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Melanie Cherdack

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GONE PHISHING: BANK AND BROKER-DEALER LIABILITY FOR ELECTRONIC WIRE FRAUD SCAMS

Melanie Cherdack[1]

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GONE PHISHING:
BANK AND BROKER-DEALER LIABILITY FOR ELECTRONIC WIRE FRAUD SCAMS

INTRODUCTION

The ubiquity and ease of mobile banking apps has made electronic money transfers more accessible to the public. But this new technology, allowing for instant payments, also comes at great cost. Thieves, scoundrels and what regulators call "bad actors" have invented multifarious ways to access consumers' financial accounts electronically, whisking away large amounts of money in a matter of moments. The most popular of these scams is an electronically initiated wire transfer. Oftentimes, when this happens, those same financial institutions that customers rely upon and entrust their money to disavow any responsibility for these fraudulent transfers, leaving consumers to shoulder the loss.

The first part of this article will discuss prevalent electronic financial scams, development of the Electronic Funds Transfer Act ("EFTA") and the later enactment of UCC Article 4A governing wire transfers. The second part will discuss the application of each rule to electronically initiated wire transfers and argue that the payment order portion of the wire transfer request is governed by the EFTA, making the financial institution strictly liable for an unauthorized transfer.

I. PHISHING AND IMPOSTER SCAMS ABOUND

According to the Federal Trade Commission ("FTC"), in 2023 "Bank Transfer or Payment" fraud caused the largest monetary loss of any financial fraud.[2] As reported by the FTC, billions of dollars have been transferred out of financial institutions by third party scammers pretending to be customers. The most common of these are "imposter scams." With 2023 losses in the $2.7 billion range, these scams include imposters pretending to be a bank's fraud department, the government, a relative in distress, a well-known business or a technical support expert each tricking a customer into providing account information or access.[3]

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[2] Bank transfers and payments accounted for $1.86 billion lost in 2023. FTC, *Consumer Sentinel Network Data Book*, 4 (Feb. 2023), https://*www.ftc.gov/system/files/ftc_gov/pdf/CSN-Annual-Data-Book-2023.pdf*.

[3] *Id.*

A. Phishing for Whales

"Phishing" is a common method used by fraudsters to gain access to a customer's account. It targets victims by sending an e-mail or text that appears to be from a well-known source, such as the customer's bank or mortgage company, asking the customer to provide personal identifying information.[4] In 2023, the FTC reported that bogus bank fraud warnings were the most common form of text message scam reported to the agency.[5] Fake bank security messages - often supposedly from large banks like Bank of America and Wells Fargo - were the most reported.[6]

The bogus texts, designed to create a sense of urgency, often ask people to verify a large transaction they did not make. When the customer responds to the texts, they are then connected to an imposter bank representative who obtains their account information. Between 2019 and 2023, the FTC reports, complaints of texts impersonating banks increased nearly twentyfold.[7] Indeed, it is a problem of massive scale.

B. Third-Party Transfers

With instant access to electronic money transfer options available to consumers, this problem is not going away. One of the most common scams involves fraudsters using electronic access to a customer account to wire money to a third party. On April 18, 2024, U.S. Senators Sherrod Brown (D-OH) and Jack Reed (D-RI), senior members of the Senate Banking and Housing

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4 FTC, *Phishing Scams and How to Spot Them*, https://*www.ftc.gov/news-events/topics/identity-theft/phishing-scams* (last visited Aug. 1, 2024). Phishing has evolved and now has several variations that use similar techniques such as vishing scams (over the phone, voice email, or VoIP), smishing scams (through SMS or text) and pharming scams (malicious code is installed on a computer redirecting to fake websites) *See* Federal Bureau of Investigation, *Spoofing and Phishing Scams*, *https://www.fbi.gov/how-we-can-help-you/scams-and-safety/common-scams-and-crimes/spoofing-and-phishing* (last visited Aug. 1, 2024).

5 FTC, *New FTC Data Analysis Shows Bank Impersonation is Most-Reported Text Message Sca*m (June 8, 2023), *https://www.ftc.gov/news-events/news/press-releases/2023/06/new-ftc-data-analysis-shows-bank-impersonation-most-reported-text-message-scam* (last visited Aug. 1, 2024).

6 *Id.*

7 *Id.*

Committee, sent letters to the CEOs of the four largest U.S. banks seeking information on their wire fraud protocols.[8]

In their letter to JPMorgan Chase, Bank of America, Wells Fargo and Citi, the senators seek, among other items:

- information on the volume of unauthorized and fraudulently induced wire transfers between 2019-2023;
- the number and amounts involved for consumer disputes for such wire transfers;
- whether the banks offer "wire transfer services on mobile devices or on consumer online banking websites; and
- to what extent, if any, has wire fraud increased since the introduction of mobile or online banking wire transfer access.[9]

Additionally, the senators seek information on the percentage of customer complaints resulting in the bank stopping or reversing the fraudulent transfer.

In seeking information on each bank's process for identifying eligibility for, and disbursement of, reimbursements to harmed consumers in cases of unauthorized or fraudulently induced wire transfers, the senators asked the following question:

> How does your bank interpret its obligations regarding disputes involving unauthorized or fraudulently induced transfers under the Electronic Funds Transfer Act and its implementing regulation, Regulation E?

The rationale for asking this pointed question is elementary. There is legislative history and legal analysis supporting the application of the Electronic Funds Transfer Act ("EFTA" or "Act") and Regulation E ("Reg. E") to an electronically initiated wire transfer, subjecting the bank to liability for the initial debit portion of the transaction. Notwithstanding this, banks and financial institutions routinely take the position that such fraudulent wire transfers are exempt from the strict liability standards of the EFTA and are instead governed by the more bank-friendly terms of UCC Article 4.

However, the legislative intent and plain language of the Act demonstrates that the EFTA clearly applies to unauthorized wire transfers electronically initiated by fraudsters.

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[8] *Brown, Reed Push Big Banks to Protect Consumers from Wire Fraud*, *https://www.reed.senate.gov/news/releases/brown-reed-push-big-banks-to-protect-consumers-from-wire-fraud* (last visited Aug. 1, 2024).

[9] *Id.*

II. EMERGING BANKING TECHNOLOGY NECESSITATES THE EFTA

In 1978, recognizing that payment systems were being taken over by burgeoning technology, Congress passed the EFTA. The legislation established an overarching legal framework governing the rights, liabilities and duties of both consumers and providers of electronic fund transfer services.[10] While EFTs were already subject to some state regulation,[11] the passing of this legislation marked the end of a long academic and political debate over the need for federal legislation to regulate the nascent EFT industry.[12] In the statute, Congress stated that the primary objective of this new legislation is the provision of individual consumer rights.[13]

The EFTA was the response to the risks inherent in emerging funds transfer technology, which included, in 1987, ATMs, direct deposits and debit cards. Congress was concerned that such new technologies lacked the protections of in-person banking and thus were "vulnerable to fraud" or "unauthorized use."[14] The law's main proponent in the Senate warned that a "consumer could awake one morning and find that his or her entire savings has disappeared by virtue of a surreptitious computer manipulation."[15] The House discussion included a report of "hundreds of cases of computer fraud," with some cases "in the thousands and some million dollar cases."[16]

Because banks were in a unique position to make their EFT systems "secure,"[17] Congress wanted to provide them with incentives to do so. If consumers were "held responsible for any losses," then banks would "have no

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[10] 15 U.S.C. § 1693.

[11] *See* Roland Brandel & Eustace Olliff III, *The Electronic Fund Transfer Act: A Primer,* 40 OHIO ST. L.J. 531, 531 n.3 (1979); *see also* Janine Hornicek, *Electronic Fund Transfers, Branch Banks, and Potential Abuse of Privacy*, 6 FORDHAM URB. L.J. 571, 576 (1978) (20 states enacted a variety of EFT legislation in one year); Roger D. Prives, *Electronic Fund Transfer Systems and State Laws,* 93 BANKING L.J. 527 (1976) (22 states had enacted some sort of EFT statute as of 1975).

[12] *See* Brandel & Oliff, *supra* n. 10 at 531.

[13] 15 U.S.C. § 1693(b) ("It is the purpose of this subchapter to provide a basic framework establishing the rights, liabilities, and responsibilities of participants in electronic fund and remittance transfer systems. The primary objective of this subchapter, however, is the provision of individual consumer rights.")

[14] *See* H.R. Rep. 95-1315, at 2 (1978); *see also* S. Rep. 95-915, at 5 (1978) (the "face-to-face contact involved in passing a forged check or using a stolen credit card does not act as a deterrent in the EFT context").

[15] 123 Cong. Rec. 27,940 (1977).

[16] 123 Cong. Rec. 37,012 (1977).

[17] H.R. Rep. 95-1315, at 10 (1978).

incentive to improve [their] security measures."[18] To encourage use of and confidence in electronic banking systems, the EFTA "provides certainty against total loss to the consumer."[19]

A. The EFTA

The term "electronic fund transfer" or "EFT" means any transfer of funds that is initiated through an electronic terminal, telephone, computer, or magnetic tape for the purpose of ordering, instructing, or authorizing a financial institution to debit or credit a consumer's account. [20] The definition of "Electronic Fund Transfer" was intended to be flexible to apply to new and developing technology.[21] Under the Act, if an unauthorized EFT transaction is timely reported by the consumer to the financial institution, a consumer's liability for the loss is substantially limited.[22] After its receipt of a consumer's notice, the financial institution must immediately investigate and report or mail the results of such investigation and determination to the consumer within 10 business days.[23] If an error is found by the financial institution, it must credit the account, with interest, within one business day after this determination. [24] If more than 10 business days is needed for the investigation, the financial institution must provisionally credit the account.[25]

Once an unauthorized EFT is established, the EFTA provides limits to a consumer's responsibility. If notice was given by the consumer within two business days, losses are capped at the smaller of $50 or the amount of the unauthorized EFT; if notice was given within 60 business days, losses are capped at the smaller of $500 or the amount of the unauthorized EFT, but only if the financial institution establishes that such losses would not have occurred had the consumer provided the two-business day notice. [26]

In any action involving liability for an unauthorized EFT, the financial institution has the burden of proof to show that transfer was authorized.[27]

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[18] 123 Cong. Rec. 37,012 (1977).

[19] S. Rep. 95-915, at 6 (1978).

[20] 12 C.F.R. § 1005.3(b)(1).

[21] *See* 124 Cong. Rec 27,940 (1978) ("Wherever possible, general principles are enunciated rather than specific requirements, thereby permitting financial institutions to modify services easily or offer new EFT systems as technology evolves.").

[22] 15 U.S.C. § 1693(f).

[23] 15 U.S.C. § 1693f(a).

[24] 15 U.S.C. § 1693f(b).

[25] 15 U.S.C. § 1693f(c).

[26] 15 U.S.C. § 1693g(a).

[27] 15 U.S.C. §1693g(b).

Significantly, negligence by the consumer cannot be used as the basis for imposing greater liability than is permissible.[28] This strict liability mandate provides both security to a consumer and encourages financial institutions to have robust anti-fraud systems in place.

The safeguards provided in the EFTA for unauthorized transfers provide safety, speed and certainty to consumers. Under the EFTA, "unauthorized electronic fund transfer" is defined as "an electronic fund transfer from a consumer's account initiated by a person other than the consumer without actual authority to initiate such transfer and from which the consumer receives no benefit."[29] The Consumer Financial Protection Bureau ("CFPB"), the governmental agency tasked with protecting consumers in the financial industry, administers the EFTA through the powers granted to it by Reg E.[30] Due to the proliferation of EFTs during the COVID pandemic (where many transactions could not be face-to-face), the CFPB noted the increased risks to consumers.

B. Access with Fraudulently Obtained Credentials is an "Unauthorized" EFT

In December 2021, in response to this increased risk, the CFPB clarified and updated its guidance regarding "unauthorized electronic fund transfers" in its Electronic Fund Transfers FAQs.[31] The FAQs provide guidance that an unauthorized EFT includes a transfer initiated by a fraudster using stolen credentials. This can occur when a consumer's account access information is obtained from a third party through fraudulent means such as computer hacking or when a third-party fraudulently induces a consumer into sharing account access information that is used to initiate an EFT from the consumer's account. [32] Specifically, the CFPB includes the following fact patterns as constituting an unauthorized EFT:

> (1) A third-party calling the consumer and pretending to be a representative from the consumer's financial institution and then tricking the consumer into providing their account login information, texted account confirmation code, debit card

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[28] 12 C.F.R. § 1005.6, cmt. 6(b)-2.

[29] 15 U.S.C. § 1693a(12).

[30] The EFTA is implemented through Regulation E, codified at 12 C.F.R. § 1005, which includes not only the regulations but also official interpretations.

[31] CFPB, *Electronic Funds Transfers FAQS* (Dec. 13, 2021) *https://files.consumerfinance.gov/f/documents/cfbp_electronic-fund-transfers-faqs.pdf.*

[32] *Id.*

> number, or other information that could be used to initiate an EFT out of the consumer's account, and
>
> (2) A third party using phishing or other methods to gain access to a consumer's computer and observe the consumer entering account login information. EFTs stemming from these situations meet the Regulation E definition of unauthorized EFTs.[33]

The CFPB's analysis relies upon and is consistent with Reg. E's Comment 1005.2(m)3 stating that "[a]n unauthorized EFT includes a transfer initiated by a person who obtained the access device from the consumer through fraud or robbery." Thus, phishing scams where a fraudster tricks a customer into giving access to her account whereby an electronic transfer is made from the account constitute "unauthorized EFTs" under the Act.

C. The Far-Reaching Scope of EFTA

In creating a non-exclusive list of methods of electronic transfer, Congress ensured that the definition of an electronic fund transfer was both broad and flexible. Because it was "[a]ware that computer technology was still in a rapid, evolutionary stage of development, Congress was careful to permit coverage of electronic services not yet in existence."[34] As the Senate Report notes, the broad definition of "electronic fund transfer" was intended to give "flexibility in determining whether new or developing electronic services should be covered by the [A]ct and, if so, to what extent."[35]

D. EFTA Covers Accounts at Crypto Exchanges and Brokerage Firms

The term "electronic fund transfer" is broadly defined by the EFTA as "any transfer of funds ... which is initiated through an electronic terminal, telephonic instrument, or computer or magnetic tape so as to order, instruct, or authorize a financial institution to debit or credit an account."[36]

The EFTA's definitions of "account" and "financial institution" are also quite broad and are not limited to bank accounts. Under the Act, the term "account" includes "a demand deposit (checking), savings, or other consumer

[33] *Id.* at 12.

[34] *See Nero v. Uphold HQ Inc.*, 688 Fed. Supp. 3d 134, 137 (S.D.N.Y. 2023) (quoting *Kashanchi v. Texas Com. Med. Bank, N.A.*, 703 F.2d 936, 939 (5th Cir. 1983), *see also* S. Rep. 95-915 at 4 (recognizing that "many people believe that EFT services may soon access other types of asset accounts").

[35] *Nero, supra* note 34 (quoting S. Rep. 95-915 at 9).

[36] 15 U.S.C. § 1693(a)(7).

asset account (other than an occasional or incidental credit balance in a credit plan) held directly or indirectly by a financial institution and established primarily for personal, family, or household purposes."[37] The Senate Report states that "[e]xamples of asset accounts which would be covered are money market mutual fund accounts and positive balances in margin accounts at a stock brokerage."[38] Specifically exempted from the EFTA and Regulation E is "any transfer of funds that has as its primary purpose the purchase or sale of securities or commodities regulated by the SEC or the CFTC, purchased or sold through a broker−dealer regulated by the SEC or through a futures commission merchant regulated by the CFTC, or held in book-entry form by a Federal Reserve Bank or federal agency" [39] Thus, absent this exception, all other funds transfers from a brokerage account are covered by the EFTA.

Further, "financial institution," is defined as "a State or National bank, a State or Federal savings and loan association, a mutual savings bank, a State or Federal credit union, *or any other person who, directly or indirectly, holds an account belonging to a consumer*.[40] Thus, any entity that holds demand accounts belonging to a consumer, for personal, family or household purposes is governed by the Act. This also includes broker dealers and crypto platforms.

The EFTA's reach is beyond traditional banks, encompassing all holders of consumer accounts and all forms of currency, including cryptocurrency. *See e.g*. *Nero v. Uphold HQ Inc.*, 688 Fed. Supp. 3d 134, (S.D.N.Y. 2023) (holding that cryptocurrency constitutes "funds" under the EFTA); *Rider v Uphold HQ, Inc.*, *657 F. Supp. 3d 491* (S.D.N.Y. 2023) (holding that a cryptocurrency platform constitutes a "financial institution" under the EFTA because it holds accounts belonging to a consumer and that cryptocurrency constitutes "funds" under the Act.);*cf. Yuille v. Uphold HQ, Inc*. 686 F. Supp. 3d 323 (S.D.N.Y. 2023) (dismissing a case against a crypto platform because the plaintiff did not allege that his account was established for "personal, family, or household purposes.").

The EFTA has also been applied to broker-dealers. In *Berenson v. National Financial Services, LLC*, 403 F.Supp.2d 133 (D. Mass. 2005) the district court held that a broker-dealer must comply with notice provisions of EFTA in connection with electronic bill payment services. Broker-dealers have also been held liable under the EFTA in arbitration actions before the Financial

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[37] 15 U.S.C. § 1693(a)(2).

[38] *Nero*, *supra* note 34 (quoting S. Rep. No. 95-915, at 9).

[39] 12 CFR 1005.3(c)(4).

[40] 15 U.S.C. § 1693a(9) (emphasis added).

Industry Regulatory Association ("FINRA"). *See e.g. Vitarelli v. E*Trade*, FINRA Case No. 22-00243 (Feb. 17, 2023).[41]

That courts are now considering cryptocurrency and crypto platforms as covered by the EFTA illustrates the elasticity of the Act's language. This was intentional. Congress, "aware that computer technology was still in a rapid, evolutionary stage of development" was mindful in permitting "coverage of electronic services not yet in existence.[42] The CFPB has recently proposed additional regulations that would give it authority to govern large payment apps such as Zelle, Paypal and Venmo, which it has stated fall within the EFTA's regulatory purview. [43]

The proposed regulations would grant it supervisory authority over larger nonbanks offering "general use consumer payment applications" such as peer-to-peer ("P2P") payment apps and digital wallets.[44] In explaining its proposed rule, the CFPB stated that this would help ensure these non-bank's compliance with federal consumer financial law, including the EFTA.[45]

E. EFTA's Application to Transactions that Contain Covered and Uncovered Activity

Although broadly drafted, the EFTA *excludes* several specified transfers, including wire transfers, certain automatic transfers and individual telephonic transfers. The wire transfer exemption applies to a "any transfer of funds, other than those processed by automated clearinghouse, made by a financial institution on behalf of a consumer by means of a service that transfers funds held at either Federal Reserve banks or other depository institutions and which is not

[41] In other FINRA awards, brokerage firms have been tagged for fraudulent or unauthorized wire transfers where claims have been made under UCC 4A. *See*, *e.g.*, *Wang v. Fidelity Brokerage Services, LLC*, FINRA Case No. 22-00309 (Feb. 15, 2023); *Gilson v. TD Ameritrade, Inc.*, FINRA Case No. 10-01816 (Nov. 26, 2012); *See also Schiff v. Charles Schwab & Co., Inc.*, FINRA Case No. 23-01909 (June 17, 2024) (claims for breach of contract, negligence, breach of the Bank Secrecy Act, 31 U.S.C. § 5318(h), and failure to prevent financial exploitation of the elderly).

[42] *Kashanchi v. Texas Com. Med. Bank, N.A.*, 703 F.2d 936, 939 (5th Cir. 1983); *see also* S. Rep. 95-915, at 4 (1978) (acknowledging that ''EFT services may soon access other types of asset accounts").

[43] CFPB, *Defining Larger Participants of a Market for General-Use Digital Consumer Payment Applications*, Docket No. CFPB-2023-0053 *https://www.regulations.gov/document/CFPB-2023-0053-0001.*

[44] *Id*.

[45] *Id.* Supplementary Information, IV. Section-by-Section Analysis Part 1090 Subpart B—Markets, "Supervision . . . would help to ensure that they are complying with applicable requirements of Federal consumer financial law, such as …. the Electronic Fund Tran

designed primarily to transfer funds on behalf of a consumer."[46] As the Senate Report recognized, the exclusion thus applies to "traditional 'wire' transfers between banks"[47] because only the transfer of funds between banks occurs "by means of a [wire] service." The "service[s]" that are not "designed primarily" for consumers are the wire services, such as Fedwire, CHIPS and SWIFT, because those are "used primarily for transfers between financial institutions or between businesses."[48]

The EFTA is essentially a consumer protection statute. At the time it was enacted, wire transfers were used largely in commercial banking settings and thus were intentionally omitted from the ambit of the new regulation. Transfers over Fedwire, which is operated by the Federal Reserve Banks, are governed by the later enacted Article 4A of the UCC as incorporated by the Federal Reserve Board's Regulation J. In contrast to EFTA's focus on consumer rights, Article 4A is "primarily intended to govern the rights and responsibilities among the commercial parties to a funds transfer, that is, the financial institution that accepts a payment order for a funds transfer and any other financial institutions that may be involved in carrying out the transfer."[49]

Because Article 4A governs a variety of transfer systems, there is a relationship between it and the EFTA. Article 4A's drafters recognized this overlap and specifically carved out of its coverage any activity governed by the EFTA. Article 4A states that, with limited exceptions, it "*does not apply* to a funds transfer any part of which is governed by the [EFTA]," and that with respect to any "inconsistency between an applicable provision of [Article 4A] and an applicable provision of the [EFTA], the provision of the [EFTA] governs to the extent of the inconsistency."[50]

The key difference in a financial institution's liability under the UCC versus the EFTA lies in its loss allocation provisions. Unlike the EFTA's strict liability standard for unauthorized transfers, the UCC applies a commercial reasonableness standard on a transferring bank. Under Article 4A of the UCC, if the bank has "a commercially reasonable method of providing security against unauthorized payment orders" and "compl[ies] with the security procedure and any written agreement or instruction of the customer restricting acceptance of payment orders issued in the name of the customer," even an unauthorized payment order will be treated as authorized.

Article 4A's drafters expected that banks would develop sufficient security systems and designed Article 4A to impose on the banks "[t]he burden of

[46] 15 U.S.C. § 1693a(7)(B).
[47] S. Rep. No. 95-915, 4, 8 (1978).
[48] 12 C.F.R. § 1005.3(c)(3).
[49] 77 Fed. Reg. 6194, 6212 (Feb. 7, 2012).
[50] U.C.C. §4-A-108 (emphasis added).

making available commercially reasonable security procedures... because they ... are in the best position to evaluate the efficacy of procedures offered to customers to combat fraud."[51]

The advent of mobile and online banking, allowing electronic movement of money by a consumer, provided the perfect scenario to highlight the glaring inconsistency of loss allocation between UCC Article 4A and the EFTA. And on January 30, 2024, New York's Attorney General brought this issue to the forefront in a high-profile federal court case.

F. The NY Attorney General Sheds Light on Truncated Application of Electronically Initiated Wires

In *The People of the State of New York, by Letitia James v Citibank, N.A.*, the New York Attorney General ("NYAG") brought an action in the Southern District of New York against Citibank ("Citi"), alleging that because Citi makes wire transfers available to consumers online and through mobile banking apps, the EFTA applies to the initial part of the transaction, when Citi electronically debits the outbound funds from the consumer's account.[52]

The NYAG's 71-page complaint, filed January 30, 2024 ("Complaint"), asserts that when wire transfers are initiated electronically, the payment order portion of the transaction is governed by the EFTA, while the wire itself is governed by Article 4A. As alleged in the Complaint, "[w]hen Citi receives Payment Orders [for wire transfers] from consumers initiated electronically via online or mobile banking, Citi applies its Agreement for Online Funds Transfers or comparable agreements. These agreements provide that consumers' electronic transfer requests to Citi, such as Payment Orders, also act as electronic authorizations for Citi to debit consumers' bank accounts to pay for the transfers."[53] Thus, when Citi receives such payment orders "from scammers initiated electronically after infiltrating consumers' online or mobile banking," Citi's electronic debits are unauthorized EFTs.[54] It is this payment

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[51] *Id.* at 614-15 *(*quoting U.C.C. § 4A-203 cmt 3).

[52] *People of the State of New York v. Citibank, N.A.*, Civil Action No. 1:24-cv-00659-JPO (S.D.N.Y. Jan. 30, 2024). ("*James v. Citibank*"). The Complaint asserts other claims as well, including violations of UCC 4A, New York's SHIELD Act, Red Flags Rule, and New York's fraud and consumer deception statutes. The Complaint also alleges shoddy and insufficient security measures by Citi which failed to effectively detect red flags, such as scammers using unrecognized devices, accessing accounts from new locations, or changing banking passwords or usernames.

[53] *Id.* at ¶ 56.

[54] *Id.* at ¶ 57.

order made electronically, according to the NYAG, that is governed by the EFTA.

As set forth by the NYAG in the Complaint, there are three parts to an electronically initiated wire transfer which Citi mischaracterizes as one transfer:

> Citi characterizes this complex set of transfers as a single, instantaneous "wire transfer" to confuse, mislead, and deprive affected consumers of their legal rights. But the payment mechanics are clear: each of (i) the unauthorized EFTs that Citi executes to pay itself for the fraudulent Payment Orders, (ii) the Bank-to-Bank Wires between Citi and the beneficiary banks, and (iii) the beneficiary banks' payments into scammers' accounts are independent fund transfers. And each is subject to particular laws, including—with respect to at least the unauthorized EFT from a consumer's account to Citi—the EFTA and Reg. E.[55]

In its motion to dismiss the Complaint, Citi argued against the application of the EFTA to its customers' electronically initiated wire transfers. It urged the court to "approach with great skepticism NYAG's novel interpretation [of EFTA], one which has somehow managed to elude lawmakers, regulators, courts and the industry for so long, and which would bring about — via litigation, not legislation — a sea change in banking law ... ."[56]

Rather than concede that different standards apply to the initial payment order tranche of an electronically initiated wire transfer, Citi asserts that Article 4A encompasses the entire transaction, end to end. Citi attempts to skirt the strict liability standards of the EFTA in favor of the bank-friendly terms for wire transfers under Article 4A. In its brief, Citi claims that CFPB guidance supports its position based upon its convoluted analysis of CPFB's comments to certain amendments in the Dodd-Frank Act allowing it to apply the EFTA to wire transfer "remittances."[57]

In response to Citi's unilateral pronouncement that the CFPB supports its "end-to-end" position on wire transfers as covered by Article 4A, CFPB filed an amicus brief countering this assertion.[58] In that brief, CFPB vehemently opposed Citi's analysis:

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55 *Id.* at ¶ 58.

56 *James v. Citibank, supra* note 47, Citibank N.A.'s Memorandum of Law in Support of Its Motion to Dismiss, at 3 (April 2, 2024).

57 *Id.* at 17.

58 *James v. Citibank, supra* note 47, Brief of Amici Curiae Consumer Financial Protection Bureau in Support of Plaintiffs (May 28, 2024).

> Citibank says that the harsh result it prefers is compelled by EFTA and longstanding regulatory history. It even goes so far as to suggest that the [CFPB] agrees with Citibank's understanding of the law. The [CFPB] does not. The [CFPB] submits this Statement of Interest to make its views clear, as the federal agency primarily responsible for administering, interpreting, and enforcing EFTA and Regulation E.
>
> Based on more than three decades of regulatory history, **the [CFPB's] understanding is that when a transaction that otherwise qualifies as an "electronic fund transfer" includes a fund transfer by wire, only the wire portion of the transfer is excluded** from EFTA and Regulation E coverage. The remaining electronic fund transfer is subject to EFTA and Regulation E.[59]

CFPB then recited a history of regulatory commentary to support the NYAG's position:

> Since 1996, Regulation E has specifically contemplated that the non-wire-transfer portions of transactions that constitute electronic fund transfers are covered by EFTA even when the transaction also includes a wire transfer covered by Regulation J. Specifically, Regulation E provides that "subpart B of the Board's Regulation J, including the provisions of Article 4A, applies to all fund transfers through Fedwire, even if a portion of the fund transfer is governed by the EFTA." And when EFTA governs a portion of a fund transfer that includes a Fedwire component, "[t]he portion of the fund transfer that is governed by the EFTA is not governed by subpart B of the Board's Regulation J." … As an example of this "dual coverage," the Board opined in 1996 that "if an institution offers consumers the ability to initiate Fedwire transfers pursuant to a telephone transfer agreement"—a method of initiating fund transfers that generally falls under EFTA—the transfer could be covered by both Regulation E and Article 4A."[60]

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59 *Id*. at 1.
60 *Id.* at 12-13 (footnotes omitted; citations omitted).

When examining the legislative history and commentary of both the EFTA and Article 4A, it is clear that a wire initiated electronically on a banking app would fall within the ambit of each rule consecutively—the EFTA to the payment order debiting the account and Article 4A to the wire transfer.

Recognizing that it might be in a pickle due to the scope and frequency of fraudulently initiated wire transfers via electronic means, the American Bankers Association, along with other bank trade associations, filed their own amicus brief. [61] Collectively, they asserted that the "EFTA and its implementing regulation (Regulation E), along with Article 4A, make clear that the components of a wire transfer are not standalone transactions but rather together constitute a single funds transfer that is expressly excluded from EFTA's reach." [62]

How the federal court will rule on the issue remains to be seen. Given the enormity of the problem and the scale of the money lost there is much at stake on both sides.

CONCLUSION

As is often the case, advances in technology beget new regulation. Here, though, existing regulations are broad enough to govern these electronically initiated transactions. The rationale for the EFTA - providing consumer confidence in new payment technologies - seems to best apply here. Financial institutions have opened the floodgates, allowing large wire transfers of money to be electronically initiated from individual consumer accounts in an instant and without face-to-face interaction. In such situations, as the EFTA's drafters well knew, banks are in the best position to prevent the loss. Both the plain language of the EFTA and the policy reasons behind it support this application.

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[61] *James v. Citibank,* supra note 47, Brief of Amici Curiae The Clearing House Association L.L.C., The Bank Policy Institute, The New York Bankers Association and the American Bankers Association in Support of Defendant's Motion to Dismiss (May 2, 2024).

[62] *Id.* at p. 3-4.

DYING FOR BENEFITS

INSURANCE AS AN ALTERNATIVE INVESTMENT: THE BLACK HOLE IN INVESTOR PROTECTION

Frederick Rosenberg, J.D.[1]

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DYING FOR BENEFITS
INSURANCE AS AN ALTERNATIVE INVESTMENT: THE BLACK HOLE IN INVESTOR PROTECTION

INTRODUCTION

What usually happens after an investor is scammed out of his or her retirement by a commission driven insurance agent? Nothing! Independent academic studies estimate that up to 90% of life insurance policies sold as investment are "surrendered" or "lapse," industry euphemisms for failure, at a rate of 5-6% a year causing millions in losses and leaving policy holders without recourse. Statistically, the problem is epidemic and unpublicized. Even after suffering disaster, policy holders still fail to understand that they've been unwittingly steered into a financial black hole by trusted sales agents incentivized principally if not solely by undisclosed, "heaping," up-front commissions.

Unlike the securities industry, the insurance industry's regulation and effective enforcement varies state to state, lacks national oversight, and often lacks adequate supervisory and compliance standards. There is no counterpart to securities arbitration as an option for these retail investors to seek redress. In any court proceedings, there may be claims under state common law. Suitability claims typically sound in fraud or fraudulent inducement based on material misrepresentations and omissions in addition to claims based on statutory protections under consumer fraud law.

Lapsing and surrender rates of insurance policies are not disclosed in the policy, illustrations, or sales and training materials. Prospective purchasers of many policies are never made aware that the policy being offered has a failure rate up to 90%, a dismal, unpublished track record. Moreover, the risks and consequences of the lapse and failure rates are concealed from retail investors along with the heaping commission structures incentivizing the sales force. Absent payment of the death benefit, the policy fails leaving policy holders years later barely recouping their premiums at best and incurring substantial tax liability on unrepaid policy loans, a complete loss of the tax benefit. Moreover, NAIC[2] model laws adopted by all states do not require disclosure of policy experience and lapse rates in sales materials. Nevertheless, the absence of specific prohibitions or mandates in the regulations is not a license for commission incentivized Agents to mislead retail investors into over-insuring themselves for retirement in policies that fail to pay full benefits 90% of the time.

This article is intended to introduce attorneys to the basics of analyzing "insurance sold as an investment" claims, how policies work, flaws in

[2] National Association of Insurance Commissioners.

illustrations and projections, misrepresentations, and material omissions needed to make the sales material not misleading.

Sources relied upon:

1. My analysis included reviewing various insurance policies, the sales materials and illustrations, customer correspondence between agent and customers disclosed in litigation, narratives provided by injured investors regarding representations and inducements they relied upon, pleadings and findings in court, and publicly available press and association publications as listed below.

2. Life Insurance Marketing and Research Association (LIMRA): LIMRA is a marketing research association of life insurance companies that sources data from a subset of participating member companies representing about 80% of industry sales. The data presented in their reports is intended to provide trends and comparative insights such as lapsing, or the "persistency" of policies to remain in force across the various Universal Life policy types. Most of the largest insurance carriers contribute their data to LIMRA, which should be discoverable, and in turn receive LIMRA's analytical reports.

3. Life Insurance Consumer Advocacy Center (LICAC): LICAC is a non-profit organization unaffiliated with the insurance industry that provides academic studies on its website relevant to consumer issues. LICAC studies examine the cumulative effects and causes of policy terminations of which there are two types: forfeiture (lapsing), and termination for value (surrender).[3] Unlike LIMRA, LICAC categorizes both surrenders and lapses as policy failure, and opines on the cumulative impact of both to arrive at its conclusions on policy outcomes.

II. BACKGROUND

Life Insurance dates back to colonial times, originally as a vehicle to pay the widows and orphans of deceased clergy. The concept caught on and term insurance policies meant to replace lost income in the event of death during working years gained popularity. Whole Life Insurance evolved not simply to replace lost income but to create an estate and it was permanent for that purpose.

A feature of Whole Life is its cash value that builds over time. Mutual Insurance companies, those owned by the policy holders, also pay dividends that add to the cash value of the policy. Over time as cash value accumulates, policy holders can borrow to meet unexpected needs. Policy loans may also be

[3] LICAC, *The Lapse Problem*, *https://lifeinsuranceconsumeradvocacycenter.org/the-lapse-problem/* (last visited Sept. 4, 2024).

used to purchase paid-up additional insurance (PUA) or have future premiums paid from the account. Policy loans are repayable from the insurance proceeds on death, if not repaid before. When sold as permanent insurance, Whole Life policies generally perform to expectation with low lapse and surrender rates. However, when sold as an investment primarily to build tax-deferred cash value, rarely do policies perform to expectation as reflected in high lapse and surrender rates and losses.

Whole Life policies, particularly of mutual insurance companies, are typically the key component of commission driven insurance scams pitched as "infinite banking" or "personal banking" where over time the customer becomes overinsured to build cash value yet becomes mired in a liquidity trap, unable to access or withdraw funds except as a surrender or as a loan from the policy simply to fund current income needs or emergency expenses.

A. Universal Life

By the mid-1970s, defined benefit plans were effectively replaced by defined contribution plans, and IRAs and 401(k) plans put control over trillions of retirement funds into the hands of individuals. This opened retirement investment dollars to products and services leading to a boom in the retail securities industry and eventually corresponding broker-dealer compliance and supervisory rules and procedures to protect investors. The insurance industry took note and combined tax-deferred accumulation with life Insurance. Universal life was born with a primary focus on tax deferred accumulation and tax-free income for retirement income rather than legacy death benefits associated with life insurance and protecting insurable interests with death benefits. It is permanent insurance as long as premiums are paid. The cost of insurance will rise significantly over time as the life expectancy of the policy holder declines leading to surrenders and lapsing when the cost of maintaining the benefits becomes unaffordable for the policy holder particularly when the illustrated non-guaranteed accumulation cash values fail to materialize. Cash value accumulates at varying interest rates set by the insurance company but not guaranteed.

B. Index Universal Life (IUL)

Index Universal Life (IUL) adds an accumulation growth feature tied to a market index with a cap on growth and a floor at zero assuring that the accumulation value of the policy will not decline because of the index. Caps are set at the discretion of the insurance company and can be reduced as low as the guaranteed minimum cap which varies by product (typical minimum cap rates

are 2-3%). Higher caps in the sales illustration simply allow for higher non-guaranteed Accumulation Values to be illustrated.

IUL Illustrations conform to the National Association of Insurance Commissioners (NAIC) "Life Insurance Illustrations Model Regulation," AG49, adopted in 2015 in an attempt to make IUL illustrations less misleading. Significantly, AG49 intentionally omits the statistical and inevitable negative impact of lapsing and surrender on projected non-guaranteed cash values. The model regulation does not require disclosure of policy experience, statistical outcomes, or reliability of the projections. Consequently, investors are induced to invest based on non-guaranteed rate projections despite a track record evidencing that 90% of IUL policies terminate prior to payout of full benefits, at a financial loss and the loss of paid-up tax benefits.

Under AG49, sales Illustrations provide three alternative scenarios,[4] a) at a minimum guaranteed rate, b) at a guaranteed low fixed income rate, and c) at a non-guaranteed growth rate calculated on an index, usually the S&P 500 average annual return without dividends over the previous 20 years. Predictably, the methodology of the illustrations for non-guaranteed values (50 years of straight-line appreciation at the S&P 500 index average) vastly overstates accumulation by failing to account for sequence risk and volatility that reduce outcomes or include lapsing or surrender in the illustration. In these cases, policy holders are commonly misled into believing that if the SP500 averages 7-7.5%/yr., the illustrated accumulation values and projection will occur, a seemingly minimal risk strategy and a competitive, and conservative investment. It is not.

C. IUL Policy Loans

IUL Policy Loans are a principal selling point of IULs because, based on the projected non-guaranteed Accumulation Values, by the 8th-10th year, illustration software forecasts maximum annual policy loans needed to fund fixed lifetime annual distributions of 12%- 15% and the loans repaid by the death benefit as long as the policy is maintained. Until 2015, there was no declared crediting rate for IULs as with traditional universal life insurers leading NAIC's adoption of AG49, revising it a few times since in an attempt to make IUL illustrations less misleading. That has not stopped IUL insurers from exploiting loopholes and illustration games that have resulted in the continuing utilization of unrealistic crediting features and unachievable non-guaranteed values. IUL illustrations frequently imply higher annual growth rates in non-guaranteed cash values that exceed the disclosed constant assumed rate in the

[4] NAIC guidelines of 1995.

illustration through accounting gimmicks that are complex and lack full disclosure.

Unfortunately, the statistics indicate that, undisclosed to the investor, the illustrated non-guaranteed outcome is exceedingly rare, and the far more likely outcome is that the policy will predictably fail to accumulate sufficient cash value and lapse or surrender at an economic loss and the loss of tax benefits (assuming the insured lives). Commonly the insured is never informed that to realize the tax benefits and tax treatment of distributions they've paid for, the death benefit must pay out. Policy holders must die for those benefits, otherwise, If an IUL policy is surrendered or lapses the tax benefits disappear and tax liability may be substantial. An insured is frequently faced having to decide whether to continue paying burdensome premiums until death, or realize an immediate loss plus tax liability on the unrepaid policy loans.

D. Modified Endowment Contract (MEC) status.

The IRS cares not whether you take a policy loan or surrender in part; the distribution will be taxed as income until all accrued gains are consumed. The IRS' intent is to eliminate over-insuring to build tax-deferred cash value and tax-free withdrawals. This is another risk that is not adequately disclosed to retail investors in the marketing and sales process. The exception to the rule requires that premiums comport with one of two tests under IRS 7702 to prevent over-funding and MEC status. A test chosen must be selected at policy inception and cannot be changed.

1. Cash Value Accumulation Test (CVT): The accumulated cash value of the contract cannot exceed the net single premium required to fund future benefits without making the policy a MEC. The accumulated cash value is the amount available under the policy upon surrender but prior to repayment of policy loans, the surrender value.

2. A Ramp-In Test where no year's paid premium can exceed the average over the first 7 years without permanently making the policy a MEC. E.g., premiums are $7,000 paid in $1,000/yr. for 7 years. In any year the premium paid exceeds the $1,000 average, say $2,000 paid in year 4, the exemption is permanently lost, the policy reclassified as a MEC, and distributions are taxed. Accumulation remains tax deferred.

Regardless, once distributions exceed the total premiums, the basis in the policy, subsequent distributions are taken as policy loans. Note, it does not matter under IRS 7702 whether the distributions are in the form of policy loans or surrenders. Caps are set at the discretion of the insurance company and can

be reduced as low as the guaranteed minimum cap which varies by product (typical minimum cap rates are 2-3%). Higher caps in the sales illustration simply allow for higher nonguaranteed values to be illustrated in sales materials, without caveats or footnotes as to lapsing and Surrender experience.

IRS 7702(c) also establishes a benefits-to-cost formula assuring that policy benefits are in line with premiums paid to prevent over-insuring for investment purposes, and all policies must be maintained under IRS guidelines to preserve the exemption as well. In short during the pay-in period the policy is not permitted to accumulate cash value in excess of the premiums paid without making the policy a MEC and that clearly limits cash value accumulation over the early years especially to overcome the fees and costs over that period. Thereafter, as long as the policy meets the 7702(c) guidelines, policy loans will be treated as return of principal until basis is exhausted. Life insurance sold as a part of a retirement plan is designed to avoid becoming a MEC. Once a MEC, always a MEC, and it cannot be corrected.

E. Non MEC status.

IULs are sold to high-net-worth clients as a tax deferred investment that forecast policy loans of 12-15% annually in 8-10 years, tax-free for retirement. Illustrations typically forecast that the Accumulated Cash Value will be sufficient to pay benefits and provide loans for life based on the average annual return of the S&P 500 index sans dividend, about 7%-7.5%/year. Withdrawals up to policy basis and then switching to policy loans is generally how distributions are managed. Exceeding the MEC limit is allowed but the taxation of distributions is changed (to be similar to annuities), taxing gains first as ordinary income and adding a 10% tax on pre-59 ½ distributions. Life insurance sold as part of retirement planning is designed to avoid becoming a MEC. Once a MEC, always a MEC, and it cannot be corrected.

Given that virtually all financial publications measure the arithmetic return of the S&P 500 at around 9%-9.5%, achieving 7% to 7.5% appears very conservative and a "no-brainer." Unfortunately, the reasoning is erroneous and over the long term many policies' cash value accumulation falls substantially below the projections despite the S&P averaging well over the projected return over the accumulation period. Depending on index volatility for many policies, by the 7th year, even assuming maximum capped return after costs over the next three years, achieving the projections becomes impossible – often leading to surrender.

F. Non-Guaranteed Accumulation Values Illustrations

Non-Guaranteed Accumulation Values Illustrations are calculated using a crediting methodology that depends on an index, and typically the S&P 500 average without dividends over twenty years is used as the straight-line annual growth rate in the illustrations with a cap limiting return in any year. The higher the cap the greater the probability of increasing cash value but note, the accompanying growth illustration will also forecast a higher and even more improbable outcome. Still the cap can be reduced. A second and equally significant factor in the growth of the illustrated non-guaranteed accumulation value is the standard deviation of the index. With higher volatility comes wider swings in returns and an increase in the number of zero return years over time against a cap that limits recovery. A third factor is the 1.5-2% annual policy costs that are deducted from the cash value yearly over the 10-year surrender period regardless of return.

G. Premium Loans

In order to maximize retirement income some affluent investors are convinced to leverage the benefits by borrowing the premiums from an outside lender and collateralizing the "Premium Loan" with the policy cash value. In the first few years as cash value accumulates, investors will post additional collateral besides paying interest. As accumulation value increases collateral is released. Based upon the policy's non-guaranteed illustrations, premium loans are projected to be fully repaid by borrowing against the accumulated cash value in the 8th to 10th year (a no-brainer). Interest on premium loans is billed to the investor but may be capitalized into the loan principle ultimately impairing cash and surrender values. Interest on premium loans collateralized by the policy cash value is not deductible.

In recent years multiple cases have appeared involving investors in their mid-40s through 50s, typically successful business owners and executives who were convinced to borrow upwards of $1 million per year for 10 years in reliance on the IUL's non-guaranteed projections that the cash accumulation value at the forecast average growth would be more than sufficient in year 10 to replace the accrued $10 million premium loan with a policy loan in that amount, and thereafter would have ample accrued value to pay the policy loan interest and borrow $250,000 per year for life tax-free, and still have insurance proceeds sufficient to repay the loan on death. It is all in the illustrations.

It is this pitch, which relies specifically on straight line appreciation over 50 years that's the inducement for recommending insurance as an investment. All that needed to happen was for the S&P 500 to average 7.25%, which it exceeded, except that the accrued cash value fell hundreds of thousands short

of projection and by the 7th year cash value with a maximum 9% cap on return before costs, net 7%, could never achieve the projected outcome by the 10th year. By the 7th year total interest payments to the lender amount to about $1.3 million in these cases in addition to over $600k of additional collateral. Premium loan Interest was projected to grow to $2.3 million by the 10th year at a constant 4.5%.

Unfortunately, in recent cases the low Premium loan interest rate used in lender projections jumped by 2.5% as the loan principal grew from $1 million to over $7 million in year 7. The S&P 500 one-year volatility jumped to near 30% and two of the first seven years were zero with a 9% cap. Still, the S&P 500 exceeded its average return over that period due to a "V" shape recovery yet accrued values fell well below projections. All policies were technically underwater and in default. If the Premium lender foreclosed on the collateral, there would be onerous tax implications so additional collateral was required or more insurance purchased. The premium loan was never reported on the Carrier's annual insurance statements, and the illustrations for the Premium Loan were prepared by the Agent and the lender and not the insurance company.

H. IUL Overloan Protection

As policy loans accrue, more insurance premium may become necessary after the pay-in-period to prevent lapsing if the Cash Value becomes insufficient to repay the accruing policy loans and capitalized interest. Under typical anti-lapse riders or "overloan protection agreements," for a fee, premiums are advanced and accrued value increased and the cost capitalized into the policy loan without affecting the accumulated cash value. Overloan protection riders are intended to prevent a policy from lapsing due to taking loans that exceed policy value. The riders have become a crutch and a rather inelegant solution. This is concerning since the protection they are promising is untested. Rather than the illustrated non-guaranteed Accumulation value relied upon, policy holders predictably find that their cash value failed to grow and often barely breaks even at best after ongoing insurance costs making projected withdrawals impossible. For some unfathomable reason, projections are run through age 120 at 7.25%/yr.

I. Lapsing Experience

Insurance policies earn very heavy front-end costs and fees typically concentrated in the first seven to eight years. After that, the burden of the death benefit becomes the insurance company's primary liability with little return to cover that outlay and an increasing drag on return over the long term. If most

IUL policies actually paid loan covering death benefits as projected, the carrier would go broke. Studies conducted by LICAC conclude, however, that an overwhelming number of IUL policies lapse or are surrendered at a rate of 5%-6% per year and are underwritten for that purpose.

In many instances an infinite banking victim's entire liquid net worth is locked away in the cash value of illiquid policies accessible only through loans or surrender, a fact that is foreseeable and likely known and intended by the agent and the insurer incentivizing the agent to market, sell, and service these products with aggressive "heaping" commission structures. Furthermore, after seven or eight years of paying premiums, most policy holders first experience the impact and expense of over-insuring and maintaining policies with increasing interest rate adjustments on policy loans capitalized into the principal, rider fee increases permitted under the policy coupled with surrender value substantially lower than projected. At this point and beyond, the benefits become increasingly burdensome and unsustainable and policies lapse or are likely surrendered for an economic loss and loss of tax benefits with tax liability.

When a policy lapses, everything is lost and unrepaid loans taxed as ordinary income, a disaster (and foreseeable failure of the underlying strategy on which the recommendation and sales was based). One way to avoid lapsing is to continue paying premiums in the expectation that eventually the death benefit will pay off. If the policy still has accumulation value, the policy can be surrendered (Terminated for Value) to recover part or most of the premiums paid, but usually at an economic loss regardless. In addition, the investor suffers the lost opportunity costs of those premiums that may be calculated by market-adjusted damages as well as all tax benefits. Damages may appropriately be based on the uncapped index return including dividends.[5]

J. Material Omissions in Policies and Sales Materials

All life Insurance contracts are underwritten based upon several factors known from industry experience. Underwriters know surrender and lapse and persistency rates with explanation; they know the percentage of policies paying death benefits; they know the duration of policies from every age group and their mortality risk, and they forecast increases in rider fees and interest rates on the impact on surrender and lapsing.

And most significantly, underwriters know from experience based on thousands of policies over four decades, the percentage of policies actually achieving projected returns and the average underperformance. These facts and related risks are concealed and not disclosed in the marketing, sales, or servicing of these products. The tactic is identical to that used by the tobacco

[5] *Miley v. Oppenheimer*, 637 F.2d 318 (5th Cir. 1981)

industry to conceal the health risks of smoking. As the Life Insurance Consumer Advocacy Center (LICAC) opines, "these policies are designed to fail."[6] This fact and the enormous investor risks are not evident to policy holders and prospects when investing and committing to the recommended strategies. It is not sufficient to simply warn or disclaim not having control over markets and interest rates that could impact the projections, when the facts are known that the projections vastly overstate actual outcomes and are unreliable. Without the projections however, IULs could not be sold. An overwhelming numbers of IUL policies lapse or are surrendered at a rate of 5%-6% per year and are underwritten for that purpose.

K. Individual State Regulations

Insurance is regulated by the individual states. There is little uniformity in laws or enforcement unlike the securities industry that sets national guidelines for mandatory and material disclosure and customer protections through compliance and supervisory processes. In the securities industry, those publicly offering investment products are mandated to disclose their track records. Not so in the insurance industry. Universal Life has been around since the 1980s and index Universal Life about half as long. The industry knows well that IULs terminate at about 5%-6%/year and in 12 years nearly 60% of all policies will lapse/surrender at a financial loss and the loss of the insurance and all tax benefits, essentially a predictable failure of the recommended strategy used to market and sell these products. In fact, according to LICAC, only about 10% of IUL policies pay death benefits and preserve the tax treatment of the distributions.

L. Shock Costs

Anybody having a 20-year level premium term policy understands shock costs when they see the Premium for the 21st year increase 10-fold. This is known as a Shock Cost, expenses that make the benefit no longer affordable. This includes the unexpected costs of emergencies, health care, or life events.

As the insured ages in an IUL, the cost of the insurance increases and accelerates particularly after 8 or 9 years at a time when their cash value accumulation falls woefully short of illustrations, dimming any hopes for sustainable lifetime tax-free loans throughout retirement. Based on lapsing studies conducted by LICAC, only about 10% of IULs "persist" long enough to pay death benefits. By implication, 90% fail to do so and lose their tax benefits, a fact not disclosed to the investor even where the policy was marketed and sold

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[6] Life Insurance Consumer Advocacy Center (LICAC).

and recommended for its purported tax-free returns rather than for its death benefits. As LICAC opines, "insurance companies benefit more from lapsing than paying death benefits."[7] Imagine telling a prospect that "Oh, by the way 90% of these policies terminate for a loss of the insurance and tax treatments and all or part of the premiums, and rarely are they in force long enough for the death benefit to repay your loans so you'll owe taxes. Do you want to give it a go?"

Insurance companies have decades of data on IULs and mutual whole life and they know and understand the lapsing problem while selling policies through unsuitable recommendations grounded in erroneous projections that rarely materialize. In short, insurance companies know how accurate their forecasts are from policy experience and fail to disclose to the investor the lapsing and surrender rates, persistency, or death benefit experience of those products, information essential and material to an investment decision.

Much of the responsibility for the omissions and misrepresentation in IUL offering material lies with NAIC, whose model law, adopted in all states, intentionally omits any requirement to disclose lapsing , surrenders, and persistency data in policy illustrations, including footnotes,[8] thereby providing cover for insurance carriers and agents to conceal that information.

The insurance industry's active concealment of vital data essential to a policy holder's understanding of the grave risk to their long-term financial health that these policies present is, in fact, undistinguishable from the Tobacco Industry's concealment of the known health risks from smoking evident after years of research while still promoting their products as safe and beneficial.

III. WHOLE LIFE INSURANCE ABUSE

A. "Infinite Banking," "Personal Banking," and Similar Insurance Frauds

"Infinite banking," "personal banking," and similar insurance frauds rely on dividend paying Whole Life policies to sell life insurance primarily as a safe retirement investment alternative with tax deferred growth and tax-free withdrawals. The infinite banking concept is heavily touted on-line and in discussion groups such as Reddit. Those induced into infinite banking schemes will ultimately over a period of years over-insure themselves through the purchase of additional insurance to build cash value with the expectation of generating a life-time tax free retirement income or funding future expenses like

[7] Life Insurance Consumer Advocacy Center (LICAC).
[8] NAIC Model Law

college or weddings through policy loans. The strategy also boasts that it can still provide the legacy benefits of an Insurance estate. Mass Mutual has banned infinite banking and personal banking in all its forms in a memo to its representatives addressing the deceptive recommendations and undisclosed risks.[9]

Commonly, even insuring minor children, ostensibly to fund college expenses or to help accelerate the cash value is part of the scheme. Over time, hundreds of thousands of dollars of savings, retirement assets, and income are funneled into and overconcentrated in illiquid life insurance cash values with access to funds limited solely to surrender or costly policy loans, with a cap on growth. Predictably, when the cost of the benefits becomes too burdensome and uneconomic, policies are surrendered or forfeited. Had the "infinite banking" premiums remained invested in an S&P 500 ETF for the long-term, over the course of the Policy, market values of the ETF will exceed the surrender value of the Policy, often by more than 7 figures, the foundation of Market Adjusted Damages. One more point, annual taxes are paid only on the 1-2% ETF dividends, not appreciation, at an actual tax cost that typically is far less than the annual cost of insurance and accruing interest.

<u>Dividends</u>: Every mutual insurance carrier advertises its dividend rates, usually between 5% and 7%, and its consistency of paying dividends every year for several decades or more (and in some cases a century). The common misconception about mutual life insurance illustrations is that the dividend rate applies to the illustrated non-guaranteed accumulation value of the policy. It does not. As proof, simply divide the interest credited in any year by the previous year's accumulation value to determine the actual growth for the year. The rate is likely around 2%-4% and well below the advertised dividend rate – a problem likely to increase in the later years.

Here's the catch, the dividend rate is applied against the "Dividend Surplus," the term Mutual Insurance companies use that equates to shareholder equity in a stock company. Insurance companies apply the dividend rate against that surplus and not the insured's cash value accumulation. Divide the interest dollars credited by the illustration's dividend rate to determine the amount the dividend was based upon; it won't be the illustration non-guaranteed accumulation value. Customers often believe they'll get a steady tax-free 5-7% dividend on their Cash Value based upon a history of dividends without ever understanding it's not the growth rate at all.

With accumulation policies, the insured rarely comprehends that obtaining the promised tax benefits requires full payout of the death benefit, an occurrence in only about 10% of policies. "Persistence" studies conducted by

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[9] Mass Mutual memo on Infinite banking

LICAC and LIMRA, indicate the vast majority of IUL policies fail to achieve payout of death benefits and are surrendered or lapse for a loss of tax benefits. In short, experience shows that these policies rarely persist long enough to realize full benefits.[10]

IRS 72t. Because infinite banking frauds continue for years, it is also common to find the systematic liquidation of qualified accounts or variable and index annuities under IRS 72t in furtherance of the scheme. Commonly, victims of Infinite Banking have substantial net worth locked into "qualified accounts" designated for retirement such as IRAs, SEPs, 401Ks, company pensions, and variable or fixed annuities inside and outside of the qualified account. IRS 72t permits early access to those qualified funds prior to age 59 ½ through systematic withdrawals without tax penalties. Scammers use 72t quite effectively to pry out qualified funds to further their scheme. Regular or systematic withdrawals from qualified accounts are not for personal expense but part of the scheme warranting restoration to the account for damages calculation.

Commissions are generous in the insurance industry. For top producers, commissions range between 80% and 140% of the first year's premium and up to 10% on subsequent premiums paid in years 2-10. On IUL's, due to over funding, commissions are calculated on the "target Premium" the amount of premium that is projected to keep the policy in force for the insured's lifetime. Depending on the target premium and the projected payment schedule, commission could range between 30%-80% of the first year's premium and 2%-10% in succeeding years.

On $1million in IUL premiums paid in ten $100k annual installments, first year premiums commissions would approach 80%, if paid in three installments the rate could be 30% of first year. Typically, policy loans are projected to cover future premiums and to distribute income after eight to ten years. If ACV is insufficient however to collateralize, additional premiums must be paid out-of-pocket to keep the policy in force. Other factors including the amount of supplemental term insurance in the policy also may actually reduce commissions. Regardless, the commissions paid Agents and Brokers in the first year on these products is substantial and ongoing but totally opaque to the purchaser, except for the scheduled withdrawal penalties intended to recover those costs upon lapsing or early surrenders

[10] Life Insurance Consumer Advocacy Center (LICAC).

B. Damages

Miley v. Oppenheimer & Co.[11] is perhaps the most cited case in support of both disgorgement of commissions and market adjusted damages. *Miley* was a commission driven churning case and the question on appeal was whether in addition to disgorgement of commissions and fees, the decline in portfolio value caused by the costs and excessive trading was also recoverable. It was. Market Adjusted Damages became a standard in churning cases. *Miley* may be best understood as endorsing a market adjustment for the impact of trading abuses on returns in commission driven churning claims. Infinite Banking is an investment scheme driven by enormous commissions that converts liquid market assets into life insurance. Damages, therefore, must reflect market-based adjustments without insurance costs.

1. Market Adjusted Damages (MADs): Cash Funded

IULs are sold principally as a tax deferred investment product that requires the purchase of Insurance in excessive amount to preserve the tax treatment of distributions and to build cash value to borrow upon in retirement tax free. Analog investments, however, do not require insurance. Typically, the S&P 500 is the analog for damages. One cannot invest in an index, but rather must invest in ETFs or funds that mirror index performance. These ETFs and funds also have the benefit of receiving and paying 1.5%-2% in annual dividends that are reinvested and typically sufficient to pay for level term insurance if needed.

2. Market Adjusted Damages (MADs): Premiums Financed

When premiums are financed, the investor's only cash outlay is the interest paid to the finance company over the course of the policy and any collateral costs. In the example above, over seven years, non-deductible interest costs would amount to $1.3 million paid out in increasing amounts as premium loan principal reached $7 million. Total Interest costs at the tenth year would amount to over $2.3 million at the 4.5% forecast interest rates. Account cash values in year seven were barely sufficient to repay the premium loan and policies surrendered with investors out $1.3 million in interest. Logically the interest cash flows, and collateral costs would be the basis for MADS.

[11] *Miley v. Oppenheimer & Co.*, 637 F.2d 318 (5th Cir. 1981).

3. Recission or Restitution

Rescission or restitution at the statutory rate also offers an alternative but there may be adverse tax consequences in doing so.

4. Benefit of the Bargain

There's implicit in a policy's non-guaranteed projections that should the index meet or exceed a stated calculated average index return of 7%-7.5%, its bogie, over the accumulation period, projected distributions would continue for life and the accumulating loans repaid by the death benefit. The S&P 500 averages about 9.5% return including dividends over the past several decades. In the preponderance of cases, the index outperforms its bogie yet, the Accumulation value falls woefully short and inadequate to meet any of the projected benefits with increasing costs forcing surrender. In those cases where the S&P 500 return actually exceeded its bogie, it is arguable that the insurance carrier should simply pay the projected distributions as shown and be bound by the illustrations.

5. Disgorgement of Commissions

Insurance frauds are commission driven. What would be considered Churning in securities trading is called Twisting in the Insurance industry and it is illegal. Under *Miley*, disgorgement of commissions is the recognized measure of damages in addition to market adjustments. When sold as an investment, the *Miley* disgorgement standard is appropriate. And when the defense claims that the Insurance company pays the commission, a canard, just produce the first year's statement and ask them to explain why the surrender value is zero or how surrender charges are amortized into policy costs over 10+ years.

6. Taxes and Cost Illustrations: Market Investment vs. IUL

Virtually all tax comparison illustrations I've seen are entirely erroneous and misleading. As is well understood, taxes are owed only on realized gains while realized losses generate a tax benefit in the form of a deduction from income with tax savings that is always ignored. Google stock bought 12 years ago for $1,100 is currently worth over $19,000 without ever being taxed and upon death passes through to heirs at stepped up basis. Conversely, on the typical illustration, Google's annual appreciation would be taxed erroneously, substantially reducing cash value accumulation, plus the dividends are ignored (Google does not pay dividends).

Despite the fact that unrealized gains and appreciation are not taxable, virtually all comparisons I've seen miscalculate tax liability on the annual appreciation and ignore the dividends. Importantly, there is no disclosure that surrender or lapse will immediately make all accrued policy loans taxable as income. In the illustrations I viewed, taxes were miscalculated at 40% on the annual appreciation each year and fees added another 1.5% annually vs unmanaged ETFs that charge about 15-25 basis points. Calculate taxes properly, include deductions for losses, add dividends, and reduce fees and the Insurance comparison would fail.

The simple truth is that unless a policy survives to pay a death claim on the insured, any expected tax benefits cannot be realized. With failure rates on various forms of cash value life insurance of 80-90%, most consumers who expect tax-free income from their policies in retirement will be, predictably, disappointed. Despite all the guarantees and illustrations of tax-free distribution and forecast annual returns in the non-guaranteed illustrations, the cash accumulation value rarely exceeds premiums paid for a net zero return over a decade or more, unless the policy holder dies, and the death benefit repays the loans and provides a residual estate.

7. Who's Liable

Insurance carriers issue policies offered through appointed licensed agents and brokers subject to state regulations. These licensed agents are appointed by the insurance product issuers or their marketing affiliate and by contract are the authorized representative and producer to market, sell, and service these products all while clothed as a trustworthy representative and sales professional of the insurer. Insurance policies typically do not have arbitration clauses.

Aggrieved investors may pursue liability claims in state and federal courts and may have strong claims against product issuers, their marketing and servicing affiliates, and their authorized retail sales agents/producers that marketed, sold, and serviced the product to the retail customers. The claims available arise under state law and may vary. Potential claims to consider, include common law claims of fraud and fraudulent inducement (suitability claims sound in fraud), negligent misrepresentation, aiding and abetting fraud, civil conspiracy, and unjust enrichment – perhaps among other common law claims. State law may provide statutory causes of action as well, including elder abuse statutes, private rights of action provided under state insurance laws and regulations addressing unfair insurance practices, and state consumer protection

statutes enacted to deter and remedy unfair and deceptive acts and practices relating broadly to consumer goods and services.[12]

RIAs and professionals like CPAs that are co-licensed to sell insurance may also have fiduciary duties that have been breached or have committed professional ethical violations that may support a professional malpractice claim. And, as with Arthur Anderson/Enron, the accountants or actuaries that prepared the projections relied upon with predictable, yet undisclosed outcomes may also have secondary liability to those relying on the projections to invest.

8. The Forum-State Court

If liability is proven in court, full damages can be anticipated and that includes disgorgement of commissions, possible punitive damages, and under consumer and senior protection laws, attorney's fees, none of which is likely in FINRA Arbitration where compromise is the mantra and respondents and claimants alike well know the rarity of sizeable awards and full recovery going into any settlement discussions or mediation. Discovery is robust and interrogatories and depositions are a vast improvement over FINRA arbitration.

9. Valuation in Settlement

Assuming a persuasive case and probable outcome at trial, mediation or settlement discussion should focus primarily on liability and presume a full award if the case is proven. That sets an entirely different tone in settlement discussions. Accumulated damages in many Infinite Banking scams can reach into seven figures over the long term, especially for middle class investors reaching retirement age. For seniors, under many consumer protection statutes, damages are trebled with attorney fees. A prevailing client is entitled to those damages under the law, and they shouldn't be ignored, disregarded, or diminished in any way when reaching a settlement.

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[12] All fifty states have enacted statutory protections covering deceptive and unfair practices and where many of these statutes are patterned after Section 5(a)(1) of the Federal Trade Commission Act, 15 U.S.C. § 45(a)(1), but unlike the federal act include a private right of action. *See generally* National Consumer Law Center, Unfair and Deceptive Acts and Practices (10th ed. 2021), *updated at*www.nclc.org/library (detailed treatise of state consumer protection laws with case annotations with online updates). Some state consumer fraud statutes have been applied to consumer transactions involving deceptive or unfair practices in the marketing and sale of life insurance products. *See, e.g., Gregg v. Ameriprise Fin., Inc.*, 664 Pa. 567, 245 A.3d 637 (2021) (applying Pennsylvania's Unfair Trade Practices and Consumer Protection Law, 73 P.S. §§ 201-1–201-9.3, to marketing and recommended sale of life insurance products). Some states specifically exempt customer insurance transactions. *See, e.g.,* Ohio Rev. Code Ann. § 1345.01(A).

CONCLUSION

There are millions of policy holders that have each paid substantial premiums with their hard-earned after-tax dollars and savings over several years for policies that predictably failed to achieve promised outcomes and often result in devastating loss for policy holders at retirement. In truth, investors are never informed through sales presentation or marketing brochures that up to 90% of the policies pitched as a sound and suitable investments for retirement, fail, never achieve full benefits, and lapse or surrender at a loss of the tax benefits. The data is overwhelming, IULs are underwritten and designed to fail, and do so at an alarming rate.

It has taken me about six months to come to my present level of understanding about how these policies work, how they're sold and marketed, and how they actually perform. One consultant in insurance litigation wrote to me, "We have to explain this arcane stuff first to the attorneys that hire us and then in declarations and depos and then, for the few that get that far, to judge and jury. Normal humans can never be expected to know this stuff!" By all measures, no investor can be said to have read the materials and policies and understood the risks from a 2-hour sales presentation with illustrations by a trained sales agent, and certainly not within the 3-day cancellation period.

HORSE AROUND AND FIND OUT: WILL *ALPINE SECURITIES V. SEC* REIN IN FINRA FOLLOWING *HORSEMEN'S II*?

B. Makoa Kawabata[1]

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HORSE AROUND AND FIND OUT:
WILL *ALPINE SECURITIES V. SEC* REIN IN FINRA FOLLOWING *HORSEMEN'S II*?

OFF TO THE RACES

"Though opportunities have abounded, no court has ever held that FINRA or its relationship with the SEC is unconstitutional."[2] However, in *Alpine Securities Corp. v. Financial Industry Regulatory Authority*, a divided motions panel for the U.S. Court of Appeals for the D.C. Circuit issued an order enjoining a FINRA enforcement proceeding, concluding that Alpine had "satisfied the stringent requirements for an injunction pending appeal,"[3] which include demonstrating a likelihood of success on the merits of its challenge to the "unconstitutional operation and structure of FINRA."[4]

Alpine Securities v. SEC is one of many recent challenges to regulatory and administrative bodies and practices that have found new purchase with courts. For example, in *Securities and Exchange Commission v. Jarkesy*, the Supreme Court held that the Seventh Amendment entitles a defendant to a jury trial when the Securities and Exchange Commission seeks civil penalties for violations of securities fraud laws,[5] a ruling that the dissent characterized as upending "[the Supreme] Court's longstanding precedent and established government practice [that] uniformly support the constitutionality of the administrative schemes like the SEC's[.]"[6] In *Loper Bright Enters. v. Raimondo*, the Supreme Court overruled *Chevron v. Natural Resources Defense Council*,[7] precedent the dissent characterized as "a cornerstone of administrative law."[8] At first blush, this judicial climate seems to indicate that Alpine's constitutional challenges based on the Appointments Clause and private nondelegation doctrine are likely to find a friendly audience and FINRA could be put out to pasture soon.

However, similar constitutional challenges have been leveled at another "private, independent, self-regulatory, nonprofit corporation"[9]—the Horseracing Integrity and Safety Authority (the "Authority")—in contemporary cases that break in FINRA's favor. The Fifth and Sixth Circuit Courts of Appeals addressed Appointments Clause and private nondelegation challenges to the

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2 *Kim v. Fin. Indus. Regul. Auth.*, 698 F. Supp. 3d 147, 153 (D. D.C. 2023).

3 *Alpine Sec. Corp. v. Fin. Indus. Regul. Auth.*, No. 23-5129, 2023 U.S. App. LEXIS 16987, at 1-2 (D.C. Cir. July 5, 2023).

4 Alpine Sec. Corp., Emergency Motion for Injunction Pending Appeal at 14, Alpine Sec. Corp. v. Fin. Indus. Regul. Auth., No. 23-5129 (D.C. Cir. July 5, 2023).

5 *Securities and Exchange Commission v. Jarkesy*, 114 S. Ct. 2117 (2024).

6 *Id*. at 698 (Sotomayor, J., dissenting).

7 *Loper Bright Enters. v. Raimondo*, 144 S. Ct. 2244 (2024).

8 *Id*. at 2294 (Kagan, J., dissenting).

9 Horseracing Integrity and Safety Act, 15 U.S.C. § 3055(a)(1).

Authority in *Nat'l Horsemen's Benevolent & Protective Ass'n v. Black* ("*Horsemen's*") and *Oklahoma v. United States*, and in so doing, emphasized several characteristics of the Authority's relationship with the FTC, similar to the FINRA-SEC relationship, that support the constitutionality of the SEC's delegation of regulatory authority to self-regulatory organizations ("SROs") like FINRA.[10]

The first section of this Article summarizes and analyzes the constitutional arguments made in *Alpine Securities v. SEC*, and the second section seeks to use the analogies drawn between the Authority-FTC relationship and the FINRA-SEC relationship by the Fifth and Sixth Circuits in *Horsemen's* and *Oklahoma v. United States* to provide context and highlight reasoning that is likely to prevail in the current judicial climate with respect to the Appointments Clause and private nondelegation challenges raised in *Alpine Securities v. SEC*.

I. THE D.C. CIRCUIT TELLS FINRA TO HOLD ITS HORSES IN *ALPINE SECURITIES V. SEC*

Put briefly, Alpine argued that an enforcement action brought by FINRA ran afoul of the Constitution because FINRA's hearing officers "wield[ed] executive power that may be exercised only by the President and officers under his supervision."[11] To obtain an order enjoining FINRA from continuing its enforcement proceedings, Alpine was required to establish, "by a clear showing," a "substantial likelihood of success on the merits" of its challenge to the "unconstitutional operation and structure of FINRA."[12] Alpine Securities' arguments in support of its challenge to the constitutionality of FINRA were largely as follow: (1) if FINRA is considered a state actor, the removal protections of its hearing officers violate separation of powers and the Appointments Clause of Article II; or, in the alternative, (2) if FINRA is not considered a state actor, its enforcement powers over its members violates the private nondelegation doctrine.[13]

Alpine succeeded in obtaining a *per curiam* injunction staying FINRA's enforcement action pending appeal. The judge concurring in the D.C. Circuit's order did not "rule out the possibility that further briefing and argument might

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[10] *See generally* 15 U.S.C. § 78k-1(a)(3)(B); *Nasdaq Stock Mkt. LLC v. SEC*, 38 F.4th 1126, 1130, (D.C. Cir. 2022) (explaining regulatory scheme under which the SEC may delegate regulatory authority to self-regulatory organizations such as, *inter alia*, national securities exchanges and FINRA).

[11] *Alpine Sec. Corp. v. Fin. Indus. Regul. Auth.*, No. 23-5129, 2023 U.S. App. LEXIS 16987, at 3 (D.C. Cir. July 5, 2023).

[12] Alpine Sec. Corp., Emergency Motion for Injunction Pending Appeal at 3, *Alpine Sec. Corp. v. Fin. Indus. Regul. Auth.*, No. 23-5129 (D.C. Cir. July 5, 2023).

[13] *Id.* at 2-3.

convince [him] that [his] current view is unfounded,"[14] but reasoned that Alpine "has raised a serious argument that FINRA impermissibly exercises significant executive power" with respect to the separation of powers and Appointments Clause challenge, on two grounds: "First, FINRA hearing officers are not appointed by a government body pursuant to the Appointments Clause. Second, . . . there are two layers of removal protection . . .. That may well infringe on the President's 'ability to execute the laws . . ..'"[15] He concludes, "FINRA might prevail on those issues, but on the briefing before us, that seems unlikely."[16]

No court has held that FINRA is a state actor for the purpose of a Constitutional challenge; "[r]ather, a multitude of courts nationwide have held the contrary—that FINRA is a private entity wholly separate from the SEC or any other government agency."[17] The question of whether an entity is a state actor has "a number of different factors or tests in different contexts"[18] that generally ask "whether there is a sufficiently close nexus between the State and the challenged action of the regulated entity so that the action of the latter may be fairly treated as that of the State itself."[19] The concurrence makes no mention of the test set forth in *Lebron v. National Railroad Passenger Corporation*, which "sets forth a three-part standard to determine whether a government-created corporation is part of the government for constitutional purposes"[20] and "provides necessary instruction"[21] when determining whether a nominally private enterprise should be considered a part of the government for the purpose of Appointments Clause and nondelegation challenges.[22] As such, the state actor analysis is unlikely to be the most significant upshot of *Alpine Securities*, since (1) courts are unlikely to determine that FINRA is a state actor; and (2) a determination that FINRA is a private actor does not end the inquiry regarding the permissive scope of authority that it can exercise, due to the existence of the much more tailored analysis presented by the private nondelegation doctrine.

The private nondelegation challenge presented in *Alpine Securities* mirrors that advanced in *Nat'l Horsemen's Benevolent & Protective Ass'n v. Black* and *Oklahoma v. United States*, where in 2023 and 2024 the Fifth and Sixth

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14 *Alpine Sec. Corp. v. Fin. Indus. Regul. Auth.*, 2023 U.S. App. LEXIS 16987, at *4-5, quoting *Ritter v. Migliori*, 142 S. Ct. 1824 (2022) (Alito, J., dissenting).

15 *Id*. at 9 (Walker, J., concurring).

16 *Id.* at 8.

17 *Scottsdale Capital Advisors Corp. v. Fin. Indus. Regul. Auth., Inc.*, 678 F. Supp. 3d 88, 104 (D.D.C. 2023).

18 *Brentwood Acad. v. Tenn. Secondary Sch. Athletic Ass'n*, 531 U.S. 288, 295 (2001).

19 *Jackson v. Metro. Edison Co*., 419 U.S. 345, 351 (1974).

20 *Herron v. Fannie Mae*, 861 F.3d 160, 167 (D.C. Cir. 2017).

21 *DOT v. Ass'n of Am. R.R.*, 575 U.S. 43, 54 (2015).

22 *Id*. at 55-56.

Circuit Courts of Appeals addressed constitutional challenges to the Horseracing Integrity and Safety Act of 2020, a law empowering a private corporation to create and enforce nationwide rules for thoroughbred horseracing.

A. The Appointments Clause and Removal Power Give the President the Carrots and Sticks, But the SEC-FINRA Relationship Is a Horse of a Different Breed

The U.S. Constitution requires Officers of the United States to be properly appointed and sufficiently accountable to the President.[23] Although FINRA is a private self-regulatory organization, the "actions of private entities can sometimes be regarded as governmental action for constitutional purposes."[24] Alpine seeks to establish that FINRA is governmental actor and its hearing officers are Officers of the United States; thus, their appointments and removal protections run afoul of the Constitution. The concurring judge in *Alpine* focused on the function of (and power wielded by) FINRA's hearing officers, analogizing them to the SEC's administrative law judges, who are considered "Officers of the United States."[25]

Alpine argues that a private party such as FINRA may be considered a government actor and subject to a constitutional challenge when "the State had so far insinuated itself into a position of interdependence with the [private parties] that it was a joint participant in the enterprise," "when it is entwined with governmental policies or when government is entwined in its management or control," or "when a private party performs a 'public function' of the sort traditionally performed only by the government."[26] Alpine argues that FINRA does all three.

In seeking to establish FINRA's adjudicative hearings and imposition of penalties as state action, Alpine argues that the sanctions imposed by FINRA Hearing Officers carry the force of law and that FINRA acts as an agent of the SEC when it carries out such enforcement activities. This is because with respect to discipline for violations of securities laws, FINRA's "power is *entirely derivative* of the SEC and uses procedures that supplant the SEC."[27] It analogized to the reasoning in *Blount v. S.E.C.*, pointing to the fact that the MSRB rules "operate[] not as a private compact among brokers and dealers but as

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23 *See generally*, *Lucia v. SEC*, 585 U.S. 237, 244 (2018).
24 *Lebron v. Nat'l R.R. Passenger Corp.*, 513 U.S. 374, 378 (1995).
25 *Lucia v. SEC*, 585 U.S. 237 (2018).
26 Alpine Sec. Corp., Emergency Motion for Injunction Pending Appeal at 7, *Alpine Sec. Corp. v. Fin. Indus. Regul. Auth.*, No. 23-5129 (D.C. Cir. July 5, 2023), quoting *Jackson v. Metro. Edison Co.*, 419 U.S. 345, 357-58 (1974); *Brentwood Acad. v. Tennessee Secondary Sch. Athletic Ass'n*, 531 U.S. 288, 288-89 (2001); *Marsh v. Alabama*, 326 U.S. 501, 506 (1946).
27 *Id.* at 8 (emphasis in original).

federal law,"[28] as do FINRA's rules.[29] Imposing sanctions that carry the force of federal law, according to this argument, is state action. Additionally, FINRA "serves as a front-line adjudicator for violations of the Exchange Act and the SEC's rules and regulations," an even more traditionally public function.[30]

In support of its position that FINRA is an agent of the federal government, Alpine argues that the SEC has "'pervasive oversight authority' over FINRA's disciplinary proceedings, and when FINRA performs this function it is subject to 'control by the SEC on an ongoing basis,'" such that FINRA has "no authority to regulate independently of the SEC's control."[31] Due to this "intimate entwinement between the SEC and FINRA in the context of enforcement proceedings," FINRA should be considered an agent of the government when it engages in enforcement actions, opening its hearing officers up to Alpine's Appointments Clause challenges. Alpine's position based on FINRA's "vast adjudicatory and prosecutorial authority to enforce federal law"[32] is mirrored by the concurring judge, who writes that "[f]rom start to finish, FINRA hearing officers execute government laws subject to a government plan, with little to no room for private control."[33] He cites that the Securities Exchange Act "*requires* FINRA to enforce government standards, including statutory provisions and SEC regulations," and states that its rules, directors, and officers are subject to SEC control, modification, and removal.[34]

As discussed *infra*, these aspects of the SEC's control over FINRA are salient factors involved in the analysis of the private nondelegation doctrine, which specifically applies to situations in which governmental authority is delegated to private entities. However, the concurrence does not analyze the private nondelegation aspect of Alpine's challenge to FINRA, instead posing and responding to the question, "Does it make a difference that FINRA hearing officers are employees of a nominally private corporation? Probably not."[35] Seemingly, the "constitutional loophole" posed by the contradiction in "the Constitution *prohibit*[*ing*] Congress from vesting significant executive power in an unappointed and unremovable government administrator but *allow*[*ing*] Congress to vest such power in an unappointed and unremovable private

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[28] *Blount v. SEC*, 61 F.3d 938, 941 (D.C. Cir. 1995).

[29] Alpine Sec. Corp., Emergency Motion for Injunction Pending Appeal at 9, *Alpine Sec. Corp. v. Fin. Indus. Regul. Auth.*, No. 23-5129 (D.C. Cir. July 5, 2023), citing *Credit Suisse First Bos. Corp. v. Grunwald*, 400 F.3d 1119, 1121 (9th Cir. 2005); see also *Birkelbach*, 751 F.3d at 475 note 2.

[30] *Id.*

[31] *Id.* at 9, quoting *Austin Mun. Sec., Inc. v. NASD*, 757 F.2d 676, 680, 690 (5th Cir. 1985)

[32] *Id.* at 10.

[33] *Alpine Sec. Corp. v. Fin. Indus. Regul. Auth.*, 2023 U.S. App. LEXIS 16987, at *8.

[34] *Id.* (emphasis in original).

[35] *Id.* at *7.

hearing officer" is sufficiently apparent for the concurrence not to include further discussion on the private nondelegation doctrine.[36]

But this seeming "loophole" is patched by simply applying a private nondelegation doctrine analysis to the delegation of regulatory authority by the SEC to FINRA. As one commentator writes, "The three occasions in which the Supreme Court has struck down a private delegation involved a type of authorized lawlessness. By contrast, every private delegation upheld by the Court has required a government official to sign off on what a private party decided."[37] The cases analyzing the private nondelegation doctrine "draw a line between impermissible delegation of unchecked lawmaking power to private entities and permissible participation by private entities in developing government standards and rules."[38]

Alpine argues that the Hearing Officers are similarly situated to the SEC ALJs determined to be Officers of the United States and subject to the Appointments Clause and limitation on removal protections, in that they are empowered to execute federal law. According to Alpine, since FINRA's hearing officers "can execute the nuclear option: expulsion from the industry," they wield even more power than the SEC ALJs[39] The concurring judge in *Alpine* also voiced these concerns, writing that "FINRA's hearing officers are near carbon copies of those ALJs."[40]

In *Lucia v. SEC*, the Supreme Court ruled that the ALJ that presided over adversarial hearings at the SEC were "Officers" of the United States.[41] Distinguishing "Officers" from employees, the Supreme Court recited the "basic framework" that "[t]o qualify as an officer, rather than an employee, an individual must occupy a 'continuing' position established by law, and must

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36 Later in the concurrence, the judge dedicates a paragraph acknowledging that "Congress may authorize private organizations to work with government regulators. For example, it does not violate the Constitution to let private entities make recommendations that the government later approves. [Citation.] But the hearing officers here do not just make recommendations—they enforce securities laws and decide parties' rights. And unless the losing party appeals to the SEC or the SEC steps in unprompted, the hearing officers' decisions are final." *Id*. at *9.

37 Paul J. Larkin, *The Private Delegation Doctrine*, 73 FLA. LAW REV. 31, 44 (2021).

38 *Oklahoma v. United States*, 62 F.4th 221, 228 (6th Cir. 2023), citing *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935); *Carter v. Carter Coal Co.*, 298 U.S. 238; *Sunshine Anthracite Coal Co. v. Adkins*, 310 U.S. 381, 388 (1940).

39 Alpine Sec. Corp., Emergency Motion for Injunction Pending Appeal at 14, *Alpine Sec. Corp. v. Fin. Indus. Regul. Auth.*, No. 23-5129 (D.C. Cir. July 5, 2023).

40 *Alpine Sec. Corp. v. Fin. Indus. Regul. Auth.*, 2023 U.S. App. LEXIS 16987, at *6.

41 *Lucia v. SEC*, 585 U.S. 237, 238 (2018)

'exercis[e] significant authority pursuant to the laws of the United States.'"[42] The SEC ALJs, "hold a continuing office established by law" because they "receive[] a career appointment" to a position created by statute.[43] And they exercise "significant discretion" when carrying out the "important functions" of exercising the "authority needed to ensure fair and orderly adversarial hearings--indeed, nearly all the tools of federal trial judges."[44] Then, "at the close of those proceedings, SEC ALJs issue decisions," which "the SEC can decide against reviewing . . . and when it does so the ALJ's decision itself 'becomes final' and is 'deemed the action of the Commission.'"[45]

However, this determination presupposes that the SEC ALJs are either mere employees or officers of the United States. The resolution of the question of whether someone already in a "continuing position established by law" in the government should be considered an "Officer" of the United States does not dictate that a private person becomes a government actor because they have been granted significant discretion within their private organization. Put another way, when a person has been purportedly granted the kind of discretion an ALJ has (but in a private organization), the private nondelegation doctrine is better suited to guide analysis of the extent of power they may properly wield than the Appointments Clause or removal frameworks.

B. Private Nondelegation Principles: Not Put Out to Pasture Yet

The private nondelegation doctrine refers to constitutional concerns that arise where a private entity—rather than a government entity—wields significant power to execute a statutory scheme.[46] Commentators have described the doctrine as "languish[ing] in relative obscurity in academia, appear[ing] infrequently in lower court decisions, and ha[ving] been sporadically applied by the Supreme Court;"[47] or even being "elusive, if not nonexistent."[48] It may not remain elusive for long. The circuit split over the constitutionality of the enforcement activities of the Horseracing Integrity and Safety Authority suggests that the Supreme Court may soon need to address private nondelegation, with

42 *Id*. at 237-38, citing *United States v. Germaine*, 99 U. S. 508; and *Buckley v. Valeo*, 424 U.S. 1, 96.

43 *Id*. at 238.

44 *Id*.

45 *Id.* at 239.

46 *Carter v. Carter Coal Co.*, 298 U.S. 238 (1936).

47 *Administrative law - nondelegation doctrine - D.C. circuit grants injunction in constitutional challenge to private regulator*, 137 HARV. L. REV. 1042, 1044 (2024).

48 Alexander Volokh, *The Myth of the Federal Private Nondelegation Doctrine*, 99 Notre Dame L. Rev. 203 (2023), available at: https://scholarship.law.nd.edu/ndlr/vol99/iss1/5.

consequences for FINRA's enforcement actions and the outcome of the challenges leveled against the constitutionality of FINRA by Alpine and others.

Alpine argued that because "FINRA has created a procedural mechanism where it can expel an entity from the securities industry without any opportunity for review," its "broad, unchecked enforcement authority violates the private nondelegation doctrine."[49] Because FINRA can use a procedural mechanism in the form of an expedited enforcement action to expel Alpine from FINRA "immediately with no SEC involvement," Alpine argues that the necessary "SEC oversight is plainly not present."[50]

FINRA and the United States laid out the history of the private nondelegation standard, which provides that statutory schemes that allow private entities to play a role in regulatory programs so long as the private entities "function subordinately" to, and under the "authority and surveillance" of, a governmental body.[51] Under the Exchange Act, the SEC has the ability to "abrogate, add to, and delete from all FINRA rules as it deems necessary,"[52] conducts plenary review of FINRA's final disciplinary actions[53] including by issuing interim stays of any sanctions pending review,[54] and regularly examines FINRA to ensure its compliance with securities laws and FINRA rules.[55] Just as the Second Circuit held in 1952, Alpine and the United States argued, "Congress did not unconstitutionally delegate[] power to the NASD[, FINRA's predecessor] because the Commission had reasonable statutory powers to review [the SRO's] rules and its disciplinary actions."[56] The challenges to the constitutionality of FINRA and its predecessor SROs have been raised, and dispensed with over the course of decades, and in "case after case, the courts have upheld this arrangement" because "the SEC's ultimate control over

49 Alpine Sec. Corp., Emergency Motion for Injunction Pending Appeal at 3, *Alpine Sec. Corp. v. Fin. Indus. Regul. Auth.*, No. 23-5129 (D.C. Cir. July 5, 2023), 15.

50 Alpine Sec. Corp., Reply Brief in Support of Alpine's Emergency Motion for Injunction Pending Appeal at 9, *Alpine Sec. Corp. v. Fin. Indus. Regul. Auth.*, No. 23-5129 (D.C. Cir. July 5, 2023).

51 Fin. Indus. Regul. Auth., Opposition to Motion Pending Appeal at 18, citing *Sunshine Anthracite Coal Co. v. Adkins*, 310 U.S. 381, 399 (1940); *see also*, United States, Opposition to Motion Pending Appeal at 15.

52 *Aslin v. FINRA*, 704 F.3d 475, 476 (7th Cir. 2013) (citations omitted), citing 15 U.S.C. § 78s(b)(1), (c).

53 15 U.S.C. § 78s(d).

54 15 U.S.C. § 78s(d)(2).

55 *See, e.g.*, U.S. Gov't Accountability Off., GAO-18-522, SEC Inspections of FINRA's Governance Were Consistent with Internal Guidance (2018), bit.ly/3h0GdCj.

56 *R.H. Johnson & Co. v. SEC*, 198 F.2d 690, 695 (2d Cir. 1952); *accord.*, *e.g.*, *Todd & Co. v. SEC*, 557 F.2d 1008, 1012-13 (3d Cir. 1977) (same); *First Jersey Sec., Inc. v. Bergen*, 605 F.2d 690, 697 (3d Cir. 1979) (same); *Sorrell v. SEC*, 679 F.2d 1323, 1325-26 (9th Cir. 1982) (same).

the rules and their enforcement makes the SROs permissible aides and advisors."[57]

II. DID THE ORDER STAYING FINRA'S ENFORCEMENT ACTION AGAINST ALPINE SECURITIES JUMP THE GUN?

"Though opportunities have abounded, no court has ever held that FINRA or its relationship with the SEC is unconstitutional."[58] However, decades of decisions regarding the constitutionality of the actions and roles of regulatory bodies were upended in the 2023-24 Supreme Court term. For example, in *Securities and Exchange Commission v. Jarkesy*, the Supreme Court held that the Seventh Amendment entitles a defendant to a jury trial when the Securities and Exchange Commission seeks civil penalties for violations of securities fraud laws.[59] In *Loper Bright Enters. v. Raimondo*, the Supreme Court overruled *Chevron v. Natural Resources Defense Council*, holding that in determining whether an agency has acted within its statutory authority, courts are no longer to defer to agency interpretations of the law when the law is ambiguous.[60]

Given the recent landscape of jurisprudence hostile to the authority of regulatory bodies, the challenges to FINRA that have been discarded in the past may find new purchase, as evinced by the D.C. Circuit motions panel enjoining FINRA's enforcement action in *Alpine Securities*. As such, it is important to put the parties' arguments in the context of contemporary decisions issuing on these subjects.

Instructive on the analysis of both the Appointments Clause challenge and the private nondelegation doctrine are the Fifth and Sixth Circuit's decisions regarding the constitutionality of the Horseracing Integrity and Safety Act's ("HISA") delegation of power to a "private, independent, self-regulatory, nonprofit corporation, to be known as the 'Horseracing Integrity and Safety Authority,'" (the "Authority") which is responsible for establishing, *inter alia*, anti-doping, medication, and racetrack safety programs, as well issuing descriptions of rule violations and establish sanctions for those violations.[61] These Circuit Courts' analyses specifically addressed the question of whether *Lebron* should be the governing test to determine whether a private regulatory body should be considered a government instrumentality, whether its officers should be considered "Officers of the United States," and

[57] *Oklahoma v. United States*, 62 F.4th 221, 229 (6th Cir. 2023).
[58] *Kim v. Fin. Indus. Regul. Auth.*, 698 F. Supp. 3d 147, 153 (D.D.C. 2023).
[59] *Securities and Exchange Commission v. Jarkesy*, 114 S. Ct. 2117 (2024).
[60] *Loper Bright Enters. v. Raimondo*, 143 S. Ct. 2635 (2023).
[61] 15 U.S.C. § 3055(a)(1); 3057(a)(1); (d)(1).

referenced the SEC-FINRA relationship when performing private nondelegation analysis.

A. The Appointments Clause and Removal Power Arguments Don't Track

In *Horsemen's II*, the Fifth Circuit applied *Lebron v. Nat'l R.R. Passenger Corp.* to conclude that the Authority "does not qualify as a government entity subject to the Appointments Clause."[62] As discussed *supra*, the analysis guiding the inquiry into whether a "private, independent, self-regulatory, nonprofit corporation" is part of the government is set forth in *Lebron*.[63] It applied the three-part test to the Authority. First, just like FINRA, the Authority was not created by the federal government, but was incorporated under Delaware law shortly before HISA's passage.[64] Unlike Amtrak, which "Congress established" by enacting the Rail Passenger Service Act of 1970,[65] neither the Authority nor FINRA or its predecessor organizations were created by the government "by special law."

The second *Lebron* factor (whether the organization was created to further governmental objectives), also distinguishes Amtrak from the Authority and FINRA, since Congress established Amtrak "to avert the threatened extinction of passenger trains in the United States" and for other goals Congress itself "establish[ed]."[66] By contrast, the Authority was created "as a private association to address doping, medication, and safety issues in the thoroughbred racing industry."[67] The history of FINRA and its predecessor organizations demonstrates that SROs in the securities industry existed before any of the statutes that delegate authority to it, and developed side-by-side with applicable securities laws. The District of Columbia District Court summarized the history of self-regulation in the securities industry in relevant part as follows:

> In January 1792, the prices of government and bank securities soared, "exceeding any sane levels of valuation." Then prices started to drop, panic spread, and, natch, prices plummeted. "[F]inancial mayhem" ensued. New York brokers did not sit idly by. On May 17, 1792, they gathered "under the shade of a buttonwood tree at 68 Wall Street" and drew up the aptly

62 *Nat'l Horsemen's Benevolent & Protective Ass'n v. Black* (*Horsemen's II*), 105 F.4th 415, 420-21 (5th Cir. 2024).

63 *Id.* at 437.

64 *Id.* at 438.

65 *Lebron v. Nat'l R.R. Passenger Corp.*, 513 U.S. 374, 383 (1995).

66 *Id.*

67 *Nat'l Horsemen's Benevolent & Protective Ass'n v. Black* (*Horsemen's II*), 105 F.4th 415, 438 (5th Cir. 2024).

named "Buttonwood Agreement." It contained rules to govern securities trading, including setting a minimum for brokers' commissions. Out of this agreement, the New York Stock Exchange was born . . . without aid of any federal or state law or government intervention, oversight, or regulation.

. . .

Over a century later, in 1929, there was another market crash. In the aftermath, Congress acted, including by passing the Securities Exchange Act of 1934. The Exchange Act subjected over-the-counter broker-dealers to direct regulation by the government, specifically the SEC, for the first time. It soon became apparent, however, that the SEC lacked the capacity to regulate the over-the-counter market directly.

In 1937, Congress considered how to address the unanticipated consequences of leaving the SEC with full regulatory power in the industry. Congress worried that governmental regulation alone "would involve a pronounced expansion of the organization of the [SEC]; the multiplication of branch offices; a large increase in the expenditure of public funds; an increase in the problem of avoiding the evils of bureaucracy; and a minute, detailed, and rigid regulation of business conduct by law."

. . .

Congress passed the Maloney Act in 1938 to keep self-regulation in the enforcement picture by establishing the concept of registered national securities association SROs. Rather than adopt a purely governmental approach, "Congress determined that it was distinctly preferable to rely on cooperative regulation, in which the task will be largely performed by representative organizations of investment bankers, dealers, and brokers, with the Government exercising appropriate supervision in the public interest, and exercising supplementary powers of direct regulation." Congress kept this regime in large part because of the "sheer ineffectiveness of attempting to assure [regulation] directly through the government on a wide scale." And yet again in 2004, the SEC explained that "[e]xperience appears to indicate that the [SEC], in its current form, does not have the resources to effectively carry out on its own the full panoply of duties for which the SROs are currently responsible."

Together, the Exchange Act, the Maloney Act, and the 1975 amendments "reflect Congress'[s] determination to rely on self-regulation as a fundamental component of U.S. market and broker-dealer regulation, despite [an] inherent conflict of interest."

> Thus, for over eight decades, federal law has maintained "a system of cooperative self-regulation through voluntary associations of brokers and dealers" to supplement the SEC's regulation of over-the-counter markets.[68]

Third, the federal government does not "control[] the operation of the [Authority or FINRA]," nor has it "retain[ed] for itself permanent authority to appoint a majority of the [Authority's or FINRA's] directors." Unlike Amtrak, where seven of its nine board members "are appointed by the President and confirmed by the Senate"[69] or the PCAOB, where its five board members are "appointed . . . by the Securities and Exchange Commission,"[70] the government has no role in appointing the Authority or FINRA's boards.

The Fifth Circuit also considered the argument that directors of the Authority should be considered "Officers of the United States" for the purpose of Appointments Clause challenges but rejected it, noting that both of the major precedent cases relied upon by parties in *Horsemen's* and *Alpine* for the argument that members of private organizations should be considered "Officers"—*Buckley v. Valeo* and *Lucia v. SEC*—"addressed whether individuals *already part* of the government should be considered 'Officers.'"[71] "Post-*Lebron*, no case has applied *Buckley* to private actors."[72] It then addressed the "loophole" concern voiced in the *Alpine* concurrence, that "if *Lebron* is the test, then the federal government can simply vest all executive power in a private corporation and avoid the Appointments Clause," reasoning that "[t]his argument ignores the role of the private nondelegation doctrine."[73]

This analysis is likely to control. The Fifth Circuit is the Court of Appeals that has issued the opinion most hostile to the constitutionality of the Authority, concluding that its enforcement actions are unconstitutional, but in that same opinion, it concluded that under the "detailed analysis" required by the *Lebron* test, the Authority is not a government instrument for constitutional purposes and explained that nondelegation is the correct analysis to apply when addressing the constitutionality of the power wielded by a private entity.

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68 *Kim v. Fin. Indus. Regul. Auth.*, 698 F. Supp. 3d 147, 155-57 (D.D.C. 2023) (citations omitted).

69 *DOT v. Ass'n of Am. R.R.*, 575 U.S. 43, 51 (2015).

70 *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477, 484-85 (2010).

71 *Nat'l Horsemen's Benevolent & Protective Ass'n v. Black* (*Horsemen's II*), 105 F.4th 415, 439 (5th Cir. 2024) (emphasis in original).

72 *Horsemen's II*, 439.

73 *Horsemen's II*, 440.

B. *Horsemen's II* and *Oklahoma v. United States* Put the Private Nondelegation Doctrine Back in the Saddle

The private nondelegation doctrine is specifically applicable to the SEC-FINRA relationship and provides an analytical framework to determine when the delegation of governmental authority to a private entity is appropriate. The Fifth and Sixth Circuits both cited to the SEC-FINRA relationship in their 2023 and 2024 cases addressing the constitutionality of the Horseracing Integrity and Safety Authority, another private entity tasked with overseeing and enforcing a nationwide industry's rules.

The initial version of the HISA directed the Federal Trade Commission (FTC) to publish the Authority's proposed rules for public comment, then determine within 60 days whether a proposed rule is "consistent" with the HISA and prior rules.[74] If so, the FTC "shall approve" the Authority's proposed rule.[75] In *Horsemen's I*, the Fifth Circuit considered a constitutional challenge to the rulemaking authority of the Authority.

The Fifth Circuit ruled that the Authority's rulemaking power was unconstitutional private delegation, on the ground that "the Authority's proposed rules were subject only to the FTC's limited 'consistency review,' which did not permit the agency to second-guess the Authority's policy choices."[76] In its discussion on this point, the Fifth Circuit explained that "given its limited review, the FTC can merely recommend modifications to rules insofar as they are 'inconsistent' with the Act, but the agency cannot second-guess the Authority's policy choices,"[77] and this "limited review" and "lack of power to change the Authority's proposed rules"[78] left the relationship between the FTC and the private Authority in a state such that "should the [FTC] prefer an alternative to [the Authority's] proposed [rules], [HISA] leaves it impotent to choose its version without [the Authority's] permission."[79] This was a violation of the private nondelegation doctrine "that forbids private entities from exercising unchecked government power"[80] because "[a]n agency does not have meaningful oversight if it does not write the rules, cannot change them, and cannot second-guess their substance."[81]

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74 15 U.S.C. § 3053(c)(1)-(2).
75 *Id*. at § 3053(c)(2).
76 *Nat'l Horsemen's Benevolent & Protective Ass'n v. Black* (*Horsemen's I*), 53 F.4th 869, 882-87 (5th Cir. 2022).
77 *Id*., 889-90.
78 *Id*., 889.
79 *Id*., 890, quoting *Sunshine Anthracite Coal Co. v. Adkins*, 310 U.S. 381, 399 (1940) (brackets in original).
80 *Id*., 873.
81 *Horsemen's I*, 872.

The Fifth Circuit drew distinctions between the (facially unconstitutional) FTC-Authority model established in the original HISA and the SEC-FINRA model established in the Moloney Act. A "key distinction" lies in the SEC's power to "abrogate, add to, and delete from FINRA rules as the [SEC] deems necessary appropriate to insure the fair administration of the self-regulatory organization."[82] "Said another way: although FINRA plays an important role in formulating securities industry rules, its role is ultimately 'in aid of' the SEC, which has the final word on the substance of the rules."[83]

Congress amended HISA to add a provision authorizing the FTC to "abrogate, add to, and modify the rules of the Authority . . . as they Commission finds necessary or appropriate to ensure the fair administration of the Authority . . .."[84] Although HISA was originally modeled on the Maloney Act, it lacked this provision until the amendment,[85] which "cured the nondelegation defect identified in *Horsemen's I*."[86]

In *Oklahoma v. United States* and *Horsemen's II*, Courts of Appeal considered private nondelegation challenges to the Authority's enforcement powers under the HISA. In *Oklahoma v. United States*, the Sixth Circuit considered the "line between impermissible delegation of unchecked lawmaking power to private entities and permissible participation by private entities in developing government standards and rules."[87]

The Sixth Circuit reasoned that "[a]n illuminating example comes from securities law. . . . The [Self-Regulatory Organization]s propose rules for the industry, and they initially enforce the rules through internal adjudication. The SEC oversees both the rulemaking and the enforcement."[88] Specifically, the Sixth Circuit noted that "[a]s to enforcement, the SEC applies fresh review to the SRO's decisions and actions."[89] It notes that "[i]n case after case, the courts have upheld this arrangement, reasoning that the SEC's ultimate control over the rules and their enforcement makes the SROs permissible aides and advisors."[90] It states that "[w]hether subordination always suffices to withstand a

[82] *Horsemen's I*, 887, citing 15 U.S.C. § 78s(c) internal quotations omitted.
[83] *Horsemen's I*, 887.
[84] 15 U.S.C. § 3053(e).
[85] *See* Consolidated Appropriations Act, 2023, Pub. L. 117-328, div. O, tit. VII, § 701, 136 Stat. 4459, 5231-32.
[86] *Nat'l Horsemen's Benevolent & Protective Ass'n v. Black* (*Horsemen's II*), 2024 U.S. App. LEXIS 16506, *13.
[87] *Oklahoma v. United States*, 62 F.4th 221, 228 (6th Cir. 2023).
[88] *Id*. at 229.
[89] *Id*., citing 15 U.S.C. § 78s(e); see *Sartain v. SEC*, 601 F.2d 1366, 1369-71 (9th Cir. 1979)
[90] *Id*., citing *R.H. Johnson & Co. v. SEC*, 198 F.2d 690, 695 (2d Cir. 1952); *Todd & Co.*, 557 F.2d at 1012-13; *First Jersey Secs., Inc. v. Bergen*, 605 F.2d 690, 697 (3d Cir. 1979); *Sorrell v. SEC*, 679 F.2d 1323, 1325-26 (9th Cir. 1982); *see also Amtrak I*, 721 F.3d at 671 n.5 (describing the SROs' role as "purely advisory or ministerial")

challenge raises complex separation of powers questions,"[91]—a position with which the concurrence "depart[s] slightly," arguing, "Whatever the exact underpinning of the private nondelegation doctrine, what is clear is that the statute is constitutional if the Authority remains subordinate to the FTC. . . . That is the beginning and end of the inquiry as to whether a statute is constitutional under the private nondelegation doctrine."[92]

This friction between the majority and the concurrence notwithstanding, the Sixth Circuit notes that the parties litigant accept the "subordination" test for the purpose of the appeal.[93] Noting that the amendment to the language of the HISA granting the FTC the "power to abrogate and change the Authority's rules creat[ting] a 'clear hierarchy,'"[94] it concludes that this rulemaking power also gives it "'pervasive' oversight and control of the Authority's enforcement activities."[95] "To ensure a fair enforcement process, the FTC could issue rules protecting covered persons from overbroad subpoenas," for example, or even "require that the Authority meet a burden of production before bringing a lawsuit or preclear the decision with the FTC."[96]

For the purpose of analogizing the Authority to FINRA enforcement, the shared features between the two organizations that the Sixth Circuit cites in support of its conclusion that the Authority is properly subordinate to the FTC include the following:

> [T]he FTC has full authority to review the Horseracing Authority's enforcement actions. [Citation]. After an independent review, the FTC may reverse the Authority's decision. [Citation.] As with rulemaking, so with adjudication: The Authority's adjudication decisions are not final until the FTC has the opportunity to review them. All told, the Horseracing Authority is "subject to [the FTC's] pervasive surveillance and authority," revealing that the Authority "operate[s] as an aid to the [FTC]," nothing more.[97]

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[91] *Id.*

[92] *Oklahoma v. United States*, 62 F.4th 221, 239 (6th Cir. 2023), citing *Adkins*, 310 U.S. at 388, 399 (holding a statute constitutional where the private entity is "an aid" to the agency and is "subject" to the agency's "pervasive surveillance and authority"); *Carter Coal*, 298 U.S. at 310-11 (invalidating a statute where private entities were granted the power to establish the maximum hours of labor without any governmental oversight or approval) (Cole, J., concurring).

[93] *Id.*, 229.

[94] *Id.*, 230.

[95] *Id.*, 231.

[96] *Id.*, 231.

[97] *Oklahoma v. United States*, 231 (internal citations omitted).

The concurring opinion posits that "[a]ll circuit courts that have ruled on the issue have held that the Maloney Act's enforcement scheme is constitutional where, as here, a private entity (the National Association of Securities Dealers ("NASD")) brought enforcement actions against covered entities."[98] It interprets that "[t]he unanimous principle from the circuit decisions—which the Supreme Court has not disturbed despite repeated opportunities to do so—is that so long as the agency retains de novo review of a private entity's enforcement proceedings, there is no unconstitutional delegation of legislative or executive power, even if the agency does not review the private entity's initial decision to bring an enforcement action.[99] Ultimately, the Supreme Court denied review to a petition for certiorari on, *inter alia*, the question of whether HISA violated the private non-delegation doctrine.[100]

In nearly a photo finish (less than two weeks after the petition for certiorari in *Oklahoma* was denied), the Fifth Circuit, "[w]ith great respect to [its] colleagues on the Sixth Circuit," disagreed with its conclusion on the constitutionality of the Authority[101]—but in doing so, pointed to several features of the SEC-FINRA model that render FINRA subordinate to the SEC (without expressing an "opinion on whether the SEC-FINRA relationship poses any constitutional issues under the private nondelegation doctrine (or any other doctrine)"[102]). It held that the Authority, which can "investigate potential violations, issue subpoenas, conduct searches, levy fines, and seek injunctions—all without the say-so of the agency—does not operate under that agency's 'authority and surveillance;'" therefore, it violates private nondelegation principles.[103] In deciding that the Authority wields enforcement power that is not subordinate to the FTC, the Fifth Circuit points to the Authority's ability to investigate potential violations, including by issuing subpoenas as well as the private nonprofit U.S. Anti-Doping Agency's ability to investigate, charge, and adjudicate rule violations and enforce civil sanctions for violations "on behalf of the Authority."[104] The Fifth Circuit reasons that the decisions to investigate a covered entity's potential violation of HISA's rules, to subpoena its records, whether to sanction it, and whether to sue it for an injunction or enforce a sanction are all examples of enforcing HISA.[105] By contrast, the

98 *Id.*, 243, citing *Sorrell v. SEC*, 679 F.2d 1323 (9th Cir. 1982); *First Jersey Sec., Inc. v. Bergen*, 605 F.2d 690 (3d Cir. 1979), cert. denied, 444 U.S. 1074 (1980); *R.H. Johnson & Co. v. SEC*, 198 F.2d 690 (2d Cir. 1952), cert. denied, 344 U.S. 855 (1952) (Cole, J, concurring).

99 *Id.*

100 *Oklahoma v. United States*, 2024 U.S. LEXIS 2724.

101 *Nat'l Horsemen's Benevolent & Protective Ass'n v. Black* (*Horsemen's II*), 107 F.4th 415, 431 (5th Cir. 2024).

102 *Id.*, 435 note 20.

103 *Id.*, 430.

104 *Id.*, 439.

105 *Horsemen's II*, 439.

HISA does not empower the FTC to decide whether to investigate an entity, whether to subpoena its records, whether to search its premises, whether to charge it with a violation, or whether to sanction or sue it.[106] Because Authority can do all this "all without the say-so of the agency," the fact that the FTC does not "retain[] the discretion to approve, disapprove, or modify the Authority's enforcement actions" led the Fifth Circuit to the conclusion the Authority does not operate under the FTC's "authority and surveillance."[107]

Addressing the issue of the FTC's ability to reverse a sanction imposed by the Authority, the Fifth Circuit reasons that this power does not make the Authority's enforcement power subordinate to the agency because it considers each of the acts taken by the Authority up to the point of the sanction being reversed—the investigation, subpoena, charging, adjudication, and fine—can occur without any supervision by the FTC and represent "enforcement" of HISA.[108] Even where a penalty is eventually reversed, it goes into effect as soon as the Authority makes its decision and the agency can only step in after the enforcement process has completed.[109]

On the issue of private entities' enforcement power, however, the Fifth Circuit distinguishes the Authority's enforcement role as "meaningfully different from FINRA's."[110] First, it points out that "Unlike the SEC-FINRA relationship, HISA does not give the FTC potent oversight power over the Authority's enforcement such as the power to enforce HISA itself, deregister the Authority as the enforcing entity, or remove its directors."[111]

Next, it points out that the SEC has the power to launch its own investigations of potential violations of the Maloney Act,[112] issue subpoenas,[113] and even "revoke FINRA's ability to enforce its rules [citation] and step in and enforce any written rule itself."[114] Unlike the FTC's inability to sue to enforce the HISA, the SEC alone has the power to bring civil suits to enforce the Maloney Act in federal court,[115] a power which the Fifth Circuit characterizes as "cut[ting] to the core of executive power."[116]

The last contrast the Fifth Circuit draws is the fact that the SEC "retains formidable oversight power to supervise, investigate, and discipline [FINRA]

106 *Id.*
107 *Id.*, 430.
108 *Id.*
109 *Id.*
110 *Horsemen's II*, 434.
111 *Id.*
112 *Id.*, citing 15 U.S.C. § 78u(a)(1).
113 Id., citing §§ 77s(c), 78u(c),
114 *Horsemen's II*, citing § 78s(g)(2) and § 78o(b)(4).
115 *Id.*, citing §§ 78u-1(a), 78u(d)(1),
116 *Id.*, citing *Buckley v. Valeo*, 424 U.S. 1, 138 (1976) ("A lawsuit is the ultimate remedy for a breach of the law, and it is to the President . . . that the Constitution entrusts [this] responsibility[.]")

for any possible wrongdoing or regulatory missteps."[117] "This 'formidable' power is manifest in the SEC's ability to derecognize FINRA's regulatory role entirely; remove FINRA board members for cause; remove any individual FINRA member; and bar any person from associating with FINRA."[118]

The distinctions the Fifth Circuit draws between the FTC-Authority relationship and the SEC-FINRA relationship illustrate ways in which FINRA's enforcement powers are subordinate to the SEC, despite the Fifth Circuit not stating that the SEC-FINRA model is an example of a constitutional delegation of powers.[119] Because the SEC-FINRA "structure has resulted in a finding that federal securities laws do not amount to an unconstitutional delegation by every court to consider the issue,"[120] and because even the Fifth Circuit (traditionally a court hostile to the authority of regulatory bodies) has used the SEC-FINRA relationship as a guide when discussing private nondelegation principles, it is likely to be upheld against a private nondelegation challenge even in a judicial climate that is skeptical of the constitutionality of regulatory bodies.

RIDIN' INTO THE SUNSET

Even in a judicial climate that shows increasing skepticism of regulatory authority, FINRA's structure and relationship with the SEC are likely to withstand the constitutional challenges leveled against it in *Alpine Securities v. SEC*. The reasoning of the Fifth and Sixth Circuits in *Nat'l Horsemen's Benevolent & Protective Ass'n v. Black* and *Oklahoma v. United States* suggests that FINRA may even be the model courts use to determine whether other SROs pass scrutiny when challenged on Appointments Clause and removal power grounds or the private nondelegation doctrine.

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117 *Id.*, 435, quoting *In re NYSE Specialists Sec. Litig.*, 503 F.3d 89, 101 (2d Cir. 2007).

118 *Id.*, internal citations omitted.

119 Following the Fifth Circuit's decision, the parties challenging the Authority's constitutionality petitioned the Supreme Court for rehearing of their petition for a writ of certiorari, arguing that there is "now a square and open conflict between the courts of appeal" on the question of "whether HISA violates the Constitution's private non-delegation doctrine," and as of the time of publication of this Article, the petition has not yet been ruled on. Oklahoma v. United States, SCOTUSblog, *https://www.scotusblog.com/case-files/cases/oklahoma-v-united-states/* (last visited Sept. 6, 2024).

120 *Scottsdale Capital Advisors Corp. v. Fin. Indus. Regul. Auth., Inc.*, 678 F. Supp. 3d 88, 107, (D.D.C. 2023), citing *Oklahoma v. United States*, 62 F.4th 221, 229 (6th Cir. 2023); *Sorrell v. SEC*, 679 F.2d 1323, 1325-26 (9th Cir. 1982); *First Jersey Secs., Inc. v. Bergen*, 605 F.2d 690, 697 (3d Cir. 1979); *Todd & Co. v. SEC*, 557 F.2d 1008, 1012-13 (3d Cir. 1977); *R.H. Johnson v. SEC*, 198 F.2d 690, 695 (2d Cir. 1952).

RECENT ARBITRATION AWARDS

Melanie Cherdack[1]

This issue's featured arbitration awards section begins with a spate of reasoned decisions. Each includes factual findings made by the arbitration panels to support their decisions. The first award is an explained Regulation Best Interest ("Reg BI") award tagging a broker-dealer for its recommendation of an account at an affiliate bank, where the broker dealer received a referral fee but did not open its own account for the customer. In a cautionary tale, another explained award imposes 1.8 million in attorney's fees where a customer lost a civil theft claim with a fee shifting provision. There is also a pair of explained awards granting relief to Claimants who purchased GWB L bonds, illustrating the wide disparity of fact finding done by panels who are tasked with drafting explained awards. The final two awards are unauthorized transfer cases, a scenario becoming more prevalent.

Stephen M. Groth v. U.S. Bancorp Investments, Inc.

Case No. 23-00823

Hearing Date: Feb 2—23 2024; June 18, 2024
Milwaukee, WI
Award Date: June 26, 2024

Counsel for Claimant:

> Sean M. Sweeney, Esq., and David Seth Hill, Esq., Halling & Cayo, S.C., Milwaukee, Wisconsin.

Counsel for Respondent:

> Michael N. Ungar, Esq., and Michael J. Charlillo, Esq., UBGreensfelder LLP, Cleveland, Ohio.

Arbitrator:

> Kevin J. Demet, Public Arbitrator, Presiding Chairperson
> Nathaniel Cade, Jr., Public Arbitrator
> Susan H. Schleisner, Non-Public Arbitrator

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[1] Melanie Cherdack is the Associate Director of the Investor Rights Clinic at the University of Miami School of Law. She would like to thank her wonderful research assistant, Elizabeth "Eba" Hendrickson, for her contributions to this article.

Issue: The causes of action relate to investments into the BTMIX Municipal Bond Fund.

Claimant's Claims:

Causes of Action in Statement of Claim:

(1) Breach of Fiduciary Duty;

(2) Negligence-Failure to Supervise; and

(3) Violation of Wisconsin Uniform Securities Law.

Relief Requested:

In the Statement of Claim:

(1) Compensatory damages in the amount of $557,108.19; and

(2) Rescission; statutory interest at 5% per annum from the date of purchase to present; attorneys' fees; refund all investment advisory fees charged by Respondent; and any other relief just and appropriate.

In the Statement of Answer:

(1) All claims against it be dismissed; and

(2) All costs assessed against Claimant and

At the hearing, Claimant requested: $700,000.00 plus attorneys' fees and 5% interest from the date of loss.

Other Issues Decided: On November 11, 2023, the Panel heard oral arguments on the Motion to Dismiss and issued an Order denying Respondent's Motion to Dismiss. At the conclusion of Claimant's case-in-chief, Respondent made a Motion to Dismiss claiming lack of jurisdiction of FINRA over Respondent. Claimant opposed the motion. After due deliberation, the Panel denied Respondent's Motion to Dismiss.

On January 31, 2024, Respondent filed a request for an explained decision which was granted.

Award

(1) Respondent is liable for and shall pay to Claimant the sum of $200,000.00 in compensatory damages.
(2) Any and all claims for relief not specifically addressed herein, including any requests for rescission, sanctions, and attorneys' fees, are denied.

Explained Award (excerpts)

The parties' experts both conceded that US Bank owed a fiduciary duty to Claimant and had complete discretion to manage Claimant's money under prudent investor standards, subject to any limitations that Claimant placed on his investments. They disagreed on whether USBI owed any duties to Claimant. USBI took the position that the wrong party was sued, USBI had no duties to Claimant, and Claimant only had a claim against US Bank. However,

> Regulation Best Interest applies to a retail customer that both receives a recommendation of any securities transaction or investment strategy involving securities by a broker-dealer and that uses that recommendation primarily for personal, family, or household purposes, and not simply those recommendations for which a broker-dealer receives compensation. In response to commenters, we interpret that a retail customer ''uses'' a recommendation of a securities transaction or investment strategy involving securities when, as a result of the recommendation: (1) The retail customer opens a brokerage account with the broker- dealer, regardless of whether the broker-dealer receives compensation, (2) the retail customer has an existing account with the broker- dealer and receives a recommendation from the broker-dealer, regardless of whether the broker-dealer receives or will receive compensation, directly or indirectly, as a result of that recommendation, or (3) the broker- dealer receives or will receive compensation, directly or indirectly as a result of that recommendation, even if that retail customer does not have an account at the firm.

When a retail customer opens or has an existing account with a broker-dealer the retail customer has a relationship with the broker-dealer and is therefore in a position to ''use'' (i.e., accept or reject) the broker-dealer's recommendation. In this context, tying ''use'' solely to a broker-dealer's receipt of compensation would inappropriately result in Regulation Best Interest not applying to the broker-dealer's recommendations to hold securities positions or to maintain an investment strategy (such as account type), recommendations to open an account, or recommendations that may ultimately be rejected by the retail customer.

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Respondent’s compliance officer later completed an affidavit dated September 7, 2023, where he again stated that USBI did not receive any commissions in connection with any transactions in Claimant’s US Bank’s wealth management account. This affidavit was once again referred to during the hearing as if there was no payment to USBI on account of Claimant’s business.

Notwithstanding the above response and affidavit, the Panel found otherwise. The trial exhibits and emails showed that USBI representatives were given incentive compensation on the placement of the Groth investments at US Bank and that USBI representatives were therefore compensated by the placement Claimant’s investments at US Bank. Claimant’s exhibits showed that the USBI representatives in Grafton received $33,633.01 in incentive compensation for selling the subject investments to Claimant.

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The Panel finds that FINRA Rule 12200 requires FINRA members and associated persons to arbitrate disputes under the FINRA Code when arbitration is “requested” by the customer and the dispute “arises in connection with the business activities of the member.” USBI contended that Claimant was not its customer. There were business activities of USBI with respect to the recommendations given to Claimant. Claimant would not have made these investments or been involved in them without the participation of USBI. Pursuant to this Rule, customers can compel registered members of FINRA to arbitrate certain disputes even when no written arbitration agreement exists.

Claimant requested an arbitration. USBI is bound to arbitrate by the Code.

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The SEC's Regulation Best Interest (Reg BI) under the Securities Exchange Act of 1934 establishes a "best interest" standard of conduct for broker-dealers and associated persons when they make a recommendation to a retail customer of any securities transaction or investment strategy involving securities, including recommendations of types of accounts. This standard is applicable to the USBI investment advisors, listed brokers and affiliated persons at US Bank who worked on Claimant’s account, to recommend the investments most suitable for his specific investment objectives.

> ...under the Care Obligation, a broker-dealer must exercise reasonable diligence, care, and skill when making a recommendation to a retail customer. The broker-dealer must understand potential risks, rewards, and costs associated with

> the recommendation. The broker-dealer must then consider those risks, rewards, and costs in light of the customer's investment profile and have a reasonable basis to believe that the recommendation is in the customer's best interest and does not place the broker-dealer's interest ahead of the retail customer's interest. A broker-dealer should consider reasonable alternatives, if any, offered by the broker-dealer in determining whether it has a reasonable basis for making the recommendation. Whether a broker-dealer has complied with the Care Obligation will be evaluated as of the time of the recommendation (and not in hindsight). When recommending a series of transactions, the broker- dealer must have a reasonable basis to believe that the transactions taken together are not excessive, even if each is in the customer's best interest when viewed in isolation. [2]

The Panel finds that the investment recommendations of Respondent USBI did not appropriately take into account Claimant's primary objective of principal preservation as stated by him at the outset and recorded in the notes. The municipal bond ladder had investments with a long maturity placing the portfolio at risk of downside. The investments were not appropriate because they risked Claimant's principal losses on the invested funds, should rates rise or even stay the same (some "income" was really amortized bond premium paid above the bond's face value), which was contrary to his primary stated objective. There was substantial interest rate risk in the municipal bond ladder that was recommended.

For Claimant's non-retirement accounts, likely a municipal money market fund would have been a more appropriate investment for Claimant, without the downside risk of BTMIX and the municipal bond ladder. For Claimant's retirement account, there were alternative investments with no downside risk. It is not clear why no such investments were considered that would have resulted in no loss of principal to Claimant, which, again, was his primary objective, above all others.

Analysis:

In this arbitration, one of the first Reg BI cases to go to an award in FINRA,

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[2] SECURITIES AND EXCHANGE COMMISSION,17 CFR Part 240,[Release No. 34–86031; File No. S7–07–18] RIN 3235–AM35, Regulation Best Interest: The Broker- Dealer Standard of Conduct

the Claimant prevailed even though he did not have an account at the Respondent firm. The rationale for this is set out in a reasoned award. The Respondent broker-dealer moved to dismiss the case arguing that it did not belong in FINRA arbitration as the Claimant did not have an account at the firm. In rejecting this jurisdictional defense, the unanimous panel of arbitrators noted that Reg BI does not require that the customer have an account at a member firm. Rather, FINRA Rule 12200 requires its members to arbitrate disputes under the FINRA Code when arbitration is "requested" and the dispute "arises in connection with the business activities of the member. The conduct constituted business activities of broker-dealer with respect to the recommendations given to Claimant. Further, Reg. BI was violated when the broker-dealer did not meet its "Care" obligation by recommending investments inconsistent with his primary objective of principal protection nor did the firm recommend alternatives to the investment recommended.

Lucy Chua and John Byrnes, as Trustees of the Yife Tien Irrevocable Dynasty Trust and Rocky Vista University, LLC v. INTL FCStone Financial, Inc., Stifel, Nicolaus & Company, Inc., RBC Capital Markets, LLC, Jandra Stephen Lubovich, Jon Cary Cooper, and Aaron Chaim Lupuloff

Case No. 18-02134

Hearing Date: Various between July 12, 2021-June 9, 2023
Miami, FL
Award Date: October 5, 2023

Counsel for Claimants:

Hendrik G. Milne, Esq. and Craig P. Kalil, Esq., Aballi Milne Kalil, P.A., Miami, Florida and Jonathan B. Butler, Esq., Jupiter, Florida.

Counsel for Respondents:

For Respondents INTL FCStone Financial, Inc. ("FCStone"), Stifel, Nicolaus & Company, Inc. ("Stifel"), Jandra Stephen Lubovich ("Lubovich"), Jon Cary Cooper ("Cooper"), and Aaaron Chaim Lupuloff ("Lupuloff"), collectively, "Respondents": Peter S. Fruin, Esq., Kathryn Roe Eldridge, Esq., T. Brannon Parker, Esq., and Matthew Bowness, Esq., Maynard Nexsen, Birmingham, Alabama.

For Respondent RBC Capital Markets, LLC ("RBC"): Katherine C. Donlon, Esq., Johnson, Newlon & Decort, P.A., Tampa, Florida.

Arbitration Panel:

Nanci Sondra Landy, Public Arbitrator, Presiding Chairperson
Meah Rothman Tell, Public Arbitrator

Seth L. Finkel, Public Arbitrator

Issue: Claimants asserted multiple causes of action related to Claimants' allegation that Respondents fraudulently sold to Claimants privately offered taxable revenue bonds, IREP Series 2014-A Bonds, misrepresenting and concealing numerous existing ongoing non-public financial and operating problems of the bond's issuer.

Claimants' Claims:

Causes of Action in Amended Statement of Claim:

(1) Fraudulent Misrepresentation and Omissions;

(2) Fraudulent Inducement;

(3) Conversion;

(4) Civil Theft;

(5) Breach of Fiduciary Duty;

(6) Failure to Supervise; and

(7) Breach of Commercial Honor and Just and Equitable Principles of Trade.

Relief Requested:

In the Amended Statement of Claim:

(1) Compensatory damages of $5,005,000. together with pre-judgment and post-judgment interest;

(2) Punitive damages of $15,015,000. pursuant to Fla. Stat.§ 768.73(1)(a)1;

(3) Treble damages of $15,015,000. pursuant to Fla. § Sec. 772.11;

(4) Rescission of the purchase agreement;

(5) Attorneys' fees, costs, forum fees, filing fees, arbitrator fees, expert fees, and other costs of investigation and arbitration;

(6) Declaratory judgement; and

(7) Such further and additional relief as the Panel may deem just and equitable, and as may be requested by Claimants at the final hearing.

At the hearing, Claimants requested damages of $18,848,229.

In the Statement of Answer:

Respondents requested:

(1) That the relief requested in the Statement of Claim be denied in all respects;

(2) That all references to this matter be expunged from Central Registration Depository ("CRD") registration records for Lubovich, Lupuloff, and Cooper; and

(3) That the costs of this proceeding be assessed against Claimants.

RBC requested:

(1) That the Panel dismiss it from the arbitration.

Award:

(1) Claimants' claims are denied in their entirety.

(2) Count IV of Claimants' Amended Statement of Claim alleged Civil Theft. Respondents were the prevailing parties on the Civil Theft claim. The Panel has determined that, pursuant to the Florida Civil Theft Statute (F.S. §772.11), Respondents are entitled to recover their attorneys' fees and costs and that the claims in the Amended Statement of Claim are inextricably intertwined. Pursuant thereto, Claimants are jointly and severally liable for and shall pay to Respondents the sum of $1,800,000.00 in attorneys' fees and $294,024.51 in costs

(3) The Panel recommends the expungement of all references to the above-captioned arbitration (Occurrence Number 1996695) from registration records maintained by the CRD for Respondent Aaron Lupuloff (CRD Number 1866423), with the understanding that, pursuant to Notice to Members 04-16, Respondent Aaron Lupuloff must obtain confirmation from a court of competent jurisdiction before the CRD will execute the expungement directive.

(4) The Panel recommends the expungement of all references to the

above-captioned arbitration (Occurrence Number 1995014) from registration records maintained by the CRD for Respondent Jandra Stephen Lubovich (CRD Number 5874882), with the understanding that, pursuant to Notice to Members 04-16, Respondent Jandra Stephen Lubovich must obtain confirmation from a court of competent jurisdiction before the CRD will execute the expungement directive.

(5) The Panel recommends the expungement of all references to the above-captioned arbitration (Occurrence Number 2021952) from registration records maintained by the CRD for Respondent Jon Cary Cooper (CRD Number 2643432) with the understanding that, pursuant to Notice to Members 04-16, Respondent Jon Cary Cooper must obtain confirmation from a court of competent jurisdiction before the CRD will execute the expungement directive.

(6) Any and all claims for relief not specifically addressed herein, including any requests for sanctions, punitive damages or treble damages, are denied.

In its explained award, the panel expunged the records of three registered representatives and made the affirmative findings of fact pursuant to FINRA Rule 2080 finding the claims were false or clearly erroneous findings based on the following facts:

> Specifically, JN testified at the hearing that she did not believe Lupuloff intentionally lied to her and that she always felt that he was an upstanding individual. Since the fraud alleged against Lupuloff was based on fraudulent representations and/or omissions he allegedly made when selling the bonds to JN, and JN specifically testified that she did not think that he lied to her, expungement is warranted under Rule 2080.
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> ***
>
> Lubovich never spoke to Claimants or their agents at Gables Capital Management ("Gables"). Lubovich did email JN of Gables before the closing date of the bond offering to answer any questions that she had. JN was also copied on numerous emails before the transaction closed discussing the transaction. JN never asked any questions of Lubovich or any other persons at Sterne Agee after her initial conversations with Lupuloff in April 2014. While Lubovich assisted in the preparation of the Limited Offering Memorandum and the Bond Purchase Agreement ("BPA"), none of the Claimants

read the documents, JN did not read any of the documents before the sale and Mr. M testified that he read the BPA, made changes to it but never asked any questions of Lubovich. Mr. M testified that he knew the offering was a private placement, knew it was potentially illiquid and tried to "bust the trade" based on the structure.

The Panel has found that there was no fraud on the part of Lubovich and that no fiduciary duty was owed by Lubovich. Therefore, based on these findings and the evidence discussed above, the Panel finds that the claims of fraudulent misrepresentation and omissions, fraudulent inducement, conversion, civil theft, and breach of fiduciary duty against Lubovich are false and should be expunged.

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Cooper supervised Lubovich; however, Cooper did not deal directly with the Claimants or their RIA. No evidence was presented that Cooper made any fraudulent misrepresentations or fraudulently omitted information. In fact, evidence was presented that Cooper had such high regard for the company issuing the bond that he tried to buy an ownership interest in the company approximately one year after the bond was sold.

The Panel has found that there was no fraud on the part of Cooper and that no fiduciary duty was owed by Cooper. Therefore, based on these findings and the evidence discussed above, the Panel finds that the claims of fraudulent misrepresentation and omissions, fraudulent inducement, conversion, civil theft, breach of fiduciary duty, and negligent supervision against Cooper are false and should be expunged.

Analysis:

This case is a cautionary tale. Not only did the Claimants lose, but the panel assessed $1,800,000 in attorneys' fees and $294,024.51 in costs against them under a fee shifting provision of Florida's civil theft statute will allows a defendant to recover reasonable attorney's fees and court costs in the trial and appellate courts upon a finding that the claimant raised a claim that was without substantial fact or legal support. *See* Fla Stat. § 772.11. This award is currently the subject of a motion to vacate.

Laurence Brown, Brown Family Maintenance Trust, Brown Revocable Trust, Donald M Brown Income Provider Trust, Robert Mecca, and Janice Mecca v. Ages Financial Services, Ltd.

Case No. 22-01908

Hearing Date: October 2, 2023
Boston, MA
Award Date: November 3, 2023

Counsel for Claimants:
Scott L. Silver, Esq., Silver Law Group, Coral Springs, Florida.

Counsel for Respondent:
Kirsten Patzer, Esq., Prince Lobel Tye LLP, Boston, Massachusetts.

Arbitration Panel:
Andrea J. Goldman, Public Arbitrator, Presiding Chairperson
Peter M. Cosel, Public Arbitrator
Stephen James McLaughlin, Public Arbitrator

Issue: The Claimants' causes of action relate to L Bonds issued by GWG Holdings, Inc. ("GWG") and investments in United Realty Capital Trust.

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Breach of Fiduciary Duty;

(2) Negligence and Negligent Misrepresentation;

(3) Breach of Contract; and

(4) Failure to Supervise.

Relief Requested:

In the Statement of Claim:

(1) Unspecified compensatory damages;

(2) Interest at the legal rate from the date of purchase;

(3) Punitive damages;

(4) Costs; and

(5) Such other relief as is just and proper.

In the Statement of Answer:

(1) That the Panel deny Claimants' Statement of Claim in its entirety, including all requests for relief and claims for damages.

Award:

(1) Respondent is liable for and shall pay to Claimants Laurence Brown, the Donald M Brown Income Provider Trust, the Brown Revocable Trust, and the Brown Family Maintenance Trust the sum of $209,180.41 in compensatory damages.

(2) Respondent is liable for and shall pay to Claimant Robert Mecca the sum of $36,933.12 in compensatory damages.

(3) Respondent is liable for and shall pay to Claimants interest on the above-stated sums at the rate of 12% per annum from the August 23, 2022, through and including the date of the award.

(4) Any and all claims for relief not specifically addressed herein, including any requests for punitive damages, are denied.

Arbitrators' Explained Decision:

The investments were inappropriate for the Brown family. Respondent did not properly inform Brown about the risks and did not discuss alternatives that would have better protected the trusts. Mecca stated that he was not properly informed about the degree of risk involved in the investment in GWG. The investments were not discussed in terms of quantitative suitability in relation to Claimants' overall portfolios. There was no follow-up after the letters were sent regarding the illiquid investments constituting greater than 10% of Claimants' overall portfolios.

Other Issues Considered and Decided:

During the hearing, Respondent made a Motion to Dismiss Claimant Janice Mecca as no evidence was presented regarding her claim, and she was absent from the hearing. After due deliberation, the Panel granted Respondent's Motion to Dismiss Claimant Janice Mecca on the grounds that no evidence was provided regarding her claim.

Analysis:

This explained award sets forth a simple and brief summary of the factual findings underlying the panel's decision to award damages. However, it is unclear as to which claims the Claimant prevailed on. It appears that risks of the investment as well as the percentage of the investment in the accounts were not disclosed. Additionally, the panel found that investments that would have been more suitable were not offered.

Ronald J. Inlow v. Michael Barrows, Eric J. Ludovico, and Mark Stewart

Case No. 22-01360

Hearing Date: September 11, 2023
Los Angeles, CA
Award Date: October 30, 2023

Counsel for Claimant:

Kalju Nekvasil, Esq, Goodman & Nekvasil, P.A., St. Petersburg, Florida.

Counsel for Respondents:

For Respondents Michael Barrows ("Barrows") and Eric J. Ludovico ("Ludovico"): Justin Chretien, Esq., Carlton Fields, PA, Washington, District of Columbia.

For Respondent Mark Stewart ("Stewart"): Nicholas J. Yocca, Nick Yocca Law Firm, Dana Point, California.

Arbitration Panel:

Stephen Howard Marcus, Public Arbitrator, Presiding Chairperson
Jason Moriarty, Public Arbitrator
Lawrence Wayne Sarokin, Public Arbitrator

Issue: Claimant asserted multiple causes of action related to GWG Holdings, Inc. L Bonds.

Claimant's Claims:

Causes of Action in Statement of Claim:

(1) Violations of Federal Securities Laws;

(2) Violations of California Securities Laws;

(3) Violations of California Unfair, Unlawful, and Fraudulent Business Practices;

(4) Breach of Contract;

(5) Common Law Fraud;

(6) Breach of Fiduciary Duty; and

(7) Negligence and Gross Negligence.

Relief Requested:

In the Statement of Claim:

(1) Actual damages;

(2) Rescissionary damages;

(3) Compensatory damages;

(4) Benefit of the bargain damages;

(5) Lost opportunity costs;

(6) Model portfolio damages;

(7) Prejudgment interest;

(8) Interest at the legal rate;

(9) Costs;

(10) Attorneys' fees;

(11) Non-economic damages;

(12) Punitive damages in an amount to be determined by the Panel;

(13) Recovery of damages in an amount to be determined by the Panel; and

(14) Such other relief as is deemed proper and necessary.

In the Statement of Answer:

(1) The Panel enter an award in Respondents' favor;

(2) Claimant's Statement of Claim be denied in its entirety with prejudice;

(3) All forum costs be assessed against Claimant;

(4) Attorneys' fees and experts' fees; and

(5) Such other and further relief as the Panel deems just and appropriate.

Award:

(1) Respondents Barrows and Ludovico are jointly and severally liable for and shall pay to Claimant the sum of $1,035,360.46 in compensatory damages, which includes interest from October 2, 2018 through July 31, 2023 at 7% per annum.

(2) Respondents Barrows and Ludovico are jointly and severally liable for and shall pay to Claimant interest on the above-stated sum at the rate of 7% per annum from August 1, 2023 through the date of this Award.

(3) All Respondents are jointly and severally liable for and shall pay to Claimant the sum of $10,655.68 in costs.

(4) All Respondents are jointly and severally liable for and shall pay to Claimant the sum of $400.00 to reimburse Claimant for the non-refundable portion of the filing fee previously paid to FINRA Dispute Resolution Services.

(5) Barrows' request for expungement of the above-captioned arbitration (Occurrence Number 2247853) from registration records maintained by the CRD is denied.

(6) Ludovico's request for expungement of the above-captioned arbitration (Occurrence Number 2247841) from registration records maintained by the CRD is denied.

(7) Stewart's request for expungement of the above-captioned arbitration (Occurrence Number 2225773) from registration records maintained by the CRD is denied.

(8) Any and all claims for relief not specifically addressed herein,

including any requests for punitive damages and attorneys' fees, are denied.

Other Issues Considered and Decided:

The Panel has provided an explanation of the decision in this award. The explanation is for the information of the parties only and is not precedential in nature.

Findings:

In the explained award, most of the seven legal claims were denied. The award provides the panel's analysis of all of the causes of action , as well as the competing claims for attorney's fees . The panel denied most of the claims asserted. It's reasoned award under the Securities Law violation is as follows:

Claimant's First Claim for Relief (Federal Securities Laws)

1. The evidence at the hearing did not establish any claim under the Securities Act of 1933 in that there was no evidence of any false statements or omissions being made by the issuer of the security (GWG Holdings, Inc.).

2. The Panel finds as follows:

a. Claimant has proven, by a preponderance of the evidence, a violation of section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder against Respondent Michael Barrows.

b. Claimant has proven, by a preponderance of the evidence, liability under Section 20(a) of the Securities Exchange Act of 1934 for the violation of Rule 10b-5, as a controlling person, against Respondent Eric J. Ludovico.

c. Claimant has not proven a claim for violation of section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder or as a controlling person under Section 20(a) of the Securities Exchange Act of 1934 against Respondent Michael Stewart.

[Note: In making this determination, the Panel concluded that, on the basis of the evidence presented, Claimant did not show by a preponderance of the evidence that the securities in question in this

case (GWG L-Bonds) was unsuitable for all customers, but did show by a preponderance of the evidence that such securities were unsuitable for Claimant Ronald J. Inlow in the quantities purchased.]

Authorities reviewed include: Section 20(a) of the Exchange Act, *Weller v. Scout Analytics, Inc*., 230 F. Supp. 3d 1085, 1096 (N.D. Cal. 2017); *Zucco Partners, LLC v. Digimarc Corp*., 552 F.3d 981, 990 (9th Cir. 2009); *Commodity Futures Trading Comm'n v. Monex Credit Co.,* No. SACV171868JVSDFMX, 2020 WL 1625808, at *4 (C.D. Cal. Feb. 12, 2020).

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Claimant's Sixth Claim for Relief – Breach of Fiduciary Duty

Under California law, based on the preponderance of evidence presented at the hearing, Claimant Ronald J. Inlow had a fiduciary relationship with Respondent Michael Barrows, but not with Respondents Eric J. Ludovico or Michael Stewart.

The Panel finds that Claimant has proven, by a preponderance of the evidence, that Respondent Michael Barrows has breached his fiduciary duty to Claimant Ronald J. Inlow in the sale of the securities at issue.

Analysis:

This case, like the *Inlow* case discussed above, sought an explained award. Read together, they demonstrate how differently panels can approach providing a reasoned award in each case. Here, it is clear that the damages awarded were under the Federal Securities Law claim under the Securities Exchange Act of 1934 and Rule 10b-5 as well as for a breach of fiduciary duty under California Law.

Raymond Schiff and Janice Schiff v. Charles Schwab & Co., Inc.

Case No. 23-01909J

Hearing Date: June 18-19, 2024
Atlanta, GA
Award Date: June 27, 2024

Counsel for Claimants:

Dennis E. Boyle, Esq., Boyle & Jasari, Washington, District of Columbia.

Counsel for Respondent:

Joshua D. Jones, Esq., Bressler, Amery & Ross, P.C., Birmingham, Alabama.

Arbitration Panel:

Harry G. Mason, Sole Public Arbitrator

Issue: The causes of action relate to Claimant's request to have Respondent reimburse them for a wire transfer

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Breach of contract;

(2) Negligence;

(3) Breach of the Bank Secrecy Act – 31 U.S.C. § 5318(h); and

(4) Failure to prevent financial exploitation of the elderly.

Relief Requested:

In the Statement of Claim:

(1) Compensatory damages in an amount to be proven but which are believed to be in excess of $94,000.00;

(2) Interest on all sums at the legal rate;

(3) Punitive damages;

(4) Attorneys' fees

(4) Costs; and

(5) Such other additional relief as deemed just and proper.

In the Statement of Answer:

(1) Arbitrator deny Claimants' claims in their entirety and recommend that all FINRA fees and costs be assessed against Claimants.

Award:

1. Respondent is liable for and shall pay to Claimants the sum of $47,000.00 in compensatory damages.
2. Any and all claims for relief not specifically addressed herein, including any requests for punitive damages and attorneys' fees, are denied.

Analysis:

This is one of a pair of recent awards in favor of a Claimant seeking reimbursement for a wrongful transfer that was sent as a result of fraud on the Claimant. Although the award did not reimburse the Claimant for the full amount, the sole arbitrator did assess a portion of the loss to Respondent. The sole arbitrator rejected the defense that the wire transfer document contained a hold harmless and indemnity clause absolving the Respondent.

Zhanling Liu v. Interactive Brokers, LLC

Case No. 23-02177

Hearing Date: June 3-4, 2024
Washington, DC
Award Date: June 19, 2024

Counsel for Claimant:

Scott Greco, Esq., Greco & Greco, P.C., Mclean, Virginia.

Counsel for Respondent:

Jovalin Dedaj, Esq. and Jason O. Billy, Esq., Interactive Brokers LLC, Greenwich, Connecticut.

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Arbitration Panel:
Nancy E. Watters, Sole Public Arbitrator

Issue: The causes of action relate to unauthorized withdrawals from Claimant's account with Respondent

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Negligence;

(2) Breach of contract;

(3) Violation of FINRA Rules ; and

(4) Breach of Fiduciary Duty

Relief Requested:

In the Statement of Claim:

(1) Compensatory damages in an amount of $48,880.09;

(2) Interest assessed up to the time of payment of the Award;

(3) Punitive damages in an amount to be determined by the Arbitrator;

(4) Costs;

(5) FINRA fees;

(6) Expert witness fees;

(7) 33/13 of compensatory damages as attorneys' fees; and

(8) Such additional relief as the Arbitrator deemed just and proper.

In the Statement of Answer:

(1) Arbitrator deny Claimants' claims in their entirety and recommend that all FINRA fees and costs be assessed against Claimants.

Award:

1. Respondent is liable for and shall pay to Claimant the sum of $48,880.09 in compensatory damages.

3. Respondent is liable for and shall pay to Claimant interest on the above-stated sum at the rate of 6% per annum from January 11, 2023, until payment of this Award.

4. Respondent is liable for and shall pay to Claimant the sum of $16,291.73 in attorneys' fees pursuant to paragraphs 17 and 33 of the parties' Customer Agreement, and Interactive Brokers LLC v. Saroop 969 F. 3d. 438, 445 (4th Cir. 2020), Connecticut law.
5. Respondent shall reimburse Claimant the sum of $150.00, which represents the non- refundable portion of the filing fee previously paid by Claimant.
6. Any and all claims for relief not specifically addressed herein, including any requests for punitive damages, and treble damages, are denied.

Analysis:

This is one of a pair of recent awards in favor of a Claimant seeking reimbursement for a wrongful transfer that was sent as a result of fraud on the Claimant. Although the award did not reimburse the Claimant for the full amount, the sole arbitrator did assess a portion of the loss to Respondent. The sole arbitrator rejected the defense that the wire transfer document contained a hold harmless and indemnity clause absolving the Respondent.

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 Hugh D. Berkson at hdb@mccarthylebit.com or Jennifer Shaw at jshaw@piaba.org for assistance.

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November 3, 2023

Via Email Only @ rule-comments@sec.gov

Ms. Vanessa Countryman
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: SR- FINRA– 2023–013– Proposed Rule Change to Revise and Restate the Qualifications for Representatives in Arbitrations and Mediations

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 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") to govern the conduct of securities firms and their representatives. In particular, our members and their clients have a strong interest in FINRA rules relating to FINRA's Code of Arbitration Procedure.

PIABA encourages the Commission to approve the proposed change to FINRA Rule 12208 which, if adopted, would revise and restate the qualifications for representatives in arbitrations and mediations administered by FINRA Dispute Resolution Services. It is PIABA's long-held belief that it is in the best interests of investors to disallow compensated non-attorney representatives ("NARs") from representing customer claimants in FINRA arbitration, with limited exceptions.

The proposed change to Rule 12208 would accomplish this meritorious goal by restricting the representation of customer claimants to attorneys in good standing, law students under the supervision of an attorney through a clinical program, or non-attorneys who are not being compensated (*e.g.*, a family member or close friend).

This new rule will protect customer investors from the risk of misconduct at the hands of NARs. Indeed, FINRA's Statement of Purpose highlights the dangers NARs pose, including that these NARs may be

engaging in the unauthorized practice of law. SR-2023-13, pp. 6-8. FINRA notes that NARs are not bound by attorney ethical codes of conduct, which has, in part, resulted in NARs requiring customer claimants to pay large non-refundable retainers, communications with NARs not being afforded the protection of the attorney-client privilege, NARs settling cases without the customer claimant's authorization, and even NARs representing customer claimants without their consent. *Id.* Further amplifying the potential harm posed by NARs is the fact that customer claimants abused by NARs are often left with little to no recourse, as NARs customarily do not maintain malpractice insurance.

Demonstrating that these issues are neither hypothetical nor rare, FINRA notes several specific examples of recent abuses suffered by customer claimants at the hands of compensated NARs. These have resulted in both civil and criminal actions being taken against the NARs. *Id*. FINRA astutely notes that by contrast, similar issues and allegations concerning law students and non-compensated NARs have not been identified.

Moreover, research by PIABA membership indicates that claimants using NARs actually get worse results in FINRA arbitration cases than had they simply pursued the claim on their own as a pro se litigant, both losing the claims more often and getting smaller recoveries when they did succeed.[1] As a result, PIABA does not believe that NARs are providing value to customers, while simultaneously exposing already injured investors to numerous risks of additional harm.

In sum, PIABA agrees with FINRA that it is appropriate to disallow compensated NARs from representing parties in arbitrations and mediations in the DRS forum and encourages the Commission to approve the proposed change to FINRA Rule 12208. I want to thank you for the opportunity to comment on this important issue.

Respectfully submitted,

Joseph C. Peiffer, President
Public Investors Advocate Bar Association

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[1] *See Ryan Cook, FINRA ARBITRATION CUSTOMER WIN-RATES: A SURVEY BY JURISDICTION,* PIABA B.J., Vol 24, No 1 (2017).

November 30, 2023

Via CFP Website

Leo Rydzewski
Certified Financial Planner
Board of Standards, Inc. 1425
K Street NW,# 800
Washington, DC 20005

Re: Proposed Changes to the Sanctions Guidelines and Fitness Standards

Dear Mr. Rydzewski:

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 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 CFP Board relating to both investor protection and disclosure.

We appreciate the opportunity to comment on proposed changes to the Sanction Guidelines and Fitness Standards developed by the CFP Board's Commission on Sanctions and Fitness. PIABA generally supports the rule proposals and hopes that these will strengthen investor protection for clients of CFP professionals. These guidelines will further serve to promote consistent application of the CFP rules and sanctions, while providing some flexibility to adjust any punishment based on the circumstances of each case.

PIABA supports the greatly expanded addition of aggravating and mitigating factors under the proposed revised sanctions guidelines. We believe that this common-sense approach will help the CFP Board adjust the punishment accordingly based on these factors.

PIABA also strongly supports the revised sanctions guidelines' increased punishment for certain conduct, such as lack of diligence, failure to disclose or manage conflicts of interest, a failure to exercise sound or objective professional judgment, violation of duty of confidentiality, or unauthorized outside business activities and private securities transactions. These are serious infractions (often with significant financial harm to clients) that deserve to have heightened sanctions and should not be tolerated. Investors who use these certified professionals are entitled

to a certain level of service and duty from their CFP, and increasing punishment for these offenses should help attain that. In this regard, PIABA applauds the CFP Board's proposals.

In addition, PIABA also supports the revised fitness standards for candidates for CFP certification and for those individuals seeking re-certification. Much like attorneys who are subject to certain fitness standards to be qualified for a state bar, these proposed fitness standards will provide more clarity to those seeking to become certified by the CFP Board. We appreciate the addition of certain felony convictions that would bar someone from qualifying for certification, such as perjury, obstruction of justice, and identity theft. While these seem like common sense, the addition ofthese proposed standards will promote greater confidence in certified professionals.

In sum, we support the CFP proposed sanctions guidelines and revised fitness standards.

PIABA thanks the CFP Board for the opportunity to comment on this proposal.

Very Truly Yours,

Joseph C. Peiffer, President
Public Investors Advocate Bar Association

December 15, 2023

Via Email Only @ rule-comments@sec.gov

Ms. Vanessa Countryman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
rule-comments@sec.gov

Re: SR-FINRA-2023-016
Proposed Rule Change to Amend FINRA Rule 2210 (Communications With the Public).

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 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 SR-FINRA-2023-16, FINRA proposes to change Rule 2210 (Communications with the Public) to Permit Projections of Performance of Investment Strategies or Single Securities in Institutional Communications.[1] Currently Rule 2210 prohibits projections of performance or targeted returns in member communications, subject to specified exceptions. The proposed rule change would allow a member to project the performance or provide a targeted return with respect to a security or asset allocation or other investment strategy in an institutional communication or a communication distributed solely to qualified purchasers as defined in the Investment Company Act of 1940 (''Investment Company Act'') that promotes or recommends specified non-public
offerings, subject to stringent conditions to ensure these projections are carefully derived from a sound basis.

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[1] *See* Federal Register/Vol. 88, No. 225/Friday, November 24, 2023/Notices

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PIABA strongly believes the "sound basis" requirement should be strictly adhered to and not just be window dressing to further a more liberal standard for communications. To that end, there must be a "reasonable basis for all assumptions, conclusions, and recommendations" contained in the illustration. Only then will FINRA's stated goal of assuring "the proposed rule amendment allowing projections or performance or targeted returns in specified communications not increase the potential harm to retail investors be met.[2]

PIABA also feels FINRA must keep a sharp eye on private placement sales abuses as the numbers of persons who can invest in private placements has increased substantially over the last several decades. By way of background, the SEC first established standards for qualifying as an "accredited" investor in 1982. This accredited investor standard included having a $1 million net worth or an income of $200,000 per year for individuals (or $300,000 per year for joint filers). By these standards, in 1982, only 1.8% of American households qualified as "accredited", while in 2013, this number had risen to 9.9%.[3] In a December 2019 statement, Commissioner Allison Herren Lee estimated that this accredited investor pool will grow to 22.7% of American households in the next decade.[4] PIABA is concerned that this enlarged the pool of "accredited" investors contains an increasing amount of investors that do not have the sophistication or financial wherewithal to adequately ascertain the risks of these investments. As such, due to this increased pool of "accredited" investors that lack the requisite financial sophistication to understand private placements and other non-standard financial products, the current proposed amendment may further increase the potential for abuse as these unsophisticated investors will also lack the financial wherewithal to understand the limitations of financial projections.

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[2] *Id.* at pg. 82483.

[3] *See* Commissioner Luis Aguilar's Statement on "Revisiting the 'Accredited Investor' Definition to Better Protect Investors at fn 3 (Dec. 17, 2014) (available at *https://www.sec.gov/news/statement/spch121714laa.html#_edn3*).

[4] *See* Commissioner Allison Herren Lee's "Statement on the Proposed Expansion of the Accredited Investor Definition" (Dec. 18, 2019) (available at *https://www.sec.gov/news/public-statement/statement-lee-2019-12-18-accredited-investor#_ftnref6*).

In summary, PIABA emphasizes FINRA must be mindful of the challenges accompanying this proposal and devote adequate resources to policing all communications while keeping mindful that any weakening of communication and accredited investor standards will only serve to harm individual investors.

Very truly yours,

Joseph C. Peiffer, President
Public Investors Advocate Bar Association

January 2, 2024

Via Federal eRulemaking Portal

Assistant Secretary Gomez Lisa M. Gomez
Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5655
U.S. Department of Labor
200 Constitution Ave. NW
Washington, D.C. 20210

Re: Retirement Security Rule; Definition of an Investment Advice Fiduciary
RIN 1210-AC02

Dear Assistant Secretary Gomez:

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 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 Department of Labor relating to investor protection and fiduciaries.

PIABA submits this comment to the above-referenced Department of Labor's rule proposal concerning the definition of investment advice fiduciary. PIABA generally supports this rule proposal and it believes the proposed rule changes would improve investor protection.

A prevailing theme of the financial services industry when they are soliciting the business of public investors is "trust us with your financial future." For example, Morgan Stanley advertises its "core values" to include "do the right thing" and "put clients first."[1] Merrill Lynch claims that "[Y]our advisor is someone who can be there for you for years to come, **providing more than just stock recommendations** and who will focus on your short-

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[1] Morgan Stanley, *About Us; Core Values*, at https://www.morganstanley.com/articles/why-you-may-need-a-trust (last visited December 22, 2023).

and long-term goals."[2] Edward Jones says that "[O]ur financial advisors know their clients best: what they need, what they value, and what it will take to help them achieve financially what is most important."[3] Many clients believe these claims, and entrust irreplaceable life savings and retirement accounts with financial services firms.

Unfortunately, when those accounts are mismanaged, these same firms have very different beliefs about their relationships with these clients. They claim that "putting clients first" does not mean they are held to the legal standard of fiduciaries. They argue that non-security investment products, such as equity indexed and fixed annuities, are not securities and therefore the brokers were "merely" acting as an insurance agent with a minimal duty of care, not even subject to a suitability rule. They insist that pervasive conflicts of interest between various related issuer companies and the sales force are not problems, even when the firms make recommendations which result in drastically larger commission payments to the broker.

PIABA believes that the proposed rule would reduce, if not necessarily eliminate, some of this double-talk between how firms market themselves to investors before the onset of a customer relationship compared to what they claim their duties are later. Clients are never told that certain investments or financial decisions that their broker is advising them on are subject to differing standards of care. As far as a public investor knows, they have one broker, and all of the conversations and recommendations from that broker have the same value and importance. Changing the rule to eliminate firms' purported legal defenses that different investment recommendations are subject to different legal rules, moves the industry towards what public investors already reasonably believe is true.

Unfortunately, the payment structure of the financial services industry is still largely transactional, commission-based. That means that some brokers will say or do anything they have to convince a public investor to roll over the client's retirement savings, which is often the vast majority of the client's entire life savings, to that broker's "management." But when the broker gets paid his commission from the assets moving over, suddenly he disappears. Having a different standard of care for a single transaction is counterintuitive. Public investors simply do not expect that to be the case, and there is no legitimate reason that it should be.

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[2] Merrill Lynch, *Our Advisors*, at https://www.ml.com/working-with-merrill-lynch-financial-advisor/our-advisors.html (last visited December 22, 2023) (emphasis added).

[3] Edward Jones, *Benefits of working with a financial advisor*, https://www.edwardjones.com/us-en/working-financial-advisor/benefits-working-financial-advisor (last visited December 22, 2023).

Additionally, recommendations to a plan sponsor should not be governed by a different standard of care. A small business owner having a discussion with his advisor about which funds to invest in his personal savings account in the corporate plan should not carry a different standard than that same business owner having a conversation with that same advisor about whether or not he should make changes to the plan itself. These rules and regulations should match what the reasonable expectations of the investing public are, rather than creating a patchwork system where there are hidden traps left for consumers who are unaware that certain types of advice they receive from their broker are not held to same strict standard of care as other advice they receive from the same broker.

PIABA thanks the Department for the opportunity to comment on this proposal.

Very Truly Yours,

Joseph C. Peiffer, President
Public Investors Advocate Bar Association

January 29, 2024

The Honorable Nick Hoheisel, Chair
House Committee on
Financial Institutions and Pensions
House of Representatives
Kansas State Capitol
300 S.W. 10th St.
Topeka, Kansas 66612
H.Financial@house.ks.gov

Re: Kansas House Bill No. 2562

Dear Chair Hoheisel:

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's mission has been to promote the interests of the public investor by, among other things, seeking to protect such investors from failing prey to investment fraud, and advocating for public education related to investment fraud and industry misconduct. As such, PIABA frequently comments upon proposed legislation in order to protect the rights and fair treatment of the investing public.

PIABA strongly supports Kansas House Bill No. 2562, which proposes to adopt the NASAA Model Act to Protect Vulnerable Adults from Financial Exploitation ("Model Act") and urges its approval.

Financial exploitation of older adults is a widespread and serious problem that impacts every community, culture, and ethnic group in the country. The Consumer Financial Protection Bureau and Department of Justice describe financial exploitation as the most common form of elder abuse in the United States.[1] Older adults own a disproportionate share of financial assets in the country and are most at risk for acute cognitive decline. Moreover, with the aging of the Baby Boom generation, this problem is likely to increase further, as it is projected that 74 million people representing 20% of the United States population will be aged 65 or older by 2030.[2]

Recognizing this growing problem, state and federal securities regulators have been issuing new rules and legislation designed to detect and

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[1] *See* Consumer Financial Protection Bureau, *Suspicious Activity Reports on Elder Exploitation* (February 2019), p 8.
[2] *See* J. Vespa, et. al., *Demographic Turning Points for the United States: Population Projections for 2020 to 2060* (February 2020), U.S. Census Bureau, available at https://www.census.gov/library/publications/2020/demo/p25-1144.html.

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prevent it.[3] In 2016, the North American Securities Administrators Association ("NASAA") approved the Model Act as a model regulation for states to adopt as way to address the increasing problem of the financial exploitation of older adults. The Model Act has been a great success with 38 jurisdictions enacting state laws that are modeled on or informed by provisions included in the Model Act.

Kansas House Bill No. 2562 would amend the Kansas Securities Act to incorporate aspects of the Model Act's five core features: (1) a mandatory reporting requirement applicable to qualified individuals of broker-dealers and investment advisors; (2) notification to certain third parties of potential financial exploitation with advance consent of the investor; (3) the authority to temporarily delay the disbursement of funds; (4) immunity from civil and administrative liability for reporting, notifications and delays; and (5) mandatory record-sharing in cases of exploitation with law enforcement and state adult protective services agencies.

PIABA believes that these provisions enhance investor protection and the protection of older and elderly Kansas residents from financial exploitation and elder abuse by giving Kansas state regulators and industry participants within the state new tools to combat and prevent such financial exploitation from occurring. It would also bring Kansas into line with the vast majority of states, including all four neighboring states, that have adopted provisions and protections of the Act. We urge you to pass this legislation and thereby enhance the investor protection of elderly Kansas residents.

Very truly yours,

Joseph C. Peiffer, President
Public Investors Advocate Bar Association

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[3] *See* FINRA Rules 2165 (Financial Exploitation of Specified Adults) and 3240 (Borrowing from or Lending to Customers) and recent revisions adopted thereto.

February 12, 2024

Via Email Only @ *rule-comments@sec.gov*

Ms. Vanessa Countryman
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

File Number SR–FINRA–2024–001– Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change To Amend FINRA Rule 3240 (Borrowing From or Lending to Customers)

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 securities litigation. 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.

PIABA welcomes the opportunity to comment on FINRA's proposed amendments to FINRA Rule 3240. In October 2019, PIABA commented on FINRA's retrospective review that, among other things, sought feedback on the effectiveness of FINRA Rule 3240. In February 2022, PIABA commented on FINRA Regulatory Notice 21-43, which contained most of the same proposed amendments to Rule 3240 that are part of FINRA's current proposal.[1]

PIABA reiterates its support for FINRA's proposed amendments to Rule 3240, which would strengthen the rule and prohibition on borrowing from or lending to customers. As PIABA previously commented, strengthening the rule to broaden and apply it to borrowing or lending arrangements that pre-exist the broker-customer relationship is a good amendment that will protect investors. Conflicts of interest would exist in the relationship irrespective of whether or

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[1] *See* PIABA Comment Letter to Jennifer Piorko Mitchell, FINRA Regulatory Notice 21-43 (February 14, 2022), attached as part of exhibit 2b (pages 111-112) to FINRA's Rule Proposal.

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not a lending arrangement existed before or after the broker-customer relationship is established. PIABA supports making clear that if a broker is already in a non-exempt lending relationship with a person that said person may not become a client.

As PIABA previously stated, we think it is a good idea to make clear that the prohibition extends to not just the registered person themselves but also to a person or entity related to the registered person. The same or very similar conflict of interest is present if a registered representative's close family member obtains a loan from a registered representative's client just as if the registered representative obtained it themselves.

PIABA is also in favor of modernizing the "immediate family" definition and limiting the "personal relationship" and "business relationship" exceptions. The risk of harm here is too great to leave the potential for abuse. PIABA commends any effort to limit the exceptions and make very clear that this conduct is not allowed.

Finally, PIABA supports extending the definition of customer to those with existing accounts and those who had accounts with a registered person previously. However, PIABA believes that rather than including only customers who had accounts with a registered representative in the previous six months, that this cooling off period should be set at one year. PIABA does not believe the extension of the lookback period from six months to one year imposes an unreasonable or inappropriate burden on firms having to track customer accounts. Moreover, a one year lookback period would match the restricted firm obligation time period in FINRA Rule 4111, would curtail attempts to evade this rule and would most importantly enhance investor protection to a greater degree than the proposed six month time period.

PIABA thanks the Commission and FINRA for the opportunity to comment on this proposal. In sum, PIABA applauds FINRA's effort to root out the problem that taking loans from clients or lending money to clients presents and urges FINRA to continue its efforts to curb this abusive conduct.

Very Truly Yours,

Joseph C. Peiffer, President
Public Investors Advocate Bar Association

March 5, 2024

The Honorable Jeff Longbine, Chair
Senate Committee on Financial Institutions and Insurance
Kansas State Capitol
300 S.W. 10th St.
Topeka, Kansas 66612
S.Financial.Insurance@senate.ks.gov

Re: Kansas House Bill No. 2562

Dear Chair Longbine:

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's mission has been to promote the interests of the public investor by, among other things, seeking to protect such investors from failing prey to investment fraud, and advocating for public education related to investment fraud and industry misconduct. As such, PIABA frequently comments upon proposed legislation in order to protect the rights and fair treatment of the investing public.

PIABA strongly supports Kansas House Bill No. 2562, which proposes to adopt the NASAA Model Act to Protect Vulnerable Adults from Financial Exploitation ("Model Act") and urges its approval.

Financial exploitation of older adults is a widespread and serious problem that impacts every community, culture, and ethnic group in the country. The Consumer Financial Protection Bureau and Department of Justice describe financial exploitation as the most common form of elder abuse in the United States.[1] Older adults own a disproportionate share of financial assets in the country and are most at risk for acute cognitive decline. Moreover, with the aging of the Baby Boom generation, this problem is likely to increase further, as it is projected that 74 million people representing 20% of the United States population will be aged 65 or older by 2030.[2]

Recognizing this growing problem, state and federal securities regulators have been issuing new rules and legislation designed to detect and

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[1] *See* Consumer Financial Protection Bureau, *Suspicious Activity Reports on Elder Exploitation* (February 2019), p 8.
[2] *See* J. Vespa, et. al., *Demographic Turning Points for the United States: Population Projections for 2020 to 2060* (February 2020), U.S. Census Bureau, available at https://www.census.gov/library/publications/2020/demo/p25-1144.html.

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prevent it.[3] In 2016, the North American Securities Administrators Association ("NASAA") approved the Model Act as a model regulation for states to adopt as way to address the increasing problem of the financial exploitation of older adults. The Model Act has been a great success with 38 jurisdictions enacting state laws that are modeled on or informed by provisions included in the Model Act.

Kansas House Bill No. 2562 would amend the Kansas Securities Act to incorporate aspects of the Model Act's five core features: (1) a mandatory reporting requirement applicable to qualified individuals of broker-dealers and investment advisors; (2) notification to certain third parties of potential financial exploitation with advance consent of the investor; (3) the authority to temporarily delay the disbursement of funds; (4) immunity from civil and administrative liability for reporting, notifications and delays; and (5) mandatory record-sharing in cases of exploitation with law enforcement and state adult protective services agencies.

PIABA believes that these provisions enhance investor protection and the protection of older and elderly Kansas residents from financial exploitation and elder abuse by giving Kansas state regulators and industry participants within the state new tools to combat and prevent such financial exploitation from occurring. It would also bring Kansas into line with the vast majority of states, including all four neighboring states, that have adopted provisions and protections of the Act. We urge you to pass this legislation and thereby enhance the investor protection of elderly Kansas residents.

Very truly yours,

Joseph C. Peiffer, President
Public Investors Advocate Bar Association

[3] *See* FINRA Rules 2165 (Financial Exploitation of Specified Adults) and 3240 (Borrowing from or Lending to Customers) and recent revisions adopted thereto.

May 8, 2024

Via Email Only @ rule-comments@sec.gov

Ms. Hester M. Peirce
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Proposal to Amend FINRA's Codes of Arbitration Procedure and Code of Mediation Procedure to Modify the Qualification for Representatives in Arbitrations and Mediations

Dear Ms. Peirce:

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 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") to govern the conduct of securities firms and their representatives. In particular, our members and their clients have a strong interest in FINRA rules relating to FINRA's Code of Arbitration Procedure.

As stated in a prior comment letter (dated November 3, 2023), PIABA encouraged the Commission to approve the proposed change to FINRA Rule 12208 revising and restating the qualifications for representatives in arbitrations and mediations administered by FINRA Dispute Resolution Services. It was and still is PIABA's long-held belief that it is in the best interests of investors to disallow compensated non-attorney representatives ("NARs") from representing customer claimants in FINRA arbitration, with limited exceptions. A notable exception being allowing law students, working through a recognized clinic program, with licensed attorney supervision (the subject of this comment letter). PIABA concurs with the commission this exception should help fill a gap in representation for Claimants, often with smaller claims, that might otherwise be unable to obtain it. As such, we support the codifying of this exception.

In sum, PIABA supports modifying the Codes of Arbitration and Mediation procedure to permit law students, under the supervision of an attorney through a clinical program, to represent Claimants in these respective FINRA forums. I want to thank you for the opportunity to comment on this important issue.

Respectfully submitted,

Joseph C. Peiffer, President
Public Investors Advocate Bar Association

June 18, 2024

Via Email Only @ rule-comments@sec.gov

Ms. Vanessa Countryman
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: SR- FINRA-2024-008
Proposed Rule to Amend FINRA Rule 12800 (Simplified Arbitration) to Clarify and Amend the Applicability of the Document Production Lists.

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 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") to govern the conduct of securities firms and their representatives. In particular, our members and their clients have a strong interest in FINRA rules relating to FINRA's Code of Arbitration Procedure.

Background

FINRA is proposing to Amend the FINRA Code of Arbitration Procedure for Customer Disputes (''Customer Code'') to clarify and, in some instances, amend the applicability of the Document Production Lists to simplified customer arbitrations and special proceedings administered under FINRA Rule 12800.

Discussion/Position

In keeping with the association's overriding goal of investor protection, PIABA views any proposed FINRA rule change in terms of how it will promote that mission. PIABA believes this proposal is in keeping with that goal and is in favor of the proposed amendments. Specifically, PIABA shares FINRA's concern as stated in its Rule Proposal that *pro se* customers may not know what documents to request from opposing parties in arbitrations, and providing these claimants with options for Document Production Lists would increase awareness and understanding of the discovery process, which

is the critical part of any arbitration in the DRS forum to receive material and relevant information to prosecute claims. Further, PIABA would be in favor of applying document production lists in all simplified cases unless the customer/investor chooses to opt out at the outset of the proceeding. PIABA is aware of FINRA providing *pro se* customers with resources on its website[1] for representing themselves, and supplements to this webpage and other resources like these informing claimants about Document Production Lists in congruence with this rule aligns with FINRA's mission of protecting investors.

In sum, PIABA supports amending Rule 12800, Code of Arbitration Procedure, to allow and clarify when Document Production Lists are permitted in Simplified Arbitration proceedings.

I want to thank you for the opportunity to comment on this important issue.

Very Truly Yours,

Jospeh C. Peiffer, President
Public Investors Advocate Bar Association

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[1] FINRA, *Resources for Individuals Representing Themselves*, at *https://www.finra.org/arbitration-mediation/about/pro-se* (accessed June 17, 2024).

September 17, 2024

Via Email Only @ rule-comments@sec.gov

Ms. Vanessa Countryman
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Proposal to Amend FINRA's Rule 12800 (Simplified Arbitration) To Clarify and Amend the Applicability of the Document Production Lists.

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 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") to govern the conduct of securities firms and their representatives. In particular, our members and their clients have a strong interest in FINRA rules relating to FINRA's Code of Arbitration Procedure.

Background

FINRA has submitted notice of Filing of Partial Amendment No. 1 and Order Instituting Proceedings To Determine Whether To Approve or Disapprove a proposed rule change as Modified by Partial Amendment 1 to Amend the FINRA Code of Arbitration Procedure for Customer Disputes (''Customer Code'') to clarify and, in some instances, amend the applicability of the Document Production Lists to simplified customer arbitrations administered under FINRA Rule 12800. PIABA previously commented on the initial rule proposal on or about June 18, 2024.

Discussion/Position

In keeping with the association's overriding goal of investor protection, PIABA views any proposed FINRA rule change in terms of how it will promote that mission. The proposed rule change, as subsequently modified by Patial Amendment No. 1, would address the applicability of the Document Production Lists to simplified customer arbitrations administered under FINRA Rule 12800. PIABA believes this proposal is in keeping with that goal and is in favor of the proposed amendments and subsequent

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modification. Further, PIABA would be in favor of applying document production lists in all simplified cases unless the customer/investor chooses to opt out at the outset of the proceeding.

In sum, PIABA supports Partial Amendment No. 1 to the proposed amending of Rule 12800, Code of Arbitration Procedure, to allow and clarify when Document Production Lists are permitted in Simplified Arbitration proceedings.

I want to thank you for the opportunity to comment on this important issue.

Very Truly Yours,

Joseph C. Peiffer, President
Public Investors Advocate Bar Association