanctions, and a Cease-And-Desist Order, Investment Advisers Act of 1940 Release No. 5943 (Jan. 11, 2022), https://www.sec.gov/litigation/admin/2022/ia-5943.pdf (last visited Jun. 15, 2022).

FINRA has long prohibited such practices,[25] and in 2021 reiterated its prohibitions to its members.[26]

3. Disclosure of Arbitration Information Must be Improved

If RIAs are permitted to impose mandatory pre-dispute arbitration requirements upon their clients, as a matter of customer protection and access to justice, that such arbitration be affordable, fair, transparent, and accountable. Regulators, and legislatures in the absence of regulatory action, will have to impose reasonable customer protections related to costs, disclosures, and providing a repository of information about RIA arbitration awards be made public in a repository similar to FINRA.[27]

a. The Arbitration Agreement Must Disclose Costs

The high cost of commercial arbitration providers' fees is not disclosed in the arbitration agreements between RIAs and their customers. No customer can be said to have made an informed choice to arbitrate without knowing the costs of arbitration. Using a commercial arbitration provider, where the arbitrators set their own fees, no customer can know the cost of arbitration until they are in the forum and presented with the arbitrator's fee schedule. An arbitration agreement must disclose the estimated per day cost of arbitrating within the selected provider(s) as well as disclosing what fees will be the responsibility of the customer and what, if any, fee waivers are available.

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25. *See* NASD, Disciplinary Actions, https://www.finra.org/sites/default/files/DisciplinaryAction/p007455.pdf : "Prudential Securities, Inc. (CRD #7471, New York, New York) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined $20,000, and required to undertake to withdraw any New York choice-of-law defense asserted in any pending arbitration, not to assert a New York choice-of-law defense in any future arbitration proceeding, and to instruct all in-house and outside attorneys representing the firm in arbitration proceedings not to assert a New York choice-of-law defense.".

26. FINRA Regulatory Notice 21-16 (2021).

27. *See* FINRA, Arbitration Awards Online, https://www.finra.org/arbitration-mediation/arbitration-awards.

b. Disclosure of Arbitration Claims Must Be Required

The unusual discrepancy which permits SEC-registered RIAs to conceal the existence of prior arbitration claims while state-registered RIAs must disclose has to be resolved in favor of disclosure. A lengthy history of arbitration claims, whether won or lost, is relevant and material for any customer considering entering into a relationship with an RIA. Knowing whether an RIA may be troubled allows a customer to make an informed choice whether to do business with that firm or find another.

c. Arbitration Awards Must Be Made Public

Arbitration awards must be made public for multiple reasons. The first is informed consent for customers seeking to do business with an RIA. A lengthy award history is material to any decision to do business with an RIA. Second, awards give regulators information about the conduct of their regulated parties. Third, making awards public gives all parties information about the arbitration process, its costs, results, arbitrator decision-making, and whether arbitration awards are being paid.

C. POTENTIAL SOLUTION #3 – INVESTOR CHOICE

RIAs are fiduciaries and have an obligation to act in their clients' best interests. The fiduciary obligation does not end at the start of the dispute. "Investor Choice" permits the customer to choose between court and arbitration after the dispute arises. This solution allows a client to make an informed decision about what will be in their best interest. In April 2021, the Investor Choice Act was introduced in the U.S. House to give customer-investors the choice of forum for their disputes.[28]

Permitting the customer choose their forum after a dispute has arisen will let the "market" set the terms and conditions under which both sides may seek arbitration over court, embrace the type of expenses they are willing to pay (e.g., elect a court and pay for deposition discovery rather than pay arbitrator fees), and determine if the benefit of a potentially speedier arbitration hearing is worth the time-consuming post-award litigation.

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28. Investor Choice Act of 2021, H.R. 2620 117th Cong. § 2 (2008).

V. CONCLUSION

The current state of customer-RIA arbitration is currently unsettled, unknown, and harmful to customer-investors.

At this point, the RIA-industry can embrace reforms to make arbitration fair and accessible, or potentially have reforms imposed, up to and including, a ban on customer-RIA arbitration.

Notes & Observations

RECENT ARBITRATION AWARDS

Melanie Cherdack, Esq. and Sara Hanley, Esq.

This issue's featured arbitration awards include a $52 million dollar employment award- the largest employment award ever issued by a FINRA panel. It also features an $80,000 *pro se* award in a sole arbitrator case, awarding damages in excess of those sought by the Claimant's Statement of Claim. In such David versus Goliath cases, sometimes the Davids are the victors given the right set of facts and arbitrators. Also, we discuss an award including $750,000 in punitive damages as well as attorney's fees under the Texas Deceptive Trade Practices Act, illustrating how important individual state statutory claims can be. Finally, we discuss a panel's award of attorney's fees pursuant to the "FINRA Dispute Resolution Services Arbitrator's Guide," where no statute, contract or other basis was alleged in the Statement of Claim for this attorney's fee award. This award highlights the significance of the Arbitrator's Guide in supporting a panel's authority to award a variety of damages in FINRA arbitration.

Ian Delahunty v. TD Ameritrade, Inc.
Case No. 21-00028
Dallas, Texas- videoconference
Hearing Dates: May 3-4, 2022
Award Date: May 11, 2022
Counsel:
  Counsel for Claimant:
    Michael S. Hill, Esq. and Gary S. Menzer, Esq., Menzer & Hill, P.A., Boca Raton, Florida
  Counsel for Respondent:
    James J. Vihstadt, Esq., TD Ameritrade, Inc., Omaha, Nebraska
Arbitration Panel:
  Karen Roberts Washington, Presiding Chairperson, Will Pryor, Public Arbitrator, Subvet West, Public Arbitrator
Investments at Issue:
  The security at issue was Velocity Shares 3x Long Crude Oil ETB, a leveraged exchange traded note.
Claimant's Claims:
  Causes of Action in Statement of Claim:
    (1) Negligent supervision;

(2) Negligence;
(3) Breach of fiduciary duty;
(4) Breach of contract;
(5) Omissions to state a material fact; and
(6) Violation of FINRA Rules.

Relief Requested in Statement of Claim:

(1) Compensatory damages of $650,000;
(2) Award of statutory damages;
(3) Accrued statutory interests;
(4) Costs;
(5) Filing and hearing fees; and
(6) Other remedies the Panel deems proper and appropriate.

Relief Requested at hearing:

(1) $480,051.00 in compensatory damages;
(2) Expert fees of $5,000.00; and
(3) All forum fees be assessed to Respondent.

Award:

(1) Respondent is liable for and shall pay to Claimant the sum of $360,000.00 in compensatory damages.
(2) Respondent is liable for and shall pay to Claimant pre-award interest on the above-stated sum at the rate of 5% per annum from December 7, 2016, through and including 30 days after the date of the award.
(3) Respondent is liable for and shall pay to Claimant post-award interest on the above-stated sum in No. 1 at the rate of 10% per annum from 31 days after the date of the award through and including the date the award is paid in full.
(4) Respondent is liable for and shall pay to Claimant the sum of $5,000.00 in costs.
(5) Respondent is liable for and shall pay to Claimant the sum of $425.00 to reimburse Claimant for the non-refundable portion of the filing fee previously paid to FINRA Dispute Resolution Services.
(6) Any and all claims for relief not specifically addressed herein, including any requests for punitive damages, treble damages, and attorneys' fees, are denied.

Analysis:

The causes of action in this case related to Claimant's allegation that Respondent knowingly put Claimant in harm's way by allowing him to hold a product for 199 days when it was intended as a short-term investment meant to be held for a day or two. The panel in this case awarded pre-award interest of 5% on the compensatory damages amount dating back to 2016 and awarded Claimant the cost of this expert witness. This award is interesting because of

the allegations regarding the improper use of a short-term investment and the award of pre-award interest for nearly six years on the compensatory damages amount recovered.

Johnny Walker v. Network 1 Financial Securities, Inc.
Case No. 20-02843
Houston, Texas
Hearing Dates: June 14-16, 2022
Award Date: June 30, 2022
Counsel:
Counsel for Claimant:
Jonathan E. Neuman, Esq., Fresh Meadows, New York.
Counsel for Respondent:
Timothy Feil, Esq. and Craig A. Riha, Esq., Carmel, Milazzo & Feil, LLP, Melville, New York.
Arbitration Panel:
Denise Ereka Peterson, Presiding Chairperson, Alan M. Holzberg, Public Arbitrator, Shannon Lyn Mays, Public Arbitrator
Investments at Issue:
The causes of action relate to various biotech and pharmaceutical stocks.
Claimant's Claims:
Causes of Action in Statement of Claim:
(1) Fraud;
(2) Unsuitability;
(3) Breach of contract;
(4) Negligence;
(5) Strict liability; and
(6) Failure to supervise.
Relief Requested in Statement of Claim:
(1) Compensatory damages of $420,000;
(2) Pre and post judgment interest at the statutory rate of 6% per annum;
(3) Punitive damages;
(4) Attorney's fees;
(5) Expenses, including expert witness fees; and
(6) Costs.
Relief Requested at hearing:
Claimant requested:
(1) $344,832.46 in compensatory damages;
(2) $1,034,497.38 in punitive damages;
(3) $551,731.94 in attorneys' fees; and

(4) $2,925.00 in costs.

Respondent requested:

(1) $94,507.50 in attorneys' fees;

(2) $28,633.13 in fees and costs.

Award:

(1) Respondent is liable for and shall pay to Claimant the sum of $344,832.46 in compensatory damages.

(2) Respondent is liable for and shall pay to Claimant interest on the above-stated sum at the rate of 6% per annum from June 13, 3019, through and including the date this Award is paid in full.

(3) Respondent is liable for and shall pay to Claimant the sum of $750,000 in punitive damages pursuant to Texas Deceptive Trade Practices Act.

(4) Respondent is liable for and shall pay to Claimant the sum of $137,932.98 in attorneys' fees pursuant to Texas Deceptive Trade Practices Act.

(5) Any and all claims for relief not specifically addressed herein, are denied.

Analysis:

In this case, Claimant alleged that Respondent's representative lied to him about having specialized, experienced analysts covering certain biotech and pharmaceutical stocks, and that Respondent used these misrepresentations to convince Claimant to invest his retirement money in such stocks. This award is interesting because Claimant alleged violations of the Texas Deceptive Trade Practices Act. Claimant was awarded punitive damages in an amount more than two times the compensatory damages award and a large attorney's fees award pursuant to that Act, demonstrating that state statutory causes of action allowing for specific remedies can result in large FINRA awards.

John L. Atkinson and Lora Atkinson, Individually and as Joint Tenants with Right of Survivorship v. J.P. Morgan Securities, LLC

Case No. 19-02212

Boca Raton, Florida

Hearing Dates: May 23-27, 2022

Award Date: June 13, 2022

Counsel:

Counsel for Claimants:

Johnathan C. Schwartz, Esq., Jason S. Haselkorn, Esq. and Matthew N. Thibaut, Esq., Haselkorn & Thibait, P.A., Juno Beach, Florida

Counsel for Respondent:

Michael A. Gross, Esq., Ulmer & Berne, LLP, Boca Raton, Florida

Arbitration Panel:

Nancy J. Cliff, Presiding Chairperson, Michael D. Felton, Public Arbitrator, Harry Albirt, Public Arbitrator

Investments at Issue:

The causes of action relate to Respondent's investment strategy and transactions in Claimants' accounts.

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Negligent acts and omissions;
(2) Professional negligence;
(3) Improper conduct;
(4) Breach of fiduciary duty;
(5) Breach of security industry rules and regulations; and
(6) Breach of Contract.

Relief Requested in Statement of Claim:

(1) Compensatory damages of $500,000;
(2) Interest;
(3) Costs;
(4) All actual damages, proximately and/or legally cause by Respondent's actions or inactions; and
(5) Any other additional damages the Panel deemed just and necessary.

Award:

(1) Respondent is liable for and shall pay to Claimants the sum of $390,000 in compensatory damages.
(2) Respondent is liable and, within ten days of the date of this Award, shall assume ownership of Claimants' short position of 15,000 shares of AMR CORP acquired on December 6, 2013, in Claimants' account at Respondent J.P. Morgan Securities, LLC, and Respondent shall be responsible for any costs associated with transfer of ownership from Claimants to Respondent.
(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 Florida based arbitration panel awarded Claimant rescission and ordered JP Morgan to buy back Claimant's short position. This award is unusual in that despite Claimant's claim for solely compensatory damages, the Panel granted Claimant rescission as part of the award. This award illustrates the importance of a "catch all" damages request, because presumably the panel granted rescission under Claimant's request for "any and other damages the Panel deemed just and necessary".

Laura Tufariello v. Joseph Gunnar & Co. LLC
Case No. 20-00366
New York, New York- videoconference
Hearing Dates: April 24-8, 2022 and April 21, 2022
Award Date: May 25, 2022
Counsel:
Counsel for Claimant:
Chase Carlson, Esq., Carlson Law, P.A., Miami Beach, Florida.
Counsel for Respondent:
John E. Lawlor, Esq., Mineola, New York.
Arbitration Panel:
Paul Bennett Marrow, Presiding Chairperson, Ronald Harris Kinser, Public Arbitrator, Susan Romano, Public Arbitrator
Investments at Issue:
The causes of action relate to investments in VIA Motors, Inc. and ZocDoc, Inc. stock.
Claimant's Claims:
Causes of Action in Statement of Claim:
(1) Negligence;
(2) Negligent supervision;
(3) Negligent misrepresentations;
(4) Fraud;
(5) Fraudulent misrepresentations;
(6) Breach of fiduciary duty;
(7) Breach of contract;
(8) Unsuitability; and
(9) Violations of FINRA Rules.
Relief Requested in Statement of Claim:
(1) Rescission or compensatory damages of approximately $750,000;
(2) Punitive damages;
(3) Costs;
(4) Expert witness costs;
(5) Pre-award interest; and
(6) Such further and appropriate relief as the Panel deems appropriate.
Award:
(1) Respondent is liable for and shall pay to Claimant the sum of $52,500.00 in compensatory damages.
(2) Respondent is liable for and shall pay to Claimant the sum of $105,000.00 in punitive damages pursuant to *Lee v. Edwards*, 101 F.3d 805, 809 (2d. Cir. 1996); *BMW of North America, Inc. v. Gore*, 517 U.S. 559 (1996); and *Bernstein v. Kelson & Co., Inc.*, 231 A.D.2d

314, 324, 659 N.Y.S.d 276 (1st Dept. 1997).

(3) Respondent is liable for and shall pay to Claimant the sum of $6,800.00 in costs for expert witness fees.

(4) Respondent is liable and shall pay to Claimant the sum of $600.00 to reimburse Claimant for non-refundable portion of the filing fee previously paid to FINRA Dispute Resolution Services.

(5) Unnamed Party Anthony Sica's request for expungement of the above captioned arbitration from registration records maintained by CRD is denied.

(6) Any and all claims for relief not specifically addressed herein, including any requests for rescission, are denied.

Analysis:

This New York based arbitration panel awarded Claimant punitive damages of approximately two times compensatory damages. Notably, the Panel relied on three cases for authority to award such substantial punitive damages. Claimant was also awarded her expert witness's fees. This award illustrates the importance of providing case law in support of the relief requested, and highlights significant Federal and U.S. Supreme Court cases supporting a punitive damages award.

Carlos Ramon Tapia Sanchez v. Merrill, Lynch, Pierce Fenner & Smith Inc, Morgan Stanley and Francisco Javier Valenzuela

Case No. 20-03591

Phoenix, AZ

Hearing Dates: April 26-27, 2022

Award Date: May 26, 2022

Counsel:

Counsel for Claimant:

Burt W. Newsome, Esq., Newsome Law, LLC, Birmingham, Alabama.

Counsel for Respondents Merrill Lynch:

Tara A. LaClair, Esq., Crowe & Dunlevy, P.C., Oklahoma City, Oklahoma.

Counsel for Respondent Morgan Stanley:

Patricia V. Waterkotte, Esq., Rusing Lopez & Lizardi, P.L.L.C., Tucson, Arizona.

Respondent Francisco Javier Valenzuela did not enter an appearance.

Arbitration Panel:

Timothy J. Kroll Presiding Chairperson, Ronald Stewart Ripley, Public Arbitrator, Vineet Mehta Shaw, Public Arbitrator

Investments at Issue:

The causes of action relate to various unspecified securities.

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Elder abuse;
(2) Misrepresentation;
(3) Manipulation;
(4) Fraud;
(5) Conversion;
(6) Negligence; and
(7) Failure to supervise.

Relief Requested in Statement of Claim:

(1) Compensatory damages of $500,000.

Relief Requested at hearing:

(1) $357,622.00 in compensatory damages;
(2) Attorney's fees.

Award:

(1) Valenzuela is liable for and shall pay to Claimant the sum of $160,000.00 in compensatory damages for misrepresentation, manipulation, and fraud.
(2) Morgan Stanley is liable for and shall pay to Claimant the sum of $160,000.00 in compensatory damages for negligence and failure to supervise.
(3) Valenzuela and Morgan Stanley are jointly and severally liable for and shall pay to Claimant the sum of $10,000.00 in attorneys' fees pursuant to FINRA Dispute Resolution Services Arbitrator's Guide.
(4) Any and all claims for relief not specifically addressed herein are denied.

Analysis:

This Phoenix based arbitration panel awarded Claimant a large percentage of the compensatory damages sought for claims including elder abuse. In so doing, the panel awarded attorneys' fees pursuant to the "FINRA Dispute Resolution Services Arbitrator's Guide." No statute, contract or other basis was stated for this attorney's fee award, although Morgan Stanley did ask for an attorney's fee award in its Answer to the Statement of Claim. The Arbitrator's Guide is often overlooked as a valuable resource for practitioners. This award illustrates its importance in providing FINRA's own support for requested relief.

Daniel Michalow v. Laurence Fishman, Julius Ralph Gaudio, Maximillian Dana Stone, Eric Karl Wepsic and D.E. Shaw & Co., L.P.
Case No. 18-03174
New York, NY
Hearing Dates: October 27-28, 2021; November 1-4, 2021; November 8-11, 2021; April 25-26, 2022; May 2-5, 2022; May 9-12, 2022; May 18-19, 2022; and May 4, 2022
Award Date: June 29, 2022
Counsel:
  Counsel For Claimant:
    Dustin Pusch, Esq., and Thomas A. Clare, Esq., Clare Locke LLP, Alexandria, Virginia; Jonathan Harris, Esq., Harris St. Laurent LLP, New York, New York; and Jeremy Wallison, Esq., Wallison & Wallison LLP, New York, New York
  Counsel for Respondents:
    Terri L. Chase, Esq., Jones Day, New York, New York; Saul B. Shapiro, Esq., and Jane Metcalf, Esq., Patterson Belknap Webb & Tyler LLP, New York, New York.
Arbitration Panel:
  Jonathan Blank, Presiding Chairperson, Richard Lee Mansdoerfer, Jr., Public Arbitrator
Conduct at Issue:
  The causes of action relate to allegations of gender discrimination, defamation and Respondent D.E. Shaw's failure to pay deferred compensation and 2018 pro-rated compensation. Claimant alleged that statements made regarding his alleged sexual misconduct were false.
Claimant's Claims:
  Causes of Action in Amended Statement of Claim:
    (1) Violations of New York Labor Law §§ 193, 198 et.seq.;
    (2) Breach of contract; and
    (3) Unjust enrichment.
Relief Requested:
  (1) Defamation damages of $600,000,000;
  (2) Discrimination damages of $600,000,000;
  (3) Damages from Respondents' failure to provide Claimant with his deferred compensation and 2018 prorated compensation;
  (4) Interest;
  (5) Liquidated damages under New York Labor Law § 198;
  (6) Costs;

(7) Attorney's fees;
(8) Punitive damages; and
(9) Such other relief as deemed just and proper.

Other Issues or Motions Decided at Hearing:

On or about May 8, 2022, the third Arbitrator withdrew from this matter. At the commencement of the evidentiary hearing on May 9, 2022, the parties agreed to continue the hearing with the two remaining Arbitrators.

Award:

(1) Respondents are jointly and severally liable for and shall pay to Claimant the sum of $52,125,000.00 in compensatory damages for defamation. The Panel specifically finds that Claimant did not commit sexual misconduct.
(2) Any and all claims for relief not specifically addressed herein, including any requests for liquidated damages, punitive damages, and attorneys' fees, are denied.

Analysis:

The New York Times has reported that this 52-million-dollar award is the largest defamation award handed down in a FINRA arbitration. The Claimant, a star hedge fund manager and Harvard alum, argued that he had been a victim of the #metoo movement and that reports of his sexual harassment were bogus-although earlier he did admit to making inappropriate jokes. This award illustrates that FINRA employment claims can result in much larger awards than customer claims given the right circumstances.

David C. Rentschler and Karen Ann H. Rentschler JTWROS v. Stephano Michael Marino

Case No. 21-00114
Nashville, TN
Hearing Dates: N/A
Award Date: May 19, 2022
Counsel:

Counsel for Claimant:

David Vermont, Esq., Securities Arbitration Law Group, Washington, District of Columbia

Counsel for Respondent:

David A. Schrader, Esq., Paykin Krieg & Adams, LLP, Purchase, New York

Arbitration Panel:

Lita S. Menkin, Presiding Chairperson, Douglas Charles Weinstein, Public Arbitrator, Darrell A. Hillis, Public Arbitrator

Investments at Issue:

The causes of action relate to Claimant's investment into shares of Smith and Wesson Holding Corp.

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Negligence;
(2) Qualitative and quantitative unsuitability;
(3) Failure to supervise;
(4) Breach of fiduciary duty;
(5) Breach of contract; and
(6) Negligent misrepresentation and omissions.

Relief Requested in Statement of Claim:

(1) Compensatory damages of $56,433;
(2) Commissions of $61,716;
(3) Interest;
(4) Costs;
(5) Attorney's fees;
(6) Expert witness fees;
(7) Punitive damages; and
(8) Other such further relief as the panel deemed appropriate.

Other Issues or Motions Decided at Hearing:

On or about March 30, 2022, Respondent filed a Motion to Dismiss based upon Claimant's failures to produce discovery and to comply with the Panel's Order dated February 2, 2022. On or about April 15, 2022, Claimant filed a response opposing the Motion to Dismiss. On or about April 20, 2022, Respondent filed a reply in support of the Motion to Dismiss. On May 17, 2022, the Panel heard oral arguments on the Motion to Dismiss. On or about May 17, 2022, the Panel granted the Motion to Dismiss with prejudice pursuant to Rules 12212 and 12511 of the Code on the following grounds:

Claimant failed to follow the Panel's valid discovery order. This material failure to produce discovery resulted in Respondent going without the necessary information to defend Respondent's case. Claimant cited no valid objections to the discovery requests. The Panel found Claimant's reasons for failure to produce discovery as required under the rules unpersuasive.

Award:

(1) Claimant's claims as stated in the Statement of Claim are dismissed in their entirety pursuant to Rules 12212 and 12511 of the Code.

Analysis:

This Nashville based arbitration panel dismissed this arbitration with prejudice prior to the final hearing. The dismissal was a sanction pursuant to the FINRA Rules allowing dismissal of a case for a violation or refusal to comply with a valid order of the panel. In this instance, the Claimant violated the panel's discovery order. The panel found that the material failure to produce the discovery left the Respondent without the information necessary to defend the case. The Claimant's stated reasons for non-compliance were deemed unpersuasive. This case illustrates the panel's unfettered authority to dismiss a claim based upon a Claimant's failure to cooperate in discovery following a panel's order to produce documents or information.

Kenneth L. Covell v. Charles Schwab & Co., Inc.

Case No. 20-02414

Boca Raton, FL

Hearing Dates: June 13-14, 2022

Award Date: June 23, 2022

Counsel:

Counsel for Claimant:

Pro Se

Counsel for Respondent:

Kevin H. Lewis, Esq., Charles Schwab & Co., Inc., San Francisco, California

Arbitration Panel:

Monica I Salis, Sole Public Arbitrator

Investments at Issue:

The cause of action relates to an alleged failure by the broker to follow Claimant's instructions to "dollar cost average" $500,000.00 that Claimant invested in a portfolio managed by a robo-advisor called Schwab Intelligent Portfolios.

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Account transfer execution error.

Relief Requested in Amended Statement of Claim:

(1) Compensatory damages of $235,000; and

(2) Other relief as is just and appropriate.

Relief Requested at hearing:

(1) Claimant initially requested estimated damages of $75,000.00, but ultimately adopted the calculations of Respondent's expert witness.

Award:

(1) Respondent is liable for and shall pay to Claimant the sum of $79,249.93 in compensatory damages, based on Claimant's losses as of March 16, 2020.
(2) Respondent is liable for and shall pay to Claimant interest on the above-stated sum at the rate of 18% per annum from March 16, 2020 through and including the date the balance is paid in full.
(3) Respondent is liable for and shall pay to Claimant the sum of $300.00 as reimbursement for the non-refundable portion of the claim filing fee previously paid by Claimant to FINRA Dispute Resolution Services.
(4) Respondent's request, on behalf of Unnamed Party Scott (CRDNumber2918260), for expungement of the above-captioned arbitration (Occurrence Number 2074637) from registration records maintained by the CRD is denied.
(5) 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 is an interesting award for two reasons. First, it is a rather large award for *a pro se* Claimant in a single arbitrator case. The second reason this award is compelling is that the Claimant alleged that he asked to be placed in a particular robo-advisor program at Schwab through "dollar cost averaging," which was not executed on by the broker. While the damages were less than sought by the Amended Statement of Claim, the panel did award compensatory damages for Schwab's failure to execute this strategy of investing.

CASES & MATERIALS

Jason Burge and Tad Bartlett

The Supreme Court holds that parties do not need to prove prejudice to establish a waiver of the right to arbitration through litigation conduct.

Morgan v. Sundance, Inc., 142 S.Ct. 1708 (2022):

When a party to an arbitration agreement sues in court, a defendant often will not immediately demand arbitration of the claims. The question thus often arises: at what point has a defendant's participation in litigation waived the defendant's right to demand arbitration?

Nine Federal Circuit Courts (all but the Seventh, Tenth, and D.C. Circuit) had adopted a rule where the party resisting an arbitration demand must show three elements to establish waiver through litigation conduct: the party seeking arbitration "knew of the right [to arbitrate]; acted inconsistently with that right; and—critical here—prejudiced the other party by its inconsistent actions." *See Morgan v. Sundance, Inc.*, 142 S.Ct. 1708, 1712 n.1 (collecting cases). The requirement to show prejudice often allowed a defendant to take various steps in a litigation—such as filing a motion to dismiss, answering, mediating, even some limited discovery[1]—while preserving the ability to demand arbitration of the plaintiff's claims.

Plaintiff Robyn Morgan brought a nationwide collective action against Sundance, a Taco Bell franchisee, alleging violations of the Fair Labor Standards Act. *Morgan*, 142 S.Ct. at 1711. Sundance initially moved to

1. *See, e.g., Demsey & Assocs., Inc. v. Steamship Sea Star*, 461 F.2d 1009, 1018 (2d Cir. 1972) ("Merely answering on the merits, asserting a counterclaim (or cross-claim) or participating in discovery, without more, will not necessarily constitute a waiver."); *Gavlik Const. Co. v. H. F. Campbell Co.*, 526 F.2d 777, 783 (3d Cir. 1975), *abrogated by Zosky v. Boyer*, 856 F.2d 554 (3d Cir. 1988) ("Recent cases have only found waiver where the demand for arbitration came long after the suit commenced and when both parties had engaged in extensive discovery."); *Morgan v. Sundance, Inc.*, 992 F.3d 711, 714 (8th Cir.), *cert. granted,* 142 S. Ct. 482, 211 L. Ed. 2d 292 (2021), and *vacated and remanded,* 142 S. Ct. 1708, 212 L. Ed. 2d 753 (2022) (Eighth Circuit found no waiver of right to arbitration where party litigated motion to dismiss and participated in formal court mediation).

dismiss Morgan's suit as duplicative of an earlier-filed litigation. *Id.* When that motion was denied, Sundance answered and filed affirmative defenses, none of which mentioned an arbitration agreement. *Id.* Sundance then participated in a joint mediation with the plaintiffs from both collective actions. *Id.* When the earlier-filed suit settled, but Morgan's did not, Sundance changed course and, eight months after the suit was filed, moved to stay the litigation and compel arbitration under the Federal Arbitration Act. *Id.* That motion was denied by the district court, but the Eighth Circuit reversed and compelled arbitration, finding that Morgan had failed to establish prejudice because no discovery had been conducted and the parties' motions had not yet contested any matters "going to the merits." *Id.* at 1712 (citing *Morgan v. Sundance, Inc.*, 992 F.3d 711, 715 (8th Cir. 2021)).

The Supreme Court granted certiorari and reversed. The Court initially assumed that waiver of arbitration was an issue of federal law. *Id.* at 1712. The Court noted that outside the arbitration context, prejudice is not normally an element of waiver, defined as "the intentional relinquishment or abandonment of a known right." *Id.* at 1713. In assessing waiver, courts usually focus "on the actions of the person who held the right," not "the effects of those actions on the opposing party." *Id.* The Eighth Circuit's rule requiring evidence of prejudice to the non-moving party before a moving party could be found to have waived the right to arbitrate was therefore an arbitration-specific rule, a "bespoke rule of waiver for arbitration." *Id.* at 1713. And the Supreme Court rejected the notion that courts should invent "special, arbitration-preferring procedural rules." *Id.*

Instead, the Court held that arbitration agreements should be "as enforceable as other contracts, but not more so." *Id.* (citing *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 404 n.12 (1967)). "A court may not devise novel rules to favor arbitration over litigation," or "make up a new procedural rule based on the FAA's 'policy favoring arbitration.'" *Morgan*, 142 S.Ct. at 1713-14. If an "ordinary procedural rule—whether of waiver or forfeiture or what-have-you—would counsel against enforcement of an arbitration contract," then the arbitration contract should not be enforced. *Id.* at 1713. To decide whether a party has waived arbitration, the Supreme Court held that courts should ask only if the party "knowingly relinquish[ed] the right to arbitrate by acting inconsistently with that right?" *Id.* at 1714.

The Supreme Court's new test for waiver has the potential to greatly expand the scenarios in which a defendant who participates in litigation, even for a relatively brief period, will be unable to enforce an arbitration clause. Parties who wish to preserve their right to compel arbitration should therefore move for arbitration in their initial response to a court complaint, or risk waiving the right. It is also an open question whether a party who files suit in

court can still demand arbitration of a counterclaim. *See, e.g., Fid. Nat. Corp. v. Blakely*, 305 F. Supp. 2d 639, 643 n.5 (S.D. Miss. 2003) (holding lender's filing of state court collection action did not waive its right to arbitrate counterclaim, in part because counterclaimant could not show prejudice). Parties who seek to avoid arbitration should carefully evaluate whether the opposing party's litigation conduct is inconsistent with arbitration and entitles the non-moving party to litigate their claims in court.

The Second Circuit holds that a plaintiff's sworn declaration is sufficient evidence to preclude employer's motion to compel arbitration based on electronically signed documents.

Barrows v. Brinker Restaurant Corp., 36 F.4th 45 (2022)

Samantha Barrows brought a collective action against Brinker Restaurant Corporation, the franchisee of the Chili's where she formerly worked, for employment law violations. *Barrows,* 36 F.4th at 47. In response, Brinker filed a motion to compel arbitration, attaching a "set of arbitration agreements and other related documents, each of which purportedly bore Barrow's electronic signature." *Id.* at 48. Brinker also attached a number of affidavits from managers, attesting to the company's onboarding process and that the managers never completed onboarding documents for employees. *Id.* In response, Barrows signed a declaration where she "adamantly, and categorically, denied having electronically signed any arbitration agreement." *Id.* Nonetheless, the district court granted Brinker's motion and compelled arbitration.

The Second Circuit reversed. The Court noted that while there is a preference for arbitration when "parties are bound to an arbitration agreement," there is no "special solicitude" on "the antecedent question of whether the parties actually agreed to arbitration (that is, whether an arbitration agreement exists at all)." *Id.* at 50. That "agreement-formation" question is a standard contract dispute to be resolved under state law. *Id.* While Brinker had come forward with evidence of an arbitration agreement, the party resisting a motion to compel, like a party resisting summary judgment, needed only to come forward with some evidence to substantiate her denial that an agreement had been made. *Id.* While noting that a party's affidavit might not always defeat a motion to compel arbitration, the court noted that Barrows' categorical denial—accompanied with specific statements that she did not use a computer at work or home and did not have any knowledge of the specific computer system used to complete the electronic documents—was "'some evidence' that

she did not agree to arbitration." *Id.* at 52-53. This created a triable issue of fact precluding the grant of a motion to compel and required a trial of whether Ms. Barrows had agreed to arbitrate her claims. *Id.*

Notably, the Second Circuit also rejected Brinker's argument that Barrows had assented to the arbitration agreement by continuing to work for Brinker. *Id.* at 53. Significantly, because the only evidence that Brinker had received a copy of the arbitration agreement was an electronic receipt signed in the same manner as the arbitration agreements, there was a genuine issue of material fact as to whether Brinker ever received or had notice of the arbitration agreement. *Id.*

In a world where electronic execution of account opening documents is increasingly common, attorneys representing plaintiffs should consider whether their clients have actually executed a purported arbitration agreement, or whether their clients could credibly attest that they neither signed nor were aware of the agreements as a way to defeat a motion to compel arbitration.

The Fifth Circuit affirms a fraud conviction of an investment advisor and its principals on a cherry-picking scheme, based on statistical analysis rather than direct evidence regarding particular trades; and upholds disgorgement award.

Securities and Exchange Commission v. World Tree Financial, L.L.C., et al., 43 F.4th 448 (5th Cir. 2022):

The Securities and Exchange Commission (SEC) brought an enforcement action against a Louisiana-based investment advisor, World Tree Financial, L.L.C., and its two principals, Wesley Perkins and Priscilla Gilmore Perkins, arising from an alleged fraudulent "cherry-picking" scheme in which the defendants engaged in block-trading across the World Tree portfolio and then allocated favorable trades to favored clients and to themselves and allocated unfavorable trades to disfavored clients. In addition, the SEC's enforcement action brought fraudulent misrepresentation claims against Perkins and Gilmore for engaging in the same trades as their clients, in contravention of representations in World Tree's compliance manual and Form ADV. The district court found the defendants liable on these claims—including that the cherry-picking claim constituted fraud in violation of § 10(b) of the Exchange Act and Rule 10b-5 and in violation of § 17(a) of the Securities Act, and that the material misrepresentations violated the Advisers Act—and enjoined the defendants from further cherry-picking, ordered disgorgement of $347,947 plus interest, and imposed civil penalties.

The Court noted that this was the first time the Fifth Circuit had addressed a cherry-picking fraud theory, but that other federal courts had found that that cherry-picking can constitute securities fraud. "Because cherry-picking involves allocating more profitable trades to certain accounts, an adviser is stealing from one customer to enrich himself, and thus the practice implicates a conflict of interest." (Internal citations and quotation marks omitted). The Court held that placing trades with a broker, as World Trade did in effecting its block trades, satisfies the "in-the-offer-or-sale" element of the fraud provisions at issue, and that "[i]t is not necessary for a specific trade or a specific purchaser or seller to be identified to satisfy the in-connection-with element."

Here, the district court relied on statistical evidence presented by the SEC's expert of patterns of trading and allocations to prove that cherry-picking occurred, and the Court of Appeals approved of statistical evidence as a means of proof. "Because cherry-picking is difficult to detect, determining whether it has occurred often requires drawing inferences from a pattern of behavior, irregularities, and trading data." (Internal citation and quotation marks omitted). Here, the SEC's expert analyzed the pattern of when block trades were made, when the allocation to individual World Tree-managed accounts occurred, and which accounts favorable and unfavorable trades were allocated to, concluding that there was a "one in a million chance that these patterns could have occurred" if the allocations were not part of a cherry-picking scheme. On a clear-error review, the Court of Appeals deferred to the district court's weighing of credibility of the witnesses and resolution of conflicting expert opinions.

The Court of Appeals rejected the defendants' argument that the showing of scienter may only be supported by direct evidence. "[I]t is well settled that scienter may be established by circumstantial evidence. … Here, the district court (1) observed that cherry-picking 'necessarily involves knowing and intentional conduct,' (2) found that scienter was 'confirmed by the testimony of Wesley Perkins,' and highlighted other facts, such as the daily deletion of allocation documentation, and (3) further found that 'the facts of this case provide strong evidence of scienter on the part of Wesley Perkins.'"

The Court also upheld the material misrepresentation claims against the principals for participating personally in the same trades as their clients, a practice that was prohibited by World Tree's documents until an amendment after Schwab (the broker used by World Tree) began questioning World Tree's block-trading practices. The Court held that the misrepresentations were material; "[t]his is logical: an adviser who participates in block trades with his clients has a greater incentive to place his interests ahead of theirs." The Court rejected the defendants' argument that the primary disfavored accountholder

had indicated he did not care whether they were personally participating in the trades, because materiality was an objective standard. The Court also rejected the defendants' challenge to the disgorgement order, because the defendants failed to challenge the proposed disgorgement in pretrial or posttrial submissions and failed in their appeal to propose specific amounts for legitimate expenses that should have been deducted from the award.

The Fifth Circuit applies *Liu* to affirm disgorgement remedy in SEC securities fraud enforcement.

Securities and Exchange Commission v. Hallam, 42 F.4th 316 (5th Cir. 2022):

The SEC initiated an enforcement action against the defendant, Parker Hallam, for numerous securities violations related to "a thicket of ersatz energy companies" that he ran. Hallam agreed not to contest liability and agreed "at a high level of generality" to certain remedies, including a civil penalty, permanent injunction, disgorgement "of ill-gotten gains," and prejudgment interest on those gains. Almost three years later the SEC moved the district court to calculate the monetary remedies and fashion the injunctive relief. Before the district court could do so, the Supreme Court issued its decision in *Liu v. SEC*, 140 S. Ct. 1936 (2020), and Hallam argued that *Liu* "banished" precedent on securities remedies and vitiated his prior consent to the remedies. He also sought an evidentiary hearing. The district court denied a hearing and ordered $1,901,480 in disgorgement; $424,375 in prejudgment interest; 1,901,480 in civil penalties; and an injunction from further participation in the issuance, purchase, offer, or sale of unregistered securities.

The Court first rejected Hallam's challenge to the lack of an evidentiary hearing. It held that he failed to preserve his appeal as to a hearing regarding details of his financial transactions because he did not request a hearing on those issues from the district court but had only requested a hearing into whether he acted in good faith and on the advice of an attorney or accountant—issues that only went to calculation of the civil penalty. On penalty calculation, the Court noted its review is for abuse of discretion, a standard that "leaves the district court substantial latitude in structuring its decisionmaking process." Because this was "far from a case in which the defendant sought to introduce essential evidence not already in the record," the Court held that here due process did not require reliance on the record and the briefs without a live hearing.

The Court held that the district court did not err in ordering disgorgement under the Circuit's pre-*Liu* case law. "The concept of 'disgorgement' as a

securities remedy is essentially the product of a runaway mutation. It found its way into our jurisprudence after the Second Circuit spliced it into the Exchange Act's general grant of jurisdiction. It then leaked from that laboratory and spread rapidly to each regional circuit, including ours. 'Disgorgement' has never been a precise legal term. Nonetheless, we must try to understand it with as much precision as it will bear because the outcome here depends on it." (Footnote omitted). The Court engaged in a detailed review of the history of the disgorgement remedy for securities violations. In discussing *Liu*, the Court noted that:

> The [Supreme] Court concluded that a remedy stripping wrongdoers of their profits is consistent with equity practice so long as it conforms to two important limitations. *First*, the award cannot exceed the 'net profits from wrongdoing,' which must account for the 'actual gains and profits' attributable to the wrong and 'deduct legitimate expenses.' *Second*, the award must be 'for the benefit of investors,' which is to say that it must reflect the notion from equity that a wrongdoer may be treated as a sort of trustee *ex delicto*, who is considered to hold the property on behalf of the wronged. (citations omitted).

The Court held that *Liu* left a question to be resolved here:

> Did the *Liu* Court recognize 'disgorgement' as an independent equitable remedy that is consistent with historical practice—terminological differences notwithstanding—so long as it stays within the Court's enumerated limitations? Or did it recognize that the Exchange Act permits courts to award traditional profit-stripping remedies—all of which share the Court's enumerated limitations—under the label 'disgorgement?'

The Court held that the answer to this question was consequential because only the first reading would support disgorgement in this case where there was no profit-generating *res* implicated nor was there a series of identifiable cash transfers from the fraudulent companies or traceable funds or assets still in Hallam's possession. The Court opined that "the plot thicken[ed]" with the amendment of the Exchange Act in 2021 to expressly provide for disgorgement as a remedy.

The Court held that the 2021 amendments were not merely a codification of *Liu*, but that they also are not irrelevant to this decision:

> As we have explained, we are bound to apply an explicitly retroactive change in the law that is effected before we render judgment. It doesn't matter that Hallam agreed to the 'disgorgement' before the statute was amended. That agreement included no further content to give meaning to that remedy's scope. So its amount was always going to be

> determined by reference to extracontractual legal principles. (Internal citation and quotation marks omitted).

The Court held that the amendment "authorizes disgorgement in a legal—not equitable—sense. In doing so, it ratifies the pre-*Liu* disgorgement framework used by every circuit court of appeals." The Court identified that framework as a burden-shifting framework:

> To get legal disgorgement, the SEC has the burden reasonably to approximate the defendant's 'unjust enrichment' attributable to the securities violation. That amount may not include income earned on ill-gotten profits, but it may include interest. If the SEC carries that burden, the burden then shifts to the defendant. To rebut the SEC's evidence, the defendant must prove that the requested amount is unreasonable, for instance, by interrupting the causal chain identified by the SEC. (Internal citations, quotation marks, and footnotes omitted).

On an abuse of discretion review of the district court's employment of that framework here, the Court held that the district court did not err in concluding that $1,901,480 was a "reasonable approximation of Hallam's net benefit from his violations[.]"

Because the Court held that the district court's disgorgement award was upholdable as legal disgorgement under the statutory amendments and the pre-*Liu* framework, it left for later cases whether equitable disgorgement survived *Liu* and, if so, the appropriate standard for measuring disgorgement as an equitable relief.

Judge Oldham briefly concurred in the majority opinion, as he would have affirmed on the basis of Hallam's consent to a disgorgement award, without reaching the questions of the effect of the 2021 statutory amendments or *Liu* on the district court's award of disgorgement.

WHERE WE STAND

Historically, PIABA has commented on a number of issues,[1] on both a formal and an informal basis, which are directly applicable to our promotion of the interests of public investors in securities arbitration proceedings that are conducted before the Financial Industry Regulatory Authority ("FINRA").

For example, among the issues that generated the most interest, from and/or on behalf of the members of our association, were proposed amendments to the rules concerning:

- Abusive pre-hearing dispositive motion practices; and
- The adoption of specific procedures that arbitrators will be required to follow before granting the extraordinary remedy of the expungement of prior customer complaints from the registration records of registered representatives.

In this section of the *PIABA Bar Journal*, we will share with our readers the comment letters and formal positions that have been submitted on behalf of our association, during the quarter, to the various regulatory authorities so that all of our constituents will know exactly where we stand.

1. To review all PIABA Comment letters, visit www.PIABA.org. For more information, contact Michael Edmiston at msedmiston@stocklaw.com or Robin S. Ringo at rsringo@piaba.org for assistance.

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The following Comment Letter regarding *Proposed Revisions to NASAA Statement of Policy Regarding Real Estate Investment Trusts (REITs)* was submitted to NASAA by Michael Edmiston on September 12, 2022. (prepared with the assistance of Darlene Pasieczny)

NASAAComments@nasaa.org
Andrea.Seidt@com.ohio.gov
Mark.Heuerman@com.ohio.gov

North American Securities Administrators Association, Inc.
Andrea Seidt, Section Char
Mark Heuerman, Project Group Chair
750 First Street NE, Suite 990
Washington, DC 20002

Re: PIABA Comments to Proposed Revisions to NASAA Statement of Policy Regarding Real Estate Investment Trusts (REITs)

Dear Ms. Seidt and Mr. Heuerman:

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") and model rules and policies promulgated by the North American Securities Administrators Association, Inc. ("NASAA") relating to both investor protection and disclosure. As such, PIABA frequently comments upon proposed rule changes, retrospective rule reviews, and policy matters to protect the rights and fair treatment of the investing public.

PIABA supports each of the four proposed revisions to the NASAA Statement of Policy Regarding Real Estate Investment Trusts (the "REIT Guidelines").

FINRA has long recognized and warned its member firms that complex products, such as non-traded REITs with their unique essential characteristics and corresponding risks, may be difficult for retail investors to understand. Accordingly, FINRA advises its member firms to apply heightened supervision for complex products, to implement comprehensive training for registered representatives, and to periodically assess the particular complex product and whether a less complex product would achieve the same result. With the application of Regulation Best Interest ("Reg BI"), as well as the fiduciary obligations of investment advisers, FINRA and the SEC have emphasized the importance of understanding the key terms, features, and risks of complex products so that the broker can establish, at a minimum, a reasonable basis to recommend the product to a particular retail customer and the investment adviser can meet their federally-mandated fiduciary obligations.

FINRA notes that such concerns can be even greater when a retail customer is purchasing complex products through a self-directed platform without the benefit of a broker or investment adviser to explain the risks and features of the product in light of the customer's investment objectives and risk tolerance.

Non-traded, unlisted REITs can create significant liquidity and valuation issues for retail investors. Effective April 11, 2016, FINRA significantly changed its then-Rule 2340 (Customer Account Statements) and provisions addressing per share estimated valuations for unlisted direct participation programs ("DPPs") and REITs. This changed the long-standing industry practice of using the offering price (typically $10 per share) of DPPs and REITs as the per share value on account statements during the offering period of that security, which could be as long as seven and a half years. This practice created a misleading representation of the current value of these securities, and a false impression of stability, sometimes for years on a customer's account statement. PIABA noted in its comment letter that curbing misleading sales and reporting practices during the early stages of DPP and REIT offerings was a critical investor protection issue.

Just as accurate, reliable valuation information about share value is critical, so is the long-recommended heightened supervision of sales of non-traded DPPs and REITs. PIABA supports NASAA's efforts to review and modernize its Statement of Policy in light of Reg BI and other current considerations.

(1) Updating REIT Guidelines to Recognize Reg BI

This proposed revision is a practical housekeeping update – formally incorporating the guidelines of Reg BI, which became effective June 30, 2020 – as well as any other updated conduct standard adopted by applicable NASAA jurisdictions. There should be no controversy regarding this update.

(2) Update Net Income and Net Worth Figures Upward to Account for Inflation

This proposed revision is another practical update – adjusting figures last updated on May 7, 2007, to account for the last 15 years of upward inflation. PIABA generally supports periodically revisiting all guiding net income / net worth figures in the context of their investor protection purpose, recognizing the changing value of a dollar over time. The adjustments proposed by NASAA, based on the U.S. Bureau of Labor Statistics Consumer Price Index for All Urban Consumers, is reasonable and appropriate.

(3) Concentration Limits

PIABA appreciates NASAA addressing the current and documented problem recognized by FINRA: that despite over two years since Reg BI's implementation, many broker-dealer firms have still not materially changed their policies, practices, or procedures regarding the sale of complex products including non-traded REITs. As noted in NASAA's explanation of the proposed revisions to the REIT Guidelines, many state securities regulators have independently imposed concentration limits regarding the maximum amount a retail investor may invest in non-traded REITs offered in their jurisdiction. Generally speaking, uniformity across the states would help curb investor confusion and improve regulatory compliance on this topic.

NASAA recommends a limitation prohibiting an aggregate investment in the issuer, its affiliates, and other non-traded DPPs or REITs that exceeds 10% of the purchaser's liquid net worth. Liquid net worth, defined as cash, cash equivalents, and marketable securities, is critical here. One of the key concerns about these complex products is that they are not traded on an open market, and thus the ability to liquidate may be nonexistent or provide mere

pennies on the dollar in a secondary market. Tying up a large percentage of liquid net worth in non-traded securities can be devastating for an investor, especially for retirees seeking regular income from their investments, but who may experience sudden, unanticipated liquidity needs. Sales of unlisted DPPs and REITs for retirement accounts can be particularly harmful to an investor who must take out required minimum distributions or face significant tax penalties.

Industry concerns that this concentration limitation would somehow harm retail investors by limiting access to DPPs and REITs is unfounded. For the retail investor appropriately seeking further diversification in so-called "alternative investments," there are many types of complex products other than unlisted DPPs and REITs for consideration. Ultimately, the mission of the SEC and state securities regulators is investor protection and integrity of the markets, not padding the pocketbooks of issuers of unlisted DPPs and REITs and those who sell their products.

(4) Prohibition to Issuers Using Gross Offering Proceeds to Pay Distribution Sources

As noted above, in 2016, FINRA changed its rule regarding permissible valuation methods for reporting unlisted DPP and REIT shares on customer account statements. NASAA's proposal to prohibit sourcing regular distributions from gross offering proceeds (creating phantom "yields" that are not clearly disclosed in a price adjustment to investments) and related proposed changes are consistent with investor protection objectives.

Non-traded DPPs and REITs are regularly described as "stable" and "fixed-income" investments and sold as income-producing investments to diversify the fixed income portion of a portfolio. The dangers of marketing phantom "yield" for securities that engage in this practice of distributing gross offering proceeds are significantly high. This is particularly true for the most vulnerable investors relying on steady income in retirement and without the benefit of long-time horizons to recover from industry declines.

Further, mere disclosure of the practice – suggested as an alternative to prohibition – is insufficient for meaningful investor protection. Given the documented industry failures to implement disclosure requirements under Reg BI, there is little confidence that a mere disclosure would be meaningfully explained to investors, let alone implemented, by the industry in this area.

We thank you for the opportunity to comment on the proposed revisions to the REIT Guidelines and encourage NASAA to continue to be a leader in proposed rules and guidelines for state securities regulators in matters impacting protection of retail investors.

Sincerely,

Michael Edmiston, President
Public Investors Advocate Bar Association

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The following Comment Letter regarding *SR-FNRA-022-024: FINRA Proposed Rule Change to Amend the Codes of Arbitration Procedure to Modify the Current Process Relating to the Expungement of Customer Dispute Information* was submitted to the SEC by Michael Edmiston on September 6, 2022. (prepared with the assistance of Daren Luma and Ryan Cook)

Via Electronic Mail @ Rule-comments@sec.gov
Vanessa Countryman, Secretary Securities and Exchange Commission
100 F St. NE
Washington, DC 20549-1090

RE: FINRA Proposed Rule Change to Amend the Codes of Arbitration Procedure to Modify the Current Process Relating to the Expungement of Customer Dispute Information – File No. SR-FINRA-2022-024

Dear Ms. Countryman:

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

Thank you for the opportunity to comment on FINRA's proposed rule changes to the FINRA Code of Arbitration Procedure for Customer Disputes and the FINRA Code of Arbitration Procedure for Industry Disputes in regard to the expungement of customer dispute information from an associated person's registration records maintained in the Central Registration Depository ("CRD"). PIABA has studied and commented extensively on issues surrounding expungement. Past PIABA studies repeatedly found that in cases where there had been a stipulated award or settlement, expungements were granted in an abnormally high number of cases. One study found expungements were granted in as much as 87.8% of all such cases.[1] In

1. PIABA, *Update to the 2013 Expungement Study of the Public Investors Arbitration Bar Association*, October 20, 2015. Available at: https://piaba.org/sites/default/files/newsroom/2015-10/Update%20on%20the%202013 %20Expungement%

practice, expungement has not been the "extraordinary remedy" that it is supposed to be, but something that has been routinely granted, with troubling consequences for investor protection. BrokerCheck, which derives its information from the CRD, is the primary source for investors to review broker disclosures. A 2021 study showed that brokers with multiple customer complaints or cases filed are far more likely to repeat future unlawful conduct.[2] Yet, brokers have been able to take advantage of the expungement process and its blind spots, to wipe their records clean nearly 90% of the time.

PIABA appreciates FINRA's continued efforts to examine the expungement problem and attempt to find solutions to the issues previously identified by PIABA's members.[3] PIABA believes that SR-2022-024 is a significant improvement over current FINRA rules, and over FINRA's prior rule proposal concerning expungement, SR-2020-030. As detailed below, PIABA particularly supports FINRA's proposal to require notification to state securities regulators in every expungement request, and to permit state securities regulators to meaningfully participate in "straight-in" expungement cases.

Notwithstanding, PIABA believes that FINRA should have proposed additional changes to the expungement rules to ensure expungement becomes the "extraordinary remedy" it is supposed to be. First, PIABA believes that the time limitations for straight-in expungement requests should be a uniform one-year, as FINRA first proposed in Regulatory Notice 17-42,[4] not the currently proposed two-year (arbitrations that end without an expungement determination) or three-year (customer complaints that do not progress to arbitration) limitation. Second, FINRA should reinstate the requirement it proposed in Regulatory Notice 17-42 that arbitration panels must find the underlying customer dispute information has "no investor protection or regulatory value" in order to recommend expungement. Finally, FINRA should prohibit associated persons from making "straight-in" expungement

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20Study%20of%20PIABA%20%28October%2020%2C%202015%29.pdf.

2. Colleen Honigsberg and Matthew Jacob, *Deleting misconduct: The Expungement of BrokerCheck Records*, 139 Journal of Financial Economics 800–831 (2021).

3. *See,* David Meyer, Jason Doss, and Lisa Braganca, *2021 Updated Study on FINRA Expungements: A Seriously Flawed Process that Should be Fixed Now to Protect the Integrity of the Public Record*, *PIABA* and *PIABA Foundation* (2021); and PIABA, *Expungement Study of the Public Investors Arbitration Bar Association,* (Oct. 16, 2013).

4. FINRA, Regulatory Notice 17-42, (December 7, 2017), available at https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-42.pdf.

requests for multiple, unrelated matters by denying the FINRA forum for such requests.

In sum, PIABA applauds FINRA's proposal as a meaningful step in the right direction, but believes there are additional and important ways that the expungement process could be further improved. In the interest of immediate investor protection concerns, and to move forward the important provisions of SR-2022-024 such as mandatory state regulator notification and opportunity to participate in expungement proceedings, PIABA urges adoption of the proposed changes.

A. PIABA Supports Most of FINRA's Proposed Revisions.

First, PIABA commends FINRA for moving away from its position in SR-2020-30 and reverting back to its proposal in Notice 17-42 that arbitration decisions recommending expungement must be unanimous. As PIABA has previously stated, the extraordinary remedy that expungement is meant to be means that "[r]equiring unanimous decisions properly reflects the heightened burden and importance for such proceedings."[5]

PIABA notes and supports the proposal to codify and update the "best practices" in the Notice to Arbitrators and Parties on Expanded Expungement Guidance be codified and updated. It has been a long time coming for these reminders to arbitrators and parties to be formally adopted as part of the procedural rules.

In regard to FINRA's proposed rule changes regarding expungement requests made during a customer arbitration, PIABA is largely supportive. In particular, PIABA supports removing the ability of an arbitration panel in a customer case to conduct separate expungement hearings after a case closes other than by award or by award without a hearing. PIABA agrees with FINRA that such arbitration panels do not get to hear the full presentation of the evidence on the merits of the underlying customer case and that "customers or their representatives have little incentive to attend and participate in an expungement hearing once their case has settled." Thus, requiring associated persons to instead file a new "straight-in" expungement request after the arbitration case has closed is a better alternative.

FINRA's proposed changes to "straight-in" expungement requests includes new, important procedural changes to the appointment of arbitrators. These proposals seek to avoid the cherry-picking of arbitrators who are

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5. *See* PIABA Comment Letter to Brent Fields, File No. SR-FINRA-2020-030 (October 23, 2020) ("PIABA Fields Letter"), p.2.

historically more likely to grant expungements. Specifically, the proposal includes a provision to require a three-arbitrator panel rather than permitting single arbitrator panels to determine these expungement requests. There would also be no permitted changing of the panel by the parties (by agreement or otherwise) including striking panel members, changing or reducing the panel by agreement, or appointing particular arbitrators by agreement. These are critically important change as they remove actual or apparent repeat-player incentives to decide expungement cases.

B. Permitting State Regulators to Participate in Straight-In Expungement Hearings is a Significant Improvement to the Expungement Process.

FINRA's proposal requiring giving notice of straight-in expungement requests to state securities regulators and to permit regulators to send representatives to participate in these proceedings is a significant improvement to the expungement rules. State securities regulators are major stakeholders and co-developers with FINRA of the CRD system. The records contained in the CRD system are state records. Through the use of uniform laws and corresponding rules, NASAA, FINRA and the SEC designed a framework that sets forth when and how regulatory information, including customer complaints and arbitrations, must be reported to regulators. Given this, as PIABA previously noted, "any decision to expunge information from the CRD system is necessarily a ***regulatory determination*** since it is superseding the considered and deliberate decisions made by securities regulators as to what information should be . . . maintained in the CRD system."[6] As such, FINRA's proposal to permit state securities regulators to participate in straight-in expungement hearings ensures that for the first time state regulators will be able to play a significant and active role in this regulatory determination, which aligns with the important regulatory function of the CRD system.

PIABA continues to believe that expungement determinations should be removed from the FINRA arbitration forum altogether and have the "determinations made by securities regulators directly or through a regulatory tribunal established and agreed to by FINRA, NASAA and the SEC."[7]

6. PIABA Comment Letter to Brent Fields, File No. SR-FINRA-2020-030, p.7 (emphasis in original).

7. *Id.*

Nevertheless, PIABA applauds FINRA for the proposed rule change to better enable state regulators to exercise their regulatory duties by examining expungement requests and participating in FINRA expungement hearings.

C. The Time Limitations for Expungement Requests Should Revert Back to the One-Year Time Limitation Previously Proposed by FINRA.

PIABA is relieved that FINRA has revised the proposed six-year time limitation for customer complaints not filed in arbitration contained in SR-FINRA-2020-030. While the currently proposed three-year time limitation for expungement requests is an improvement over prior SR-FINRA-2020-030, PIABA continues to believe that FINRA should revert back to a one-year time limitation for expungement requests both not filed in arbitration and for arbitrations which closed without an expungement determination, as proposed by FINRA in Regulatory Notice 17-42.

D. FINRA's Previously Proposed "No Investor Protection or Regulatory Value" Requirement Should be Reinstated.

In Regulatory Notice 17-42, FINRA proposed that arbitration panels recommending expungement would be required to find that "the customer dispute information ha[d] no investor protection or regulatory value."[8] PIABA supported this proposal noting that, "[r]equiring that an arbitration panel to find that customer dispute information does not have any investor protection or regulatory value . . . emphasizes the notion that arbitrators' actions have significant repercussions on investor protection."[9]

However, both in SR-FINRA-2020-030 and its current proposal, FINRA removed the "no investor protection or regulatory value" requirement. PIABA disagrees with this decision, and again urges the reinstatement of this requirement. PIABA believes that the "no investor protection or regulatory value" finding requirement is consistent with the extraordinary nature and high standards of expungement relief.

Further, PIABA believes that this requirement would be very helpful to arbitration panels that may misinterpret and misapply FINRA Rule 2080 standards, by providing additional clarity as to the standard that must be met

8. FINRA, Notice to Members 17-42, p. 9.

9. *See* PIABA Comment Letter to Marcia Asquith, FINRA Regulatory Notice 17-42, *Expungement of Customer Dispute Information* (February 2, 2018), p. 10.

to grant expungement. This would help ensure that the highly valuable, relevant information contained in the CRD system is not inappropriately removed from the investing public's view.

PIABA urges the Commission to reinstate this requirement into the proposed revised expungement rules.

E. FINRA Should Prohibit Straight-In Expungement Requests for Multiple, Unrelated Matters.

Perhaps the worst abuse of the current expungement rules are the straight-in expungement requests to expunge multiple, often dated, and unrelated matters from an associated person's CRD records. FINRA is well aware of this abusive tactic, but FINRA's proposal contains no specific prohibition against it. Rather, in discussing the proposed shorter time limitations, FINRA notes, "[t]he proposed time limits may also curtail the common practice of bundling unrelated and aged expungement requests in one straight in request."[10] While PIABA agrees that tighter time limitations, along with some of the other revisions proposed, may help curtail the practice of bundling unrelated expungement requests, FINRA should prohibit the practice altogether.

FINRA's proposal for expungement requests during an arbitration hearing notes that the "Director would be authorized to deny the DRS forum to requests made during a customer arbitration to expunge customer dispute information that is not associated with the customer's statement of claim."[11] In this way, arbitration panels are prevented from hearing expungement requests from multiple, unrelated matters.[12] FINRA should use the same denial of the forum mechanism for straight-in expungement requests that join multiple, unrelated matters in a combined expungement request.

The extraordinary nature of expungement relief and the high burden necessary to obtain this relief does not and should not lend itself to straight-in requests for the expungement of multiple, unrelated matters. An arbitration

10. *See* Securities and Exchange Commission Release No. 34-95455; File No. SR-FINRA-2022-024 (August 15, 2022), 50181.

11. *Id.* at 50175.

12. In a contested customer arbitration, multiple, unrelated claims could also be subjected to a motion to sever pursuant to FINRA Rules 12312, should the opposing party believe they did not arise from "the same transaction or occurrence or series of transactions or occurrences.".

panel for a straight-in expungement request should be focused and limited to one particular prior arbitration claim or CRD occurrence and the facts and circumstances surrounding that claim or occurrence. Permitting multiple, unrelated claims to be subject to a single straight-in expungement request unnecessary complicates the case and broadens its intended, limited scope. Further, such requests cheapen the extraordinary nature of expungement and, by extension, are inappropriate for FINRA arbitration since they are contrary to FINRA's purpose and the intent of the Code.[13] As such, FINRA should specifically prohibit these requests.

PIABA appreciates the opportunity to submit these comments. PIABA will continue to advocate for the additional improvements in the expungement process. However, recognizing that these proposed rule changes have been years in the making, and because of the urgency of protecting the investing public and maintaining the integrity of the CRD system, PIABA supports adoption of the proposed changes in SR-FINRA-2022-024.

Respectfully submitted,

Michael S. Edmiston
PIABA President

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13. *See* FINRA, Rule 12203, Denial of FINRA Forum.

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The following Comment Letter regarding SR-FINRA-2022-021: *Proposed Rule Change to Adopt Supplementary Material .18 (Remote Inspections Pilot Program) under FINRA Rule 3110 (Supervision)* was submitted to the SEC by Michael Edmiston on September 6, 2022. (prepared with the assistance of William Young and David Neuman)

Via Email Only @ rule-comments@sec.gov
Vanessa Countryman
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: SR-FINRA-2022-021: Proposed Rule Change to Adopt Supplementary Material .18 (Remote Inspections Pilot Program) under FINRA Rule 3110 (Supervision)

Dear Ms. Countryman:

I write on behalf of the Public Investors Advocate Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in disputes with the securities industry. Since its formation in 1990, PIABA has promoted the interests of the public investor in all forums where securities and commodities disputes are heard, 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.

Pursuant to Rule of Practice 192(a) of the Securities and Exchange Commission ("SEC" or "Commission"), PIABA submits this comment to the SEC concerning FINRA's above-captioned recent filing, a proposed rule change to amend FINRA Rule 3110 (Supervision). FINRA proposes adopting new Supplementary Material section .18 (Remote Inspections Pilot Program) to Rule 3110 (Supervision). The proposed amendment would create a new voluntary, three-year remote inspection pilot program. The program would allow member firms to fulfill their obligation under Rule 3110(c) (Internal Inspections) by conducting inspections of some or all branch offices and locations remotely, without an on-site visit to such office or location, subject to specified terms.

For the same reasons that PIABA urged the Commission to reject the amendments proposed by SR-FINRA-2022-019 (proposed rule change to

adopt new Supplementary Material .19 for residential supervisory locations), PIABA urges the Commission to reject remote inspections and the proposed pilot program in this SR-FINRA-2022-21.

The Exigencies of the Pandemic Should Not Lead to Weakening of Supervisory Structures

Beginning many years ago, SEC staff and FINRA interpreted FINRA rules to require member firms to conduct on-site inspections of branch offices and unregistered offices (i.e., non-branch locations) in accordance with the periodic schedule described under Rule 3110(c)(1).[2] In its proposal to create the pilot program, FINRA states that over the years, widespread advancements in technology and communications in the financial industry have significantly changed the way in which members and their associated persons conduct their business and communicate.[1] The proposal argues that this includes the practices that formed the original bases for an *on-site* inspection requirement:

> The COVID-19 pandemic has accelerated the use of a wide variety of compliance and workplace technology as many government and private employers, including member firms, were driven to adopt a broad remote work environment by quickly moving their employees out of their usual office setting to an alternative worksite such as a private residence. Insights obtained from member firms and other industry representatives, through various pandemic-related initiatives and other industry outreach, have led FINRA to carefully consider whether some processes and rules, including the manner in which a firm may satisfy its Rule 3110(c) obligations, should be modernized. Technological improvements and developments in regulatory compliance have provided more tools than before to create more effective and efficient compliance programs. To that end, FINRA believes that regulatory models should evolve to benefit from the availability and use of effective technology tools.[2]

To address the operational challenges in conducting on-site inspections during the pandemic, FINRA adopted temporary Rule 3110.17, effective since November 2020, to provide member firms the option to conduct inspections of their branch offices and non-branch locations remotely, subject to specified

1. SR-FINRA-2022-021, page 6 of 96. Full text of SR-FINRA-2022-021 accessed here: https://www.finra.org/rules-guidance/rule-filings/sr-finra-2022-021.

2. *Id.*

terms therein. FINRA seems to believe that now is the time to assess making what has been a temporary and necessary program to deal with the extraordinary exigencies of quarantines and health and safety concerns over the past two years of the global pandemic, into an accepted norm.

This is not acceptable. The proposed amendment, much like the recently proposed amendment to Rule 3110.19, to allow a home office to be considered residential supervisory location and creating rules and procedures for the supervision of same (SR-FINRA-2022-019), runs counter to FINRA's stated objective of investor protection. While it is understood that FINRA is attempting to change with the increased use of virtual technology, allowing more permanent home offices and remote supervision leaves considerable opportunity for brokers and their Member Firms to skirt the rules and harm investors.

As the SEC considers FINRA's proposal for the pilot program, we ask that the Commission staff consider numerous past enforcement cases from both FINRA and the SEC relating to inadequate supervision of remote offices. One such case is *In the Matter of Royal Alliance Associates, Inc*., Release No. 38174, 63 SEC Docket No. 1606 (Jan. 15, 1997). In this case, the SEC took issue with Royal Alliance's practice of performing announced audits on "small dispersed offices" beyond the "direct aegis of the firm":

> …Royal Alliance operates 1,500 offices with 2,700 registered representatives. Some 49 of these are one-person Offices. Here, Royal Alliance's failure to scrutinize adequately the securities-related business of its registered representatives, which were conducted beyond the direct aegis of the firm, was a certain recipe for trouble. Further, Royal Alliance's practice of conducting a pre-announced compliance examination only once a year was inadequate to satisfy its supervisory obligations.
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> * * *
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> Nevertheless, such arrangements necessarily entail greater supervisory challenges and the Commission requires firms organized in such a fashion, and individual supervisors at those firms, to meet the same high standards of supervision as at more traditionally organized firms.

The SEC continued to recognize this problem in another matter, *In the Matter of 1st Discount Brokerage, Inc.,* Release No. 66212A, Admin. Proc. File No. 3-14710 (Jan. 23, 2012). Therein, the SEC opined that firms that have an independent broker model *require greater supervision* than that of a traditional wire house brokerage firm. The lack of unannounced audits for a far-away broker with no one looking over their shoulder was wholly deficient.

The firm's failure to adequately supervise the broker's conduct resulted in enabling the broker to conduct a nearly $9 million Ponzi scheme.

Other regulatory actions involving brokers "selling away" or running Ponzi schemes from residential or remote (often one-broker) offices are too plentiful to count. For a few examples: *In re Lawrence John Fawcett, Jr.*, FINRA No. 2017056329801 (operating from home); *see also Hailey v. Westpark Capital, Inc*., FINRA Arb No. 20-00320 (detailing the lack of sufficient supervision of Fawcett's home office); *In re Jerry Irvin Chancy*, FINRA No. 2014043629801 (operating from home), *In re Mark Lewton Hopkins*, FINRA No. 2018060968101 (operating from an office on a golf course owned by the broker); *In re Malcolm Segal*, FINRA No. 2014041990901 (home office); *In re Robert Van Zandt*, FINRA No. 2011027577001; *In re Nevin Gillette*, FINRA No. 2006007067401; *In re Charles Caleb Fackrell*, FINRA No. 2014043705201; *In re Thomas H. Laws*, FINRA No. 2019061095601; *In re Brian Royster*, FINRA No. 2017052882601; *In re Michael James Blake*, FINRA No. 2010021710501; *In re Murray Todd Petersen*, FINRA No. 2019064432901; *In the Matter of Rebecca Engle*, SEC Admin. Release 34-75127 (June 9, 2015); *In the Matter of Brian Schuster*, SEC Admin. Release 34-75128 (June 9, 2015); *In the Matter of Larry Dearman Sr.*, SEC Release No. 75292 (June 24, 2015); *In the Matter of Levi D. Lindemann*, SEC Release No. 77696 (Apr. 22, 2016); and *In the Matter of Securities America Advisors, Inc*., SEC Release No. 94995 (May 26, 2022) (regarding a failure to supervise Hector May, who ran a $8 million Ponzi scheme).

This partial history of enforcement cases indicates member firms have been and remain unable or unwilling to effectively supervise remote offices. While the pandemic brought technological advancements, the same cannot be assumed for broker-dealer supervisory and compliance cultures.

Similarly, remote inspections simply cannot uncover nefarious conduct by brokers who keep records in paper form and meet with clients in-person, notwithstanding rules or guidance to the contrary.

Likewise, a review of all electronic communications that are made through the member firm's electronic data systems would only be sufficient if the rules governing how firms are required to adequately review these emails are strengthened. Often, firms only review a small *sampling* of electronic correspondence. Our members have seen numerous cases where a broker engaged in secretly selling unauthorized investments *was openly discussing* the unlawful conduct through their firm-approved email address, but the firm did not detect it for years (or ever) because the firm did not have adequate systems in place to monitor and catch the emails.

Any provision that weakens the rules as it relates to inspections of home or remote offices is unacceptable and will lead to more harmed investors. These proposed rules would provide additional opportunities for a broker to engage in fraudulent conduct without a supervisor or auditor adequately supervising the broker's conduct. If anything, FINRA should require firms to develop and implement more unannounced, *in-person* inspections as remote offices and virtual technology becomes more prevalent. Additionally, regardless of whether the pilot program is implemented or not, the Commission should demand that FINRA require firms to review more than just a sampling of electronic correspondence.

PIABA thanks the Commission and FINRA for the opportunity to comment on this proposal.

Very Truly Yours,

Michael S. Edmiston
PIABA President

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The following Comment Letter regarding SR-FINRA-2022-019: *Proposed Rule Change to Adopt Supplementary Material .19 (Residential Supervisory Location) under FINRA Rule 3110* was submitted to the SEC by Michael Edmiston on August 23, 2022. (prepared with the assistance of William Young)

Via Email Only @ rule-comments@sec.gov
Vanessa Countryman
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: SR-FINRA-2022-019 – Proposed Rule Change to Adopt New Supplementary Material .19 (Residential Supervisory Location) under FINRA Rule 3110

Dear Ms. Countryman:

I write on behalf of the Public Investors Advocate Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in disputes with the securities industry. Since its formation in 1990, PIABA has promoted the interests of the public investor in all forums where securities and commodities disputes are heard, 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.

Pursuant to Rule of Practice 192(a) of the Securities and Exchange Commission ("SEC" or "Commission"), PIABA submits this comment to the SEC concerning FINRA's above-captioned recent filing, a proposed rule change to amend FINRA Rule 3110 (Supervision). FINRA proposes adding new Supplementary Material as section .19 to Rule 3110 (3110.19 - Residential Supervisory Location). The proposed amendment would allow a home office to be considered a residential supervisory location and creates rules and procedures for the supervision of same.

PIABA urges the Commission to reject the proposed amendment.

The Exigencies of the Pandemic Should Not Lead to Permanent Weakening of Supervisory Structures

As a result of the COVID-19 pandemic, regulators eased regulatory requirements to accommodate brokerage firm employees working from home. This effort included the introduction of new technologies to permit remote supervision. By way of this proposal, FINRA appears to be adapting to a new, post-pandemic "blended workforce" model, one in which employees work at both traditional offices as well as in their homes. FINRA has noted that "technological advances in surveillance and monitoring capabilities" have enabled greater "workplace flexibility."[1] FINRA thus considers this rule change proposal to be a reassessment of "the manner in which firms may effectively and efficiently carry out their supervisory responsibilities considering evolving business models and practices, advances in technology, and regulatory benefits."[2]

In its proposal, FINRA argues that classifying some private residences as "non-branch" locations, "aligns" with procedures already in place (with certain exclusions) for non-traditional methods of supervision.[3] FINRA further argues, unconvincingly, that the elevation of private residences to non-branch status "will not result in a loss of the important regulatory information that the rules were designed, in part, to provide regarding the locations or associated persons."

Under the FINRA proposal, the private residential (non-branch) locations would be subject to limitations including but not limited to: 1) that only one associated person can conduct business at the location; 2) that the location is not held out to the public as an office (and that the associated person cannot meet with clients or prospects there); 3) that no customer funds or securities are handled there; 4) that the associated person is assigned to a specific branch office; 5) that all electronic communications are made through the member firm's electronic data systems; and 6) that typical books and records must be maintained as is customary for the brokerage industry. It should be noted,

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1. Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change To Adopt Supplementary Material .19 (Residential Supervisory Location) Under FINRA Rule 3110 (Supervision), 87 Fed. Reg. 47249 (Tuesday, August 2, 2022) (notice of proposing rule change Proposed Rule Change To Adopt Supplementary Material .19 (Residential Supervisory Location) Under FINRA Rule 3110 (Supervision)).

2. *Id.*

3. *Id.*at 47255.

FINRA has pointed out that, once a home office has been designated a "residential supervisory location," inspections would be required on a regular periodic schedule (likely once every three years, as opposed to annually), as is required of other more traditional supervisory branch offices.

PIABA submits this comment because the bar association believes the amendment runs counter to FINRA's stated objective of investor protection. While it is understood that FINRA is attempting to change with the increased use of virtual technology, it leaves considerable opportunity for brokers working from home to skirt the rules and harm investors. As discussed below, the existing supervisory structure regarding remote offices commonly leads to rogue brokers' and advisors' poor conduct continuing unmolested for extended periods of time. It would be ill advised to further weaken an already porous supervisory structure.

As the SEC considers FINRA's proposal, we ask that the Commission staff consider numerous past enforcement cases from both FINRA and the SEC relating to inadequate supervision of remote offices. One such case is *In the Matter of Royal Alliance Associates, Inc*., Release No. 38174, 63 SEC Docket No. 1606 (Jan. 15, 1997). In this case, the SEC took issue with Royal Alliance's practice of performing announced audits on "small dispersed offices" beyond the "direct aegis of the firm":

> …Royal Alliance operates 1,500 offices with 2,700 registered representatives. Some 49 of these are one-person Offices. Here, Royal Alliance's failure to scrutinize adequately the securities-related business of its registered representatives, which were conducted beyond the direct aegis of the firm, was a certain recipe for trouble. Further, Royal Alliance's practice of conducting a pre-announced compliance examination only once a year was inadequate to satisfy its supervisory obligations.
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> Nevertheless, such arrangements necessarily entail greater supervisory challenges and the Commission requires firms organized in such a fashion, and individual supervisors at those firms, to meet the same high standards of supervision as at more traditionally organized firms.

The SEC continued to recognize this problem in another matter, *In the Matter of 1st Discount Brokerage, Inc.,* Release No. 66212A, Admin. Proc. File No. 3-14710 (Jan. 23, 2012). Therein, the SEC opined that firms that have an independent broker model *require greater supervision* than that of a traditional wire house brokerage firm. The lack of unannounced audits for a far-away broker with no one looking over their shoulder was wholly deficient.

The firm's failure to adequately supervise the broker's conduct resulted in enabling the broker to conduct a nearly $9 million Ponzi scheme.

Other regulatory actions involving brokers "selling away" or running Ponzi schemes from residential or remote (often one-broker) offices are too plentiful to count. For a few examples: *In re Lawrence John Fawcett, Jr.*, FINRA No. 2017056329801 (operating from home); *see also Hailey v. Westpark Capital, Inc*., FINRA Arb No. 20-00320 (detailing the lack of sufficient supervision of Fawcett's home office); *In re Jerry Irvin Chancy*, FINRA No. 2014043629801 (operating from home), *In re Mark Lewton Hopkins*, FINRA No. 2018060968101 (operating from an office on a golf course owned by the broker); *In re Malcolm Segal*, FINRA No. 2014041990901 (home office); *In re Robert Van Zandt*, FINRA No. 2011027577001; *In re Nevin Gillette*, FINRA No. 2006007067401; *In re Charles Caleb Fackrell*, FINRA No. 2014043705201; *In re Thomas H. Laws*, FINRA No. 2019061095601; *In re Brian Royster*, FINRA No. 2017052882601; *In re Michael James Blake*, FINRA No. 2010021710501; *In re Murray Todd Petersen*, FINRA No. 2019064432901; *In the Matter of Rebecca Engle*, SEC Admin. Release 34-75127 (June 9, 2015); *In the Matter of Brian Schuster*, SEC Admin. Release 34-75128 (June 9, 2015); *In the Matter of Larry Dearman Sr.*, SEC Release No. 75292 (June 24, 2015); *In the Matter of Levi D. Lindemann*, SEC Release No. 77696 (Apr. 22, 2016); and *In the Matter of Securities America Advisors, Inc*., SEC Release No. 94995 (May 26, 2022) (regarding a failure to supervise Hector May, who ran a $8 million Ponzi scheme).

This partial history of enforcement cases indicates member firms have been and remain unable or unwilling to effectively supervise remote offices. While the pandemic brought technological advancements, the same cannot be assumed for broker-dealer supervisory and compliance cultures.

FINRA's rule proposal includes a provision that the broker would not be allowed to visit with clients at their remote office. Our members, industry participants, and the regulators, know all too well that a dishonest broker cannot be trusted to follow the rules, especially when there is no real oversight. Likewise, other aspects of the proposed rules do not inspire confidence. A review of all electronic communications that are made through the member firm's electronic data systems would only be sufficient if the rules governing how firms are required to adequately review these emails are strengthened. Often, firms only review a small *sampling* of electronic correspondence. Our members have seen numerous cases where the broker engaged in secretly selling unauthorized investments *was openly discussing* the unlawful conduct through their firm-approved email address, but the firm did not detect it for

years (or ever) because the firm did not have adequate systems in place to monitor and catch the emails.

Any provision that weakens the supervisory rules as they relate to inspections of home or remote offices is unacceptable and will lead to more harmed investors. These proposed rules will provide additional opportunities for a broker to engage in fraudulent conduct without a supervisor or auditor adequately supervising the broker's conduct. If anything, FINRA should require firms to develop and implement more unannounced inspections, improved electronic communications surveillance, and increased monitoring for selling-away activity as remote offices and virtual technology become more prevalent.

PIABA thanks the Commission and FINRA for the opportunity to comment on this proposal.

Very Truly Yours,

Michael S. Edmiston
PIABA President

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The following Comment Letter regarding *S7-16-22: SEC Names Rule* was submitted to the SEC by Michael Edmiston on August 15, 2022. (prepared with the assistance of Dayton Haigney)

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

Re: SEC Names Rule - S7-16-22

Dear Ms. Countryman:

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

PIABA appreciates the opportunity to comment on the proposed changes to 17 CFR 270.35d-1, also referred to as Rule 35d-1 under the Investment Company Act of 1940 ("Names Rule"). For the most part, PIABA supports the proposed amendments to the Names Rule as it relates to investor protection.

As a preliminary matter, it appears that the Commission closely reviewed PIABA's prior letter relating to the solicitation for general comments on the Names Rule (SEC Names Rule Comment - S7-04-20; https://www.sec.gov/comments/s7-04-20/s70420-7068508-215496.pdf). PIABA greatly appreciates the fact that the Commission considered our members' interests and concerns when drafting the current proposed amendments.

The transparency of fund names is crucially important to individual investors. Oftentimes, retail investors, especially those who are not sophisticated in mutual fund analysis, base their purchase of funds solely upon the name of the fund. The reasonably rely on the name to inform them of a fund's objectives and risks. Similarly, retail investors frequently do little to investigate, much less monitor, the portfolio holdings or the specific strategy

of a fund beyond relying on the fund's name. This is especially problematic for 401(k) plan investments, which are almost exclusively invested in mutual funds that employers make available from a pre-determined list of options, and comprise the entirety of retirement funds and savings for many Americans.

PIABA welcomed the initial adoption of the Names Rule in 2001. Our members saw instances of misleading fund names plummet following the implementation of the Names Rule. The larger asset management firms appear to have, by and large, adhered to the provisions of the Names Rule. Unfortunately, our members are seeing investors lured into unsuitable investments due to a resurgence of misleading names. Most of these instances involve small and medium fund managers. PIABA urges the Commission to increase the surveillance of these smaller fund managers and to uniformly enforce the Names Rule. Rigorous enforcement of the Names Rule will serve to protect individual investors.

PIABA believes that the Commission adopted the correct position that the Names Rule should be expanded to include the terms "growth" or "value." We urge the Commission to reconsider its position with respect to terms such as "balanced," "long/short," and "real return," as these types of fund names can also create a potentially misleading expectations of an investment focus.

As mentioned in PIABA's prior submission, affinity fraud occupies one of the darkest spaces of investment fraud. The proposed amendments to the Names Rule do not touch upon affinity groups. PIABA recommends, the Commission adopt a strict prohibition of the use of terms of well-known organizations (other than the fund issuer), affinity groups, or the reference to a specific population of investors (*e.g.,* "veterans" or "municipal employees") in fund names.

PIABA understands the complexities that index fund and ETF managers face when allocating investments, especially when their underlying holdings consist of other indices. It is unclear whether the proposed amendment to the Names Rule will apply to index funds with respect to the 80 percent holdings rule. Index funds should not be allowed to use any exemption from the technical holding requirements from the Names Rule as a 'safe harbor' for misleading fund names. In the event that index funds are not covered by the Names Rule, the Commission should issue a notice that misleading names used by index funds are still subject to the anti-fraud provisions of the Securities Acts.

PIABA appreciates the fact that the Commission proposes that funds holding substantial amounts of derivatives set forth notional values. It should be noted that individual investors generally do not understand the difference between fair market value and notional values. In the event that a fund is required to set forth a notional value, investors should be given adequate

information as to how the notional value was determined, why it is being used, and how the concept of "notional value" differs from "market value."

The proposed changes to the Names Rule appear to be heavily focused on ESG. PIABA understands that many investors may want to invest in ESG focused funds. However, PIABA is concerned that ESG-focused names may distract investors to the actual risks involved in investing in these funds. As pointed out in our previous submission, many of these ESG funds invest in start-ups, an inherently risky sector, which may not be suitable for many individual investors. Additionally, these funds sometimes place a premium on ESG at the expense of a reasonably safe return on investment. PIABA recommends the Commission to closely monitor the marketing emphasis placed upon ESG funds to prevent investors from being misled that ESG funds are always suitable investments.

Investors heavily rely on the names of funds when making investment decisions. PIABA largely supports the proposed amendments to the Names Rule and applauds the Commission in placing the interests of investors first.

Thank you for your consideration herein.

Sincerely,

Michael S. Edmiston
PIABA President

The following Comment Letter regarding *SR-FINRA-2022-015: Proposed Rule Change to Amend FINRA Rule 8312 (FINRA BrokerCheck Disclosure) to Release Information on BrokerCheck® Relating to Firm Designation as a Restricted Firm* was submitted to the SEC by Michael Edmiston on July 8, 2022. (prepared with the assistance of Jason Kane)

J. Matthew DeLesDernier
Assistant Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
rule-comments@sec.gov

Re: PIABA Comments to SR-FINRA-2022-015

Dear Mr. DeLesDernier:

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 in order to protect the rights and fair treatment of the investing public.

In general, as it did with SR-FINRA-2020-041, PIABA supports SR-FINRA-2022-015, which proposes to amend FINRA Rule 8312 to release information on BrokerCheck as to whether a member firm is a designated "Restricted Firm." A "Restricted Firm" is one that has been identified by FINRA as one that provides a high degree of risk to the investing public. PIABA believes that making this information about firms publicly available on BrokerCheck is the common-sense next step to the newly adopted FINRA Rule 4111 and comports with that rule's intended investor protection goal.

PIABA continues to encourage FINRA to go even further in its investor protections efforts. Putting more information on BrokerCheck is a step in the right direction. However, most investors still do not know what BrokerCheck

is, and that it is a place to get information about the firms and brokers through which they invest their monies. FINRA should couple this rule change with an investor outreach program or marketing effort that draws attention to the importance of BrokerCheck and the types of information that can be found there. Our membership often finds itself educating clients and prospective clients about BrokerCheck. Most investors have no idea that their trusted financial professionals and firms had disclosure events, despite the fact that they were disclosed on BrokerCheck. We fear that the same would be true about the important "Restricted Firm" status disclosures absent a concerted outreach program.

While PIABA supports FINRA's continuing efforts to build and strengthen the tools currently available to protect investors against unscrupulous member firms and securities professionals, we also recognize more must be done to ensure high-risk bad actors are found, held accountable for prior misconduct, and successfully culled from the securities industry before they can take advantage of unsuspecting investors.

We thank you for the opportunity to comment on the Rule Proposal and urge FINRA to consider the issues set forth above before any final version is adopted.

Sincerely,

Michael S. Edmiston
President
Public Investors Advocate Bar Association