

PIABA 30th Annual Meeting

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THE FINANCIAL INDUSTRY REGULATORY AUTHORITY'S DISPUTE RESOLUTION ACTIVITIES

Revised August 2, 2021

I. BACKGROUND

The Financial Industry Regulatory Authority (FINRA) administers a dispute resolution forum for investors, brokerage firms, and their registered employees in the U.S. through its network of 69 hearing locations, including at least one in each state and Puerto Rico. FINRA administers between 3,500 and 8,500 arbitrations and numerous mediations annually. FINRA maintains a diverse roster of over 8,000 arbitrators and 270 mediators. The National Arbitration and Mediation Committee (NAMC), which is composed of investor, industry, and neutral (arbitrator and mediator) representatives, provides policy guidance to FINRA's Dispute Resolution staff. A majority of the NAMC members and its chair are public. FINRA is regulated by the United States Securities and Exchange Commission (SEC).

FINRA's Dispute Resolution program is administered out of four regional offices: Northeast, Southeast, Midwest, and West, located in New York City, Boca Raton, Chicago, and Los Angeles, respectively, with headquarters in New York City. Contact information for the regional offices, as well as for other FINRA staff, is available on FINRA's website [here](#). Below is a map showing the hearing locations and the regional offices to which they are generally assigned:



Below are highlights on: Statistics and Trends; FINRA's Response to COVID-19; Recent Significant Rule Changes; Proposed Rule Changes; Regulatory Notice on Forum Selection; Significant Initiatives; FINRA Neutrals; Technology Initiatives; and Mediation.

II. STATISTICS AND TRENDS

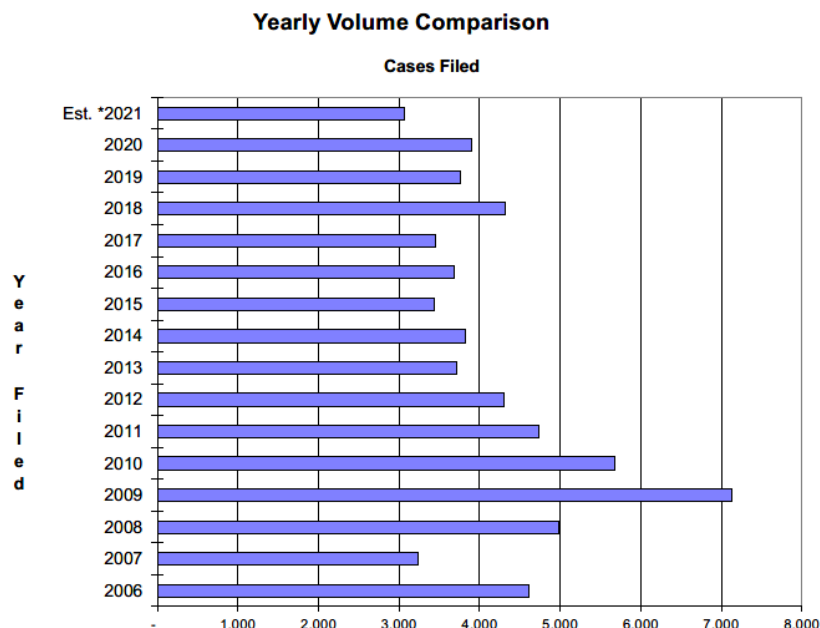
Arbitration case filings decreased in June 2021 compared to June 2020. In June 2021, parties filed 1,533 cases – an 18% decrease from the 1,880 cases filed in June 2020. Customer claims decreased in June 2021 compared to June 2020. In June 2021, 34% of filed claims were intra-industry cases.

Mediation cases decreased in June 2021 compared to June 2020. In June 2021, 223 mediation cases were filed compared to 241 in June 2020.

Case Filing Statistics for June 2021 - This section provides key filing data and trends.

Overall Arbitration Case Filings:

June 2021: 1,533 (18% decrease compared to June 2020).



Overall Mediation Case Filings:

June 2021: 223 (7% decrease compared to June 2020).

Customer Award Statistics

Cases in which customers were awarded damages in June 2021:

- Overall: 29% (32% in 2020, 45% in 2019, and 40% in 2018).
- Regular Hearing cases (not including cases decided by Special Proceeding or review of documents only): 37% (34% in 2020, 45% in 2019 and 42% in 2018).

Case Processing Statistics

Processing times from service of the claim to close of the case in June 2021:

- Overall: 13.7 months (10% decrease compared to June 2020).
- Hearing cases: 15.2 months (2% increase compared to June 2020).
- Paper cases (decided on the documents submitted without a hearing): 5.4 months (6% increase compared to June 2020).
- Special Proceeding cases: 8.1 months (14% increase compared to June 2020).

Percentage of all arbitration cases closed by award in June 2021:

- 13% (compared to 13% in 2020, 16% in 2019 and 17% in 2018).
- In June 2021, customer cases closed by settlement approximately 74% of the time.

FINRA Dispute Resolution Services
Top 15 Controversy Types in Customer Arbitrations Through June

Type of Security *		2021 Cases Served	2020	2019	2018	2017
Breach of Fiduciary Duty	Through June	786	842	981	1,183	920
	Year-End	--	1,714	2,053	2,290	1,899
Negligence	Through June	735	763	884	973	816
	Year-End	--	1,592	1,826	1,974	1,662
Misrepresentation	Through June	644	679	742	984	771
	Year-End	--	1,384	1,688	1,775	1,663
Failure to Supervise	Through June	627	713	818	959	794
	Year-End	--	1,433	1,731	1,935	1,621
Breach of Contract	Through June	597	623	722	830	641
	Year-End	--	1,292	1,563	1,711	1,318
Suitability	Through June	530	629	708	1,021	774
	Year-End	--	1,220	1,580	1,779	1,606
Omission of Facts	Through June	529	593	664	852	684
	Year-End	--	1,215	1,468	1,547	1,493
Fraud	Through June	390	506	695	864	639
	Year-End	--	918	1,499	1,707	1,389
Violation of Blue Sky Laws	Through June	192	153	291	397	228
	Year-End	--	338	657	810	547
Manipulation	Through June	165	170	166	128	138
	Year-End	--	316	384	302	299
Unauthorized Trading	Through June	90	91	106	128	146
	Year-End	--	190	197	245	263
Elder Abuse	Through June	80	91	101	117	0
	Year-End	--	172	207	216	61
Errors-charges	Through June	79	42	33	45	23
	Year-End	--	102	98	81	66
Churning	Through June	50	73	91	102	127
	Year-End	--	115	167	205	219
Margin Calls	Through June	45	29	50	38	30
	Year-End	--	68	88	85	62

* Each case can be coded to contain multiple controversy types. Therefore the columns in this table cannot be totaled to determine the number of cases served in a year.

FINRA Dispute Resolution Services
Top 15 Security Types in Customer Arbitrations Through June

Type of Security *		2021 Cases Served	2020	2019	2018	2017
Common Stock	Through June	244	196	243	324	297
	Year-End	--	385	436	579	604
Real Estate Investment Trust	Through June	228	136	112	91	103
	Year-End	--	421	236	205	177
Business Development Company	Through June	115	24	13	6	5
	Year-End	--	218	26	20	14
Mutual Funds	Through June	94	95	265	341	193
	Year-End	--	177	526	731	447
Options	Through June	87	97	118	103	63
	Year-End	--	180	204	150	127
Private Equities	Through June	84	145	63	54	69
	Year-End	--	213	149	111	111
Limited Partnerships	Through June	76	84	53	77	98
	Year-End	--	146	128	144	183
Annuities	Through June	44	38	49	51	58
	Year-End	--	93	97	101	115
Variable Annuities	Through June	41	48	53	51	73
	Year-End	--	95	109	105	129
Exchange-Traded Funds	Through June	36	51	60	104	74
	Year-End	--	95	138	167	131
Municipal Bond Funds	Through June	33	81	338	446	205
	Year-End	--	136	717	959	558
Corporate Bonds	Through June	32	38	44	70	57
	Year-End	--	79	74	135	119
Municipal Bonds	Through June	30	98	331	462	209
	Year-End	--	148	702	971	565
401(k)	Through June	18	41	26	45	38
	Year-End	--	73	58	94	69
Structured Products	Through June	16	24	24	41	21
	Year-End	--	35	60	78	45

* Each case can be coded to contain multiple security types. Therefore the columns in this table cannot be totaled to determine the number of cases served in a year.

FINRA Dispute Resolution Services Top 15 Controversy Types in Intra-Industry Arbitrations Through June						
Type of Security *		2021 Cases Served	2020	2019	2018	2017
Breach of Contract	Through June	142	157	175	177	203
	Year-End	--	309	345	413	403
Promissory Notes	Through June	72	127	120	135	138
	Year-End	--	229	240	261	296
Libel or Slander on Form U-5	Through June	46	73	60	77	64
	Year-End	--	148	119	135	136
Compensation	Through June	47	72	71	79	77
	Year-End	--	135	135	168	161
Wrongful Termination	Through June	33	54	55	65	59
	Year-End	--	101	102	122	116
Commissions	Through June	27	38	40	42	56
	Year-End	--	72	82	95	103
Libel, Slander, or Defamation	Through June	24	73	74	90	51
	Year-End	--	152	135	166	117
Discrimination or Harassment**	Through June	18	20	26	24	16
	Year-End	--	38	46	38	37
Breach of Fiduciary Duty	Through June	13	13	22	25	17
	Year-End	--	31	30	39	52
Raiding Disputes	Through June	8	13	11	18	14
	Year-End	--	28	21	37	33
Misrepresentation	Through June	4	27	26	42	12
	Year-End	--	57	29	68	54
Suitability	Through June	3	41	15	53	12
	Year-End	--	82	17	63	59
Fraud	Through June	3	11	9	13	7
	Year-End	--	16	11	24	26
Omission of Facts	Through June	3	7	12	8	8
	Year-End	--	11	14	18	16
Failure to Supervise	Through June	3	4	4	6	5
	Year-End	--	10	7	11	13

* Each case can be coded to contain multiple controversy types. Therefore the columns in this table cannot be totaled to determine the number of cases served in a year.

Comparison of Results of All-Public Panels and Majority-Public Panels in Customer Claimant Cases

Year Decided	Cases Decided by All-Public Panels	Number of Cases Decided by All-Public Panels Where Customer Awarded Damages	Percentage of Cases Decided by All-Public Panels Where Customer Awarded Damages	Cases Decided by Majority-Public Panels	Number of Cases Decided by Majority-Public Panels Where Customer Awarded Damages	Percentage of Cases Decided by Majority-Public Panels Where Customer Awarded Damages
2016	145	63	43%	72	26	36%
2017	137	66	48%	71	26	37%
2018	158	67	42%	58	27	47%
2019	149	79	53%	47	13	28%
2020	76	25	33%	26	6	23%
YTD 2021	42	17	40%	17	5	29%

In June 2021, investors prevailed 40% of the time (17 out of 42 cases) in cases decided by all-public panels and 29% of the time (5 out of 17 cases) in cases decided by majority-public panels. To find more information on case statistics and award outcomes please visit the [Dispute Resolution Statistics](https://www.finra.org/dispute-resolution/statistics) page at FINRA.org.

III. FINRA'S RESPONSE TO COVID-19

Thanks to a strong Technology team and broad remote-work functionality already in place, FINRA was well equipped for this unforeseen challenge and we remain fully operational during this time. We successfully migrated our staff to full-time remote work without issue and without impacting our productivity. We lost no time in making the necessary changes to ensure that all aspects of our claim intake, case processing, award tracking, and suspension processes remain intact and operational.

Impact on Arbitration and Mediation Hearings

Beginning August 2, 2021, FINRA DRS will reopen all of its hearing locations for in-person arbitration and mediation proceedings. Previously, FINRA DRS announced the resumption of in-person hearings in 62 of 69 hearing locations, effective July 5. In-person hearings will resume in the following hearing locations on August 2: Augusta, Boca Raton, Buffalo, Detroit, Philadelphia, Providence, and Wilmington. More information is available on FINRA.org [here](#).

FINRA Dispute Resolution Services Arbitrator Resource Guide for Virtual Hearings

FINRA is offering virtual hearing services (via Zoom and teleconference) to parties in all cases by joint agreement or by panel order. These services provide high-quality, secure, user-friendly options for conducting video and telephonic hearings and sharing documents remotely. More information about Zoom security features for arbitrations and mediations is available on FINRA.org [here](#). Staff is available to schedule virtual hearings and provide technical support.

FINRA has also released an online resource guide for arbitrators conducting hearings using Zoom, which is available [here](#). This guide includes information about the equipment arbitrators will need, promoting fairness and impartiality throughout Zoom hearings, and best practice tips for topics like participant etiquette, when and how often to take breaks, and how to set up your Zoom background to minimize distractions. We have also released [Zoom training videos](#) and the [Fall 2020 Neutral Workshop](#) for arbitrators which offer guidance and best practice tips for virtual hearings. Arbitrators should contact their case administrator with additional questions about virtual hearings.

IV. RECENT SIGNIFICANT RULE CHANGES

Amendment to the Codes to Increase Arbitrator Chairperson ("Chair") Honoraria

On December 17, 2020, the SEC approved amendments to the Codes of Arbitration Procedure (Codes) to: (1) increase the additional hearing-day honorarium Chairs receive for each hearing on the merits from \$125 to \$250 and (2) create a new \$125 Chair honorarium for each prehearing conference in which the Chair participates. Under the rule change, these increases will be funded primarily by minimal increases to the member surcharge and process fees for claims of more than \$250,000 or claims for non-monetary or unspecified damages. The rule change also increases filing fees and hearing session fees for customers, associated persons and members bringing claims of more than \$500,000 or claims for non-monetary or unspecified damage.

These amendments apply to cases filed on or after April 19, 2021. Please see [Regulatory Notice 21-04](#) for more information.

Rule Change to Amend the Codes to Apply Minimum Fees to Requests for Expungement of Customer Dispute Information

On May 26, 2020, the SEC approved a proposed rule change to amend the Codes to apply minimum fees to requests for expungement of customer dispute information. The proposed rule change amends Part IX (Fees and Awards) of the Codes to apply minimum filing fees to requests for expungement of customer dispute information, whether the request is made as part of the customer arbitration or the associated person files an expungement request in a separate arbitration (straight-in request). The proposed rule change also applies a minimum process fee and member surcharge to straight-in requests, as well as a minimum hearing session fee to expungement-only hearings.

These amendments apply to cases filed on or after September 14, 2020. Please see [Regulatory Notice 20-25](#) for more information.

V. PROPOSED RULE CHANGES

Proposed Rule Changes Filed with the SEC

Proposed Amendments to the Codes of Arbitration Procedure Relating to Requests to Expunge Customer Dispute Information, Including Creating a Special Arbitrator Roster to Decide Certain Expungement Requests

On September 22, 2020, FINRA filed with the SEC proposed amendments to the Codes of Arbitration Procedure (Codes) to: (1) impose requirements on expungement requests (a) filed during an investment-related, customer initiated arbitration by an associated person, or by a party to the customer arbitration on-behalf-of an associated person, or

(b) filed by an associated person separate from a customer arbitration (“straight-in request”); (2) establish a roster of arbitrators with enhanced training and experience from which a three-person panel would be randomly selected to decide straight-in requests; (3) establish procedural requirements for expungement hearings; and (4) codify and update the best practices of the Notice to Arbitrators and Parties on Expanded Expungement Guidance that arbitrators and parties must follow. In addition, the proposed rule change would amend the Code of Arbitration Procedure for Customer Disputes to specify procedures for requesting expungement of customer dispute information arising from simplified arbitrations. The proposed rule change would also amend the Codes to establish requirements for notifying state securities regulators and customers of expungement requests.

On May 28, 2021, following discussions with SEC staff, FINRA temporarily [withdrew](#) from SEC consideration the rule filing establishing specialized arbitration panels for expungement requests so that FINRA can further consider whether modifications to the filing are appropriate. FINRA posted on its [website](#) a statement regarding the withdrawal, as well as an expungement webpage with data and key regulatory initiatives. FINRA continues to take [meaningful steps](#) to enhance controls on the existing expungement process in the near term.

Proposal to Prohibit Compensated Non-Attorney Representatives (NARs) in Arbitration and Mediation

At its [December 2018](#) meeting, the Board approved filing with the SEC proposed amendments to the Codes of Arbitration and Mediation Procedure to greatly limit compensated NARs from practicing in the FINRA arbitration and mediation forums. The rule proposal would also specify that a student enrolled in a law school, who is participating in a clinical program or its equivalent, and is practicing under the supervision of an attorney pursuant to state law, is allowed to represent parties in arbitration and mediation. It would also include guidelines for resolving issues regarding the qualifications of NARs or law students in the forum. The proposed amendments will next be filed with the SEC.

VI. REGULATORY NOTICE ON FORUM SELECTION PROVISIONS INVOLVING CUSTOMERS, ASSOCIATED PERSONS AND MEMBER FIRMS

In July 2016, FINRA published [Regulatory Notice 16-25](#) to remind member firms that customers have a right to request arbitration at FINRA's arbitration forum at any time and do not forfeit that right under FINRA rules by signing any agreement with a forum selection provision specifying another dispute resolution process or an arbitration venue other than the FINRA arbitration forum. In addition, FINRA reminded member

firms that FINRA rules do not permit member firms to require associated persons to waive their right to arbitration under FINRA's rules in a pre-dispute agreement.

VII. SIGNIFICANT INITIATIVES

List of Member Firms and Associated Persons with Unpaid Customer Arbitration Awards

In October 2018, FINRA posted a list on its website of firms and individuals responsible for unpaid customer arbitration awards. FINRA has provided this information in an effort to increase transparency regarding those firms and individuals with unpaid arbitration awards, and to make this information more readily accessible to investors. The list includes the names of firms and individuals whose FINRA registration has been terminated, suspended, canceled, or revoked, or who have been expelled from FINRA. This information will also continue to appear on the firms' or individuals' BrokerCheck reports. FINRA updates this information on a regular basis.

The list is available on the [Member Firms and Associated Persons with Unpaid Customer Arbitration Awards](#) page on FINRA.org.

Expanded Expungement Guidance for Arbitrators and Parties

Notice to Arbitrators and Parties: In October 2013, the forum sent to all arbitrators a notice and published on its website guidance for parties and arbitrators concerning expungement requests. The guidance emphasizes the extraordinary nature of expungement relief and advises arbitrators to consider the importance of the Central Registration Depository (CRD) information to regulators, firms, and investors (through BrokerCheck) when considering requests for expungement. The guidance encourages arbitrators to request any documentary or other evidence they believe is relevant to the expungement request, particularly in cases that settle before an evidentiary hearing or in cases where only the requesting party participates in the expungement hearing. It also suggests that arbitrators ask the broker requesting expungement to provide a current copy of his or her BrokerCheck report when determining the appropriateness of expungement. The guidance further recommends that arbitrators identify in the award the specific documentary evidence that they relied upon when recommending expungement.

On July 22, 2014, the SEC approved FINRA Rule 2081, which prohibits conditioned settlements, and it became effective on July 30, 2014. In September 2014, the forum sent to all arbitrators a notice and published on its website updated guidance wherein we addressed settlement payments and prohibited conditions relating to

expungement of customer dispute information. The updated guidance reminds arbitrators to consider whether the party seeking expungement contributed to the settlement. Further, the updated guidance provides that if arbitrators learn of prohibited conditions, as described in Rule 2081, they should consult FINRA's procedures on disciplinary referrals.

In September 2014, we e-mailed to arbitrators a notice and published on our website updated guidance wherein we addressed the importance of allowing customers and their counsel to participate in the expungement hearing in settled cases. This section of the updated guidance reminds arbitrators to allow the customer, among other things, to introduce documents and evidence at the expungement hearing, cross-examine the broker and other witnesses called by the party seeking expungement, and to present opening and closing arguments if the panel allows any party to present such arguments.

In December 2014, we published on our website updated guidance about cases in which an associated person will file an arbitration claim against a member firm solely for the purpose of seeking expungement, without naming the customer in the underlying dispute as a respondent. This section of the updated guidance reminds arbitrators to order the associated person to provide a copy of their Statement of Claim to the customer in the underlying arbitration to ensure that the customer is aware that an expungement claim is pending regarding his or her prior dispute. This will also give the customer an opportunity to advise the arbitrators and parties (in writing or through participation in the expungement hearing) of their position on the expungement request, which may assist arbitrators in making the appropriate finding under Rule 2080.

In September 2017, we updated the guidance published on our website to discuss requests for expungement prior to the conclusion of the underlying arbitration. This section states that a broker may not file a request for expungement of customer dispute information arising from a customer arbitration claim until the underlying arbitration has concluded. If a broker files a request for expungement prior to the conclusion of the related customer arbitration, FINRA will deny the forum as to the second expungement-only case. This procedure ensures that the underlying customer arbitration is resolved before any subsequent request to expunge customer dispute information from the underlying customer arbitration is considered.

[Notice to Arbitrators and Parties on Expanded Expungement Guidance](#) can be found on the Arbitration Special Procedures page of FINRA.org.

Neutral Workshop: In December 2013, FINRA conducted a neutral workshop that provided an overview of CRD and BrokerCheck, stressing the important role arbitrators play in safeguarding the integrity of the information in CRD in the expungement process. In May 2014, FINRA conducted a neutral workshop that provided expanded expungement guidance and an overview of the proposed new rule to address expungement of customer dispute information. In February 2015, FINRA filmed a neutral workshop addressing expungement, among other matters. In June 2019, FINRA filmed a neutral workshop that focused on the particular challenges of expungement hearings and provided practical tips for arbitrators when considering requests for expungement of customer dispute information. FINRA pre-records the workshops to allow neutrals to pause and playback the audio file. These and other recorded workshops provide an additional resource for information to neutrals and can be found on the [Neutral Workshop page](#) and the [audio Neutral Workshop page](#) on FINRA.org.

The Neutral Corner: The December 2013 edition (Volume 4, 2013) of the arbitrator newsletter, *The Neutral Corner*, was devoted to the topic of expungement. The issue included an article emphasizing the procedural requirements in recommending expungement and another article discussing the limitations on the types of disclosures that may be expunged from CRD through arbitration. The September 2014 edition (Volume 3, 2014) included articles about the revised Award Information Sheet, the new Rule 2081 to address prohibited conditions relating to expungement of customer dispute information, and expanded expungement guidance for arbitrators to allow customers and their counsel to participate in the expungement hearing. The October 2015 edition (Volume 3, 2015) included information on recent court decisions on expungement. The December 2015 edition (Volume 4, 2015) included information on parties making second expungement requests after a previous denial. The March 2019 edition (Volume 1, 2019) noted that the Board approved proposed amendments to the Codes to codify the Notice to Arbitrators and Parties on Expanded Expungement Guidance and establish a minimum fee for expungement claims. The October 2019 edition (Volume 3, 2019) included information on the Spring 2019 Neutral Workshop titled "Expungement of Customer Dispute Information." The March 2020 edition (Volume 1, 2020) included information about FINRA's rule filing to apply minimum filing fees to requests for expungement of customer dispute information, the July 2020 edition (Volume 2, 2020) included information about the SEC approval of the rule filing, and the September 2020 edition (Volume 3, 2020) included information about Regulatory Notice 20-25 and FINRA amending the arbitration Codes to apply minimum fees to requests for expungement of customer dispute information.

The Questions and Answers sections of the following issues of *The Neutral Corner* feature answers to frequently asked questions about expungement as well: Volume 1, 2020; Volume 2, 2013; and Volume 1, 2014.

The latest edition of [The Neutral Corner](#), along with previous issues, can be found on the Publications page on FINRA.org.

Online Arbitration Claim Filing Guide: FINRA revised the [Online Arbitration Claim Filing Guide](#) to include new information that asks claimants filing expungement claims to provide the occurrence number for the underlying disclosure and other registration information.

Award Information Sheet: To assist arbitrators with the updated expungement guidance, FINRA revised the Award Information Sheet.

We believe the above initiatives will help arbitrators safeguard the integrity of the information in CRD.

Short List Option to Reduce Extended List Appointments

Forum constituents want to select their own neutrals from the roster and thus have complained about the appointment of “extended list” arbitrators. Extended list arbitrators are not selected by the parties and may only be challenged for cause. (FINRA has virtually eliminated the appointment of extended list arbitrators in the initial appointment process.) FINRA has increased parties’ options to reduce the likelihood of extended list appointments when an arbitrator withdraws or is no longer available, no ranked arbitrators remain on the parties’ initial ranking lists and hearing dates are scheduled in a case. Under the “short list option,” parties may stipulate to use a list of three arbitrators to select a replacement arbitrator. All parties must agree to use the short list option. Each side may strike one arbitrator’s name from the list and may rank all remaining arbitrators’ names in order of preference within a prescribed number of days.

If a hearing is scheduled within five calendar days of an arbitrator’s withdrawal, removal, or unavailability, parties need to postpone the hearing to use the short list option. The postponement allows FINRA staff time to prescreen arbitrators for conflicts and to ensure they are available for scheduled hearing dates and to provide parties with time to review the list and strike and rank arbitrators. A postponement fee is charged in accordance with current FINRA rules. An additional fee is assessed for postponements granted within ten business days of the hearing date, also in accordance with current FINRA rules. Arbitrators may allocate the fees among the parties that agreed to the postponement. Arbitrators may also waive the fees.

As of May 2020, parties may complete the ranking and striking process for short lists by using the DR Portal. More information, along with an FAQ, about the Short List Procedure can be found at the [Short List Option to Reduce Extended List Appointments](#) page of FINRA.org.

VIII. FINRA NEUTRALS

Arbitrator Disclosure

FINRA continually stresses to arbitrators the need to make complete and accurate disclosures. Below are recent measures we have taken to emphasize the importance of disclosing all information that may be relevant:

Arbitrator Disclosure Report Reviews

FINRA staff regularly conducts comprehensive reviews of arbitrators' disclosure reports to ensure accuracy and freshness of information.

- This review includes a search of legal databases such as PACER, detailed internet searches for new public information or publications, employment records, professional license records, etc.
- If new information is found, staff will contact the arbitrator for confirmation and add the information to the arbitrator's disclosure report.

Internet Searches

- We verify the accuracy of arbitrator disclosure by conducting internet searches of arbitrators prior to appointment to a case.
- If staff finds information during an internet search that is not disclosed in the arbitrator's disclosure report, staff contacts the arbitrator, confirms the validity of the information, and adds the information to the neutral's disclosure report.

Last Affirmation Dates

- FINRA displays the date that arbitrators last affirmed the accuracy of their disclosure reports at the top of the disclosure report documents.

- Arbitrators are advised to regularly review and affirm the accuracy of their disclosures on the DR Portal, as parties may consider the last affirmation date as a factor when selecting arbitrators for their cases.
- Arbitrators can confirm the accuracy of their disclosures in two ways:
 - Submitting an update through the DR Portal; and
 - Submitting an Oath of Arbitrator when assigned to a case.

Attorney Information

- Disclosure reports feature the names of party representatives and the city and state in which the representative practices on each of the arbitrator's active cases.
- This feature helps to alert parties to potential conflicts based on legal representation.

More information on [Arbitrator Disclosure](#) can be found on the Information for Arbitrators page at FINRA.org.

Arbitrator Recruitment

A primary goal of FINRA's arbitrator recruitment program is to identify and train a qualified pool of potential arbitrators from which parties can choose to hear their disputes. The strategic goal has been to continue to shift the balance of the arbitrator pool to include more public arbitrators and a more diverse roster nationwide. FINRA has implemented an aggressive recruitment campaign to seek individuals from diverse backgrounds from across different industries to serve as arbitrators. Ongoing recruitment initiatives thus far have included more than 100 women and minority organizations nationwide to source and recruit all types of people through on-site events, targeted recruiting advertisement, and direct marketing campaigns.

To help maximize our resources and opportunities further, we leveraged our staff talent in the regions to assist with recruitment efforts, particularly in reaching women-focused groups, LGBT communities and other untapped diverse organizations. We also hired an additional full-time national recruiter in 2015.

In 2020, our recruitment team focused on virtual events and digital advertising because they were unable to travel due to the pandemic. The team attended one in-person event prior to March 2020 with the Alpha Kappa Alpha Sorority at their North Atlantic

Regional Conference in Hartford, CT. They also attended a virtual conference with the National Association of Black Accountants, Inc.

The first phase of DRS' digital advertising campaign launched in May 2020 and targeted 14 cities. The second phase of the campaign launched in September 2020 and targeted 14 additional hearing locations. In 2021, the digital advertising campaign will target at least 28 cities over a 7-month period. Depending on the results over that time, DRS may add additional cities.

We are continuously enhancing the diversity of our arbitrator roster. In 2020, we saw increases in the female and Asian categories. More specifically, 40% of arbitrators added to the roster in 2020 were female versus 39% in 2019. Additionally, 4% of arbitrators added to the roster in 2020 were Asian versus 3% in 2019. Also noteworthy is the 14% of arbitrators added to the roster in 2020 that were Black or African-American.

We are also enhancing the diversity of our mediator roster. Of mediators (who may also be arbitrators) polled in 2020, 26% were women, 8% African-American, 3% Hispanic or Latino, 1% Asian, and 1% were LGBT.

To learn more about FINRA's efforts to diversify our arbitrator and mediator rosters visit [Our Commitment to Achieving Arbitrator and Mediator Diversity at FINRA](#) at FINRA.org.

Finally, to become more effective in how we communicate our message, we have begun using social media to recruit arbitrators. All FINRA Dispute Resolution Services Twitter updates can be found under FINRA's Twitter handle, [@FINRA](#). We also released our first formal recruitment video on several social media platforms including Vimeo, LinkedIn and YouTube in December 2016: <https://vimeo.com/188349814>.

Arbitrator Application and Approval

Individuals interested in becoming an arbitrator can apply to our roster using the online arbitrator application available in the [Become an Arbitrator](#) section of our website. Applicants can complete the arbitrator application and submit it electronically along with a completed Consent to Background Search and Investigation Form and Social Security Number Verification Form. FINRA conducts a review of applications and works with applicants to ensure their submissions are complete before forwarding them to a subcommittee of the NAMC for final approval. FINRA processes applications and notifies applicants within 120 days from the date of receipt.

In 2020, we received 1,094 applications, well exceeding our goal of 750 applications. The average time for application process completion was 109 days. As of July 15, 2021, there were 3,955 public arbitrators on our roster.

Arbitrator Training

Arbitrator applicants are required to complete the Basic Arbitrator Training program, consisting of: (1) online basic training and (2) online expungement training. In 2020, the average time to train arbitrators was 71 days (746 candidates trained). New arbitrators are invited to participate in voluntary live Arbitrator Orientation Sessions where they can ask questions and learn more about the forum in an informal setting. We are continuing to expand and improve our online training offerings.

To be considered for the chairperson roster, arbitrators must complete FINRA's online chairperson training and satisfy the case service requirement. FINRA staff has discretion to select arbitrators to serve on the chairperson roster from among those arbitrators who have completed the online chairperson training and: (1) have a law degree, are a member of a bar of at least one jurisdiction, and served as an arbitrator through award in at least one arbitration administered by a self-regulatory organization; or (2) if not an attorney, served as an arbitrator through award in at least three arbitrations administered by a self-regulatory organization (Customer Code Rule 12400(c) and Industry Code Rule 13400(c)).

In addition to the required trainings, FINRA offers advanced, subject-specific courses.

For more information on Basic and Advanced Arbitrator Training visit the [Arbitrator Training](#) page at FINRA.org.

IX. FINRA DISPUTE RESOLUTION SERVICES TECHNOLOGY INITIATIVES

Online Portals

Portal for Parties. Use of the Portal is mandatory for all parties, excluding pro se investors. This rule applies to all cases filed on or after April 3, 2017. Parties using the Portal can sign into a secure website and perform many functions online, including:

- filing a claim;
- receiving service of a claim;
- submitting an answer to a received claim;
- submitting additional case documents;
- viewing the status of a case;

- viewing case documents;
- striking and ranking arbitrators online;
- viewing and downloading disclosure reports of prospective arbitrators;
- scheduling hearing dates online; and
- paying invoiced fees.

Portal for Neutrals. Neutrals are not required to use the Portal on a mandatory basis, but arbitrators and mediators must register in the Portal to take advantage of the numerous functions it provides, such as:

- viewing and printing their disclosure reports;
- viewing and updating their personal profiles and disclosures;
- accessing information about their assigned cases, including upcoming hearings and payment information;
- viewing case documents;
- submitting documents;
- scheduling hearing dates;
- reviewing and signing awards; and
- viewing how often their names have appeared on arbitrator ranking lists sent to parties, and how often they are ranked or struck on those lists.

FINRA Dispute Resolution Services Website

The FINRA Dispute Resolution Services website, <https://www.finra.org/arbitration-mediation>, provides various resources for parties and neutrals regarding FINRA's arbitration and mediation processes. On the website users can find, among other things: an overview of arbitration and mediation; information on how to file a claim; forms that parties and arbitrators need in the arbitration process; arbitrator and mediator applications; the Codes; and rule filing information.

Arbitration Awards Online

FINRA's Arbitration Awards Online database is available without charge on FINRA's website at <https://www.finra.org/arbitration-mediation/arbitration-awards>. Through the database, users can access FINRA arbitration awards from February 1989 through the present.

In addition, users can access all the New York Stock Exchange (NYSE) arbitration awards, as well as the awards of all arbitration programs absorbed over the years by FINRA (which include the American Stock Exchange, Chicago Board Options Exchange,

International Stock Exchange, Philadelphia Stock Exchange, and Municipal Securities Rulemaking Board) and NYSE (which includes Pacific Exchange/NYSE ARCA).

The database provides users with access to awards and the ability to search for awards by using multiple criteria, such as by case number, keywords within awards, arbitrator names, date ranges set by the user, and any combination of these features. FINRA now includes in customer awards information about the panel selection method and panel composition.

Videoconferencing

All four of FINRA's regional office locations have videoconferencing capabilities. We also offer videoconferencing in DRS's Jersey City, NJ hearing rooms. With the consent of all parties or with the permission of the arbitration panel, parties or witnesses may appear at hearings by videoconference for hearings held in one of the regional office locations or Jersey City. There is no additional cost to use the videoconferencing equipment at FINRA. Parties are encouraged to notify their Case Administrator at least 30 days prior to the hearing to request videoconferencing services. All videoconferencing requests are honored in the order they are received.

Additionally, with the consent of all parties or with the permission of the arbitration panel, parties or witnesses may appear at hearings by videoconference for hearings held in other hearing locations not in one of the regional office locations or Jersey City. FINRA is responsible for providing microphones and speakers (if required for social distancing protocols), and a recording device for each hearing. Parties are responsible for arranging and paying for all other audio-visual equipment, such as screens, cameras, telephones, or other equipment required for telephonic testimony or videoconferencing.

X. MEDIATION

Mediation remains an important service that FINRA offers. Since the program's inception in 1995, FINRA's mediation staff has administered thousands of cases involving a wide variety of securities disputes with over 80 percent resulting in settlement between the parties.

Parties interested in mediation can fill out an online [Request for Mediation Form](https://www.finra.org/arbitration-mediation/initiate-mediation) which is located on the Initiate a Mediation page at <https://www.finra.org/arbitration-mediation/initiate-mediation>. Parties involved in current arbitration cases can also indicate their interest in mediation by checking the box on the Party Case Submission Form in the DR Portal. Both methods relay a

message to mediation staff, who will follow-up with other parties regarding available mediation options.

Additionally, FINRA Dispute Resolution Services offers virtual hearing services (via [Zoom](#) and teleconference) to parties in all cases by joint agreement of parties and mediator. These services provide high-quality, secure, user-friendly options for conducting video and telephonic mediation sessions and sharing documents remotely. Staff is available to schedule virtual hearings and provide technical support.

Interested parties should contact the Mediation Administrator for their region.

Mediation Program for Small Arbitration Claims

Since February 2013, FINRA has offered reduced fee and pro bono telephonic mediation to parties in simplified cases. The program benefits forum users by: (1) increasing the number of cases that settle and giving parties more control over the results of their cases; (2) reducing travel and preparation costs; (3) providing an alternative for senior, seriously ill, and physically challenged parties who may find traveling to and attending an in-person mediation especially difficult; and (4) offering parties in small cases an efficient and cost-effective option to meet their needs within our forum.

Under the program, mediators serve on a pro bono basis on cases alleging \$25,000 or less in damages. We also offer significantly reduced fee mediation at \$50 per hour on cases alleging damages between \$25,000.01 and \$50,000. Effective November 1, 2020, FINRA has expanded the program to allow parties to pay \$100 per hour for cases with claims over \$50,000 to \$100,000. We have made all virtual platforms (telephonic and video) available for these mediations. With these changes, the program will be able to provide more parties the benefit of an expedient and cost-effective option for resolving small claims while also introducing parties to diverse and qualified, but underutilized, mediators on our roster.

Separately, the program provides newer mediators with an opportunity to demonstrate their mediation skills. Staff has processed hundreds of requests to mediate through the Mediation Program for Small Arbitration Claims with parties settling over 80% of cases mediated. FINRA continues to communicate the opportunity for parties to mediate through this program to all eligible cases, and highlights the benefits of this affordable mediation option for small claims.

For more information on FINRA's Mediation Program visit the [Learn About Mediation](#) page at FINRA.org.

FINANCIAL ELDER ABUSE HOW TO ASSIST SENIORS AND OTHER VULNERABLE VICTIMS OF FINANCIAL EXPLOITATION

Jon C. Furgison and Dr. Stacey Wood PhD ABPP

The impacts of fraud and financial exploitation on seniors reach far beyond finances. While the economic losses can be financially catastrophic, they are generally relatively easy to calculate. But the emotional harm is much more difficult to quantify and can be even more devastating and far reaching. However, attorneys and supporting professionals have the power to help.

What is financial exploitation, and how does it happen?

Financial exploitation is a form of financial elder abuse that involves the illegal, unauthorized, or improper use of a vulnerable adult's resources for the perpetrator's personal gain. While anyone can fall victim to financial exploitation, seniors are some of the most common victims, and we witness its effects all too often in my practice as a securities attorney representing investors and my colleague's work as a geropsychology expert. In this article, we share what we've learned from our research and experience.

Unfortunately, there is an almost endless number of ways by which someone can financially exploit an older adult. Common types of financial exploitation include theft, fraud, Ponzi schemes, forgery, the improper use of guardianship or power of attorney, and the use of coercion, deception, or false pretenses to surrender finances and property or sale unsuitable investment products. Harassment, duress, or threats may also be used to coerce the victim.

Electronic scams such as "phishing" emails and lottery or sweepstake scams are some of the most well-known forms of financial exploitation designed to target seniors. However, more covert forms of exploitation involving breaches of fiduciary duty by trusted financial advisors, insurance agents, and even romantic or familial relationships are just as pervasive.

Perpetrators often attempt to build a relationship with the victim to establish trust, or they may take advantage of a relationship that already exists. Since seniors are especially vulnerable to loneliness, isolation, and elevated trust levels, they can be an ideal target for this type of deception. When other risk factors like cognitive impairment, poor physical health, and a subsequent need for daily assistance come into play, an older adult's vulnerability to these acts, as well as their risk of experiencing serious non-economic impacts as a result of it, only amplifies.

What are the non-economic impacts of financial exploitation?

Financial exploitation is one of the most common types of elder abuse, with numbers rising at staggering rates. Despite this, the devastating effects of this form of exploitation, outside of the expected financial impacts, remain little understood in the general public. Although, a great deal has been learned from studies following the Bernie Madoff Ponzi Scheme meltdown.

Recent research on the emotional impact of financial fraud has consistently found that victim's perception of the emotional impact of fraud victimization is more severe than the victim's perception of the financial losses across fraud types.

PTSD type symptoms

Audrey Freshman described the psychological aftermath of victims following the Bernie Madoff Ponzi scheme in her 2012 study *Financial disaster as a risk factor for posttraumatic stress disorder: Internet survey of trauma in Victims in the Madoff Ponzi Scheme*. Health & Social Work. Doi10.1093/hsw/hls002. In the Madoff study, 55.7 % of respondents met criteria for presumptive Post Traumatic Stress Disorder ("PTSD") reporting symptoms of anxiety, depression, sleep disorders, health related problems, and increased use of prescription medications. Other statistically significant items included "life choices altered", immediate family negatively affected, felt betrayed by FEC. This research has demonstrated that a catastrophic financial event can result in a clinical picture very similar to PTSD. Assessment of these symptoms can include tools that have been validated for use with PTSD.

Decreased physical health

Financial fraud victimization has been linked to physical symptoms such as poor health, poor sleep and poor quality of life secondary to the high level of stress experienced by victims. Zunzunegui, M.V. (2017). *Financial Fraud and Health: The Case of Spain*. GAc Sanit. 2017; (31(4) 313-319. Assessment of physical health following the catastrophic loss is another component to consider.

Anxiety and depression

Common symptoms after a financial setback are stress, depression, anxiety, worry, rumination, and lack of sleep. Button, Lewis & Tapley (2014). *Not A Victimless Crime: The Impact of fraud on individual victims and their families*. Security Journal, 27(1), 36-54. Tools that have scales assessing anxiety and depression symptoms that have been validated for use in older adults could also be considered.

Social isolation and social relationships

Button and colleagues reported high incidences of financial setbacks on the victims as well as their families. Families may blame the victim for squandering money that was hoped to be used for college educations, etc. Adult children may have financial burdens that were unexpected. The change in social support can result in decreased quality of life.

Lack of Trust

Victims may also report feelings of anger, distrust and betrayal. This is particularly true when scammers use a trusted individual or institutions. Lack of trust can impact future social relationships and ability to move forward. A senior's feelings of betrayal, bitterness, and shame can also translate into changes in attitudes, which in turn impacts their relationships. They may be less trusting of people in general, but more specifically friends, family members, and institutions. This distrust leads to isolation and a loss of relationships, which in turn leads to a lower quality of life.

In summary, being financially exploited can be a truly traumatic experience for an older adult, and seniors who fall victim to financial exploitation or financial elder abuse often experience a range of significant mental health symptoms because of it. These include the following:

- Depression

- Anxiety
- Intrusive thoughts
- Rumination
- Nightmares
- An increased risk of suicide
- Disrupted Sleep

Our clients who have been victims of unscrupulous financial advisors feel intense shame. The shame arises from the recognition that they were duped, and it is intensified by the uncomfortable attention that the fraud attracts from clients' children, social service agencies, law enforcement, and the court. Often, these clients feel and are treated like vulnerable children. The embarrassment of this indignity causes some clients to close themselves off from their support network and makes them even more vulnerable to self-neglect and exploitation.

Additional feelings of self-doubt and an inability to plan for the future can leave a senior feeling lost, stagnant, and powerless. In the most severe cases of financial exploitation, a senior can experience significant debt, tax burdens, and even homelessness, further compounding these psychological impacts.

While most younger people could expect to eventually recover from these impacts, older adults have limited time horizons, so any effects will have a greater sense of permanency for them. Not all time is equal. When time is limited, it is more precious. A limited time frame of misery for a middle-aged person is different than an elder's misery for all the rest of their life. Many victims of financial elder abuse will never return to life as they knew it. Further, when you reach your retirement years, there is a premium placed on the value of those few remaining "Golden Years".

Families of victims

Financial abuse and fraud can also impact the finances and emotional well-being of future generations, whether it's due to family members taking care of the exploited senior's damaged finances, a depletion of assets to be eventually passed down to loved ones, or the emotional burden that loved ones carry.

The non-economic impact of financial elder abuse isn't limited to an elder's loss of self-confidence, the feeling of safety, and or increased mortality rate. It also can devastate a victim's family and loved ones. The secondary victims of financial elder abuse are those who struggle to prevent the elder from further harm while managing their frustrations trying to reason with someone who, because of their failing abilities, are incapable of accepting their counsel.

Fortunately, not all hope is lost if a senior is exposed to financial exploitation, but it takes a quick and coordinated effort between loved ones and supporting professionals to mitigate its effects before it takes a destructive and irreversible toll on a senior's well-being.

What are the warning signs of financial exploitation?

When financial exploitation occurs, early intervention is key to stop the abuse and limit the spread and severity of its impacts. Since it is so pervasive among seniors, anyone who regularly spends time with an older adult should be aware of—and on the lookout for—the warning signs of financial exploitation.

First, any changes in a senior's mental health or behavior should be treated as a warning sign of abuse. Some individuals may openly express feelings of shame, hopelessness, or distrust, while others may show more subtle signs of depression or other psychological impacts, including isolation, irritability, or a diminished interest in previously enjoyed activities.

While these may be difficult to measure, one clear sign is if the elderly person stops answering the phone or communicating with loved ones. One of the biggest non-economic impacts of fraud on seniors is that a vulnerable and isolated senior who is targeted by fraudsters often stops answering their phone regularly after receiving so many unwanted calls. This common response to being inundated with constant phone calls can leave a senior even more isolated if they are not answering phone calls from family, friends, or neighbors who truly care about them.

It's also important to look out for any resulting physical changes, such as sudden, significant weight loss or gain and signs of poor sleep like baggy eyes, lethargy, and unexplained impairments in memory.

Other, more obvious, signs of financial exploitation can include events such as sudden changes in one's financial situation, including unpaid bills, termination of vital utilities, and notices for eviction, foreclosure, or repossession despite adequate income. In addition to a reluctance toward discussions of financial matters, checks written to "cash", unexplained changes to estate documents, or extravagant spending can also be warning signs.

How can attorneys and other supporting professionals help?

Attorneys and other supporting professionals who work directly with seniors are in a unique position to help their clients who are facing financial exploitation. This begins with establishing trust. However, this may be more difficult than it sounds because this type of emotional trauma often results in the seniors feeling a sense of betrayal. They have been betrayed by someone they wholeheartedly believed they could trust. Now, they don't know who to believe anymore and this makes it difficult for them to trust even the attorneys who are trying to help them obtain justice. It also makes it difficult for the victims to trust their family members and previously trusted inner circle.

That doesn't mean that all hope is lost, though. In my practice, the most important step is for the victim to have a sense of purpose in pursuing justice and working to break the vicious cycle of isolation. And for the attorney to know the best paths to recovery. Fortunately, the California financial elder abuse statutes provide some very powerful remedies to aid in that mission.

Treble damages via Civil Code § 3345

California's Legislature enacted the California's Elder Abuse Act "to protect elders by providing enhanced remedies which encourage private, civil enforcement of laws against elder abuse and neglect." *Negrete v. Fid. & Guar. Life Ins. Co.* (C.D. Cal. 2006) 444 F.Supp.2d 998, 1001. The "enhanced remedies" entitles Claimants to treble recovery. "Section 3345 establishes that when a defendant knew or should have known his conduct was directed to a senior citizen, and that conduct caused the senior to suffer loss of income or property, that the court may impose a remedy up to three times greater than the amount the trier of fact would impose absent such a finding." *King v. Portfolio Preservation, LLC* (E.D. Cal., Feb. 22, 2021, No. 2:19-CV-01916-JAM-CKD) 2021 U.S. Dist. LEXIS 32770, at *17-18, fn. 3.

California Civil Code section 3345 provides that “Whenever the trier of fact makes an affirmative finding in regard to one or more of the following factors, it may impose a fine, civil penalty or other penalty, or other remedy in an amount up to three times greater than authorized by the statute...”

Section 3345’s “trebled recovery provision comes into play when the governing statutory remedy has ‘the purpose or effect’ of punishing or deterring. (Civ. Code, § 3345, subd. (b))” *Clark v. Superior Ct.* (2010) 50 Cal. 4th 605, 614 [holding that trebled recovery may be awarded under Civ. Code § 3345(b) only if the statute under which recovery is sought permits a remedy that is in the nature of a penalty]. Trebling may be applied to statutory claims that are alleged in conjunction with an underlying cause of action involving unfair practices or deceptive acts against vulnerable or dependent adults. *Hood v. Hartford Life & Accident Ins. Co.* (E.D. Cal. 2008) 567 F. Supp. 2d 1221, 1229; see Statutory damages, Cal. Civ. Prac. Procedure (April 2021 Update), § 8:10 [defining statutory remedies as penal damages permitted under certain statutes (including Civil Code § 3345) that impose a penalty in a specified sum, sometimes regardless of actual damages suffered, and in addition to the award of compensatory damages]. This includes punitive damages under Section 3294, which qualifies as statutorily imposed punitive remedy subject to trebling under Section 3345. See *Hood*, supra, 567 F. Supp. 2d at 1229.

All damages authorized under the Elder Abuse Act are “punitive” in nature and thus should be subject to Section 3345’s trebling provisions. “The purpose of the [Elder Abuse Act] is essentially to protect a particularly vulnerable portion of the population from gross mistreatment [...]”, which the Legislature enacted after recognizing in 1982 that “this state has a responsibility to protect such persons.’ (Former § 15600, added by Stats. 1982, ch. 1184, § 3, p. 4223.)” *Delaney v. Baker* (1999) 20 Cal.4th 23, 33. “The purpose of the Elder Abuse Act is to protect and deter, but not to compensate. [*Delaney v. Baker*, 20 Cal. 4th 23, 33 (1999)] General damages under the Act may be measured in relation to the harm done, but the purpose of such damages is nonetheless to protect (and deter).” California Practice Guide: Elder Abuse Litigation ¶ 9.89 (The Rutter Group, September 2020 Update); Welf. & Inst. § 15600(h), (j).

Summary

While the non-economic impacts of financial exploitation are well-established, recognizing and effectively addressing them isn’t always as simple. However, with a coordinated and compassionate effort from loved ones, knowledgeable attorneys armed with the most powerful elder protection statutes, and supporting professionals, a senior who has experienced these impacts will have significantly greater odds of recovery.

CLEARING FIRM LIABILITY: PROVING MORE THAN “CLEARING AND EXECUTING”

Michael C. Bixby, Philip Vujanov, Bob Lowry, Joel Everest

Clearing firms are commonly involved with most independent brokerage firms and registered investment advisors. Clearing firms carry and maintain custody of securities and other assets for the introducing firm/broker dealer. The law does provide some limited protection to clearing firms from liability for acts of its introducing firms. The principal behind the limitation is that clearing firms performing only back office functions of clearing and executing should not be held responsible for every single wrongful action of the introducing firm. Clearing firm liability may be ill-suited for most claims where the primary fraudster or wrongdoer is solvent. However, there are increasing number of cases where rogue registered investment advisors, barred and jailed brokers, and/or bankrupt firms commit wrongdoing but are not solvent. This session will focus on the on conduct by clearing firms that goes beyond purely clearing and executing transactions that may serve as a basis for liability against the clearing firm. This session will also explore clearing firm liability in scenarios including forgeries, account hacks, and failure to execute or properly perform a function. For a thorough treatment of the use of control person liability and agency liability in Clearing Firm Liability, see the materials from the 2020 PIABA Conference Session on Secondary & Clearing Firm Liability moderated by the legend himself Bob Banks and featuring the incomparable Joe Peiffer.

As a FINRA member broker-dealer firms, clearing firms are required to comply with industry rules, regulations, and laws, which include observing high standards of commercial honor and just and equitable principles of trade. Clearing firms, just like any other FINRA member, are subject to a comprehensive set of statutory requirements, SEC and SRO requirements that are designed to promote business conduct that protects investors from abusive practices. These conduct obligations and requirements cannot be waived or contracted away by customers.

Clearing Firms are also duty-bound under FINRA Rule 2090 to "use reasonable diligence, in regard to opening and maintenance of every account, to know the 'essential facts' concerning every customer and concerning the authority of each person acting on behalf of each customer." FINRA Rule 2090 further provides, in its supplemental materials:

.01 Essential Facts. For purposes of this Rule, facts "essential" to "knowing the customer" are those required to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules.

The duties the clearing firm owes its customers are not mitigated by either 1) the absence of a recommendation made to the customer by it or any associated person or by 2) the exculpatory language it inserts in its customer agreements or any introducing firm agreements or delegation of responsibilities. Clearing firms owe customers a duty to exercise reasonable care and diligence to find the facts it needed to reasonably service and protect the assets contained in its customer accounts.

FINRA Rule 2010 mandates that, in the conduct of their business, broker-dealers "observe high standards of commercial honor and just and equitable principles of trade." In interpreting this rule,

FINRA stated that Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing. IM-2310-2 "Fair Dealing with Customers." Such duties and standards of conduct were instituted by FINRA "to protect investors and the public interest." FINRA By-laws Art. XI Sec. 1.

A clearing firms duty of fair dealing is established under the antifraud provision of the federal securities laws and SRO rules, including SRO rules addressing just and equitable principles of trade. By virtue of engaging in the brokerage profession, a broker-dealer makes an implicit representation to those persons whom it transacts business with that it will deal fairly with them consistent with the standards of the profession. As has been stated by FINRA in the past:

Implicit in all member and registered relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that could be judged as being within the ethical standards of the Association's Rules with particular emphasis on the requirement to deal fairly with the public.

Numerous instances of fraudulent conduct have been acted upon by the Association and have resulted in penalties against members. Among these activities include: (i) Fictitious Accounts . . . (iii) Unauthorized Transactions ... (iv) Misuse of Customers Funds or Securities.

In addition, other fraudulent activities, such as forgery, non-disclosure or misstatement of material facts, manipulations and various deceptions, have been found in violation of Association Rules.

See IM-2310-2 and FINRA Rule 2111 Supplementary Materials. All FINRA members have an obligation to promote high standards of professional conduct. Members have additional duties, so as to prevent fraudulent conduct and to disclose facts and information material to its customers regarding their accounts, supported by its fundamental responsibility of fair dealing. A broker-dealer's obligation to meet minimum business conduct requirements cannot be waived, contracted away or satisfied through disclosure to customers. Clearing firms may be liable to their customers for its breach of their duties.

Broker-dealer firms, particularly clearing firms, long ago realized that there is big money in providing a trading platform to independent investment advisors. Firms like Fidelity, Interactive Brokers and others have developed a variety of platforms to accommodate and profit from activities of independent advisors including by offering independent advisors the opportunity to associate with its prestigious brand, access to a sophisticated trading platform to manage clients' assets and back-office support.

Some clearing firms have attempted to create an ultimate business model - one in which all money falls to the bottom line and there is little to no liability because the "broker" has been removed. Despite this business model, nothing exempts clearing firms from compliance with applicable securities laws and FINRA Rules. Simply put, clearing firms have a duty to protect their

customers' accounts through exercising due diligence on any individual or investment advisory firm holding trading authority on the account.

Clearing firm liability claims often center on allegations of a wide variety of conduct by the clearing firm, including but not limited to situations involving:

- Red Flags that clearing firm knew or should have known or failed to act on;
- Failure by clearing firm to conduct Due Diligence on the customers and brokers with trading authority (permitting non-registered advisors or barred advisors);
- Clearing firm providing access to platform to non-registered advisors, barred advisors, or high-risk individuals;
- Clearing firms who offer or provide ancillary services beyond “mere” clearing activity;
- Clearing firms providing or approving pricing of securities (particularly in cases of thinly traded or private investments);
- Situations involving forgeries;
- Transfer of funds to third party accounts (including SARs, AML, and due diligence issues);
- Account hacks and third party access situations; and
- Failure to execute or properly perform functions.

Credibility offered to fraudsters, or unscrupulous brokers or investment advisors is often a key feature of clearing firm claims. Often, brokers or advisers who have red flags, have been terminated or suspended will utilize a clearing firm to establish credibility and foster trust for their investors.

Oftentimes, fraudsters who are not associated with a broker dealer need the assistance from a reputable broker-dealer to carry out their wrongdoing. When clearing firms provide fraudsters with access to its infrastructure and backing, this can create potential liabilities for the clearing firms. Successful clearing firm cases will argue that the assistance provided by the clearing firm to the wrongdoer operating the scheme was more than substantial; it was essential. For instance, other successful clearing firm cases have involved claims that the clearing firms:

- to offer assurances to Claimants and convince them that it was a legitimate business, the wrongdoer needed the “backing” of a prestigious financial institution – the clearing firm;
- to transfer and take custody of Claimants' savings from another brokerage firm/bank, the wrongdoer needed a custodian and back-office support;
- to be given managing authority over investors' accounts, the wrongdoer needed a broker-dealer who would not look into the red flags or the wrongdoers checkered background;
- to have a platform to liquidate the securities holding of Claimants (e.g., to liquidate the holdings to recommend a Ponzi scheme the broker/advisor needs a platform to be able to liquidate and move assets);

Clearing firms may agree that the wrongdoer is able to assert control over their customers' accounts in order to sell their existing securities holdings or transfer assets. Liability may attach when a clearing firm blindly allows an individual or company to join its roster of independent investment advisors, performing inadequate or no due diligence, and gives the wrongdoer authority to trade the accounts of the clearing firm's customers on the clearing firm's platform.

Broker-dealers may also be liable to their customers for violations of the rules of conduct promulgated by FINRA, NASD and/or NYSE, when such violations result in losses to customers. A broker-dealer's duty to supervise the types of business in which it engages arises from Section 15(b)(4)(E) and 15(b)(6)(A) of the Securities Exchange Act of 1934 and former NASD Rule 3010 and NYSE Rule 342 (current FINRA Conduct Rule 3110). Broker-dealers are liable to their customers for violations of the rules of conduct promulgated by FINRA, NASD and/or NYSE, when such violations result in losses to customers.

A broker-dealer's duty to supervise the types of business in which it engages arises from Section 15(b)(4)(E) and 15(b)(6)(A) of the Securities Exchange Act of 1934 and former NASD Rule 3010 and NYSE Rule 342 (current FINRA Conduct Rule 3110).³ The purpose of the rule is to detect and prevent securities law violations before they occur, thus to protect the investing public.

FINRA Rule 3110 requires each member, including clearing firms, to

shall establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules. Final responsibility for proper supervision shall rest with the member.

NYSE Rule 342 mandates that "[e]ach . . . business activity of a member or member organization . . . shall be under the supervision or control of the member or member organization establishing it." NYSE Rule 342(a). In regard to the customer accounts it carries, a broker-dealer's duties under Rule 342(b)(i) mandate that the broker-dealer

Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by [the broker-dealer] and every person holding power of attorney over any account accepted or carried by [the broker-dealer].

NYSE Rule 405(1) [emphasis supplied].

"Supervision is an essential function of the broker-dealer. It is critical for investor protection that a broker establish and enforce effective procedures to supervise its employees." Signal Securities, Inc. [Release No. 43350; File No. 3-10304] Sept. 26, 2000. Further, investors "are entitled to receive proper treatment and to be protected against fraud and other misconduct, and may properly rely on the [securities] firm to provide this protection." Reynolds & Co. 39 SEC 902, 917 (1960).

Clearing firms are required to take action in response to each "red flag" it discovers. This is well-settled:

Red Flags and suggestions of irregularity demand inquiry as well as adequate follow-up and review. When indications of impropriety reach the attention of those in authority, they must act decisively to detect and prevent violations of securities laws.

Consolidated Investment Services, Inc. SEC [File No. 3-8312] December 12, 1994. Red Flags must be treated "with the utmost vigilance." *Id.*

The SEC has roundly rejected the argument that a broker-dealer firm can deflect responsibility for its own failure to supervise:

...[I]t is not the investors who are tasked with the serious duty of identifying irregularities and supervising registered representatives, but rather the broker-dealer and its principals under Exchange Act sections 15(b)(4)(E) and 15(b)(6)(A).

Consolidated Investment Services, Inc., SEC File No. 3-8312, *34 (December 12, 1994). As provided by FINRA Rule 3110, "[f]inal responsibility for proper supervision shall rest with the member."

Since firms are required to learn the essential facts concerning the authority of each person acting on behalf of its customers, such due diligence would uncover facts that might compromise such authority, including: a record of customer complaints, advisor experience, bankruptcies and regulatory actions.¹

FINRA clarified that obtaining the essential facts from the customer or power of attorney is not static and is to take place beyond the opening of the account:

A broker-dealer must know its customers not only at account opening but also throughout the life of its relationship with customers in order to, among other things, effectively service and supervise the customers' accounts. Since a broker-dealer's relationship with its customers is dynamic, FINRA does not believe that it can prescribe a period within which broker-dealers must attempt to update this information.

As with a customer's investment profile under the suitability rule, a firm should verify the "essential facts" about a customer under the know-your-customer rule at intervals reasonably calculated to prevent and detect any mishandling of a customer's account that might result from the customer's change in circumstances.

FINRA, Regulatory Notice 11-02 n.5 (2011). This is the primary obligation of FINRA: to prevent the mishandling of customer accounts.²

NYSE specifically mandated that a broker-dealer must establish and maintain an appropriate supervisory system for the activities of non-affiliated investment advisors whose customer accounts are carried by broker-dealers. In 2005, NYSE brought an enforcement action against Charles Schwab & Co. ("Charles Schwab") for its failure to supervise certain activities of investment advisors who were not affiliated with Charles Schwab but who managed accounts carried by Charles Schwab.³ As the Decision makes clear, the fact that Schwab was not actively

¹ See FINRA Rule 2360(b) 16(B)(ii)(b) stating that for certain activities, customer records must contain "discretionary authorization agreements on file, name, relationship to customer and experience of the person holding trading authority." FINRA, Regulatory Notice 11-02 (2011). See also FINRA Rule 4512 ("the member shall maintain a record of the dates, manual signature of each named, natural person authorized to exercise discretion on the account").

² Financial Industry Regulatory Authority, What We Do, <https://www.finra.org/about/what-we-do> ("FINRA's mission is to safeguard the investing public against fraud and bad practices. We pursue that mission by writing and enforcing rules and regulations for every single brokerage firm.").

involved with the fraud of the non-affiliated investment advisors who were using the platform, that Schwab still had responsibilities:

6. The business activity involved here is Respondent Firm's non-employee investment advisor platform. Respondent Firm currently offers certain services to approximately 5,000 non-employee investment advisors. These investment advisors manage approximately 1.3 million client accounts with Respondent Firm. As of May 30, 2005, these accounts represented approximately \$350 billion in assets at Respondent Firm.

7. Respondent Firm provides these investment advisors and their clients with clearing and related support, including a dedicated website providing access to client accounts. The customer account assets managed by these non-employee investment advisors are custodied by Respondent Firm. The customer accounts can be cash, margin or option accounts. In general, the customers grant their investment advisors authority to trade securities in their accounts at Respondent Firm.

9. The investment advisors who manage accounts at Respondent Firm do not have any affiliation with Respondent Firm. These investment advisors are not subject to the jurisdiction of the Exchange, but are regulated by the Securities and Exchange Commission (the "SEC") or the state securities regulators that register them.

In the Schwab case, Charles Schwab was censured by the NYSE for its failure to supervise the activities of the non-affiliated investment advisors, which resulted in failures to detect misappropriation of clients' funds from the investment advisor-managed accounts. NYSE held that

During the period 1998 through the first quarter of 2003, Respondent Firm's procedures relating to the transfer of assets from customer accounts managed by non-employee investment advisors, and its system of follow-up and review, were not reasonable to supervise and control money movements, and to protect accounts adequately. . .

Charles Schwab & Co. Inc., NYSE Exchange Hearing Panel Decision 05-110, ¶16. The NYSE panel censured Charles Schwab and imposed, by unanimous vote, a fine of \$1,000,000, stating that "[t]he scope of harm that resulted from Respondent Firm's failures warrant a significant penalty." The panel also noted, as a mitigating circumstance, that "Respondent Firm has paid out millions of dollars to compensate those customers who were harmed by the violative conduct at issue here" *Id.*, at p. 7.

By way of another example, Interactive Brokers promoted, advertised, and marketed its online "Friends and Family" trading platform for unregistered investment advisers, advisers whose registrations were pending, or those who aspired to become registered investment advisers. The "Friends and Family" platform allowed unregistered investment advisers to establish an "adviser master account" with Interactive Brokers, which could then be used to manage subaccounts of up to a certain number of clients by entering trades in the master account that could then be allocated to the subaccounts. Interactive Brokers is the one of the largest U.S. electronic brokers

³ See Charles Schwab & Co., Inc., NYSE Exchange Hearing Panel Decision 05-110 (October 17, 2005).

as measured by number of customer revenue trades, which increased 14% over the prior year [2014], driving a 12% increase in commissions and execution fees. See Interactive Brokers Group, Inc., Form 10-K (Annual Report). In a May 14, 2019 Interview in RIABIZ Magazine, IB executive vice-president Steve Sanders detailed Interactive Broker's strategy to grow its business, stating: "We've decided to make an all-out push for the advisor business." The article describes Interactive Broker's "Family and Friends" trading platform as:

[A]n in-house incubator for advisors, giving it a sizable network of potential start-ups. ...A small portion of these are simply family offices, and a large number are just investment professionals looking after their immediate family's wealth; but the third group uses this offering as a springboard into the RIA world.

However, firms like Interactive Brokers have been subject to regulatory scrutiny, including for not having appropriate procedures for conducting due diligence of advisors managing accounts on the Interactive Brokers platform.

FINRA promulgated Rule 3012(1)(2), requiring procedures that are reasonably designed to review and monitor the following activities:

- (i) all transmittals of funds (e.g.) wires or checks, etc.) or securities from customers to third party accounts (i.e. transmittal that would result in a change of beneficial ownership); from customer accounts to outside entities (e.g., banks, investment companies, etc.); from customer accounts to locations other than a customer party's primary residence (e.g., post office box, "in care of" accounts, alternate address, etc.); and between customers and registered representatives, including the hand-delivery of checks;
- (ii) customer change of address and the validation of such changes of address; and
- (iii) customer changes of investment objectives and validation of such changes of investment objectives.

The policies and procedures established pursuant to paragraph (a)(2)(B) must include a means or method of customer confirmation, notification, or follow-up that can be documented.

On the other hand, clearing firms will argue that as a clearing firm their liability is limited. Clearing firms are likely to use case law from state and federal courts and argue they are merely clearing trades and performing strictly clearing activities that protect the clearing firm from liability for acts of the introducing firms. See *O'Keefe v. Courtney*, 655 F. Supp. 16 (N.D. Ill. 1985) (independent clearing agent has no obligation to know what is and is not a high-risk investment, let alone a duty to ensure that clients of investment advisors are aware of such risks); *Fezzani v. Bear, Stearns & Co., Inc.*, 384 F.Supp.2d 618 (S.D.N.Y. 2004) ("It has been consistently held that clearing brokers owe no duty of disclosure to customers of introducing brokers"); *Katz v. Fin. Clearing Servs. Corp.*, 794 F. Supp. 88, 94 (S.D.N.Y. 1992) ("Neither primary nor aiding and abetting liability under the securities laws attaches to a clearing broker who merely clears trades for an introducing broker").

Clearing firms are likely to argue that to establish liability the customer must prove some clearing firm conduct beyond its routine clearing functions and became "*actively and directly* involved in [the alleged] misdeeds." *Id.* at 353 (emphasis added); *Berwecky v. Bear Stearns & Co.*, 197 F.R.D. 65 (S.D.N.Y. 2000). In *Dillon v. Militano*, the court dismissed the plaintiff's claims for failing

to make any allegations that the clearing firm was actively or directly involved with the plaintiff's accounts:

In no way, shape or form does the complaint plead that [the clearing broker] was making decisions regarding the accounts. The pleading indicates that [the clearing broker] simply executed the . . . transactions. [The clearing broker] was not in a fiduciary relationship with [the] customers. This being so, no primary liability may attach to [the clearing broker].

731 F.Supp. at 636.

Clearing firms are also likely to argue that they have no duty to supervise the customers' investments. Clearing firms are likely to argue that their limited involvement was disclosed to the customer. Clearing firms are also likely to point to cases such as:

- *Congregation of the Passion, Holy Cross Province v. Kidder Peabody & Co., Inc.*, 800 F.2d 177, 183 (7th Cir. 1986) (no duty to disclose where the broker-dealer acted merely as the instrument for executing the transactions orchestrated by the customers' independent investment advisor);
- *SFM Holdings, Ltd. v. Banc of America*, 600 F.3d 1334 (11th Cir. 2010) (broker owed no fiduciary duty where third party acted as independent advisor and account documents explicitly stated no fiduciary relationship existed);
- *Sterner v. Penn*, 583 S.E. 2d 670 (N.C. App. 2003) (broker-dealer executing trades for investment advisor customer owed no duty to the advisor's customers)
- *Rolf v. Blyth, Eastman, Dillon & Co.*, 570 F.2d 38 (2d Cir. 1978) (broker liable for investment advisor's fraud because broker had assumed duty to supervise advisor and had repeatedly reassured customer of the correctness of advisor's actions without investigating them; court later amended decision to add footnote 16A: "decision does not impose liability on a broker/dealer who merely executes orders for 'unsuitable' securities made by an investment advisor vested with sole discretionary authority to control the account")
- *Chee v. Marine Midland Bank, N.A.*, 1991 WL 15301 (E.D.N.Y. 1991) (holding that a discount broker had no duty "to monitor the independent investment decisions of their clients" and noting "there is even greater reason to reject monitoring liability in the case of discount brokers whose admitted function is *not* to give advice so investors can save money on commissions.");
- *Unity House, Inc. v. North Pacific Investment, Inc.*, 918 F. Supp. 1384, 1391-93 (D. Haw. 1996) (holding that Fidelity and Charles Schwab as discount brokers owed no duty to monitor the activity in a non-discretionary account and stating "such a proposed duty is a good example of a plaintiff's deep-pocket theory that attempts to stretch the securities laws beyond recognition.");
- *Cromer Finance Ltd. v. Berger*, 137 F.Supp.2d 452 (S.D.N.Y. 2001) (granting firm's motion to dismiss because "while the Ponzi scheme may only have been possible because of [the firm's] actions, or inaction, [the firm's] conduct was not a proximate cause of the Ponzi scheme.");
- *First Union Discount Brokerage Serv., Inc. v. Milos*, 744 F. Supp. 1145, 1157 (S.D. Fla. 1990), *aff'd.*, 997 F.2d 835 (11th Cir. 1993) (discount broker's "only obligation to the [customers] was to enter their orders within a reasonable period of time").

THE WHOLE PICTURE: MAXIMIZING DAMAGES IN SECURITIES CASES

Sean Sweeney, Darlene Pasieczny, Robert Port, Elizabeth Falk

I. Defining Damages

FINRA's Arbitrator's Guide itemizes the following types of damages¹:

- Net Out of Pocket Losses
- Benefit of the Bargain
- Well-Managed Portfolio Account
- Statutory Damages
- Rescission
- Disgorgement
- Specific Performance

Much of this presentation is focused on Well-Managed Portfolio Account or "Market Adjusted Damages" and what FINRA and the Case Law has to tell arbitrators about applying those damages.

FINRA Defines Well-Managed Portfolio Account Damages in its Arbitrator's Guide as:

This measure of damage allows the claimant to recover the difference between what the claimant's account made or lost versus what a well-managed account, given the investor's objectives, would have made during the same time period.

(Arbitrator's Guide p. 63).

In the PIABA Journal Article, "Market Adjusted Damages" PIABA B.J., Vol 21, No. 2 p. 135 (2014) the authors² define it as:

Market adjusted damages utilize industry benchmarks to compute what an investor would have received had the portfolio been properly invested. These damages compensate an investor for losses caused by wrongful conduct in both a rising and falling market by adding or reducing return according to the actual performance of the market.

¹An excerpt from FINRA's Arbitrator's Guide is attached at the end of these materials.

²Philip M. Aidikoff, Robert A. Uhl, Ryan K. Bakhtiari, and Katrina M. Boice. We encourage all attendees to read the article in its entirety which is attached to these materials.

II. FINRA AUTHORITY REGARDING DAMAGES

In addition to the guidance above in the Arbitrator's Guide about Well-Managed or Market Adjusted Damages, the FINRA Arbitrator Training focuses on Training Arbitrator's that the goal, if liability is found, is to make the Claimant "Whole"

While arbitrators have flexibility to award damages to suit the particular case, they should have a rational and understandable basis for their award. Furthermore, actual damages should not be based on speculation, but should be designed to make the claimant "whole" for losses suffered due to misconduct found to exist.

Office of Dispute Resolution Basic Arbitrator Training p. 109³.

As Aidikoff, Uhl, Bakhtiari, and Boice point out in their "Market Adjusted Damages" article,

FINRA's well managed portfolio remedy is consistent with FINRA's know your customer and suitability rule:

2090. KNOW YOUR CUSTOMER

Every member shall use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer.

2111. SUITABILITY

(a) A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.

"Market Adjusted Damages" PIABA B.J., Vol 21, No. 2 (2014), p. 138.

III. Case Law on Securities Damages

A far more thorough analysis of the case law is contained within the article previously cited, "Market Adjusted Damages" PIABA B.J., Vol 21, No. 2 (2014), p. 138 and in Robert Port's Article "Daubert, the "Well Managed Portfolio," and "Net-out-of-pocket (NOP) Losses" Are NOPs Junk Science?" PIABA B.J., Vol 21, No. 2 p. 151 (2014). However, some key sections of those articles are as follows:

³An excerpt from that training is attached at the end of these materials.

[S]ettled law respecting computation of damages unquestionably supports the use of WMP in assessing the damages caused by an advisor's misconduct.

The seminal case is the Second Circuit's decision in *Rolf v. Blyth Eastman Dillon & Co., Inc.* 570 F.2d 38 (2d Cir. 1978), cert. denied, 439 U.S. 1039, (1978), aff'd in part and remanded, 637 F.2d 77 (2d Cir. 1980). *Rolf* involved a claim that defendant's broker purchased unsuitable securities which rapidly deteriorated in value. With respect to the proper calculation of damages, the Second Circuit directed that the district court should first compute the "gross economic loss" suffered by subtract[ing] the value of the portfolio on the date when [misconduct ended] . . . from the value on the date when [misconduct started] The district court should then reduce *Rolf's* gross economic loss by the average percentage decline in value of the Dow Jones Industrials, the Standard & Poor's Index, or any other well recognized index of value, or combination of indices, of the national securities markets during the period [of the misconduct]." 570 F.2d at 50. The court further recognized that if "the quality of stocks in the portfolio was such that a broad-based index would not be representative of those stocks, then [the district court] may select a more appropriate gauge, perhaps a portion of an index, perhaps a composite of indices, perhaps expert opinion." *Id.* at n.22. *Rolf* thus recognized the legitimacy of "market adjusted damages" -- benchmarking a portfolio to an appropriate market index as a method of computing the damages caused by an advisor's misconduct.

The *Rolf* analysis as was followed by the Fifth Circuit in *Miley v. Oppenheimer & Co.* 637 F.2d 318, 326-27 (5th Cir. 1981). In *Miley*, plaintiff asserted that his account had been churned. ("Churning occurs when a securities broker buys and sells securities for a customer's account, without regard to the customer's investment interests, for the purpose of generating commissions." *Thompson v. Smith Barney, Harris Upham & Co.*, 709 F.2d 1413, 1416 (11th Cir. 1983); see also *McNeal v. Paine, Webber, Jackson & Curtis, Inc.*, 598 F.2d 888, 890 n.1 (5th Cir. 1979)). The court instructed district courts to measure damages according to "how the investor's portfolio would have fared in the absence of the such [sic] misconduct." *Miley* at 328. The finder of fact "must be afforded significant discretion to choose the indicia by which such an estimation is made, based primarily on the types of securities comprising the portfolio." *Id.* The court observed that "in the absence of either a specialized portfolio or a showing by either party that a different method is more accurate," it would be "preferable" for district courts to use "the average percentage of performance of the Dow Jones Industrials or the Standard & Poor's Index during the relevant period as the indicia of how a given portfolio would have performed in the absence of the broker's misconduct." *Id.* The damages due plaintiff would be "the difference between what [the plaintiff] would have had if the account ha[d] been handled legitimately and what he in fact had at the time the violation ended." *Id.* at 327.

The "Well Managed Portfolio" PIABA B.J., Vol. 21, No 2 (2014) p. 157-158.

Similarly the Aidikoff, Uhl, Bakhtiari, and Boice article "Market Adjusted Damages" addresses *Rolf* and *Miley* and points out

The Fifth Circuit acknowledged that market adjusted damages “attempt to prevent a windfall to either the injured investor or the wrongdoer, regardless of whether the misconduct at issue is viewed as federal or state law violation.” (Miley, 637 F.2d at 329. See also *Donovan v. Bierwirth*, 754 F.2d 1049 (2d Cir. 1985), which adopted the market index approach where a breach of fiduciary duty was found under ERISA: One appropriate remedy in cases of breach of fiduciary duty is the restoration of the trust beneficiaries to the position they would have occupied but for the breach of trust. [w]e hold that the measure of loss applicable under ERISA section 409 requires a comparison of what the Plan actually earned on the Grumman investment with what the Plan would have earned had the funds been available for other Plan purposes.

In determining what the Plan would have earned had the funds been available for other Plan purposes, the district court should presume that the funds would have been treated like other funds being invested during the same period in proper transactions. Where several alternative investment strategies were equally plausible, the court should presume that the funds would have been used in the most profitable of these. The burden of proving that the funds would have earned less than that amount is on the fiduciaries found to be in breach of their duty. Any doubt or ambiguity should be resolved against them. *Id.* at 1056.

“Market Adjusted Damages” PIABA B.J., Vol 21, No. 2 (2014), p. 142-143

While attendees should read the entirety of the article and its analysis, the “Market Adjusted Damages” article also provides great language from the New York Supreme Court Appellate Division regarding the applicability of “Market Adjusted Damages” in suitability and other securities cases:

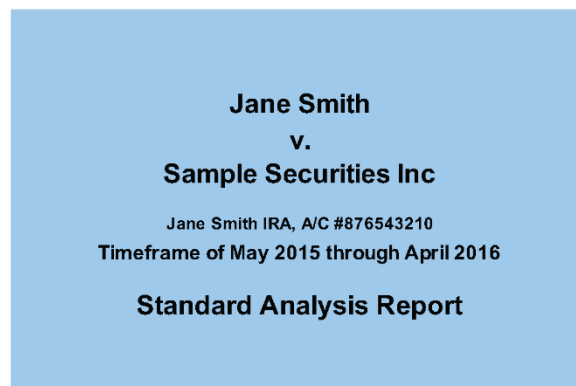
In reaching its holding, the appellate court dismissed the broker and brokerage firm’s argument that the “only proper and nonspeculative measure of damages is the value of the capital actually lost by the [investors]:” *Scalp & Blade, Inc.*, 309 A.D.2d at 222.

Based on the foregoing, we hold that in a case such as this, involving claims of churning, investment unsuitability, or other acts of unauthorized trading by defendants, an appropriate measure of damages is plaintiffs’ “gross economic loss, adjusted for the overall market’s performance”. We thus conclude that the court erred in foreclosing plaintiffs as a matter of law from recovering market index or other like lost appreciation damages. Plaintiffs are not necessarily limited to recovering the value of their lost capital, and might well recover compensatory damages calculated in part on the basis of general market performance. Plaintiffs have alleged a necessary predicate for such recovery, namely, a breach of fiduciary duty extending beyond mere negligent retention of the portfolio’s holdings and violation of a duty to sell or diversify. Indeed, plaintiffs have alleged deliberate and flagrant self-dealing and dishonesty on the part of defendants, namely, their unauthorized trading of the fund and speculative and otherwise unsuitable investment decisions with regard to it, transactions allegedly engaged in for defendants’ own benefit. To employ the metaphor used in Miley, the “spilt milk” of defendants’ alleged overtrading and inappropriate investment of the fund may

include both plaintiffs' lost capital and plaintiffs' lost opportunity to realize generalized market appreciation or gain. *Id.* at 220, 232 (citations omitted).

"Market Adjusted Damages" PIABA B.J., Vol 21, No. 2 (2014), p. 148

I. EXAMPLE PRESENTATION OF DAMAGES



Prepared by
Elizabeth Falk
of

FALK FINANCIAL ANALYSIS


Jane Smith v. Sample Securities Inc

Jane Smith IRA, A/C #876543210 - Timeframe of May 2015 through April 2016

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Jane Smith v. Sample Securities Inc	
Jane Smith IRA, A/C #876543210 - Timeframe of May 2015 through April 2016	
ACCOUNT ANALYSIS SUMMARY	
TOTAL ACCOUNT INFLOW	
BEGINNING CASH BALANCE	\$0.00
SECURITIES LONG AT THE START OF THE ANALYSIS	\$0.00
SECURITIES RECEIVED	\$459,874.51
SECURITIES TRANSFERRED IN FROM OTHER ACCOUNT	\$0.00
CASH TRANSFERRED IN FROM OTHER ACCOUNT	\$0.00
CASH DEPOSITED	\$1,467.92
TOTAL VALUE IN:	(\$461,342.43)
TOTAL ACCOUNT OUTFLOW	
CLOSING CASH BALANCE	\$0.00
SECURITIES LONG AT THE END OF THE ANALYSIS	\$0.00
SECURITIES DELIVERED	\$0.00
SECURITIES TRANSFERRED OUT TO OTHER ACCOUNT	\$0.00
CASH TRANSFERRED OUT TO OTHER ACCOUNT	\$0.00
TAXES WITHHELD	\$5,760.00
CASH WITHDRAWN	\$298,707.32
TOTAL VALUE OUT:	\$304,467.32
MONEY IN / MONEY OUT PROFIT / (LOSS):	(\$156,875.11)
PROFIT & LOSS FROM TRADING / INCOME	
REALIZED TRADING PROFIT / (LOSS)	(\$163,013.30)
UNREALIZED TRADING PROFIT / (LOSS)	\$0.00
CASH IN LIEU	\$0.00
RETURN OF CAPITAL	\$0.00
CAPITAL GAINS PAID	\$0.00
INCOME	\$6,273.19
TOTAL PROFIT / (LOSS):	(\$156,745.11)
FEES (& OTHER ADJUSTMENTS)	
MARGIN INTEREST	\$0.00
DEBIT INTEREST	\$0.00
ACCOUNT FEES	\$130.00
TOTAL FEES & OTHER ADJUSTMENTS:	(\$130.00)
NET PROFIT / (LOSS):	(\$156,875.11)
OVERALL TIME WEIGHTED RETURN:	-35.48%
ANNUALIZED TIME WEIGHTED RETURN:	-35.48%
ANNUALIZED TOR (USING AVG MONTH END ACCT VALUE)	0.42
ANNUALIZED TOR (USING AVG MONTH END NON-CASH ASSET VALUE)	0.51
ANNUALIZED CEMR (USING AVG MONTH END ACCT VALUE)	2.48%
ANNUALIZED CEMR (USING AVG MONTH END NON-CASH ASSET VALUE)	3.01%

Jane Smith v. Sample Securities Inc

Jane Smith IRA, A/C #876543210 - Timeframe of May 2015 through April 2016

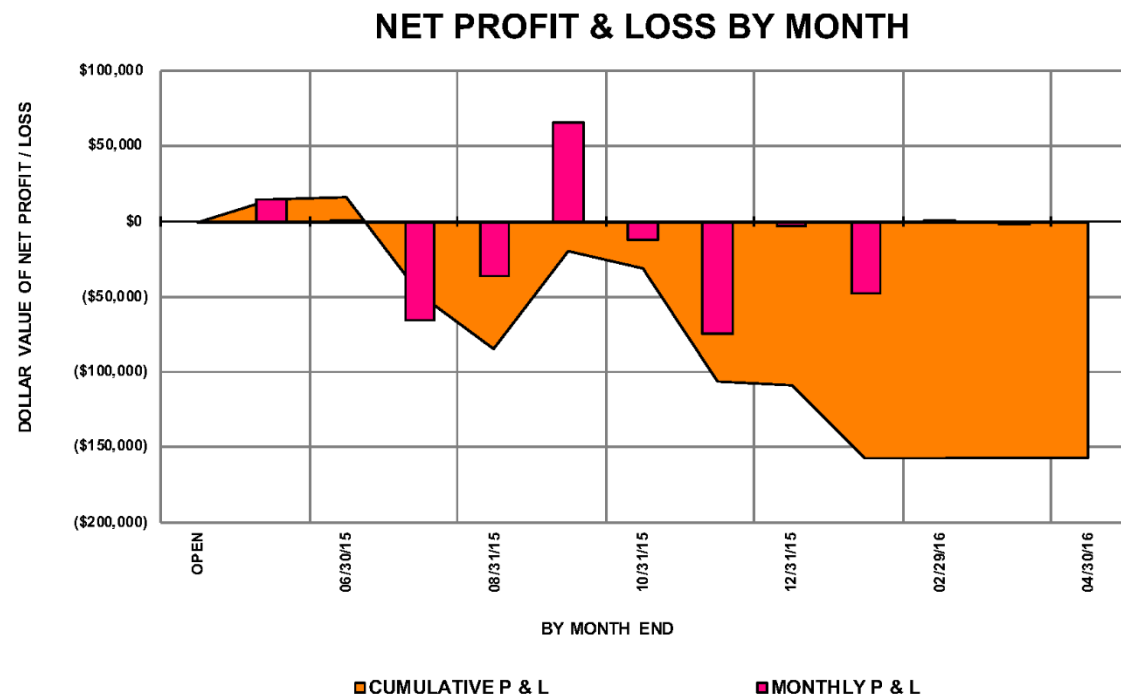
NET PROFIT & LOSS BY MONTH

MONTH ENDING	VALUES IN		INTERNAL TFRS IN	INTERNAL TFRS OUT	VALUES OUT		CUMULATIVE				
	DEPOSITS	SEC REC'D			WITHDRAWALS	SEC DEL'D	NET INVESTMENT	TOTAL MONTH END ACCOUNT VALUE	TOTAL MONTHLY PROFIT & LOSS	RATE OF RETURN	CUMULATIVE PROFIT & LOSS
OPEN	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0.00		\$0.00
05/31/15	\$1,468	\$459,875	\$0	\$0	\$0	\$0	\$461,342	\$476,243	\$14,900.94	3.23%	\$14,900.94
06/30/15	\$0	\$0	\$0	\$0	(\$3,200)	\$0	\$458,142	\$474,272	\$1,228.97	0.26%	\$16,129.91
07/31/15	\$0	\$0	\$0	\$0	(\$3,200)	\$0	\$454,942	\$405,761	-\$85,311.50	-13.86%	-\$49,181.59
08/31/15	\$0	\$0	\$0	\$0	(\$3,200)	\$0	\$451,742	\$366,775	-\$35,785.97	-8.89%	-\$84,967.56
09/30/15	\$0	\$0	\$0	\$0	(\$3,200)	\$0	\$448,542	\$429,055	\$65,479.77	18.01%	-\$19,487.79
10/31/15	\$0	\$0	\$0	\$0	(\$3,200)	\$0	\$445,342	\$414,165	-\$11,689.99	-2.75%	-\$31,177.78
11/30/15	\$0	\$0	\$0	\$0	(\$3,200)	\$0	\$442,142	\$336,260	-\$74,704.91	-18.18%	-\$105,882.69
12/31/15	\$0	\$0	\$0	\$0	(\$3,200)	\$0	\$438,942	\$329,544	-\$3,515.35	-1.06%	-\$109,398.04
01/31/16	\$0	\$0	\$0	\$0	(\$3,200)	\$0	\$435,742	\$278,970	-\$47,374.12	-14.52%	-\$156,772.16
02/29/16	\$0	\$0	\$0	\$0	(\$3,200)	\$0	\$432,542	\$275,790	\$19.65	0.01%	-\$156,752.51
03/31/16	\$0	\$0	\$0	\$0	(\$275,660)	\$0	\$156,883	\$7	-\$122.60		-\$156,875.11
04/30/16	\$0	\$0	\$0	\$0	(\$7)	\$0	\$156,875	\$0	\$0.00		-\$156,875.11
	\$1,468	\$459,875	\$0	\$0	(\$304,467)	\$0					

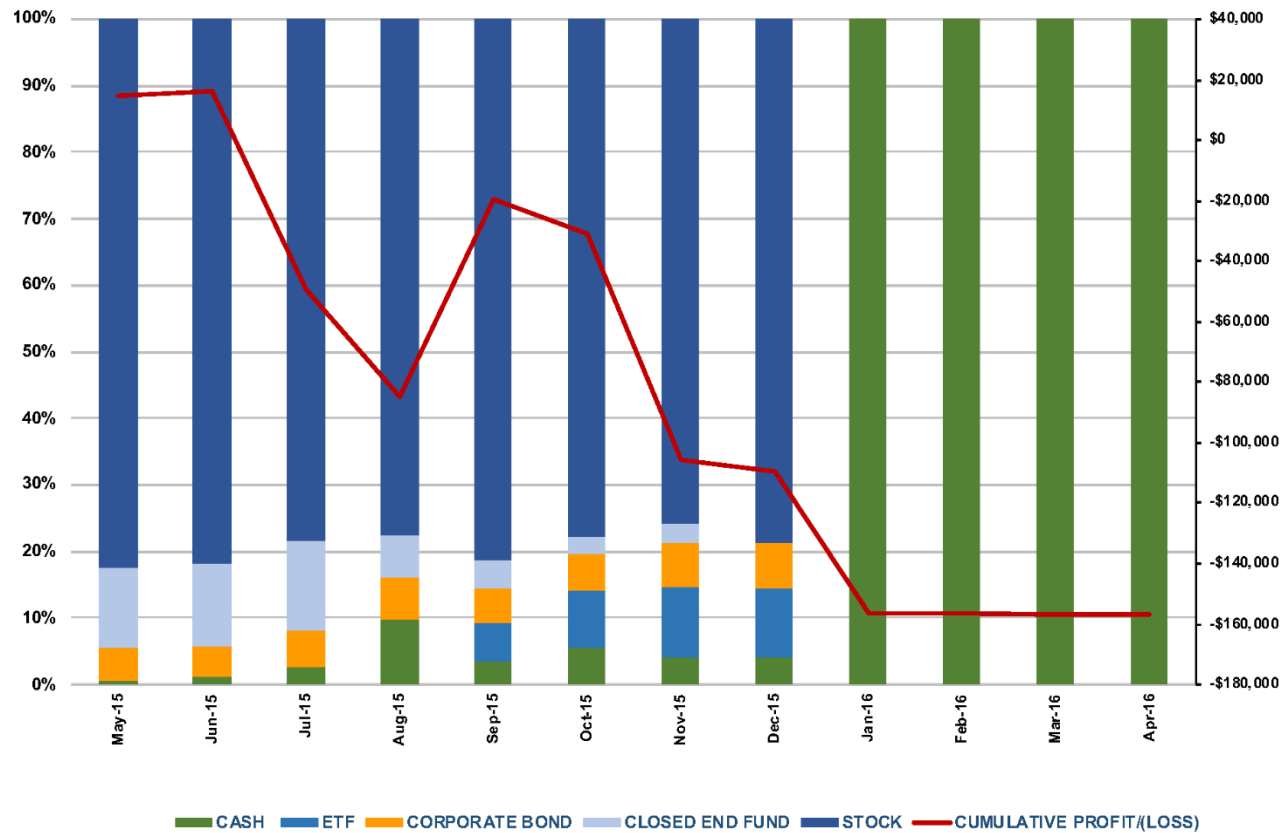
OVERALL NET PROFIT & LOSS: (\$156,875)

AVERAGE MONTHLY RATE OF RETURN -3.77%

MONTHLY STANDARD DEVIATION	10.61%
ANNUALIZED STANDARD DEVIATION	36.76%



ASSET ALLOCATION BY INVESTMENT TYPE WITH CUMULATIVE PERFORMANCE



6

CONFIDENTIAL / PRIVILEGED ATTORNEY WORK PRODUCT PREPARED BY FALK FINANCIAL ANALYSIS

Jane Smith v. Sample Securities Inc

Jane Smith IRA, A/C #876543210 - Timeframe of May 2015 through April 2016

ASSET ALLOCATION BY INVESTMENT TYPE

MONTH	STOCK	CLOSED END FUND	CORPORATE BOND	ETF	CASH
05/31/15	82.28%	12.31%	4.75%	0.00%	0.66%
06/30/15	81.79%	12.37%	4.73%	0.00%	1.11%
07/31/15	78.33%	13.66%	5.52%	0.00%	2.49%
08/31/15	77.41%	6.55%	6.08%	0.00%	9.96%
09/30/15	81.17%	4.47%	5.19%	5.69%	3.49%
10/31/15	77.68%	2.83%	5.36%	8.52%	5.61%
11/30/15	75.81%	2.95%	6.58%	10.54%	4.11%
12/31/15	78.79%	0.00%	6.65%	10.56%	3.99%
01/31/16	0.00%	0.00%	0.00%	0.00%	100.00%
02/29/16	0.00%	0.00%	0.00%	0.00%	100.00%
03/31/16	0.00%	0.00%	0.00%	0.00%	100.00%
04/30/16	0.00%	0.00%	0.00%	0.00%	100.00%

Jane Smith v. Sample Securities Inc

Jane Smith IRA, A/C #876543210 - Timeframe of May 2015 through April 2016

TRADING ACTIVITY - CHRONOLOGICAL

DATE	TYPE	C/P	UNITS	UNDERLYING	DESCRIPTION	PRICE	AMOUNT	COMM	NOTES
05/22/15	RECEIVE		7,500	WEATHERFORD INTL PLC	WEATHERFORD INTL PLC	\$0.00	(\$108,650.00)	\$0.00	
05/22/15	RECEIVE		3,750	CLEARBRIDGE AMERICAN ENERGY MLP FUND	CLEARBRIDGE AMERICAN ENERGY MLP FUND	\$0.00	(\$59,100.00)	\$0.00	
05/22/15	RECEIVE		5,000	EVOLVING SYSTEMS INC NEW	EVOLVING SYSTEMS INC NEW	\$0.00	(\$43,400.00)	\$0.00	
05/22/15	RECEIVE		7,000	LUMOS NETWORKS CORP	LUMOS NETWORKS CORP	\$0.00	(\$97,020.00)	\$0.00	
05/22/15	RECEIVE		20,000	MORGAN STANLEY MTN 6.625% EXP 04/01/18	MORGAN STANLEY MTN 6.625% EXP 04/01/18	\$0.00	(\$22,754.51)	\$0.00	
05/22/15	RECEIVE		5,000	STRAIGHT PATH COMMUNICATIONS INC	STRAIGHT PATH COMMUNICATIONS INC	\$0.00	(\$127,950.00)	\$0.00	
06/04/15	SELL		(500)	STRAIGHT PATH COMMUNICATIONS INC	STRAIGHT PATH COMMUNICATIONS INC	\$27.59	\$13,064.09	(\$729.91)	
06/19/15	BUY		500	CLEARBRIDGE AMERICAN ENERGY MLP FUND	CLEARBRIDGE AMERICAN ENERGY MLP FUND	\$14.83	(\$7,754.70)	(\$339.95)	
07/09/15	SELL		(2,000)	LUMOS NETWORKS CORP	LUMOS NETWORKS CORP	\$14.58	\$29,619.51	(\$540.49)	
07/21/15	BUY		500	ARDMORE SHIPPING CORP	ARDMORE SHIPPING CORP	\$13.50	(\$6,750.00)	\$0.00	
07/21/15	BUY		1,000	ARDMORE SHIPPING CORP	ARDMORE SHIPPING CORP	\$13.49	(\$13,827.75)	(\$339.95)	
08/24/15	SELL		(2,250)	CLEARBRIDGE AMERICAN ENERGY MLP FUND	CLEARBRIDGE AMERICAN ENERGY MLP FUND	\$12.38	\$27,624.66	(\$240.46)	
08/23/15	BUY		150	SPDR DOW JONES AVERAGE ETF	SPDR DOW JONES AVERAGE ETF	\$164.10	(\$24,855.45)	(\$239.95)	
08/24/15	SELL		(1,500)	ARDMORE SHIPPING CORP	ARDMORE SHIPPING CORP	\$12.71	\$19,827.11	(\$240.29)	
08/28/15	BUY		2,000	EVOLVING SYSTEMS INC NEW	EVOLVING SYSTEMS INC NEW	\$6.00	(\$12,339.95)	(\$339.95)	
10/01/15	BUY		50	SPDR DOW JONES AVERAGE ETF	SPDR DOW JONES AVERAGE ETF	\$160.37	(\$8,158.45)	(\$139.95)	
10/15/15	BUY		1,500	EVOLVING SYSTEMS INC NEW	EVOLVING SYSTEMS INC NEW	\$6.25	(\$9,614.95)	(\$239.95)	
10/15/15	SELL		(500)	STRAIGHT PATH COMMUNICATIONS INC	STRAIGHT PATH COMMUNICATIONS INC	\$39.67	\$19,294.68	(\$540.32)	
10/28/15	BUY		1,500	EVOLVING SYSTEMS INC NEW	EVOLVING SYSTEMS INC NEW	\$6.20	(\$9,499.95)	(\$189.95)	
10/28/15	SELL		(1,000)	CLEARBRIDGE AMERICAN ENERGY MLP FUND	CLEARBRIDGE AMERICAN ENERGY MLP FUND	\$11.55	\$11,359.83	(\$190.17)	
10/30/15	BUY		2,500	EVOLVING SYSTEMS INC NEW	EVOLVING SYSTEMS INC NEW	\$6.20	(\$15,739.95)	(\$239.95)	
10/30/15	SELL		(500)	STRAIGHT PATH COMMUNICATIONS INC	STRAIGHT PATH COMMUNICATIONS INC	\$47.35	\$23,134.61	(\$540.39)	
11/03/15	BUY		200	STRAIGHT PATH COMMUNICATIONS INC	STRAIGHT PATH COMMUNICATIONS INC	\$31.88	(\$6,515.15)	(\$139.95)	

DATE	TYPE	C/P	UNITS	UNDERLYING	DESCRIPTION	PRICE	AMOUNT	COMM	NOTES
12/03/15	BUY		500	STRAIGHT PATH COMMUNICATIONS INC	STRAIGHT PATH COMMUNICATIONS INC	\$10.81	(\$5,597.20)	(\$189.95)	
12/18/15	SELL		(1,000)	CLEARBRIDGE AMERICAN ENERGY MLP FUND	CLEARBRIDGE AMERICAN ENERGY MLP FUND	\$6.78	\$6,639.92	(\$140.08)	
01/14/16	SELL		(2,500)	WEATHERFORD INTL PLC	WEATHERFORD INTL PLC	\$6.87	\$16,934.73	(\$240.27)	
01/19/16	BUY		2,000	CONCURRENT COMPUTER CORP NEW	CONCURRENT COMPUTER CORP NEW	\$5.33	(\$11,154.76)	(\$498.75)	
01/21/16	SELL		(2,500)	WEATHERFORD INTL PLC	WEATHERFORD INTL PLC	\$5.93	\$14,684.77	(\$140.23)	
01/21/16	SELL		(2,000)	LUMOS NETWORKS CORP	LUMOS NETWORKS CORP	\$10.51	\$20,785.06	(\$240.34)	
01/22/16	SELL		(2,500)	WEATHERFORD INTL PLC	WEATHERFORD INTL PLC	\$6.09	\$15,024.71	(\$200.29)	
01/22/16	SELL		(2,000)	CONCURRENT COMPUTER CORP NEW	CONCURRENT COMPUTER CORP NEW	\$5.03	\$10,000.81	(\$50.19)	
01/22/16	SELL		(1,000)	EVOLVING SYSTEMS INC NEW	EVOLVING SYSTEMS INC NEW	\$5.01	\$4,969.45	(\$41.05)	
01/22/16	SELL		(3,500)	EVOLVING SYSTEMS INC NEW	EVOLVING SYSTEMS INC NEW	\$5.03	\$17,567.52	(\$50.33)	
01/22/16	SELL		(4,000)	EVOLVING SYSTEMS INC NEW	EVOLVING SYSTEMS INC NEW	\$5.01	\$19,972.02	(\$50.38)	
01/22/16	SELL		(4,000)	EVOLVING SYSTEMS INC NEW	EVOLVING SYSTEMS INC NEW	\$5.02	\$20,042.83	(\$50.37)	
01/22/16	SELL		(1,500)	LUMOS NETWORKS CORP	LUMOS NETWORKS CORP	\$10.58	\$15,675.58	(\$200.27)	
01/22/16	SELL		(1,500)	LUMOS NETWORKS CORP	LUMOS NETWORKS CORP	\$10.69	\$15,939.48	(\$90.22)	
01/22/16	SELL		(20,000)	MORGAN STANLEY MTN 5.625% EXP 04/01/18	MORGAN STANLEY MTN 5.625% EXP 04/01/18	\$108.60	\$22,088.59	(\$38.95)	
01/22/16	SELL		(200)	SPDR DOW JONES AVERAGE ETF	SPDR DOW JONES AVERAGE ETF	\$159.19	\$31,696.86	(\$140.54)	
01/22/16	SELL		(4,200)	STRAIGHT PATH COMMUNICATIONS INC	STRAIGHT PATH COMMUNICATIONS INC	\$13.05	\$54,708.55	(\$90.95)	

TOTAL PROFIT & (LOSS): (\$163,018.30)

TOTAL COMMISSION PAID: (\$7,685.76)

¹ THE VALUES USED FOR TRANSFERS IS THE MARKET VALUE FOR THE POSITION UPON TRANSFER AS REPORTED IN THE STATEMENT ACTIVITY.

SOURCE: MONTHLY ACCOUNT STATEMENTS
TRADE CONFIRMATIONS

9
CONFIDENTIAL / PRIVILEGED ATTORNEY WORK PRODUCT
PREPARED BY FALK FINANCIAL ANALYSIS

Jane Smith v. Sample Securities Inc

Jane Smith IRA, A/C #876543210 - Timeframe of May 2015 through April 2016

TRADING ACTIVITY - BY ISSUE

DATE	TYPE	UNITS	UNDERLYING	DESCRIPTION	PRICE	AMOUNT	COMM	NOTES
07/21/15	BUY	500	ARDMORE SHIPPING CORP	ARDMORE SHIPPING CORP	\$13.50	(\$6,750.00)	\$0.00	
07/21/15	BUY	1,000	ARDMORE SHIPPING CORP	ARDMORE SHIPPING CORP	\$13.49	(\$13,827.75)	(\$339.95)	
09/24/15	SELL	(1,500)	ARDMORE SHIPPING CORP	ARDMORE SHIPPING CORP	\$12.71	\$18,827.11	(\$240.29)	
PROFIT / (LOSS) FOR POSITION:						(\$1,750.64)	(\$580.24)	
05/22/15	RECEIVE	3,750	CLEARBRIDGE AMERICAN ENERGY MLP FUND	CLEARBRIDGE AMERICAN ENERGY MLP FUND	\$0.00	(\$59,100.00)	\$0.00	
06/19/15	BUY	500	CLEARBRIDGE AMERICAN ENERGY MLP FUND	CLEARBRIDGE AMERICAN ENERGY MLP FUND	\$14.83	(\$7,754.70)	(\$339.95)	
08/24/15	SELL	(2,250)	CLEARBRIDGE AMERICAN ENERGY MLP FUND	CLEARBRIDGE AMERICAN ENERGY MLP FUND	\$12.38	\$27,624.66	(\$240.46)	
10/28/15	SELL	(1,000)	CLEARBRIDGE AMERICAN ENERGY MLP FUND	CLEARBRIDGE AMERICAN ENERGY MLP FUND	\$11.56	\$11,359.83	(\$190.17)	
12/18/15	SELL	(1,000)	CLEARBRIDGE AMERICAN ENERGY MLP FUND	CLEARBRIDGE AMERICAN ENERGY MLP FUND	\$6.78	\$6,639.92	(\$140.06)	
PROFIT / (LOSS) FOR POSITION:						(\$21,230.29)	(\$910.66)	
01/19/16	BUY	2,000	CONCURRENT COMPUTER CORP NEW	CONCURRENT COMPUTER CORP NEW	\$5.33	(\$11,154.76)	(\$498.76)	
01/22/16	SELL	(2,000)	CONCURRENT COMPUTER CORP NEW	CONCURRENT COMPUTER CORP NEW	\$5.03	\$10,000.81	(\$50.19)	
PROFIT / (LOSS) FOR POSITION:						(\$1,153.95)	(\$548.95)	
05/22/15	RECEIVE	5,000	EVOLVING SYSTEMS INC NEW	EVOLVING SYSTEMS INC NEW	\$0.00	(\$43,400.00)	\$0.00	
09/28/15	BUY	2,000	EVOLVING SYSTEMS INC NEW	EVOLVING SYSTEMS INC NEW	\$6.00	(\$12,339.95)	(\$339.95)	
10/15/15	BUY	1,500	EVOLVING SYSTEMS INC NEW	EVOLVING SYSTEMS INC NEW	\$6.25	(\$9,614.95)	(\$239.95)	
10/28/15	BUY	1,500	EVOLVING SYSTEMS INC NEW	EVOLVING SYSTEMS INC NEW	\$6.20	(\$9,489.95)	(\$189.95)	
10/30/15	BUY	2,500	EVOLVING SYSTEMS INC NEW	EVOLVING SYSTEMS INC NEW	\$6.20	(\$15,739.95)	(\$239.95)	
01/22/16	SELL	(1,000)	EVOLVING SYSTEMS INC NEW	EVOLVING SYSTEMS INC NEW	\$5.01	\$4,969.45	(\$41.05)	
01/22/16	SELL	(3,500)	EVOLVING SYSTEMS INC NEW	EVOLVING SYSTEMS INC NEW	\$5.03	\$17,567.62	(\$50.33)	

SOURCE: MONTHLY ACCOUNT STATEMENTS
TRADE CONFIRMATIONS

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CONFIDENTIAL / PRIVILEGED ATTORNEY WORK PRODUCT
PREPARED BY FALK FINANCIAL ANALYSIS

DATE	TYPE	UNITS	UNDERLYING	DESCRIPTION	PRICE	AMOUNT	COMM	NOTES
01/22/16	SELL	(4,000)	EVOLVING SYSTEMS INC NEW	EVOLVING SYSTEMS INC NEW	\$5.01	\$19,972.02	(\$50.38)	
01/22/16	SELL	(4,000)	EVOLVING SYSTEMS INC NEW	EVOLVING SYSTEMS INC NEW	\$5.02	\$20,042.83	(\$50.37)	
PROFIT / (LOSS) FOR POSITION:						(\$28,032.88)	(\$1,201.93)	
05/22/15	RECEIVE	7,000	LUMOS NETWORKS CORP	LUMOS NETWORKS CORP	\$0.00	(\$97,020.00)	\$0.00	
07/08/15	SELL	(2,000)	LUMOS NETWORKS CORP	LUMOS NETWORKS CORP	\$14.58	\$28,619.51	(\$540.49)	
01/21/16	SELL	(2,000)	LUMOS NETWORKS CORP	LUMOS NETWORKS CORP	\$10.51	\$20,785.06	(\$240.34)	
01/22/16	SELL	(1,500)	LUMOS NETWORKS CORP	LUMOS NETWORKS CORP	\$10.58	\$15,675.58	(\$200.27)	
01/22/16	SELL	(1,500)	LUMOS NETWORKS CORP	LUMOS NETWORKS CORP	\$10.69	\$15,938.48	(\$90.22)	
PROFIT / (LOSS) FOR POSITION:						(\$16,001.37)	(\$1,071.32)	
05/22/15	RECEIVE	20,000	MORGAN STANLEY MTN 6.625% EXP 04/01/18	MORGAN STANLEY MTN 6.625% EXP 04/01/18	\$0.00	(\$22,754.51)	\$0.00	
01/22/16	SELL	(20,000)	MORGAN STANLEY MTN 6.625% EXP 04/01/18	MORGAN STANLEY MTN 6.625% EXP 04/01/18	\$108.60	\$22,088.59	(\$39.95)	
PROFIT / (LOSS) FOR POSITION:						(\$665.92)	(\$39.95)	
09/23/15	BUY	150	SPDR DOW JONES AVERAGE ETF	SPDR DOW JONES AVERAGE ETF	\$164.10	(\$24,855.45)	(\$239.96)	
10/01/15	BUY	50	SPDR DOW JONES AVERAGE ETF	SPDR DOW JONES AVERAGE ETF	\$160.37	(\$8,158.45)	(\$139.96)	
01/22/16	SELL	(200)	SPDR DOW JONES AVERAGE ETF	SPDR DOW JONES AVERAGE ETF	\$159.19	\$31,896.86	(\$140.54)	
PROFIT / (LOSS) FOR POSITION:						(\$1,317.04)	(\$620.45)	
05/22/15	RECEIVE	5,000	STRAIGHT PATH COMMUNICATIONS INC	STRAIGHT PATH COMMUNICATIONS INC	\$0.00	(\$127,950.00)	\$0.00	
09/04/15	SELL	(500)	STRAIGHT PATH COMMUNICATIONS INC	STRAIGHT PATH COMMUNICATIONS INC	\$27.59	\$13,064.09	(\$729.91)	
10/15/15	SELL	(500)	STRAIGHT PATH COMMUNICATIONS INC	STRAIGHT PATH COMMUNICATIONS INC	\$39.67	\$19,294.68	(\$540.32)	
10/30/15	SELL	(500)	STRAIGHT PATH COMMUNICATIONS INC	STRAIGHT PATH COMMUNICATIONS INC	\$47.35	\$23,134.61	(\$540.39)	
11/03/15	BUY	200	STRAIGHT PATH COMMUNICATIONS INC	STRAIGHT PATH COMMUNICATIONS INC	\$31.88	(\$6,515.15)	(\$139.96)	
12/03/15	BUY	500	STRAIGHT PATH COMMUNICATIONS INC	STRAIGHT PATH COMMUNICATIONS INC	\$10.81	(\$5,597.20)	(\$189.96)	

SOURCE: MONTHLY ACCOUNT STATEMENTS
TRADE CONFIRMATIONS

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CONFIDENTIAL / PRIVILEGED ATTORNEY WORK PRODUCT
PREPARED BY FALK FINANCIAL ANALYSIS

DATE	TYPE	UNITS	UNDERLYING	DESCRIPTION	PRICE	AMOUNT	COMM	NOTES
01/22/16	SELL	(4,200)	STRAIGHT PATH COMMUNICATIONS INC	STRAIGHT PATH COMMUNICATIONS INC	\$13.05	\$54,708.55	(\$80.95)	
PROFIT / (LOSS) FOR POSITION:						(\$29,860.42)	(\$2,231.47)	
05/22/15	RECEIVE	7,500	WEATHERFORD INTL PLC	WEATHERFORD INTL PLC	\$0.00	(\$109,650.00)	\$0.00	
01/14/16	SELL	(2,500)	WEATHERFORD INTL PLC	WEATHERFORD INTL PLC	\$6.87	\$16,934.73	(\$240.27)	
01/21/16	SELL	(2,500)	WEATHERFORD INTL PLC	WEATHERFORD INTL PLC	\$5.93	\$14,684.77	(\$140.23)	
01/22/16	SELL	(2,500)	WEATHERFORD INTL PLC	WEATHERFORD INTL PLC	\$6.09	\$15,024.71	(\$200.29)	
PROFIT / (LOSS) FOR POSITION:						(\$63,005.79)	(\$580.79)	

TOTAL PROFIT & (LOSS): (\$163,018.30)

TOTAL COMMISSION PAID: (\$7,685.76)

¹ THE VALUES USED FOR TRANSFERS IS THE MARKET VALUE FOR THE POSITION UPON TRANSFER AS REPORTED IN THE STATEMENT ACTIVITY.

SOURCE: MONTHLY ACCOUNT STATEMENTS
TRADE CONFIRMATIONS

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CONFIDENTIAL / PRIVILEGED ATTORNEY WORK PRODUCT
PREPARED BY FALK FINANCIAL ANALYSIS

Jane Smith v. Sample Securities Inc

Jane Smith IRA, A/C #876543210 - Timeframe of May 2015 through April 2016

HIGHEST TRADING LOSS TO HIGHEST TRADING GAIN

POSITION	POSITION PROFIT / (LOSS)	% POSITION RETURN	COMMISSIONS	NOTE
WEATHERFORD INTL PLC	(\$63,005.79)	-57.46%	(\$580.79)	
STRAIGHT PATH COMMUNICATIONS INC	(\$29,860.42)	-21.32%	(\$2,231.47)	
EVOLVING SYSTEMS INC NEW	(\$28,032.88)	-30.95%	(\$1,201.93)	
CLEARBRIDGE AMERICAN ENERGY MLP FUND	(\$21,230.29)	-31.76%	(\$910.66)	
LUMOS NETWORKS CORP	(\$16,001.37)	-16.49%	(\$1,071.32)	
ARDMORE SHIPPING CORP	(\$1,750.64)	-8.51%	(\$580.24)	
SPDR DOW JONES AVERAGE ETF	(\$1,317.04)	-3.99%	(\$520.45)	
CONCURRENT COMPUTER CORP NEW	(\$1,153.95)	-10.34%	(\$548.95)	
MORGAN STANLEY MTN 6.625% EXP 04/01/18	(\$665.92)	-2.93%	(\$39.95)	
TOTAL TRADING PROFIT & (LOSS):	(\$163,018.30)		(\$7,685.76)	

Jane Smith v. Sample Securities Inc

Jane Smith IRA, A/C #876543210 - Timeframe of May 2015 through April 2016

HIGHEST TRADING LOSS TO HIGHEST TRADING GAIN - BY INVESTMENT TYPE

POSITION	INVESTMENT TYPE ¹	POSITION PROFIT / (LOSS)	% POSITION RETURN	COMMISSIONS	NOTE
CLEARBRIDGE AMERICAN ENERGY MLP FUND	CLOSED END FUND	(\$21,230.29)	-31.76%	(\$910.67)	
TOTAL TRADING PERFORMANCE OF CLOSED END FUND		(\$21,230.29)		(\$910.67)	
WEATHERFORD INTL PLC	COMMON STOCK	(\$63,005.79)	-57.46%	(\$580.79)	
STRAIGHT PATH COMMUNICATIONS INC	COMMON STOCK	(\$29,860.42)	-21.32%	(\$2,231.47)	
EVOLVING SYSTEMS INC NEW	COMMON STOCK	(\$28,032.88)	-30.95%	(\$1,201.93)	
LUMOS NETWORKS CORP	COMMON STOCK	(\$16,001.37)	-16.49%	(\$1,071.32)	
ARDMORE SHIPPING CORP	COMMON STOCK	(\$1,750.64)	-8.51%	(\$580.24)	
CONCURRENT COMPUTER CORP NEW	COMMON STOCK	(\$1,153.95)	-10.34%	(\$548.95)	
TOTAL TRADING PERFORMANCE OF COMMON STOCK		(\$139,805.05)		(\$6,214.70)	
MORGAN STANLEY MTN 6.625% EXP 04/01/18	CORPORATE BOND	(\$665.92)	-2.93%	(\$39.95)	
TOTAL TRADING PERFORMANCE OF CORPORATE BOND		(\$665.92)		(\$39.95)	
SPDR DOW JONES AVERAGE ETF	ETF	(\$1,317.04)	-3.99%	(\$520.45)	
TOTAL TRADING PERFORMANCE OF ETF		(\$1,317.04)		(\$520.45)	

TOTAL TRADING PROFIT & (LOSS): **(\$163,018.30)** **(\$7,685.76)**

Jane Smith v. Sample Securities Inc

Jane Smith IRA, A/C #876543210 - Timeframe of May 2015 through April 2016

HIGHEST NET LOSS TO HIGHEST NET GAIN (TOTAL RETURN)

POSITION	NET PROFIT / (LOSS)	% POSITION TOTAL RETURN	COMMISSIONS	NOTE
WEATHERFORD INTL PLC	(\$63,005.79)	-57.46%	(\$580.79)	
STRAIGHT PATH COMMUNICATIONS INC	(\$29,860.42)	-21.32%	(\$2,231.47)	
EVOLVING SYSTEMS INC NEW	(\$25,557.88)	-28.21%	(\$1,201.93)	
CLEARBRIDGE AMERICAN ENERGY MLP FUND	(\$18,485.29)	-27.65%	(\$910.66)	
LUMOS NETWORKS CORP	(\$16,001.37)	-16.49%	(\$1,071.32)	
ARDMORE SHIPPING CORP	(\$1,600.64)	-7.78%	(\$580.24)	
SPDR DOW JONES AVERAGE ETF	(\$1,087.78)	-3.29%	(\$520.45)	
CONCURRENT COMPUTER CORP NEW	(\$1,153.95)	-10.34%	(\$548.95)	
MORGAN STANLEY MTN 6.625% EXP 04/01/18	(\$3.42)	-0.02%	(\$39.95)	
TOTAL NET PROFIT & (LOSS):	(\$156,756.54)		(\$7,685.76)	

Jane Smith v. Sample Securities Inc

Jane Smith IRA, A/C #876543210 - Timeframe of May 2015 through April 2016

CASH ACTIVITY - CHRONOLOGICAL

DATE	DESCRIPTION	TRANSACTION TYPE	AMOUNT
05/22/15	FUNDS RECEIVED VIA ACATS	DEPOSIT	\$1,467.90
05/28/15	FUNDS RECEIVED VIA ACATS	DEPOSIT	\$0.02
05/29/15	CLEARBRIDGE AMERICAN ENERGY MLP FUND DIVIDEND	INCOME	\$1,143.75
05/29/15	EVOLVING SYSTEMS INC NEW DIVIDEND	INCOME	\$550.00
06/05/15	TAX WITHHELD - FEDERAL	TAX WITHHELD	(\$640.00)
06/05/15	FUNDS DELIVERED VIA NORMAL DISTRIBUTION	WITHDRAWAL	(\$2,560.00)
06/30/15	MONEY MARKET DIVIDEND	INCOME	\$0.08
07/02/15	TAX WITHHELD - FEDERAL	TAX WITHHELD	(\$640.00)
07/02/15	FUNDS DELIVERED VIA NORMAL DISTRIBUTION	WITHDRAWAL	(\$2,560.00)
07/31/15	MONEY MARKET DIVIDEND	INCOME	\$0.14
08/05/15	TAX WITHHELD - FEDERAL	TAX WITHHELD	(\$640.00)
08/05/15	FUNDS DELIVERED VIA NORMAL DISTRIBUTION	WITHDRAWAL	(\$2,560.00)
08/14/15	ARDMORE SHIPPING CORP DIVIDEND	INCOME	\$150.00
08/28/15	CLEARBRIDGE AMERICAN ENERGY MLP FUND DIVIDEND	INCOME	\$1,296.25
08/28/15	EVOLVING SYSTEMS INC NEW DIVIDEND	INCOME	\$550.00
08/31/15	MONEY MARKET DIVIDEND	INCOME	\$0.12
09/04/15	TAX WITHHELD - FEDERAL	TAX WITHHELD	(\$640.00)
09/04/15	FUNDS DELIVERED VIA NORMAL DISTRIBUTION	WITHDRAWAL	(\$2,560.00)
09/30/15	MONEY MARKET DIVIDEND	INCOME	\$0.26

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CONFIDENTIAL / PRIVILEGED ATTORNEY WORK PRODUCT
PREPARED BY FALK FINANCIAL ANALYSIS

SOURCE: MONTHLY ACCOUNT STATEMENTS

DATE	DESCRIPTION	TRANSACTION TYPE	AMOUNT
10/01/15	MORGAN STANLEY MTN 6.625% EXP 04/01/18 INTEREST	INCOME	\$662.50
10/05/15	TAX WITHHELD - FEDERAL	TAX WITHHELD	(\$640.00)
10/05/15	FUNDS DELIVERED V/A NORMAL DISTRIBUTION	WITHDRAWAL	(\$2,560.00)
10/30/15	MONEY MARKET DIVIDEND	INCOME	\$0.09
11/05/15	TAX WITHHELD - FEDERAL	TAX WITHHELD	(\$640.00)
11/05/15	FUNDS DELIVERED V/A NORMAL DISTRIBUTION	WITHDRAWAL	(\$2,560.00)
11/16/15	SPDR DOW JONES AVERAGE ETF DIVIDEND	INCOME	\$15.92
11/27/15	CLEARBRIDGE AMERICAN ENERGY MLP FUND DIVIDEND	INCOME	\$305.00
11/30/15	MONEY MARKET DIVIDEND	INCOME	\$0.12
12/04/15	EVOLVING SYSTEMS INC NEW DIVIDEND	INCOME	\$1,375.00
12/04/15	TAX WITHHELD - FEDERAL	TAX WITHHELD	(\$640.00)
12/04/15	FUNDS DELIVERED V/A NORMAL DISTRIBUTION	WITHDRAWAL	(\$2,560.00)
12/14/15	SPDR DOW JONES AVERAGE ETF DIVIDEND	INCOME	\$114.65
12/31/15	MONEY MARKET DIVIDEND	INCOME	\$0.08
01/05/16	TAX WITHHELD - FEDERAL	TAX WITHHELD	(\$640.00)
01/05/16	FUNDS DELIVERED V/A NORMAL DISTRIBUTION	WITHDRAWAL	(\$2,560.00)
01/11/16	SPDR DOW JONES AVERAGE ETF DIVIDEND	INCOME	\$81.51
01/29/16	MONEY MARKET DIVIDEND	INCOME	\$0.67
02/05/16	TAX WITHHELD - FEDERAL	TAX WITHHELD	(\$640.00)
02/05/16	FUNDS DELIVERED V/A NORMAL DISTRIBUTION	WITHDRAWAL	(\$2,560.00)
02/16/16	SPDR DOW JONES AVERAGE ETF DIVIDEND	INCOME	\$17.18
02/29/16	MONEY MARKET DIVIDEND	INCOME	\$2.47
03/11/16	RETIREMENT CLOSEOUT FEE	FEE	(\$95.00)

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CONFIDENTIAL / PRIVILEGED ATTORNEY WORK PRODUCT
PREPARED BY FALK FINANCIAL ANALYSIS

SOURCE: MONTHLY ACCOUNT STATEMENTS

DATE	DESCRIPTION	TRANSACTION TYPE	AMOUNT
03/11/16	RETIREMENT MAINTENANCE FEE	FEE	(\$35.00)
03/17/16	FUNDS DELIVERED VIA ACATS	WITHDRAWAL	(\$275,659.92)
03/31/16	MONEY MARKET DIVIDEND	INCOME	\$7.40
04/05/16	FUNDS DELIVERED VIA ACATS	WITHDRAWAL	(\$7.40)

TOTAL CASH IN AND OUT: (\$296,856.21)

Jane Smith v. Sample Securities Inc

Jane Smith IRA, A/C #876543210 - Timeframe of May 2015 through April 2016

CASH ACTIVITY - BY TRANSACTION TYPE

DATE	DESCRIPTION	TRANSACTION TYPE	AMOUNT
05/22/15	FUNDS RECEIVED VIA ACATS	DEPOSIT	\$1,467.90
05/28/15	FUNDS RECEIVED VIA ACATS	DEPOSIT	\$0.02
		DEPOSIT	\$1,467.92
03/11/16	RETIREMENT CLOSEOUT FEE	FEE	(\$95.00)
03/11/16	RETIREMENT MAINTENANCE FEE	FEE	(\$35.00)
		FEE	(\$130.00)
05/29/15	CLEARBRIDGE AMERICAN ENERGY MLP FUND DIVIDEND	INCOME	\$1,143.75
05/29/15	EVOLVING SYSTEMS INC NEW DIVIDEND	INCOME	\$550.00
06/30/15	MONEY MARKET DIVIDEND	INCOME	\$0.08
07/31/15	MONEY MARKET DIVIDEND	INCOME	\$0.14
08/14/15	ARDMORE SHIPPING CORP DIVIDEND	INCOME	\$150.00
08/28/15	CLEARBRIDGE AMERICAN ENERGY MLP FUND DIVIDEND	INCOME	\$1,296.25
08/28/15	EVOLVING SYSTEMS INC NEW DIVIDEND	INCOME	\$550.00
08/31/15	MONEY MARKET DIVIDEND	INCOME	\$0.12
09/30/15	MONEY MARKET DIVIDEND	INCOME	\$0.26
10/01/15	MORGAN STANLEY MTN 6.625% EXP 04/01/18 INTEREST	INCOME	\$662.50
10/30/15	MONEY MARKET DIVIDEND	INCOME	\$0.09

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CONFIDENTIAL / PRIVILEGED ATTORNEY WORK PRODUCT
PREPARED BY FALK FINANCIAL ANALYSIS

SOURCE: MONTHLY ACCOUNT STATEMENTS

DATE	DESCRIPTION	TRANSACTION TYPE	AMOUNT
11/16/15	SPDR DOW JONES AVERAGE ETF DIVIDEND	INCOME	\$15.92
11/27/15	CLEARBRIDGE AMERICAN ENERGY MLP FUND DIVIDEND	INCOME	\$305.00
11/30/15	MONEY MARKET DIVIDEND	INCOME	\$0.12
12/04/15	EVOLVING SYSTEMS INC NEW DIVIDEND	INCOME	\$1,375.00
12/14/15	SPDR DOW JONES AVERAGE ETF DIVIDEND	INCOME	\$114.65
12/31/15	MONEY MARKET DIVIDEND	INCOME	\$0.08
01/11/16	SPDR DOW JONES AVERAGE ETF DIVIDEND	INCOME	\$81.51
01/29/16	MONEY MARKET DIVIDEND	INCOME	\$0.67
02/16/16	SPDR DOW JONES AVERAGE ETF DIVIDEND	INCOME	\$17.18
02/29/16	MONEY MARKET DIVIDEND	INCOME	\$2.47
03/31/16	MONEY MARKET DIVIDEND	INCOME	\$7.40
		INCOME	\$6,273.19
06/05/15	TAX WITHHELD - FEDERAL	TAX WITHHELD	(\$640.00)
07/02/15	TAX WITHHELD - FEDERAL	TAX WITHHELD	(\$640.00)
08/05/15	TAX WITHHELD - FEDERAL	TAX WITHHELD	(\$640.00)
09/04/15	TAX WITHHELD - FEDERAL	TAX WITHHELD	(\$640.00)
10/05/15	TAX WITHHELD - FEDERAL	TAX WITHHELD	(\$640.00)
11/05/15	TAX WITHHELD - FEDERAL	TAX WITHHELD	(\$640.00)
12/04/15	TAX WITHHELD - FEDERAL	TAX WITHHELD	(\$640.00)
01/05/16	TAX WITHHELD - FEDERAL	TAX WITHHELD	(\$640.00)
02/05/16	TAX WITHHELD - FEDERAL	TAX WITHHELD	(\$640.00)
		TAX WITHHELD	(\$5,760.00)

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CONFIDENTIAL / PRIVILEGED ATTORNEY WORK PRODUCT
PREPARED BY FALK FINANCIAL ANALYSIS

SOURCE: MONTHLY ACCOUNT STATEMENTS

DATE	DESCRIPTION	TRANSACTION TYPE	AMOUNT
06/05/15	FUNDS DELIVERED VIA NORMAL DISTRIBUTION	WITHDRAWAL	(\$2,560.00)
07/02/15	FUNDS DELIVERED VIA NORMAL DISTRIBUTION	WITHDRAWAL	(\$2,560.00)
08/05/15	FUNDS DELIVERED VIA NORMAL DISTRIBUTION	WITHDRAWAL	(\$2,560.00)
09/04/15	FUNDS DELIVERED VIA NORMAL DISTRIBUTION	WITHDRAWAL	(\$2,560.00)
10/05/15	FUNDS DELIVERED VIA NORMAL DISTRIBUTION	WITHDRAWAL	(\$2,560.00)
11/05/15	FUNDS DELIVERED VIA NORMAL DISTRIBUTION	WITHDRAWAL	(\$2,560.00)
12/04/15	FUNDS DELIVERED VIA NORMAL DISTRIBUTION	WITHDRAWAL	(\$2,560.00)
01/05/16	FUNDS DELIVERED VIA NORMAL DISTRIBUTION	WITHDRAWAL	(\$2,560.00)
02/05/16	FUNDS DELIVERED VIA NORMAL DISTRIBUTION	WITHDRAWAL	(\$2,560.00)
03/17/16	FUNDS DELIVERED VIA ACATS	WITHDRAWAL	(\$275,659.92)
04/05/16	FUNDS DELIVERED VIA ACATS	WITHDRAWAL	(\$7.40)
		WITHDRAWAL	(\$298,707.32)

TOTAL CASH IN AND OUT: (\$296,856.21)

Jane Smith v. Sample Securities Inc

Jane Smith IRA, A/C #876543210 - Timeframe of May 2015 through April 2016

AVERAGE MONTH END ACCOUNT VALUE

MONTH	MONTH END ACCOUNT VALUE
May-15	\$476,243
Jun-15	\$474,272
Jul-15	\$405,761
Aug-15	\$366,775
Sep-15	\$429,055
Oct-15	\$414,165
Nov-15	\$336,260
Dec-15	\$329,544
Jan-16	\$278,970
Feb-16	\$275,790
Mar-16	\$7
Apr-16	\$0

AVERAGE MONTH END ACCOUNT VALUE: \$315,570**AVG MONTH END NON-CASH ASSET VALUE: \$259,320**

Jane Smith v. Sample Securities Inc

Jane Smith IRA, A/C #876543210 - Timeframe of May 2015 through April 2016

ANNUALIZED TURNOVER RATE (USING AVG MONTH END ACCT VALUE)

TOTAL BUYS	÷	AVERAGE MONTH END ACCT VALUE	=	TURNOVER	YEARS	ANNUALIZED TOR
\$131,798.26		\$315,570		0.4177	1.00	0.42

ANNUALIZED TURNOVER RATE CALCULATION

STEP ONE:	$\frac{\text{TOTAL PURCHASES}}{\text{AVERAGE MONTH END ACCT VALUE}}$	=	TOTAL TURNOVER

STEP TWO:	$\frac{\text{TOTAL TURNOVER}}{\text{YEARS IN TIME PERIOD}}$	=	ANNUALIZED TOR

STEP ONE:	$\frac{\$131,798}{\$315,570}$	=	0.42

STEP TWO:	$\frac{0.42}{1.00}$	=	0.42	ANNUALIZED TOR

Jane Smith v. Sample Securities Inc

Jane Smith IRA, A/C #876543210 - Timeframe of May 2015 through April 2016

ANNUALIZED TURNOVER RATE (USING AVG MONTH END NON-CASH ASSET VALUE)

TOTAL BUYS	÷	AVERAGE MONTH END NON-CASH ASSET VALUE	=	TURNOVER	YEARS	ANNUALIZED TOR
\$131,798.26		\$259,320		0.5082	1.00	0.51

ANNUALIZED TURNOVER RATE CALCULATION

STEP ONE:	$\frac{\text{TOTAL PURCHASES}}{\text{AVERAGE MONTH END NON-CASH ASSET VALUE}}$	=	TOTAL TURNOVER

STEP TWO:	$\frac{\text{TOTAL TURNOVER}}{\text{YEARS IN TIME PERIOD}}$	=	ANNUALIZED TOR

STEP ONE:	$\frac{\$131,798}{\$259,320}$	=	0.51

STEP TWO:	$\frac{0.51}{1.00}$	=	0.51	ANNUALIZED TOR

Jane Smith v. Sample Securities Inc

Jane Smith IRA, A/C #876543210 - Timeframe of May 2015 through April 2016

ANNUALIZED COST EQUITY MAINTENANCE RATIO (USING AVG MONTH END ACCT VALUE)

COMM & MARGIN INT	÷ AVERAGE MONTH END ACCT VALUE	=	CEMR	YEARS	ANNUALIZED CEMR
\$7,815.76	\$315,570		0.0248	1.00	2.48%

ANNUALIZED COST EQUITY MAINTENANCE RATIO CALCULATION

STEP ONE:
$$\frac{\text{COMM, MARGIN INT \& FEES}}{\text{AVERAGE MONTH END ACCT VALUE}} = \text{TOTAL COST EQUITY MAINTENANCE RATIO}$$

STEP TWO:
$$\frac{\text{TOTAL CEMR}}{\text{YEARS IN TIME PERIOD}} = \text{ANNUALIZED CEMR}$$

STEP ONE:
$$\frac{\$7,816}{\$315,570} = 0.02$$

STEP TWO:
$$\frac{0.02}{1.00} = 2.48\% \quad \text{ANNUALIZED CEMR}$$

Jane Smith v. Sample Securities Inc

Jane Smith IRA, A/C #876543210 - Timeframe of May 2015 through April 2016

ANNUALIZED COST EQUITY MAINTENANCE RATIO (USING AVG MONTH END NON-CASH ASSET VALUE)

COMM & MARGIN INT	÷ AVERAGE MONTH END NON-CASH ASSET VALUE	=	CEMR	YEARS	ANNUALIZED CEMR
\$7,815.76	\$259,320		0.0301	1.00	3.01%

ANNUALIZED COST EQUITY MAINTENANCE RATIO CALCULATION

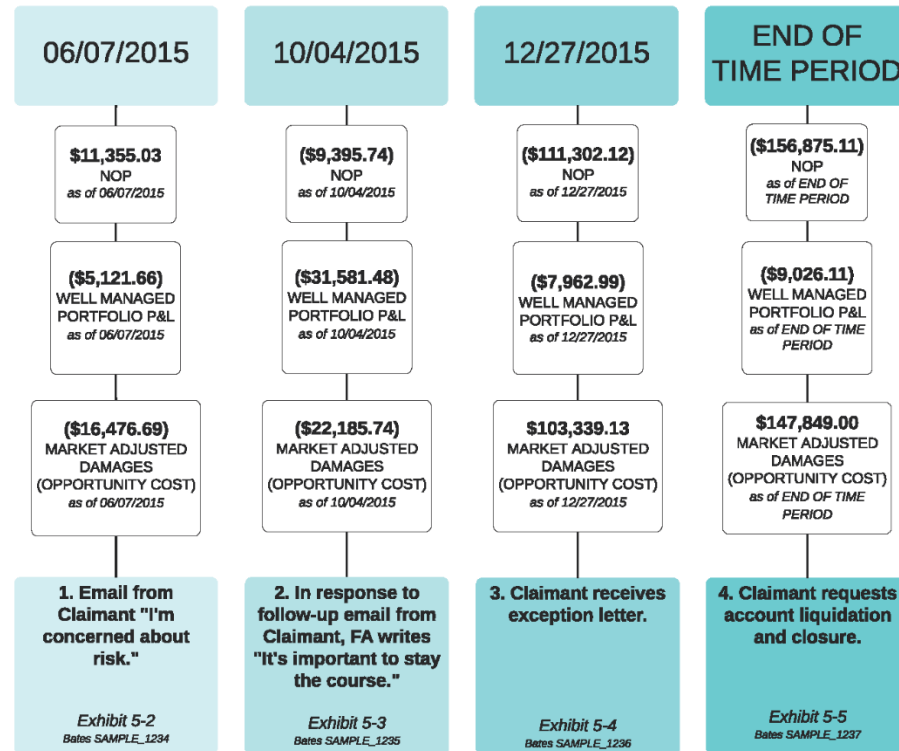
STEP ONE:
$$\frac{\text{COMM, MARGIN INT \& FEES}}{\text{AVERAGE MONTH END NON-CASH ASSET VALUE}} = \text{TOTAL COST EQUITY MAINTENANCE RATIO}$$

STEP TWO:
$$\frac{\text{TOTAL CEMR}}{\text{YEARS IN TIME PERIOD}} = \text{ANNUALIZED CEMR}$$

STEP ONE:
$$\frac{\$7,816}{\$259,320} = 0.03$$

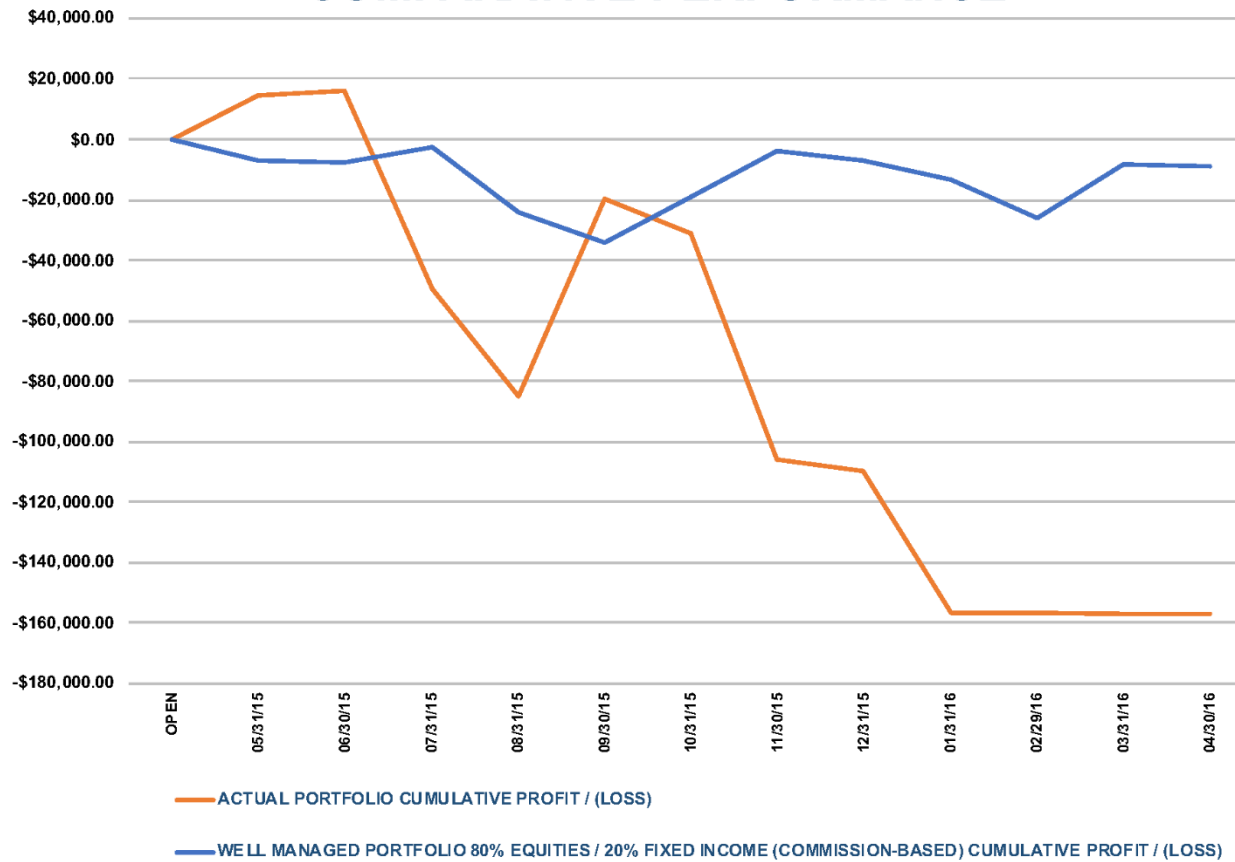
STEP TWO:
$$\frac{0.03}{1.00} = 3.01\% \quad \text{ANNUALIZED CEMR}$$

Sample Timeline of Key Events



Prepared by Falk Financial Analysis

COMPARATIVE PERFORMANCE



CONFIDENTIAL / PRIVILEGED ATTORNEY WORK PRODUCT PREPARED BY FALK FINANCIAL ANALYSIS

Jane Smith v. Sample Securities Inc

Jane Smith IRA, A/C #876543210 - Timeframe of May 2015 through April 2016

WELL MANAGED PORTFOLIO ANALYSIS**BASED UPON CLAIMANT'S STATED OBJECTIVES AND RISK TOLERANCE¹**

A 20% FIXED INCOME AND 80% EQUITIES PORTFOLIO AS REPRESENTED BY ISHARES CORE US AGGREGATE BOND ETF (AGG) AND ISHARES CORE S&P 500 ETF (IVV)

- ALL HYPOTHETICAL DIVIDENDS ARE REINVESTED AND HYPOTHETICAL COMMISSION (1.50%) IS ASSESSED ON ALL TRADES.

MONTH END	DEBITS	CREDITS	20% FIXED INCOME	80% EQUITIES	TOTAL COMMISSION 1.50%	TOTAL MARKET VALUE
			AGG MKT CLOSE FUND VALUE	IVV MKT CLOSE FUND VALUE		
05/01/15	\$0	\$0	\$0	\$0	\$0	\$0
05/07/15	\$0	\$0	\$0	\$0	\$0	\$0
05/31/15	\$0	\$461,342	\$92,268	\$369,074	\$6,920	\$464,422
06/01/15	\$0	\$0	\$90,884	\$368,357	\$0	\$459,241
06/05/15	\$0	\$0	\$91,065	\$365,166	\$0	\$456,391
06/24/15	\$0	\$0	\$91,065	\$366,195	\$0	\$457,249
06/30/15	\$3,200	\$0	\$90,415	\$357,917	\$48	\$450,326
07/01/15	\$0	\$0	\$90,405	\$360,486	\$0	\$450,891
07/08/15	\$0	\$0	\$90,583	\$355,269	\$0	\$446,030
07/31/15	\$3,200	\$0	\$89,943	\$362,835	\$48	\$452,729
08/03/15	\$0	\$0	\$89,933	\$361,794	\$0	\$451,727
08/07/15	\$0	\$0	\$90,107	\$358,523	\$0	\$448,804
08/31/15	\$3,200	\$0	\$89,467	\$338,338	\$48	\$427,756
09/01/15	\$0	\$0	\$89,457	\$328,313	\$0	\$417,770
09/08/15	\$0	\$0	\$89,638	\$337,974	\$0	\$427,792
09/25/15	\$0	\$0	\$89,638	\$329,880	\$0	\$419,518
09/30/15	\$3,200	\$0	\$88,998	\$325,520	\$48	\$414,469
10/01/15	\$0	\$0	\$88,988	\$327,973	\$0	\$418,787
10/07/15	\$0	\$0	\$89,154	\$340,427	\$0	\$429,746
10/31/15	\$3,200	\$0	\$88,514	\$337,867	\$48	\$426,332
11/02/15	\$0	\$0	\$88,504	\$356,363	\$0	\$444,867
11/09/15	\$0	\$0	\$88,676	\$355,785	\$0	\$444,634
11/30/15	\$3,200	\$0	\$88,036	\$350,653	\$48	\$438,641

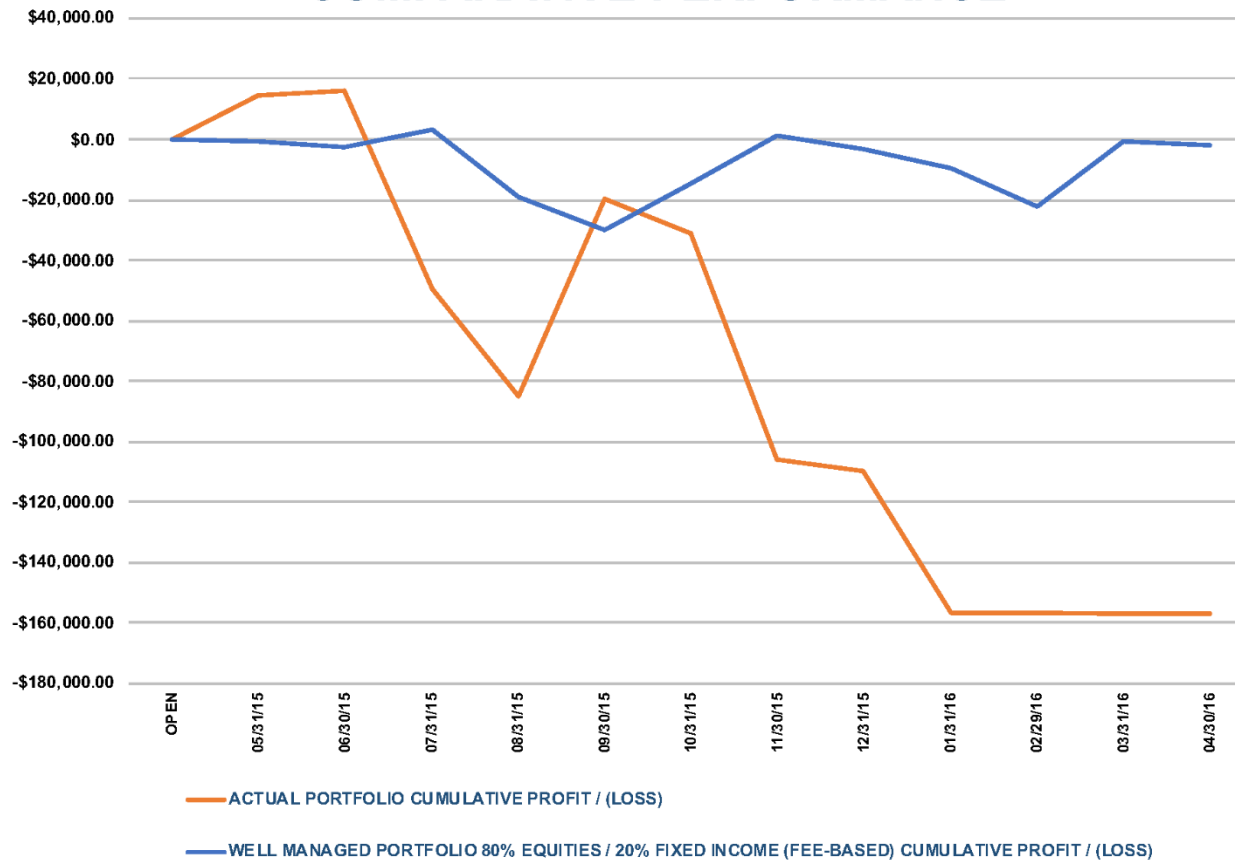
MONTH END	DEBITS	CREDITS	20% FIXED INCOME	80% EQUITIES	TOTAL COMMISSION 1.50%	TOTAL MARKET VALUE
			AGG MKT CLOSE FUND VALUE	IVV MKT CLOSE FUND VALUE		
12/01/15	\$0	\$0	\$88,027	\$354,385	\$0	\$442,412
12/07/15	\$0	\$0	\$88,322	\$350,202	\$0	\$438,520
12/24/15	\$0	\$0	\$88,322	\$345,857	\$0	\$434,179
12/29/15	\$0	\$0	\$88,322	\$348,523	\$0	\$436,845
12/31/15	\$3,200	\$0	\$87,861	\$342,212	\$48	\$432,188
01/05/16	\$0	\$0	\$87,861	\$338,009	\$0	\$426,178
01/31/16	\$3,200	\$0	\$87,211	\$335,449	\$48	\$422,612
02/01/16	\$0	\$0	\$87,201	\$322,842	\$0	\$410,043
02/05/16	\$0	\$0	\$87,382	\$313,179	\$0	\$400,741
02/29/16	\$3,200	\$0	\$86,742	\$319,988	\$48	\$406,681
03/01/16	\$0	\$0	\$86,732	\$327,591	\$0	\$414,323
03/07/16	\$0	\$0	\$86,906	\$331,588	\$0	\$418,667
03/30/16	\$0	\$0	\$86,906	\$342,308	\$0	\$431,052
03/31/16	\$275,660	\$0	\$31,774	\$121,083	\$4,135	\$148,721
04/01/16	\$0	\$0	\$30,947	\$118,542	\$0	\$149,488
04/07/16	\$0	\$0	\$31,009	\$116,848	\$0	\$147,919
04/30/16	\$7	\$0	\$31,008	\$116,842	\$0	\$147,849
\$11,487.15						

ENDING BALANCE OF ACTUAL PORTFOLIO AS OF 04/30/16:	\$0
ENDING BALANCE OF WELL MANAGED PORTFOLIO AS OF 04/30/16:	\$147,849
WELL MANAGED PORTFOLIO NET PROFIT / (LOSS):	(\$9,026)
EXISTING NET PROFIT / (LOSS):	(\$156,875)
OPPORTUNITY LOSS:	\$147,849
MONTHLY STANDARD DEVIATION	3.23%
ANNUALIZED STANDARD DEVIATION	11.19%

¹THE BENCHMARKS AND ALLOCATION WERE SELECTED BY THE LIABILITY EXPERT.

²HISTORICAL PRICING AND DISTRIBUTION DATA SOURCE IS THE FUND COMPANY.

COMPARATIVE PERFORMANCE



CONFIDENTIAL / PRIVILEGED ATTORNEY WORK PRODUCT PREPARED BY FALK FINANCIAL ANALYSIS

Jane Smith v. Sample Securities Inc

Jane Smith IRA, A/C #876543210 - Timeframe of May 2015 through April 2016

WELL MANAGED PORTFOLIO ANALYSIS**BASED UPON CLAIMANT'S STATED OBJECTIVES AND RISK TOLERANCE¹**

A 20% FIXED INCOME AND 80% EQUITIES PORTFOLIO AS REPRESENTED BY ISHARES CORE US AGGREGATE BOND ETF (AGG) AND ISHARES CORE S&P 500 ETF (IVV)

- ALL HYPOTHETICAL DIVIDENDS ARE REINVESTED AND A HYPOTHETICAL MANAGEMENT FEE (1% APR) IS ASSESSED QUARTERLY.

MONTH END	DEBITS	CREDITS	20% FIXED INCOME	80% EQUITIES	MANAGEMENT FEE (1% APR)	TOTAL MARKET VALUE
			AGG MKT CLOSE FUND VALUE	IVV MKT CLOSE FUND VALUE		
05/01/15	\$0	\$0	\$0	\$0		\$0
05/07/15	\$0	\$0	\$0	\$0		\$0
05/31/15	\$0	\$461,342	\$92,268	\$369,074	\$384	\$460,968
06/01/15	\$0	\$0	\$92,192	\$373,585		\$465,777
06/05/15	\$0	\$0	\$92,364	\$370,349		\$462,886
06/24/15	\$0	\$0	\$92,364	\$371,392		\$463,757
06/30/15	\$3,200	\$0	\$91,724	\$363,034	\$1,142	\$455,887
07/01/15	\$0	\$0	\$91,496	\$364,765		\$456,261
07/08/15	\$0	\$0	\$91,676	\$369,486		\$461,341
07/31/15	\$3,200	\$0	\$91,036	\$367,172		\$468,207
08/03/15	\$0	\$0	\$91,036	\$366,158		\$467,193
08/07/15	\$0	\$0	\$91,211	\$362,847		\$454,235
08/31/15	\$3,200	\$0	\$90,571	\$342,449		\$433,020
09/01/15	\$0	\$0	\$90,571	\$332,341		\$422,912
09/08/15	\$0	\$0	\$90,754	\$342,121		\$433,058
09/25/15	\$0	\$0	\$90,754	\$333,928		\$424,682
09/30/15	\$3,200	\$0	\$90,114	\$329,545	\$1,049	\$418,610
10/01/15	\$0	\$0	\$89,904	\$331,228		\$422,981
10/07/15	\$0	\$0	\$90,072	\$343,806		\$434,045
10/31/15	\$3,200	\$0	\$89,432	\$341,246		\$430,677
11/02/15	\$0	\$0	\$89,432	\$359,966		\$449,397
11/09/15	\$0	\$0	\$89,606	\$359,382		\$449,162
11/30/15	\$3,200	\$0	\$88,966	\$354,224		\$443,190

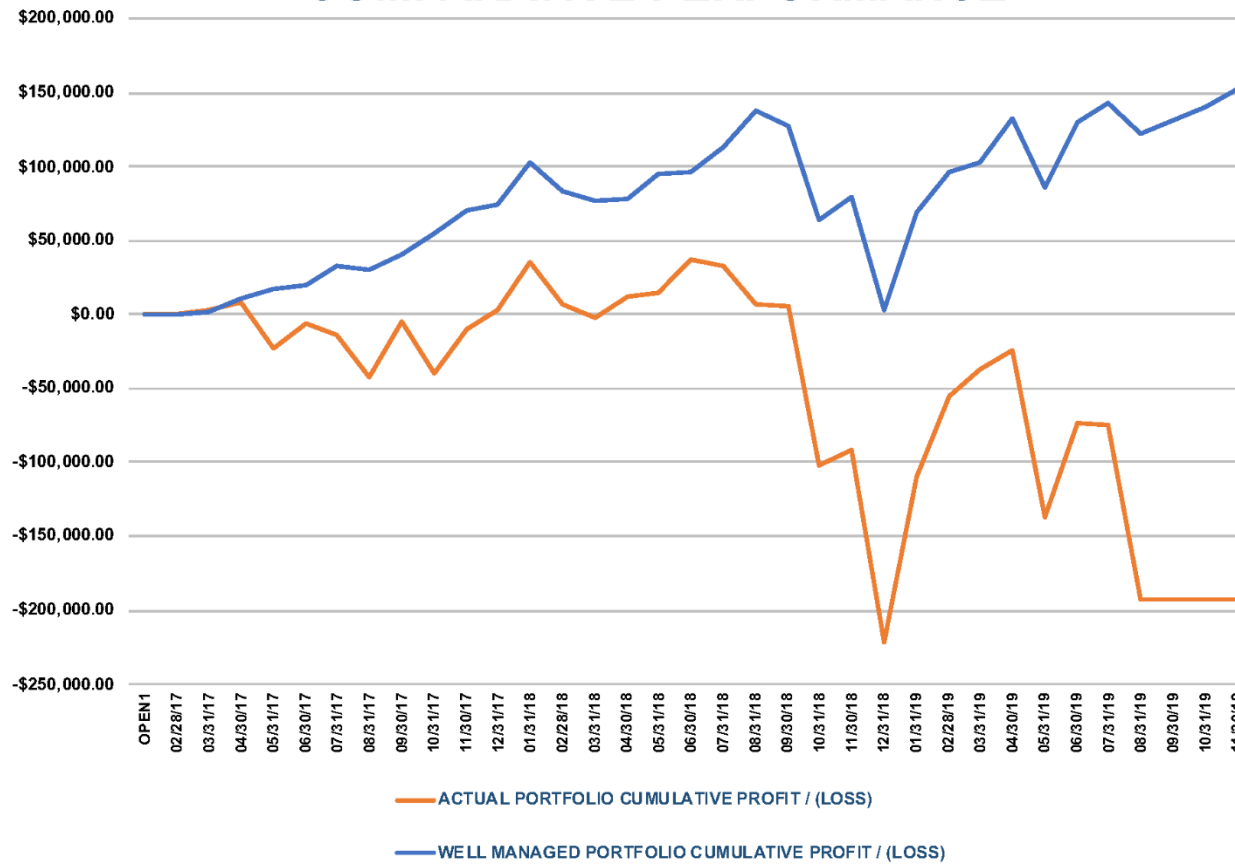
MONTH END	DEBITS	CREDITS	20% FIXED INCOME	80% EQUITIES	MANAGEMENT FEE (1% APR)	TOTAL MARKET VALUE
			AGG MKT CLOSE FUND VALUE	IVV MKT CLOSE FUND VALUE		
12/01/15	\$0	\$0	\$88,966	\$358,033		\$446,999
12/07/15	\$0	\$0	\$89,264	\$353,807		\$443,370
12/24/15	\$0	\$0	\$89,264	\$349,417		\$438,682
12/29/15	\$0	\$0	\$89,264	\$352,111		\$441,375
12/31/15	\$3,200	\$0	\$88,805	\$345,761	\$1,092	\$435,659
01/05/16	\$0	\$0	\$88,586	\$340,680		\$429,587
01/31/16	\$3,200	\$0	\$87,946	\$338,120		\$426,066
02/01/16	\$0	\$0	\$87,946	\$325,451		\$413,397
02/05/16	\$0	\$0	\$88,128	\$315,710		\$404,020
02/29/16	\$3,200	\$0	\$87,488	\$322,594		\$410,082
03/01/16	\$0	\$0	\$87,488	\$330,298		\$417,787
03/07/16	\$0	\$0	\$87,663	\$334,328		\$422,166
03/30/16	\$0	\$0	\$87,663	\$345,136		\$434,654
03/31/16	\$275,660	\$0	\$32,531	\$123,906	\$391	\$156,046
04/01/16	\$0	\$0	\$32,453	\$124,378		\$156,831
04/07/16	\$0	\$0	\$32,518	\$122,600		\$155,184
04/30/16	\$7	\$0	\$32,517	\$122,594	\$129	\$154,982
\$4,187.90						

ENDING BALANCE OF ACTUAL PORTFOLIO AS OF 04/30/16:	\$0
ENDING BALANCE OF WELL MANAGED PORTFOLIO AS OF 04/30/16:	\$154,982
WELL MANAGED PORTFOLIO NET PROFIT / (LOSS):	(\$1,893)
EXISTING NET PROFIT / (LOSS):	(\$156,875)
OPPORTUNITY LOSS:	\$154,982
MONTHLY STANDARD DEVIATION	3.24%
ANNUALIZED STANDARD DEVIATION	11.22%

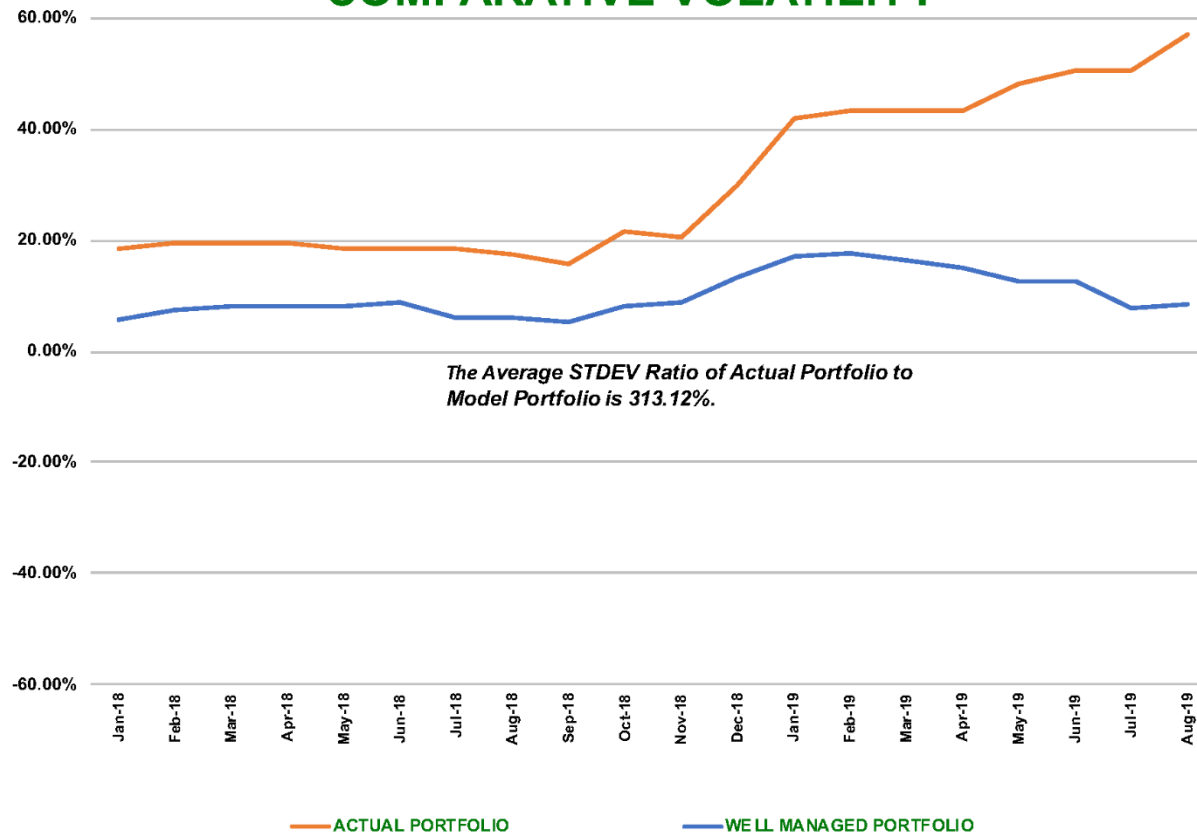
¹THE BENCHMARKS AND ALLOCATION WERE SELECTED BY THE LIABILITY EXPERT.

²HISTORICAL PRICING AND DISTRIBUTION DATA SOURCE IS THE FUND COMPANY.

COMPARATIVE PERFORMANCE



COMPARATIVE VOLATILITY



Volatility (Risk) is measured by the Annualized Standard Deviation of Monthly Returns.

2

CONFIDENTIAL ATTORNEY WORK PRODUCT PREPARED BY FALK FINANCIAL ANALYSIS

Mike Smythe v. Example Investments

Mike Smythe, A/C # 12345-678910 - Timeframe of February 2017 through November 2019

WELL MANAGED PORTFOLIO ANALYSIS

BASED UPON THE CLAIMANT'S STATED OBJECTIVES AND RISK TOLERANCE¹

A PORTFOLIO OF 30% SPDR BLOOMBERG BARCLAYS HIGH YIELD BOND ETF (JNK) , 30% ISHARES IBOXX \$ HIGH YIELD CORPORATE BOND ETF (HYG),

20% VANGUARD S&P500 GROWTH ETF (VOOG), AND 20% INVESCO QQQ ETF (QQQ)

- ALL HYPOTHETICAL DIVIDENDS ARE REINVESTED AND A HYPOTHETICAL MANAGEMENT FEE (1% APR) IS ASSESSED QUARTERLY.

MONTH END	DEBITS	CREDITS	30% HIGH YIELD FIXED INCOME JNK MKT CLOSE FUND VALUE	30% HIGH YIELD CORPORATE FIXED INCOME HYG MKT CLOSE FUND VALUE	20% LARGE CAP GROWTH VOOG MKT CLOSE FUND VALUE	20% LARGE CAP GROWTH QQQ MKT CLOSE FUND VALUE	MANAGEMENT FEE (1% APR)	TOTAL MARKET VALUE
02/01/17	\$0	\$0	\$0	\$0	\$0	\$0		\$0
02/07/17	\$0	\$0	\$0	\$0	\$0	\$0		\$0
02/09/17	\$0	\$0	\$0	\$0	\$0	\$0		\$0
02/28/17	\$0	\$500,000	\$150,000	\$150,000	\$100,000	\$100,000		\$500,000
03/07/17	\$0	\$0	\$150,356	\$149,422	\$99,206	\$100,422		\$499,739
03/09/17	\$0	\$0	\$150,299	\$148,866	\$98,210	\$100,551		\$498,047
03/28/17	\$0	\$0	\$149,290	\$149,101	\$98,770	\$102,595		\$500,255
03/31/17	\$0	\$0	\$149,592	\$149,866	\$99,944	\$102,919	\$837	\$501,484
04/07/17	\$0	\$0	\$148,971	\$149,208	\$98,759	\$102,719		\$499,981
04/11/17	\$0	\$0	\$149,006	\$149,721	\$99,571	\$102,752		\$501,168
04/28/17	\$0	\$0	\$150,987	\$151,704	\$100,618	\$107,234		\$511,430
04/30/17	\$2,666	\$0	\$150,187	\$150,904	\$100,085	\$106,701		\$507,877
05/05/17	\$0	\$0	\$151,176	\$151,903	\$100,225	\$108,423		\$512,050
05/09/17	\$0	\$0	\$151,162	\$151,566	\$99,634	\$108,878		\$511,347
05/31/17	\$2,693	\$0	\$151,603	\$151,797	\$98,428	\$109,639		\$511,466
06/07/17	\$0	\$0	\$153,001	\$153,312	\$99,587	\$111,288		\$517,512
06/09/17	\$0	\$0	\$153,056	\$153,467	\$100,699	\$110,350		\$517,716
06/30/17	\$2,614	\$0	\$151,212	\$151,836	\$99,914	\$110,054	\$1,283	\$511,734
07/05/17	\$0	\$0	\$151,436	\$151,888	\$100,657	\$109,733		\$514,446
07/10/17	\$0	\$0	\$151,179	\$151,879	\$99,853	\$108,930		\$512,166

MONTH END	DEBITS	CREDITS	30% HIGH YIELD FIXED INCOME JNK MKT CLOSE FUND VALUE	30% HIGH YIELD CORPORATE FIXED INCOME HYG MKT CLOSE FUND VALUE	20% LARGE CAP GROWTH VOOG MKT CLOSE FUND VALUE	20% LARGE CAP GROWTH QQQ MKT CLOSE FUND VALUE	MANAGEMENT FEE (1% APR)	TOTAL MARKET VALUE
07/12/17	\$0	\$0	\$152,291	\$152,979	\$100,904	\$110,311		\$516,598
07/31/17	\$4,604	\$0	\$152,657	\$153,015	\$100,570	\$112,531		\$519,988
08/07/17	\$0	\$0	\$153,379	\$153,013	\$100,111	\$112,692		\$519,508
08/09/17	\$0	\$0	\$153,100	\$151,998	\$99,065	\$111,726		\$515,988
08/31/17	\$4,915	\$0	\$151,753	\$150,984	\$98,638	\$111,516		\$512,890
09/08/17	\$0	\$0	\$151,189	\$150,824	\$98,138	\$111,516		\$511,980
09/12/17	\$0	\$0	\$153,468	\$153,042	\$99,835	\$112,984		\$519,428
09/30/17	\$3,382	\$0	\$153,193	\$153,162	\$101,917	\$112,626	\$1,302	\$519,595
10/02/17	\$0	\$0	\$153,395	\$153,377	\$103,357	\$112,429		\$523,311
10/06/17	\$0	\$0	\$154,715	\$154,707	\$103,660	\$113,505		\$526,894
10/10/17	\$0	\$0	\$154,897	\$154,480	\$103,493	\$113,663		\$526,637
10/31/17	\$2,337	\$0	\$155,768	\$154,886	\$103,525	\$116,928		\$531,817
11/07/17	\$0	\$0	\$156,743	\$154,909	\$102,998	\$117,468		\$532,424
11/09/17	\$0	\$0	\$156,533	\$154,649	\$102,852	\$117,699		\$531,604
11/30/17	\$8,016	\$0	\$158,255	\$157,393	\$105,129	\$118,726		\$539,503
12/07/17	\$0	\$0	\$157,668	\$156,891	\$104,061	\$117,911		\$536,838
12/11/17	\$0	\$0	\$159,169	\$157,983	\$104,284	\$119,354		\$540,897
12/22/17	\$0	\$0	\$159,872	\$158,554	\$105,856	\$120,012		\$545,067
12/28/17	\$0	\$0	\$160,274	\$159,780	\$106,394	\$119,887		\$546,739
12/29/17	\$0	\$0	\$159,454	\$158,818	\$105,752	\$120,450		\$545,506
12/31/17	\$5,684	\$0	\$157,749	\$157,113	\$104,615	\$119,313	\$1,347	\$537,442
01/31/18	\$4,916	\$0	\$164,894	\$162,083	\$106,348	\$127,337		\$560,662
02/07/18	\$0	\$0	\$156,755	\$154,839	\$101,629	\$122,568		\$536,180
02/28/18	\$76,676	\$130,772	\$175,147	\$172,035	\$112,843	\$135,798		\$595,822
03/07/18	\$0	\$0	\$176,160	\$175,947	\$116,575	\$137,888		\$606,990
03/29/18	\$0	\$0	\$170,023	\$171,580	\$114,362	\$134,449		\$590,994
03/31/18	\$10,020	\$0	\$167,017	\$168,574	\$112,358	\$132,445	\$1,451	\$578,942
04/06/18	\$0	\$0	\$164,424	\$165,842	\$110,584	\$129,430		\$570,691
04/30/18	\$11,656	\$0	\$163,812	\$164,692	\$110,114	\$129,408		\$568,943

MONTH END	DEBITS	CREDITS	30% HIGH YIELD FIXED INCOME JNK MKT CLOSE FUND VALUE	30% HIGH YIELD CORPORATE FIXED INCOME HYG MKT CLOSE FUND VALUE	20% LARGE CAP GROWTH VOOG MKT CLOSE FUND VALUE	20% LARGE CAP GROWTH QQQ MKT CLOSE FUND VALUE	MANAGEMENT FEE (1% APR)	TOTAL MARKET VALUE
05/07/18	\$0	\$0	\$165,494	\$166,275	\$112,405	\$132,293		\$576,889
05/31/18	\$10,774	\$0	\$164,632	\$164,713	\$113,554	\$131,483		\$574,382
06/07/18	\$0	\$0	\$168,769	\$168,689	\$116,093	\$134,612		\$588,598
06/30/18	\$11,319	\$0	\$161,580	\$162,581	\$111,841	\$130,283	\$1,416	\$564,869
07/03/18	\$0	\$0	\$160,853	\$162,198	\$112,847	\$129,049		\$565,561
07/09/18	\$0	\$0	\$165,268	\$166,619	\$115,808	\$132,561		\$580,678
07/31/18	\$161,309	\$300,000	\$208,860	\$208,267	\$141,968	\$160,199		\$720,492
08/07/18	\$0	\$0	\$212,191	\$210,438	\$144,173	\$162,940		\$730,253
08/31/18	\$12,280	\$100,000	\$242,104	\$240,204	\$165,884	\$184,384		\$832,575
09/10/18	\$0	\$0	\$240,330	\$239,152	\$164,337	\$179,519		\$823,927
09/30/18	\$13,761	\$0	\$238,410	\$234,285	\$159,934	\$177,877	\$2,026	\$808,480
10/01/18	\$0	\$0	\$238,661	\$233,124	\$159,303	\$178,522		\$810,966
10/05/18	\$0	\$0	\$235,705	\$229,227	\$155,687	\$172,233		\$793,454
10/31/18	\$12,784	\$0	\$217,845	\$210,642	\$142,116	\$160,409		\$732,395
11/07/18	\$0	\$0	\$226,247	\$219,604	\$148,348	\$167,443		\$762,259
11/30/18	\$7,348	\$0	\$220,217	\$213,966	\$143,732	\$162,644		\$740,559
12/07/18	\$0	\$0	\$210,329	\$205,011	\$136,639	\$155,343		\$707,886
12/18/18	\$0	\$0	\$202,403	\$196,716	\$130,872	\$143,793		\$674,567
12/24/18	\$0	\$0	\$186,929	\$181,396	\$119,935	\$133,894		\$622,594
12/26/18	\$0	\$0	\$196,358	\$189,847	\$125,838	\$139,916		\$652,108
12/31/18	\$13,689	\$0	\$195,441	\$188,613	\$125,082	\$140,934	\$1,630	\$650,176
01/31/19	\$21,914	\$0	\$204,034	\$201,477	\$135,190	\$153,714		\$694,415
02/07/19	\$0	\$0	\$204,396	\$203,446	\$136,375	\$153,118		\$697,886
02/28/19	\$12,885	\$0	\$206,854	\$206,563	\$139,131	\$155,946		\$708,494
03/07/19	\$0	\$0	\$204,419	\$203,190	\$135,471	\$154,851		\$698,471
03/28/19	\$0	\$0	\$208,439	\$207,590	\$137,705	\$157,353		\$711,913
03/31/19	\$14,575	\$0	\$205,478	\$204,625	\$135,356	\$155,650		\$701,109
04/05/19	\$0	\$0	\$209,900	\$210,031	\$138,979	\$159,450		\$718,881
04/30/19	\$12,075	\$0	\$210,310	\$209,076	\$137,821	\$159,088		\$716,275

MONTH END	DEBITS	CREDITS	30% HIGH YIELD FIXED INCOME	30% HIGH YIELD CORPORATE FIXED INCOME	20% LARGE CAP GROWTH	20% LARGE CAP GROWTH	MANAGEMENT FEE (1% APR)	TOTAL MARKET VALUE
			JNK MKT CLOSE FUND VALUE	HYG MKT CLOSE FUND VALUE	VOOG MKT CLOSE FUND VALUE	QQQ MKT CLOSE FUND VALUE		
04/30/19	\$0	\$0	\$210,310	\$209,076	\$137,821	\$180,294		\$718,726
05/07/19	\$0	\$0	\$206,084	\$205,093	\$136,277	\$157,399		\$705,356
05/31/19	\$12,536	\$0	\$193,307	\$193,006	\$126,323	\$147,121		\$668,757
06/07/19	\$0	\$0	\$202,316	\$202,125	\$130,203	\$151,316		\$686,729
06/30/19	\$9,232	\$0	\$203,483	\$203,572	\$131,883	\$154,488		\$693,426
07/02/19	\$0	\$0	\$205,650	\$204,939	\$133,112	\$156,450		\$701,152
07/08/19	\$0	\$0	\$206,302	\$205,957	\$133,307	\$155,525		\$701,844
07/31/19	\$9,189	\$0	\$204,011	\$203,890	\$132,725	\$153,576		\$694,202
07/31/19	\$0	\$0	\$204,011	\$203,890	\$132,725	\$155,096		\$697,242
08/07/19	\$0	\$0	\$197,851	\$197,093	\$127,192	\$149,686		\$672,529
08/31/19	\$32,990	\$0	\$191,266	\$188,812	\$120,804	\$145,469	\$1,616	\$644,735
09/09/19	\$0	\$0	\$194,618	\$191,928	\$122,417	\$146,736		\$656,386
09/30/19	\$329,188	\$0	\$95,023	\$93,209	\$55,969	\$79,911		\$324,111
10/01/19	\$0	\$0	\$93,860	\$91,907	\$55,430	\$79,061		\$320,706
10/07/19	\$0	\$0	\$94,008	\$91,943	\$55,545	\$79,273		\$321,095
10/31/19	\$0	\$0	\$97,252	\$94,394	\$57,334	\$83,341		\$333,063
11/07/19	\$0	\$0	\$99,006	\$95,482	\$58,405	\$84,648		\$337,870
11/30/19	\$0	\$0	\$100,953	\$97,600	\$59,712	\$86,910		\$345,175

ENDING BALANCE OF ACTUAL PORTFOLIO AS OF 11/30/19: \$0

ENDING BALANCE OF MODEL PORTFOLIO AS OF 11/30/19: \$345,175

MODEL PORTFOLIO NET PROFIT / (LOSS): \$152,429

EXISTING NET PROFIT / (LOSS): (\$192,746)

OPPORTUNITY LOSS: \$345,175

MONTHLY STANDARD DEVIATION 1.77%

ANNUALIZED STANDARD DEVIATION 6.12%

¹THE ALLOCATIONS AND BENCHMARKS USED HERE WERE PROVIDED BY THE LIABILITY EXPERT.

²HISTORICAL FUND BENCHMARK PRICING SOURCE IS BARCHART.COM. HISTORICAL DISTRIBUTION DATA SOURCE IS THE FUND COMPANY.

II. “Market Adjusted Damages” PIABA B.J., Vol 21, No. 2 p. 135 (2014).

Philip M. Aidikoff, Robert A. Uhl, Ryan K. Bakhtiari, and Katrina M. Boice.

I. INTRODUCTION

Investors open accounts with brokerage firms to increase the value of their principal consistent with their time horizon, investment objectives and risk tolerance. It is logical for a client to seek and recover market adjusted damages when a brokerage firm recommends securities or pursues strategies that are inconsistent with the client’s objectives.

Market adjusted damages utilize industry benchmarks to compute what an investor would have received had the portfolio been properly invested. These damages compensate an investor for losses caused by wrongful conduct in both a rising and falling market by adding or reducing return according to the actual performance of the market.¹

This article discusses how an award of market adjusted damages should be pursued in the FINRA forum by a review of FINRA guidance, case law and practical application. This article concludes that market adjusted damages are an accurate and fair measure of compensation that appropriately reflects the harm caused to the investor adjusted for actual market performance.

II. ASSET ALLOCATION AND DIVERSIFICATION

“A review of historical data and empirical studies provides strong support for the contention that the asset allocation decision is a critical component of the portfolio management process.”² In fact, it has been recognized that “... the most important part of [investment] policy determination is asset allocation.”³ Studies have demonstrated that 90% or

1. “Market adjusted damages” are known by many names, including, *inter alia*, properly-managed account damages, well-managed account damages, *Miley* damages, and lost profits damages. For purposes of this article we will refer to them as market adjusted damages.

2. FRANK K. REILLY & KEITH C. BROWN, INVESTMENT ANALYSIS AND PORTFOLIO MANAGEMENT 57 (8th ed. 2005).

3. ZVI BODIE, ALEX KANE & ALAN J. MARCUS, INVESTMENTS 946 (6th ed. 2005).

more of the performance in an investment portfolio returns are driven by the asset allocation decision.⁴

Courts have recognized that a brokerage firm can manage the inherent risk of the market through asset allocation amongst negatively correlated asset classes and diversification within each class.⁵ It has been held that stockbrokers have fiduciary duties including full and fair disclosure of all material facts regardless of whether or not an investor is sophisticated or unsophisticated.⁶

Twomey remains the controlling statement of the law applicable to this case. Contrary to appellants' position the relationship between a stockbroker and his or her customer is fiduciary in nature; the distinction between a "sophisticated" investor and an "unsophisticated" one is not controlling in this regard.⁷

Additionally, brokers and brokerage firms have an independent duty to investigate securities to determine whether they are consistent with a client's investment objectives and risk tolerance:

Brokers and salesmen are 'under a duty to investigate, and their violation of that duty brings them within the term 'willful' in the Exchange Act. Thus, a salesman cannot deliberately ignore that which he has a duty to know and recklessly state facts about matters of which he is ignorant. He must analyze sales literature and must not blindly accept recommendations made therein. The fact that his customers may be sophisticated and knowledgeable does not warrant a less stringent standard. Even where the purchaser follows the market activity of the stock and does not rely upon the salesman's statements, remedial sanctions may be imposed since reliance is not an element of fraudulent misrepresentation in this context.⁸

4. *E.g.*, Gary Brinson et al., *Determinants of Portfolio Performance II: An Update*, FIN. ANALYSTS J. (May-June 1991); Roger G. Ibbotson & Paul D. Kaplan, *Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance?*, FIN. ANALYSTS J. (Jan.-Feb. 2000).

5. A private cause of action for failure to diversify has been recognized. *See* Liss v. Smith, 991 F. Supp. 278, 301 (S.D.N.Y. 1998).

6. *See* Duffy v. Cavalier, 215 Cal. App. 3d 1517, 1533 (Cal. Ct. App. 1981).

7. *Id.*

8. Hanly v. Sec. & Exch. Comm'n, 415 F.2d 589, 595-96 (2d Cir. 1969) (footnotes omitted).

A brokerage firm that fails to invest a customer's portfolio with an appropriate asset allocation among negatively correlated asset classes and diversification within each class may be held responsible for a breach of duty. This conduct may also constitute a failure to comply with the standard of care in the financial services industry.

III. FINRA GUIDANCE ON AWARDING MARKET ADJUSTED DAMAGES

FINRA recognizes the importance of asset allocation and managing investment risk:

In big-picture terms, managing risk is about the allocation and diversification of holdings in your portfolio. So when you choose new investments, you do it with an eye to what you already own and how the new investment helps you achieve greater balance. For example, you might include some investments that may be volatile because they have the potential to increase dramatically in value, which other investments in your portfolio are unlikely to do.

Whether you're aware of it or not, by approaching risk in this way—rather than always buying the safest investments—you're being influenced by what's called modern portfolio theory, or sometimes simply portfolio theory. While it's standard practice today, the concept of minimizing risk by combining volatile and price-stable investments in a single portfolio was a significant departure from traditional investing practices.

In fact, modern portfolio theory, for which economists Harry Markowitz, William Sharpe, and Merton Miller shared the Nobel Prize in 1990, employs a scientific approach to measuring risk, and by extension, to choosing investments. It involves calculating projected returns of various portfolio combinations to identify those that are likely to provide the best returns at different levels of risk.⁹

Additionally, the FINRA Dispute Resolution Arbitrator's Guide in explaining different remedies available, recognizes that well-managed account damages (*i.e.*, market adjusted damages) can be awarded:

9. FINRA, *Managing Investment Risk, Modern Portfolio Theory*, <http://www.finra.org/Investors/SmartInvesting/AdvancedInvesting/ManagingInvestmentRisk/> (last visited May 8, 2014).

WELL-MANAGED PORTFOLIO ACCOUNT

This measure of damage allows the claimant to recover the difference between what the claimant's account made or lost versus what a well-managed account, given the investor's objectives, would have made during the same time period.¹⁰

FINRA's well managed portfolio remedy is consistent with FINRA's know your customer and suitability rule:

2090. KNOW YOUR CUSTOMER

Every member shall use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer.¹¹

2111. SUITABILITY

(a) A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.¹²

10. FINRA Dispute Resolution Arbitrator's Guide 63 (Feb. 2014 ed), <http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@arbtors/documents/arbmed/p009424.pdf> (last visited May 8, 2014).

11. FINRA Rule 2090 (Know Your Customer), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9858 (last visited May 8, 2014).

12. FINRA Rule 2111 (Suitability), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859 (last visited May 8, 2014).

IV. CASE LAW AWARDING MARKET ADJUSTED DAMAGES

For years, courts have explored awarding market adjusted damages in securities cases involving churning and unsuitable portfolios. The accepted practice in securities cases involving churning and unsuitable portfolios is to calculate damages based on net economic loss or market indexing (such as the Barclays Aggregate Bond Index, Vanguard Total Bond Fund, S&P 500, Dow Jones Industrial Average, or similar benchmarks), regardless of whether state or federal law applied.

The Second Circuit in *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, provided a road map for calculating damages using market indexing.¹³ In that case, an investor brought an action against his broker and the brokerage firm seeking damages for stock market losses.¹⁴ Rolf's long term advisor retired and his account was reassigned to a broker and an investment advisor who would collectively manage his accounts.¹⁵ The investor's long term investments goals and strategy emphasized preservation and growth of capital for which he executed an authorization giving his broker full trading authority.¹⁶ Over the course of a year, the value of the investor's portfolio dropped by approximately 70% as the result of purchasing risky securities.¹⁷ The District Court for the Southern District of New York found the broker and brokerage firm liable.¹⁸ The court reasoned that the broker owed a fiduciary duty to the investor which he breached which aided and abetted the investment advisor's fraud.¹⁹ Additionally, the court found the brokerage firm liable under the doctrine of "respondeat superior or the securities law doctrine of controlling person liability."²⁰ The court then limited the damage award and failed to take into account market adjusted damages.²¹ The broker and brokerage firm appealed the decision and the investor cross-appealed the

13. *Rolf v. Blyth Eastman Dillon & Co.*, 570 F.2d 38, 49 (2d Cir. 1978), *cert. denied*, 439 U.S. 1039 (1978), *modifying*, 637 F.2d 77 (2d Cir. 1980).

14. *Id.* at 38, 41.

15. *Id.* at 41-42.

16. *Id.* at 42.

17. *See id.* at

42.18. *Id.* at 38,

41.

19. *Rolf*, 570 F.2d at 43.

20. *Id.*

21. *Id.*

district court's measure of damages.²² The Court of Appeals for the Second Circuit affirmed the broker and brokerage firm's liability and remanded the damage calculation back to the district court.²³ The Second Circuit acknowledged that while it was not capable of measuring the investor's damages, it disagreed that the damages should be limited to those arising in a churning case (*i.e.*, commissions).²⁴ Therefore, the Second Circuit set forth the following guidelines for the district court to follow when calculating damages on remand:

First, the district court should determine as near as possible the time when [the broker] began to aid and abet [the investment advisor's] fraud and compute the market value of [the investor's] portfolio on that date. Second, the district court should subtract the value of the portfolio on the date when [the broker's] participation in and assistance to the fraudulent scheme ceased from the value on the date when [the broker] became an aider and abettor. This amount is [the investor's] gross economic loss. The district court should then reduce [the investor's] gross economic loss by the average percentage decline in the value of the Dow Jones Industrials, the Standard & Poor's Index, or any other well recognized index of value, or combination of indices, of the national securities markets during the period commencing with [the broker's] aiding and abetting and terminating with its cessation.²⁵

The court further explained the investor's gross economic loss calculation as follows:

Here [the broker's] participation in [the investment advisor's] fraud infected [the investor's] portfolio during a specific period of time to be determined on remand. In a sense the portfolio will be deemed sold as of the last day of the aiding and abetting period in order to determine what the resale price would have been if the portfolio had been liquidated on that day.²⁶

22. *Id.* at 38, 41.

23. *Id.* at 38, 41, 48, 49-50.

24. *Id.* at 48.

25. *Id.* at 49 (citations omitted); *see also In re Drexel Burnham Lambert Group, Inc.* 161 B.R. 902, 909 (S.D.N.Y. 1993) (the measure of damages for unsuitability claims is the plaintiff's gross economic loss, adjusted for the overall market's performance citing *Rolf v. Blyth Eastman Dillon & Co.*).

26. 570 F.2d at 49, n.21.

The court also acknowledged that the use of the market indices does not hold the broker and brokerage firm responsible for the general decline in the market:

[the investor's] portfolio, even if it had not been fraudulently mismanaged, would have declined in value during the bear market of the aiding and abetting period. [The broker] and [brokerage firm] have no responsibility for the general decline in economic conditions.²⁷

Shortly thereafter, in *Miley v. Oppenheimer & Company, Inc.*, the Court of Appeals for the Fifth Circuit approved the market adjusted damage calculation utilized in *Rolf*.²⁸ In *Miley*, an investor sought to recover damages based on federal securities law, common law and statutory law against his brokerage firm and two of its registered representatives for the churning of his account.²⁹ The District Court for the Northern District of Texas found that the brokerage firm and registered representatives breached their fiduciary duties to the investor and awarded actual and punitive damages.³⁰ The brokerage firm and registered representative appealed.³¹ On appeal, the Fifth Circuit affirmed the district court's decision and discussed damages at length.³² The court found, *inter alia*, that the investor was "entitled to recover the difference between what he would have had if the account had been handled properly and what he in fact had at the time the violation ended with the transfer of the account to a new broker."³³ In making these findings the Fifth Circuit reasoned:

The investor is harmed by the decline in the value of his portfolio - the "spilt milk" of the churning violation - as a result of the broker's having intentionally and deceptively concluded transactions, aimed at generating fees, which were unsuitable for the investor. The intentional and deceptive mismanagement of a client's account, resulting in a decline in the value of that portfolio,

27. *Id.* at 49, n.22.

28. *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 318 (5th Cir. 1981), *abrogated by* *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213 (1985).

29. *Id.*

30. *Id.* at 318, 325.

31. *Id.*

32. *Id.* at 326-29.

33. *Id.* at 327.

constitutes a compensable violation of both the federal securities laws and the broker's common law fiduciary duty, regardless of the amount of the commissions paid to the broker. In sum, once a jury finds that the broker has churned an investor's account, it may also find that the investor would have paid less commissions and that his portfolio would have had a greater value had the broker not committed the churning violation...³⁴

The Fifth Circuit recognized that although calculation of market adjusted damages may not be exact, "... neither the difficulty of the task nor the guarantee of imprecision in results can be a basis for judicial abdication from the responsibility to set fair and reasonable damages in a case."³⁵ Additionally, "a refusal by a court to estimate the amount of trading losses caused by the churning of an account could only yield a certain windfall for either the investor or the broker."³⁶ Therefore, the court stated:

In order to approximate the trading losses caused by the broker's misconduct, it is necessary to estimate how the investor's portfolio would have fared in the absence of [sic] such misconduct. The trial judge must be afforded significant discretion to choose the indicia by which such estimation is to be made, based primarily on the types of securities comprising the portfolio. However, in the absence of either a specialized portfolio or a showing by either party that a different method is more accurate, it seems that the technique discussed [in *Rolf*]... and employed by [the district court judge] in this case is preferable... This mode of estimation utilizes the average percentage performance in the value of the Dow Jones Industrials or the Standard and Poor's Index during the relevant period as the indicia of how a given portfolio would have performed in the absence of the broker's misconduct.³⁷

Further the Fifth Circuit acknowledged that market adjusted damages "attempt to prevent a windfall to either the injured investor or the wrongdoer, regardless of whether the misconduct at issue is viewed as federal or state law violation."³⁸

34. *Miley*, 637 F.2d at 326 (footnote omitted).

35. *Id.* at 327.

36. *Id.* at 328.

37. *Id.* (footnote and citations omitted).

38. *Id.* at 329. See also *Donovan v. Bierwirth*, 754 F.2d 1049 (2d Cir. 1985), which adopted the market index approach where a breach of fiduciary duty was found under ERISA:

The Ninth Circuit in *Hatrock v. Edward D. Jones & Co.* adopted the *Miley* analysis for market adjusted damages in churning cases.³⁹ In that case, customers brought suit against their broker and brokerage firm for misrepresentations and churning in the District Court of Idaho.⁴⁰ A jury returned a verdict in favor of the investors and awarded compensatory damages, punitive damages and attorneys' fees against the broker.⁴¹ Thereafter, the broker and brokerage firm appealed and the investors cross-appealed.⁴² In affirming the lower court's ruling, the Ninth Circuit addressed the damages an investor can recover for churning as follows:

...when a securities broker engages in excessive trading in disregard of his customer's investment objectives for the purpose of generating commission business, the customer may hold the broker liable for churning without proving loss causation. The investor may recover excessive commissions charged by the broker, and the decline in value of the investor's portfolio resulting from the broker's fraudulent transactions. The recoverable decline in portfolio value is "the difference between what [the plaintiff] would have had if the account ha[d] been handled legitimately and what he in fact had at the time the violation ended." The finder of fact "must be afforded

One appropriate remedy in cases of breach of fiduciary duty is the restoration of the trust beneficiaries to the position they would have occupied but for the breach of trust. [w]e hold that the measure of loss

applicable under ERISA section 409 requires a comparison of what the Plan actually earned on the Grumman investment with what the Plan would have earned had the funds been available for other Plan purposes.

In determining what the Plan would have earned had the funds been available for other Plan purposes, the district court should presume that the funds would have been treated like other funds being invested during the same period in proper transactions. Where several alternative investment strategies were equally plausible, the court should presume that the funds would have been used in the most profitable of these. The burden of proving that the funds would have earned less than that amount is on the fiduciaries found to be in breach of their duty. Any doubt or ambiguity should be resolved against them.

Id. at 1056.

39. *Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767, 773-74 (9th Cir. 1984).

40. *Id.* at 767-70.

41. *Id.*

42. *See Id.*

significant discretion to choose the indicia by which such an estimation is made, based primarily on the types of securities comprising the portfolio.”⁴³

Likewise, the District Court of New Hampshire in *Winer v. Patterson* found *Miley* and its progeny persuasive for the computation of damages in a churning case.⁴⁴ In *Winer*, the investor brought suit against his former stockbroker for violations of federal and state securities law and common law.⁴⁵ The broker moved for summary judgment or for an order *in limine* regarding the proper measure of damages.⁴⁶ In denying the broker’s motion for partial summary judgment or, in the alternative, for an order *in limine*, the court reasoned:

The Court finds the analysis in *Miley v. Oppenheimer, supra*, and its progeny to be persuasive and accordingly holds that should churning liability be established, plaintiff is entitled to recover the difference between the value of his account after the churning and what its value would have been absent the violation. Given that this is the proper standard, the Court can conceive of no reason to exclude recovery of the profits plaintiff’s account would have earned absent the churning, provided that plaintiff meets his burden of establishing that this would have occurred and in what amount. While the Court is aware that some uncertainties in establishing these damages are unavoidable, plaintiff will have to present testimony to support his claim that he has lost profits in the amount of “at least \$21,952.00.” To this end, plaintiff must establish that comparison of the performance of his account to that of the DJIA would be an accurate measure of how his portfolio would have fared; the Court is not willing to blindly accept such a comparison as the proper method to measure lost profits. Moreover, given that the Court finds that plaintiff is entitled to collect damages so as to put him in the position in which he would have been but for the alleged churning, there is no support for plaintiff’s claim that he is entitled to twice recover the excess commissions paid.⁴⁷

43. *Id.* at 773-74 (citations and footnotes omitted).

44. *Winer v. Patterson*, 644 F. Supp. 898, 900-01 (D.N.H. 1986), *order vacated in part on reconsideration*, 663 F. Supp. 723 (D.N.H. 1987).

45. *Id.* at 898-99.

46. *Id.*

47. *Id.* at 900-01 (citations and footnotes omitted).

The theory of market adjusted damages has also been adopted in the District Court for the Western District of New York. In *Medical Associates of Hamburg, P.C. v. Advest, Inc.*,⁴⁸ the parties brought competing motions for summary judgment regarding the appropriate measure of damages to be awarded.⁴⁹ Relying on the Second Circuit's opinion in the *Rolf* case, the district court rejected the brokerage firm's argument that the market index approach was appropriate only when the overall market declined during the relevant time period.⁵⁰ In rejecting the brokerage firm's approach to damages, the court reasoned:

The defendants' distinction is untenable. *Rolf* laid no stress on the direction of the shift of the stock market in fashioning its market adjusted damage formula, and the defendants have not advanced a reasoned basis for enabling this Court to do so. Obviously, as in *Rolf*, where the securities market is in decline over the relevant period, a decline in a plaintiff's particular portfolio is partially attributable to market forces (instead of the defendant's fraud) and the plaintiff's recovery should thus be reduced accordingly to reflect his "actual damages." By the same token, as in this case, where a plaintiff's portfolio declines in value notwithstanding an overall rise in the market, such plaintiff's actual injury is not limited to the simple decline in value of his securities but encompasses also damages occasioned by the failure of such securities to keep pace with the market - as they otherwise generally would have.⁵¹

Accordingly, the court denied the brokerage firm's motion for summary judgment and granted the investor's request for the use of market adjusted damages.⁵²

The Eighth Circuit in *Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, upheld an award of market adjusted damages where the investor made a profit despite churning.⁵³ In *Davis*, the investor brought suit against the brokerage firm for violations of federal securities law, common-law fraud

48. *Medical Associates of Hamburg, P.C. v. Advest, Inc.*, No. CIV-85-837E, 1989 WL 75142, at *1 (W.D.N.Y. July 5, 1989).

49. *See id.*

50. *Id.*

51. *Id.* at *2 (citations omitted).

52. *Id.* at *3.

53. *Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 906 F.2d 1206, 1218 & n.13 (8th Cir. 1990).

and breach of fiduciary duty. In the first trial, the jury awarded compensatory damages and punitive damages.⁵⁴ The brokerage firm then filed post-trial motions for judgment notwithstanding the verdict, new trial or remittitur.⁵⁵ The district court granted the brokerage firm's motion for remittitur (reducing the punitive damage claim) on the condition that the investor accepts remittitur or a new trial would be granted on the issue of damages.⁵⁶ The investor refused remittitur and a second trial followed wherein the jury again awarded compensatory and punitive damages.⁵⁷ On appeal, the Eighth Circuit addressed, *inter alia*, the award of compensatory damages as follows:

We disagree with [the brokerage firm's] argument that no actual damages were sustained because after deducting the unauthorized commissions, the account nevertheless realized a cumulative net profit of over \$53,000 during the period it was churned. The implications of this argument are disturbing. If we were to adopt [the brokerage firm's] view, securities brokers would be free to churn their customers' accounts with impunity so long as the net value of the account did not fall below the amount originally invested. Churning is not excused by the fact that the account realizes a new profit. In *Nesbit*, 896 F.2d at 386, the Ninth Circuit refused to offset the gains in portfolio against the losses in commissions. The court held that allowing securities customers to recover compensatory damages in the amount of excess commissions even when the account realizes a profit will have the salutary deterrent effect of "inform [ing] the brokerage community that churning is a fraud that will violate the securities laws, regardless of the ultimate condition of the client's portfolio." *Id.* We agree. Churning is a species of fraud prohibited by Section 10(b) and Rule 10b(5) regardless of whether the account's profits or its principal is misappropriated. Under the law of this circuit, if an account earned \$50,000 but would have earned \$100,000 if it was not churned, the customer has sustained actual damages in the amount of \$50,000 plus excess commissions paid. Because [the investor] paid over \$40,000 in commissions and would have earned over \$50,000 more

54. *Id.* at 1210-12.

55. *Id.*

56. *Id.*

57. *Id.*

than she did had her account not been churned, it is nonsensical to argue that she did not suffer actual damages as a result of the churning.⁵⁸

More recently, in *Scalp & Blade, Inc. v. Advest, Inc.*, the Supreme Court, Appellate Division, Fourth Department, New York, held that gross economic loss adjusted for the market's performance is an appropriate measure for damages in cases involving churning, unsuitability, or unauthorized trading wherein a fiduciary duty was breached.⁵⁹ In that case, investors brought suit against a broker and brokerage firm for the mismanagement, including churning, of their trust fund held in an investment account.⁶⁰ In *Scalp*, the investors were a non-profit corporation that administered a scholarship program which was funded through income/gains from a trust fund held in an investment account.⁶¹ The investors alleged that the broker failed to diversify assets and engaged in an excessive number of unsuitable transactions while in the course of his employment, with and under the supervision of, the brokerage firm.⁶² Further, the investors alleged that as a consequence of the broker's wrongful conduct the trust fund fell approximately 50% in value during a time period in which the trust could have doubled in value had it been invested in suitable securities as measured

58. *Id.* at 1218-19; *see also* *Levine v. Frutrinsky*, 636 F. Supp. 899, 900 (N.D. Ill. 1986) (the district court held "that plaintiffs suffered damages even though the investment portfolios incurred a net gain. Plaintiffs may be entitled to recover the difference between the losses incurred on the sale of the speculative securities and the greater amount plaintiffs would have received had they not been defrauded and the more conservative securities had been bought and sold") (quoting *Affiliated Ute Citizens v. United States*, 406 US 128, 155 (1972) (holding that plaintiff should be awarded the difference between the "fair market value of all received and the fair value of what he would have received had there been no fraudulent conduct")); *Smith v. Fahnstock & Co., Inc.*, No. 00 CIV. 9691, 2002 WL 334511 (S.D.N.Y. Mar. 1, 2002) (the court denied summary judgment and rejected the brokerage firm's argument that since "plaintiff's account showed an overall profit, and therefore, under the *Rolf* measure of damages, plaintiff could not recover based on losses in specific stocks."); *Laney v. American Equity Inv. Life Ins. Co.* 243 F.Supp.2d 1347, 1355 (M.D. Fla. 2003) (which recognized that the *Miley* and *Rolf* methods of calculating damages can be extended to cases where an investor made money).

59. *Scalp & Blade, Inc. v. Advest, Inc.* 309 A.D.2d 219, 232 (N.Y. App. Div. 2003).60.

Id. at 219-20.

61. *See id.* at 220-21.

62. *See id.* at 221-22.

by the S&P 500 index.⁶³ In response to the investors' allegations, the broker and brokerage firm moved for an order precluding the investors from offering proof of market adjusted damages at trial which was granted.⁶⁴ In reaching its holding, the appellate court dismissed the broker and brokerage firm's argument that the "only proper and nonspeculative measure of damages is the value of the capital actually lost by the [investors]."⁶⁵

Based on the foregoing, we hold that in a case such as this, involving claims of churning, investment unsuitability, or other acts of unauthorized trading by defendants, an appropriate measure of damages is plaintiffs' "gross economic loss, adjusted for the overall market's performance". We thus conclude that the court erred in foreclosing plaintiffs as a matter of law from recovering marketindex or other like lost appreciation damages. Plaintiffs are not necessarily limited to recovering the value of their lost capital, and might well recover compensatory damages calculated in part on the basis of general market performance. Plaintiffs have alleged a necessary predicate for such recovery, namely, a breach of fiduciary duty extending beyond mere negligent retention of the portfolio's holdings and violation of a duty to sell or diversify. Indeed, plaintiffs have alleged deliberate and flagrant self-dealing and dishonesty on the part of defendants, namely, their unauthorized trading of the fund and speculative and otherwise unsuitable investment decisions with regard to it, transactions allegedly engaged in for defendants' own benefit. To employ the metaphor used in *Miley*, the "spilt milk" of defendants' alleged overtrading and inappropriate investment of the fund may include both plaintiffs' lost capital and plaintiffs' lost opportunity to realize generalized market appreciation or gain.⁶⁶

V. PRACTICAL APPLICATION

Consistent with FINRA guidance and the law, arbitration panels have recognized and awarded market adjusted damages in asset allocation cases as

63. *See id.*

64. *Id.* at 219-20, 222.

65. *Scalp & Blade, Inc.*, 309 A.D.2d at 222.

66. *Id.* at 220, 232 (citations omitted).

well as product cases.⁶⁷

Prior to filing a Statement of Claim, it is useful to have a profit and loss analysis prepared which includes market adjusted comparisons (*i.e.*, appropriate asset allocation percentages modeled to determine how a properly managed account would have performed). Broad indices as proxies for both fixed income and equities might include the Barclays Aggregate Bond Index, Vanguard Total Bond Fund and the S&P500 Index. This provides the practitioner with an understanding of damages and damaged defenses that a brokerage firm might plead in an answer. By incorporating the damage analysis into the Statement of Claim it alerts the brokerage firm that the claimant will be seeking market adjusted damages at the hearing.

Additionally, it is imperative to propound relevant document requests during the discovery phase of the arbitration. This allows the practitioner the opportunity to adjust the initial profit and loss analysis upon receipt of further responsive models and other documents. By way of example, the following categories of documents should be requested:

1. All income and/or growth asset allocation models prepared or used by Respondent;
2. All conservative, moderate and speculative investment asset allocation models prepared or used by Respondent;
3. All documents which mention relate or pertain to how the Investment at Issue or investment strategy was marketed to Claimants;
4. All documents which concern the suitability of securities purchased on Claimants' behalf by Respondent; and
5. All documents which concern any research of securities undertaken in connection with any transaction in the Accounts.

In presenting market adjusted damages at the arbitration hearing, courts have recognized that expert opinions on market adjusted damages help to reduce speculation:

[The expert's] approach ... was one of fiscally sound, conservative, active management of the trust estate. His alternative to the Bank's investment in [a concentrated stock position] was to concentrate the assets in the Standard and Poor's 500 index and in fixed income treasury bills. Although the Bank argues strenuously that [the expert's] approach was speculative and mere hindsight, the trial court had substantial evidence upon which to base its conclusion

67. It is important to note that many FINRA panels do not describe the award as market adjusted damages. Rather, the awards reflect a compensatory damage amount in excess of net out of pocket damages but based on a market adjusted calculation.

that [the expert's] approach was a responsible investment alternative to the Bank's management method.⁶⁸

It is important to explain to the panel that market adjusted damages are based on historical data (*i.e.*, benchmarks) and therefore are not the product of speculation or guesswork.

Asset allocation cases that have awarded market adjusted damages typically involve an over concentration in equities which was inconsistent with the client's risk tolerance and investment objectives. By way of example, in the case of an elderly client who had conservative investment objectives which included principal protection and a need for income, an 80% fixed income/cash and 20% equities allocation might be appropriate to evidence what the portfolio should have earned over the same time period.

Product cases that have awarded market adjusted damages have included a security that Citigroup sold to its clients as a fixed income alternative that would generate tax-free returns between 6-9%. In truth, the security was high risk and speculative. In their presentation to clients, Citigroup brokers failed to disclose, *inter alia*, the high risk and speculative nature of the security to its clients, continued to misrepresent the product and continued to mismanage the security until its implosion in 2008. Again, since Citigroup represented the security as a fixed income alternative, a 100% fixed income proxy was a consistent benchmark to establish market adjusted damages.

VI. CONCLUSION

In conclusion, market adjusted damages are an accurate and fair measure of compensation that appropriately reflects the harm caused to the investor adjusted for actual market performance.

68. First Alabama Bank of Huntsville v. Spragins, 515 So.2d 962, 966 (Ala. 1987) (market adjusted damages are "the amount of the loss [calculated] by weighing the actual value of the trust principal against what the value would have been had it been prudently managed." *Id.* at 964); *see also* McCoy v. Goldberg, [1992-1993] Fed. Sec. L. Rep. (CCH) ¶97,314 (S.D.N.Y. 1993) (on claim of breach of fiduciary duty, the court allowed recovery of interest the investor would have earned on "risk-free" investment in Treasury bonds in addition to losses incurred in purchase of units of limited partnerships).

69.

III. “Well Managed Portfolio” PIABA B.J., Vol. 21, No 2 p. 151 (2014).

DAUBERT, THE “WELL MANAGED PORTFOLIO,” AND “NET-OUT-OF-POCKET (NOP) LOSSES” ARE NOPS JUNK SCIENCE?

Robert C. Port

Proof of damages to the satisfaction of the trier of fact is the end game for all plaintiffs. When faced with a claim of financial advisor misconduct, the investor’s attorney must have the ability to not only identify possible causes of action that might provide relief, but to also develop a methodology of proving damages that will not be subject to attack as speculative or otherwise illegitimate.

This article discusses one approach to quantifying damages caused by advisor misconduct.¹ The analytical approach is grounded in the academic research surrounding Modern Portfolio Theory, which considers how a rational investor would use diversification and asset allocation to optimize their portfolio for their particular risk profile and circumstances. That portfolio is, for that individual investor, the “Well Managed Portfolio” (“WMP”).² I conclude that when tested against the directives of the Supreme Court in *Daubert*,³ WMP presents a sound basis for assessing damages caused by advisor misconduct, while the industry’s commonly used approach

1. Under the facts of a particular case, other methods of assessing damages might be appropriate, including the damages computed based on the methodology set forth by the Uniform Securities Act (the “Act”) and many state securities acts (“Blue Sky” Acts), which provides for rescission as the sole remedy. Under the Act, an aggrieved investor is entitled to rescind the transactions, tender the securities to the seller, and recover the consideration paid for the securities, plus interest from the date of the payment for the securities to the date of judgment, plus costs and reasonable attorney’s fees. While providing a precise monetary remedy, the Uniform Act may not place a defrauded securities buyer in the position they would have been in had the fraud not occurred, since the buyer is entitled to receive only a return of the consideration paid plus statutory interest. Had the portfolio been managed properly, the appreciation may well have been much greater than the statutory interest rate. WMP damages thus provides an alternative measure, under the right facts, for accurately determining the harm caused by advisor misconduct.

2. This damages theory is also sometimes referred to as “Market Adjusted Damages.”

3. *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993).

– “Net-Out-of-Pocket Losses” – not only fails to adequately compensate the investor for their losses, it is also a methodology that ought to be precluded by any thoughtful *Daubert* analysis.

MODERN PORTFOLIO THEORY

Modern Portfolio Theory had its genesis in a paper entitled “Portfolio Selection,” by Professor Harry Markowitz, published in 1952 by the Journal of Finance.⁴ Markowitz mathematically demonstrated that, based on historical market returns, a diversified investment portfolio can be constructed which has a high probability of achieving a maximum possible expected return for a given level of risk. Thus, it is possible to create a portfolio to match an individual investor’s risk-reward tolerance. Markowitz’ findings were the basis for subsequent important findings by Merton Miller, William Sharpe, and others, which collectively came to be known as Modern Portfolio Theory (“MPT”).⁵

A detailed discussion of MPT is beyond the scope of this article – or the capabilities of this author. Further, it is fair to recognize that MPT has its critics.⁶ Nevertheless, while imperfect, MPT offers a serious academic and practical approach to the investment decision-making process.

In sum, MPT focuses on how to construct an investment portfolio. Securities are chosen for the portfolio based on how they interact relative to other securities, rather than on how they perform in isolation. Studies of the long-term returns and volatility (price movement) of securities have found

4. Harry M. Markowitz, *Portfolio Selection*, 7 J. FIN. 77-91 (1952). Markowitz is currently a Professor of Finance at the Rady School of Management, University of California.

5. In 1990, Markowitz was awarded the Nobel Prize in Economic Sciences, along with Merton Miller and William Sharpe, for his work. See *infra* note 44.

6. Criticisms include the fact that actual financial returns do not follow a normal distribution; that correlations between asset classes are not fixed but can vary depending on external events; that MPT neglects taxes and transaction costs; that investors may not be entirely rational; and that markets are not completely efficient. The utility of MPT was also questioned during the 2008 financial crisis, in which even most diversified investment portfolios suffered significant losses. Markowitz addressed these arguments in *Crisis Mode: Modern Portfolio Theory Under Pressure*, 2 INVESTMENT. PROF., no. 2 (Spring 2009).

that a reasonably predictable range of returns can be determined for each security or classes of securities, expressed in the statistical concept of standard deviation.⁷ Securities also have reasonably predictable correlations in their price movements relative to other securities, meaning that some move in tandem (a positive correlation), while others move inversely (a low or negative correlation).⁸ Once these historical variables are identified for specific securities, the expected or predicted return (the reward) and volatility (the risk) of any portfolio can be estimated. Using these techniques, an advisor can construct, from the myriad of possible portfolios, a portfolio that will attempt to optimally balance the return an investor seeks with the risk the investor desires to take.⁹

One of the principal tenants of Modern Portfolio Theory is that a diversified portfolio can be constructed for every level of risk as measured by standard deviation.. Thus, investable assets are allocated amongst various categories of market investments, such as U.S. equities, foreign equities, domestic and foreign government bonds, domestic and foreign corporate bonds, domestic and international real estate, commodities, and cash. In turn, those assets should be diversified amongst various issuers within those investment categories.¹⁰ Diversification has long been held to be a duty of a trustee or fiduciary managing assets.¹¹ The common cliché is to not have “all

7. Standard deviation measures the dispersion of a set of data around the mean of the data. A “bell curve” is a graphic illustration of a normal distribution of data. With respect to measuring a security’s risk, standard deviation measures the range or variation of returns around the security’s average returns. In a normal distribution, approximately 68% of data falls within plus or minus one standard deviation of the mean, and 95% fall within plus or minus two standard deviations of the mean. The standard deviation of an investment can give a clue as to the risk associated with achieving its average returns. For example, the SPDR S&P 500 (SPY) had a standard deviation of 14.66, with a return of 7.69%, for the 10 years ending June 30, 2014. See Morningstar, *SPDR S&P 500*, <http://performance.morningstar.com/funds/cef/ratings-risk.action?t=SPY> (last visited Sep. 2, 2014). If that performance persists, that means that there is a 68% probability that SPY could be expected to have a return in any given year of between 6.97% and 22.35%.

8. LAWRENCE J. GITMAN & MICHAEL D. JOEHNK, *FUNDAMENTALS OF INVESTING* 188-95 (9th ed. 2005).

9. This is often referred to as an “efficient portfolio,” which is a portfolio where no additional expected return can be gained without increasing the risk of the portfolio.

10. Gitman & Joehnk, *supra* note 8, at 204.

11. “Diversification is a uniformly recognized characteristic of prudent investment and, in the absence of specific authorization to do otherwise, a trustee’s lack of

your eggs in one basket.”¹² A portfolio will likely have less volatility (i.e., less extreme price movement) when the investments within it are negatively correlated, and thus individually have different price reactions to economic variables, such as inflation, world events, commodities prices, consumer spending, business investment, or unemployment rates. Indeed, studies have shown that broad asset allocation – not stock selection or market timing – can substantially reduce portfolio volatility without materially reducing returns.”¹³

The extensive academic research on Modern Portfolio Theory suggests that an advisor should construct a portfolio by selecting investments that, in combination, would have the best chance of providing the highest probable reward consistent with his client’s risk tolerance. To do otherwise is, at minimum, to recommend an “irrational [investment] strategy.”¹⁴ More importantly, the failure to select a portfolio consistent with a client’s needs,

diversification would constitute a breach of its fiduciary obligations. *See*, RESTATEMENT (THIRD) OF TRUSTS 229(d).” *Robertson v. Central Jersey Bank & Trust Co.*, 47 F.3d 1268, 1275 (3rd Cir. 1995) (citation in original). “Under the duty of diversification, the trustee should not normally invest all or an unduly large portion of plan funds in a single security, or in any one type of security, or even in various types of securities that depend on the success of one enterprise.” *Bruner v. Boatmen’s Trust Co.*, 918 F. Supp. 1347, 1353 (E.D. Mo. 1996). *See also*, *Whitfield*

v. Tomasso, 682 F.Supp. 1287, 1301 (E.D.N.Y. 1988) (concentration of between 25% and 89% of the assets in one type of investment violated diversification requirement); *Jones v. O’Higgins*, No. 87-CV-1002, 1989 U.S. Dist. LEXIS 10537 (N.D.N.Y. Sept. 5, 1989) (putting 90% of portfolio in only 3 stocks would permit finding of lack of diversification, absent showing of special circumstances).

12. Recent vivid examples of the continuing validity of this colloquialism include those investors who were heavily concentrated in “dot com” stocks in the late 1990’s, as well as those employees of WorldCom and Enron who kept all of their retirement funds in the stock of their respective companies.

13. Roger G. Ibbotson, et al., *Does Asset Allocation Policy Explain 40%, 90%, or 100% of Performance?*, FIN. ANALYSTS J., 32 (Jan. – Feb. 2000) (“our analysis shows that asset allocation explains about 90 percent of the variability of a funds returns over time”)(emphasis in original); Richard P. Booth, *The Suitability Rule, Investor Diversification, and Using Spread to Measure Risk*, 54 BUS. LAW 1599, 1605-06 (1999) (“Rational investors diversify. By investing in a diversified portfolio, an investor can eliminate as much as ninety percent of the risk that goes with investing in an individual stock without any sacrifice of expected return.”).

14. Booth, *supra* note 13 at 1599, 1606.

circumstances and risk tolerance may form the basis for various causes of action, including breach of fiduciary duty,¹⁵ breach of contract, negligence,

15. *Gochnauer v. A.G. Edwards & Sons, Inc.*, 810 F.2d 1042, 1049 (11th Cir. 1987) (“The law is clear that a broker owes a fiduciary duty of care and loyalty to a securities investor.”); *accord* RESTATEMENT (SECOND) OF AGENCY § 425 (agents who are employed to make, manage, or advise on investments have fiduciary obligations). At least 37 states also recognize that brokers owe fiduciary duties to their customers. Alabama: *Chipser v. Kohlmeyer & Co.*, 600 F.2d 1061, 1066-67 (5th Cir. 1979); Arizona: *SEC v. Rauscher Pierce Refsnes, Inc.*, 17 F. Supp. 2d 985, 992-93 (D. Ariz. 1998); Arkansas: *Greenwood v. Dittmer*, 776 F.2d 785, 788 (8th Cir. 1985); California: *Duffy v. Cavalier*, 264 Cal. Rptr. 740 (Cal. Ct. App. 1989); Colorado: *Rupert v. Clayton Brokerage Co.*, 737 P.2d 1106, 1109 (Colo. 1987); Delaware: *O’Malley v. Boris*, No. Civ.A. 15735, 1999 WL 39548 (Del. Ch. Jan. 19, 1999); Florida: *First Union Brokerage v. Milos*, 717 F. Supp. 1519, 1526 (S.D. Fla. 1989); Georgia: *Holmes v. Grubman*, 691 S.E.2d 196 (Ga. 2010); Hawaii: *Unity House, Inc. v. North Pacific Invs., Inc.*, 918 F. Supp. 1384, 1392 (D. Haw. 1996); Illinois: *Martin v. Heinold Commodities, Inc.*, 643 N.E.2d 734, 738, (Ill. 1994); Indiana: *Holtz v. J.J.B. Hillard W.L. Lyons, Inc.*, 185 F.3d 732 (7th Cir. 1999); Iowa: *Cunningham v. PFL Life Ins. Co.*, 42 F. Supp. 2d 872, 888-89 (N.D. Iowa 1999); Kansas: *Denison State Bank v. Madeira*, 640 P.2d 1235, 1241, (Kan. 1982); Louisiana: *Beckstrom v. Parnell*, 730 So. 2d 942, 948-49 (La. App. 1998); Maryland: *Kaufman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 464 F. Supp. 528, 536 (D. Md. 1978); Massachusetts: *Cannistraci v. Dean Witter Reynolds, Inc.*, 796 F. Supp. 619, 623 (D. Mass. 1992); Michigan: *Davis v. Keyes*, 859 F. Supp. 290, 294 (E.D. Mich. 1994); Minnesota: *McGinn v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 736 F.2d 1254, 1258 (8th Cir. 1984); Mississippi: *Puckett v. Rufenacht, Bromagen & Hertz, Inc.*, 587 So. 2d 273, 279 (Miss. 1991); Missouri: *Vogel v. A.G. Edwards & Sons, Inc.*, 801 S.W.2d 746 (Mo. Ct. App. 1990); Montana: *Chor v. Piper, Jaffray & Hopwood, Inc.*, 862 P.2d 26, 32 (Mont. 1993); Nebraska: *Woodruff v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 709 F. Supp. 181, 185 (D. Neb. 1989); New Jersey: *McAdam v. Dean Witter Reynolds, Inc.*, 896 F.2d 750, 766 (3rd Cir. 1990); New Mexico: *Reinhart v. Rauscher Pierce Secs. Corp.*, 83 N.M. 194, 490 P.2d 240 (N.M. App. 1971); New York: *Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529, 536 (2nd Cir. 1999); North Dakota: *Ray E. Friedman & Co. v. Jenkins*, 738 F.2d 251, 254 (8th Cir. 1984); Ohio: *Thropp v. Bache Halsey Stuart Shields, Inc.*, 650 F.2d 817, 822 (6th Cir. 1981); Oregon: *Berki v. Reynolds Sec., Inc.*, 560 P.2d 282, 285-86 (Or. 1977); Pennsylvania: *Merrill Lynch, Pierce, Fenner & Smith v. Perelle*, 514 A.2d 552, 561 (Pa. Super. Ct. 1986); Rhode Island: *Jonklaas v. Silverman*, 370 A.2d 1277 (R.I. 1977); South Dakota: *Dinsmore v. Piper Jaffray, Inc.*, 1999 SD 56, 593 N.W.2d 41, 46 (S.D. 1999); Tennessee: *J.C. Bradford Futures, Inc. v. Dahlonga Mint, Inc.*, 907 F.2d 150 (6th Cir. 1990); Texas: *Tapia v. The Chase Manhattan Bank, N.A.*, 149 F.3d 404, 412 (5th Cir. 1998); Utah: *Marchese v. Nelson*, 809 F. Supp. 880, 894 (D. Utah 1993); Vermont: *Jarvis v. Dean Witter Reynolds, Inc.*, 614 F. Supp. 1146, 1150 (D. Vt. 1985); West Virginia: *Baker v. Wheat First Secs.*, 643 F.

or fraud.¹⁶ Moreover, under applicable regulatory directives, a broker has a duty to determine each client's individual risk tolerance before recommending a securities transaction.¹⁷

Using the precepts of Modern Portfolio Theory leads to a portfolio that is, in theory, suitable and appropriate for an investor. That portfolio has the diversification and asset allocation that, based on historical data and statistical analysis such as standard deviation, would be expected in the future to have risk and return characteristics that are consistent with that individual investor's particular risk profile and circumstances. That portfolio is, for that individual investor, the "Well Managed Portfolio" ("WMP").

There is, however, no singular "right" portfolio, to the exclusion of all others. Given the myriad of investing options, the precepts of MPT can be accomplished using various investment vehicles to supply the diversification and asset allocation required to meet an investor's needs. What MPT does teach, however, is that a portfolio can be the "wrong" portfolio for an investor. For example, if an investor's profile suggests that a portfolio of roughly 60% bonds, 35% equities, and 5% cash is likely to comport with that investor's risk tolerance and income needs, a portfolio of 95% equities and 5% cash is almost certainly unsuitable and inappropriate.

CASE LAW SUPPORT FOR A BENCHMARK "WELL MANAGED PORTFOLIO"

Since the Supreme Court's 1987 decision in *Shearson/American Express Inc. v. McMahon*,¹⁸ the overwhelming majority of disputes between individual investors and their stockbrokers have been resolved by compulsory arbitration, now conducted by the Financial Industry Regulatory Authority (FINRA). The decisions reached by arbitration panels, though publicly available, do not generally give a written rationale for the decision,

Supp. 1420 (S.D. W.Va. 1986); Wisconsin: Associated Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc., 3 F.3d 208, 212 (7th Cir. 1993).

16. Robert C. Port, *Theories of Stockbroker and Brokerage Firm Liability*, 9 GA. BAR J., no. 5, at 12 (2004).

17. FINRA Rule 2111 requires, in part, that a broker-dealer or associated person "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the [firm] or associated person to ascertain the customer's investment profile."

18. 482 U.S. 220 (1987).

and are final and not subject to appeal or judicial review except in very limited circumstances.¹⁹ Nor do such arbitration awards have the precedential value of a court decision.²⁰ As a result, the development of the law in this area has been stagnant, since it is not subject to the continued refinement, analysis, and appellate review that would otherwise have occurred in litigated claims.²¹

Nevertheless, case law as it was developing before *McMahon* certainly foreshadowed the concept of damages based upon comparison to a Well-Managed Portfolio (“WMP”). More importantly, settled law respecting computation of damages unquestionably supports the use of WMP in assessing the damages caused by an advisor’s misconduct.

The seminal case is the Second Circuit’s decision in *Rolf v. Blyth Eastman Dillon & Co., Inc.*²² *Rolf* involved a claim that defendant’s broker purchased unsuitable securities which rapidly deteriorated in value. With respect to the proper calculation of damages, the Second Circuit directed that the district court should first compute the “gross economic loss” suffered by “subtract[ing] the value of the portfolio on the date when [misconduct ended]

. . . from the value on the date when [misconduct started] The district court should then reduce Rolf’s gross economic loss by the average percentage decline in value of the Dow Jones Industrials, the Standard & Poor’s Index, or any other well recognized index of value, or combination of

19. See, e.g., 9 U.S.C. § 10 (setting forth grounds vacating an arbitration award); *B.L. Harbert Int’l v. Hercules Steel Co.*, 441 F.3d 905 (11th Cir. 2006), in which the Eleventh Circuit made it clear that it was issuing notice and warning that it is “ready, willing, and able to consider imposing sanctions” on “those who attempt to salvage arbitration losses through litigation that has no sound basis in the law applicable to arbitration awards.” *B.L. Harbert Int’l* at 914.

20. See, e.g., *El Dorado Technical Servs., Inc. v. Union General de Trabajadores de Puerto Rico*, 961 F.2d 317, 321 (1st Cir. 1992).

21. “The lack of new cases that would further develop a standard for unsuitable recommendation liability is because almost all unsuitability claims are heard in arbitration.” *Estate of Ives v. Ramsden*, 2008 Wash. App. LEXIS 1 (2007); see also *The Arbitration Fairness Act of 2007: Hearing on S. 1782 Before the Subcomm. on the Constitution S. Comm. on the Judiciary*, 110th Cong. (2007) (testimony of Richard M. Alderman) (“[A]rbitrators cannot create or modify the common law. They are bound by existing legal doctrine, essentially freezing the common law of consumer transactions, denying courts the ability to develop and adapt the law.”) (footnote omitted).

22. 570 F.2d 38 (2d Cir. 1978), *cert. denied*, 439 U.S. 1039, (1978), *aff’d in part and remanded*, 637 F.2d 77 (2d Cir. 1980).

indices, of the national securities markets during the period [of the misconduct].”²³ The court further recognized that if “the quality of stocks in the portfolio was such that a broad-based index would not be representative of those stocks, then [the district court] may select a more appropriate gauge, perhaps a portion of an index, perhaps a composite of indices, perhaps expert opinion.”²⁴ Rolf thus recognized the legitimacy of “market adjusted damages” -- benchmarking a portfolio to an appropriate market index as a method of computing the damages caused by an advisor’s misconduct.

The *Rolf* analysis as was followed by the Fifth Circuit in *Miley v. Oppenheimer & Co.*²⁵ In *Miley*, plaintiff asserted that his account had been churned.²⁶ The court instructed district courts to measure damages according to “how the investor’s portfolio would have fared in the absence of the such [sic] misconduct.”²⁷ The finder of fact “must be afforded significant discretion to choose the indicia by which such an estimation is made, based primarily on the types of securities comprising the portfolio.”²⁸ The court observed that “in the absence of either a specialized portfolio or a showing by either party that a different method is more accurate,” it would be “preferable” for district courts to use “the average percentage of performance of the Dow Jones Industrials or the Standard & Poor’s Index during the relevant period as the indicia of how a given portfolio would have performed in the absence of the broker’s misconduct.”²⁹ The damages due plaintiff would be “the difference between what [the plaintiff] would have had if the account ha[d] been handled legitimately and what he in fact had at the time the violation ended.”³⁰

23. 570 F.2d at 50.

24. *Id.* at n.22.

25. 637 F.2d 318, 326-27 (5th Cir. 1981).

26. “Churning occurs when a securities broker buys and sells securities for a customer’s account, without regard to the customer’s investment interests, for the purpose of generating commissions.” *Thompson v. Smith Barney, Harris Upham & Co.*, 709 F.2d 1413, 1416 (11th Cir. 1983); see also *McNeal v. Paine, Webber, Jackson & Curtis, Inc.*, 598 F.2d 888, 890 n.1 (5th Cir. 1979).

27. *Miley* at 328.

28. *Id.* (footnote omitted).

29. *Id.*

30. *Id.* at 327.

In sum, a WMP analysis is nothing more than a refined approach to the use of broad indexes to compute damages, as countenanced in *Rolf* and *Miley*. Despite the diversion of most individual investor cases to arbitration, the propriety of computing using indexes or similar benchmarks (sometimes called “market adjusted damages”) has been recognized in a host of state and federal courts as appropriate methodologies for quantifying the investors’ damages -- the probable value of the investor’s account but for the misconduct.³¹ In fact, in certain types of trustee³² and ERISA³³ cases, there is well-established law that confirms the propriety of using this approach.

31. *Williams v. Sec. Nat’l Bank*, 358 F. Supp. 2d 782 (N.D. Iowa 2005) (“stock indices are relevant to the determination of damages for mismanagement of investments or trust assets”); *In re Drexel Burnham Lambert Group, Inc.*, 161 B.R. 902 (S.D.N.Y. 1993); *In re Thomson McKinnon Sec., Inc.*, 191 B.R. 976, 987-88 (S.D.N.Y. 1996); see also *Kronfeld v Advest, Inc.*, 675 F. Supp. 1449, 1456 (S.D.N.Y. 1987); *Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 906 F.2d 1206, 1217-18 n. 13 (8th Cir. 1990); *McGinn v Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 736 F.2d 1254, 1257 (8th Cir. 1984); *Brabham v. A.G. Edwards & Sons, Inc.*, 265 F. Supp. 2d 720, 725 (S.D. Miss. 2003); *Laney v. American Equity Inv. Life Ins. Co.*, 243 F. Supp. 2d 1347, 1353-1356 (M.D. Fla. 2003); *Winer v. Patterson*, 644 F. Supp. 898, 900-01 (D.N.H. 1986) (plaintiff entitled to attempt to prove value of account had it not been churned), *vacated in part on other grounds*, 663 F. Supp. 723 (1st Cir. 1987); *Lopez v. Dean Witter Reynolds, Inc.*, 591 F. Supp. 581, 589-90 (N.D. Cal. 1984); *In re Rosenfeld Found. Trust*, No. 1664 IV, 2006 Phila. Ct. Com. Pl. LEXIS 394, 107-09 (Phila. Commw. Ct. July 31, 2006); *Scalp & Blade v. Advest, Inc.*, 309 A.D. 2d 219, 232 (N.Y. App. Div. 2003); *Brabham v.*

A.G. Edwards & Sons, Inc., 376 F.3d 377, 382 (5th Cir. 2004); *Dasler v. E.F. Hutton*, 694 F. Supp. 624 (6th Cir. 1988); *Medical Assocs. of Hamburg, P.C. v. Advest, Inc.*, No. CIV-85-837E, 1989 Lexis 11253, 1989 WL 75142 (W.D.N.Y. July 5, 1989) (“The proper method of calculating damages is to take the initial value of plaintiff’s portfolio, adjust it by a percentage change in an appropriate index, during the relevant period, and subtract the value of the portfolio at the end of the period.”); *Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767, 773-74 (9th Cir. 1984) (“The recoverable decline in portfolio value is the difference between what [the claimant] would have had if the account ha[d] been handled legitimately and what he in fact had at the time the violation ended.”) (quotations and citations omitted).

32. See, e.g., *LaRue v. DeWolff, Boberg & Assocs., Inc.*, 552 U.S. 248, 253 n.4 (2008) (“Under the common law of trusts, . . . trustees are “chargeable with . . . any profit which would have accrued to the trust estate if there had been no breach of trust.”) (citing 1 RESTATEMENT (SECOND) OF TRUSTS § 205, cmt. i, § 211 (1957); 3 A. SCOTT, LAW ON TRUSTS §§ 205, 211 (3d ed. 1967)).

33. Since 1979, ERISA regulations have required that a ERISA fiduciary act as a prudent investment manager under the precepts of modern portfolio theory rather

Moreover, a WMP approach to determining damages is consistent with the legal and public policy goal of providing a proper and adequate remedy to a party injured by the actions of another. The long recognized goal of the law of damages is to place the injured party in the position he would have been in had the fraud, tort, breach of contract, or other wrong not occurred.³⁴ This goal is particularly appropriate when the actions of the wrongdoer harm an asset, and the legal measure of damages is the difference between what that asset is presently worth, and what it would have been worth had the wrong not been committed.³⁵ A WMP analysis seeks, in fact, to determine

than under the common law of trusts standard, which examined each investment with an eye toward its individual riskiness. 29 C.F.R. § 2550.404a-1. *See generally*, *Laborers Nat'l Pension Fund v. Northern Trust Quantitative Advisors, Inc.*, 173 F.3d 313, 317 (5th Cir. 1999). *See also* *DiFelice v. U.S. Airways, Inc.*, 436 F. Supp. 2d 756, 786 (D. Va. 2006) ("ERISA requires that the prudence of selecting a particular investment be viewed in light of its contribution to the risk and return of the entire portfolio, and not in light of its individual risk."); *In re Cardinal Health, Inc. ERISA Litig.*, 424 F. Supp. 2d 1002, 1020 (S.D. Ohio 2006) ("[A] fiduciary with investment duties must act as a prudent investment manager under the modern portfolio theory rather than under the common law of trusts standard, which examined each investment with an eye toward its individual riskiness."); *Donovan v. Bierwith*, 754 F.2d 1049, 1056 (2d Cir. 1985) ("[Under ERISA] The measure of loss . . . requires a comparison of what the Plan actually earned on the [investment] with what the Plan would have earned [T]he district court should presume that the funds would

have been treated like other funds being invested during the same period in proper transactions."); *Dasler v. E.F. Hutton & Co., Inc.*, 694 F. Supp. 624 (D. Minn. 1988). (Plan damages computed by reference to what would have been earned if investments had performed according to the S&P 500 Stock Index).

34. *See, e.g.*, RESTATEMENT (SECOND OF CONTRACTS) § 344(a), which states the "remedies under the rules stated in this Restatement serve to protect one or more of the following interests of a promisee: (a) his "expectation interest," which is his interest in having the benefit of his bargain by being put in as good a position as he would have been in had the contract been performed."

35. *See Affiliated Ute Citizens v. United States*, 406 US 128, 155 (1972) (holding that plaintiff should be awarded the difference between the "fair market value of all [he] received and the fair value of what he would have received had there been no fraudulent conduct."); *Levine v. Futransky*, 636 F. Supp. 899, 900 (N.D. Ill. 1986) ("this Court holds that Plaintiffs suffered damages even though the investment portfolios incurred a net gain. Plaintiffs may be entitled to recover the difference between the losses incurred on the sale of the speculative securities and the greater amount plaintiffs would have received had they not been defrauded and the more conservative securities had been bought and sold.").

the expected value of the investor's portfolio, given actual market conditions, had the unsuitable or improper investing activity not taken place. WMP damages thus provide an automatic adjustment for both upward and downward market movements during the relevant time frame that is unrelated to the advisor's misconduct.³⁶

Using a WMP measure of damages thus directly rebuts the argument that the damages sought are "speculative." A WMP computation necessarily takes into account the actual market risk to which the investor would have been exposed had he or she been invested in a portfolio suitable for their particular circumstances. Significantly, *Miley* rejected the argument that use of a market index would render a WMP calculation improperly speculative. Although "the inherent uncertainties of the operation of the stock market

36. "*Rolf* laid no stress on the direction of the shift of the stock market in fashioning its market adjusted damage formula, and the defendants have not advanced a reasoned basis for enabling this Court to do so. Obviously, as in *Rolf*, where the securities market is in decline over the relevant period, a decline in a plaintiff's particular portfolio is partially attributable to market forces (instead of the defendant's fraud) and the plaintiff's recovery should thus be reduced accordingly to reflect his 'actual damages.'" *Rolf*, supra, at 84. "By the same token, as in this case, where a plaintiff's portfolio declines in value notwithstanding an overall rise in the market, such plaintiff's actual injury is not limited to the simple decline in value of his securities but encompasses also damages occasioned by the failure of such securities to keep pace with the market -- as they otherwise generally would have. His compensatory recovery should therefore be augmented accordingly." *Medical Associates*, 1989 U.S. Dist. LEXIS 11253, at * 6-7. *But see* *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 604 (2d Cir. 1978) ("Although the facts of *Rolf* required the gross economic loss to be offset by an amount which reflected the effects of a bear market, no such offset is appropriate here. The damages in *Rolf* were for fraudulent mismanagement and there was evidence in the case that even properly managed securities would have declined in value because of market conditions. In this case, damages were awarded because appellants fraudulently induced appellee to buy unsuitable securities. Appellants will not be permitted to avoid making appellee whole merely because upon discovery of the fraud she happened to sell the securities in a declining market. Similarly, they cannot be heard to complain when making appellee whole requires them to pay out more than they received from their dealings with her."); *Levine v. Futransky & E. F. Hutton & Co.*, 636 F. Supp. 899 (N.D. Ill. 1986) ("this Court holds that plaintiff suffered damages even though the investment portfolio incurred a net gain. Plaintiff may be entitled to recover the difference between the losses incurred on the sale of the speculative securities and the greater amount plaintiffs would have received had they not been defrauded and the more conservative securities had been bought and sold."). *Levine* at 900.

make exact implementation of this elementary legal theory impossible, . . . neither the difficulty of the task nor the guarantee of imprecision in results can be a basis for judicial abdication from the responsibility to set fair and reasonable damages in a case.”³⁷ This conclusion is well supported in the law.³⁸

37. *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 327 (5th Cir. 1981).

38. It is well settled that any uncertainty in proving damages is resolved against the wrongdoer. “The rule which precludes the recovery of uncertain damages applies to such as are not the certain result of the wrong, not to those damages which are definitely attributable to the wrong and only uncertain in respect of their amount. .

.. Where the tort itself is of such a nature as to preclude the ascertainment of the amount of damages with certainty, it would be a perversion of fundamental principles of justice to deny all relief to the injured person, and thereby relieve the wrongdoer from making any amend for his acts. In such case, while the damages may not be determined by mere speculation or guess, it will be enough if the evidence show the extent of the damages as a matter of just and reasonable inference, although the result be only approximate. The wrongdoer is not entitled to complain that they cannot be measured with the exactness and precision that would be possible if the case, which he alone is responsible for making, were otherwise.” *Story Parchment Co. v. Patterson*, 282 U.S. 555, 562-63 (1930). *See also* *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761, 781 (3rd Cir. 1976) (“In these cases the risk of uncertainty as to the amount of damages is cast on the wrongdoer and it is the duty of the fact finder to determine the amount of the damages as best he can from all the evidence in the case. If this were not so, [the securities laws] could be violated with impunity in any situation in which the violation does not cause out of pocket loss.”) (internal citations omitted); *Donovan v. Bierwith*, 754 F.2d 1049, 1056 (2d Cir. 1985). (“Where several alternative investment strategies were equally plausible, the court should presume that the funds would have been used in the most profitable of these. The burden of proving that the funds would have earned less than that amount is on the fiduciaries found to be in breach of their duty. Any doubt or ambiguity should be resolved against them. This is nothing more than application of the principle that, once a breach of trust is established, uncertainties in fixing damages will be resolved against the wrongdoer.”); *Medical Associates*, 1989 U.S. Dist. LEXIS 11253 (“The defendants’ contention that the use of an ‘appropriate market index’ . . . is overly speculative is entirely misguided. If a market index is not too speculative for purposes of reduction of a plaintiff’s recovery (as in *Rolf*), the same index can hardly be too speculative for purposes of enhancement thereof. A degree of uncertainty is of course unavoidable by use of an index, but ‘neither the difficulty of the task nor the guarantee of imprecision in results can be a basis for judicial abdication from the responsibility to set fair and reasonable damages in a case.’”) (citing to *Rolf* and *Miley*).

DAUBERT AND WELL MANAGED PORTFOLIO DAMAGES

The Supreme Court's recent decisions tightening the admissibility of expert witness testimony suggest that an argument should be made that (unless statutory "Blue Sky" damages, or another recognized common law method of calculating damages are being sought), anything *other* than marketadjusted damages may be improper and subject to exclusion. The *Daubert*,³⁹ *Kumho Tire*,⁴⁰ and *Joiner*⁴¹ cases directed that federal district court judges should be the "gatekeepers" of evidence, and must evaluate proffered expert witnesses with a two-pronged test of admissibility to determine expert's testimony is "relevant to the task at hand" and that it rests "on a reliable foundation."⁴²

For securities arbitrations, state and federal rules of evidence are inapplicable, so it is illegitimate to assert that a strict *Daubert* analysis applies.⁴³ However, to the extent that arbitrators should be concerned about the fairness and integrity of the arbitration process, they, too, should view with caution and suspicion damages that might properly be characterized as "junk science" or otherwise unreliable.

39. *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993).

40. *Kumho Tire Co., Ltd. v. Carmichael*, 526 U.S. 137 (1999).

41. *Gen. Elec. Co. v. Joiner*, 522 U.S. 136 (1997).

42. *Daubert*, 509 U.S. at 584-87; *Kumho*, 526 U.S. at 141; *Joiner*, 522 U.S. at 141. Fed. R. Evid. 702 has been amended in an attempt to codify and structure elements embodied in the "Daubert trilogy." Fed. R. Evid. 702 provides that "A witness who is qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion or otherwise if: (a) the expert's scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue; (b) the testimony is based on sufficient facts or data; (c) the testimony is the product of reliable principles and methods; and (d) the expert has reliably applied the principles and methods to the facts of the case."

43. FINRA Rule 12604(a) ("The panel will decide what evidence to admit. The panel is not required to follow state or federal rules of evidence").

**A WELL MANAGED PORTFOLIO ANALYSIS IS RELEVANT AND RELIABLE IN
DETERMINING AN INVESTOR'S DAMAGES**

WMP damages derived from the principles of Modern Portfolio Theory are unquestionably a relevant and reliable method of demonstrating the probable losses suffered by an investor.

First, there can be little debate that evidence proffered to address the extent and measure of financial loss suffered by an investor is "relevant" in a proceeding where an investor claims they have suffered damage by the actions of a broker or financial advisor. Under Fed. R. Evid. 401, "[e]vidence is relevant if: (a) it has any tendency to make a fact more or less probable than it would be without the evidence; and (b) the fact is of consequence in determining the action."

Moreover, a Well Managed Portfolio analysis derived from the principles of Modern Portfolio Theory is product of reliable principles and methods. In ascertaining whether expert testimony is reliable, a court can consider a number of factors, including (i) whether a theory or technique can be or has been tested; (ii) whether it has been subjected to peer review and publications; (iii) whether, in respect to a particular technique, there is a high known or potential rate of error and whether there are standards controlling the technique's operations; and (iv) whether the theory or technique enjoys general acceptance within a relevant scientific community. *See, e.g.,* Quiet Tech. DC - 8. Inc. v. Hurel-Dubois U.K. Ltd., 326 F.3d 1333, 1341 (11th Cir. 2003).

Modern Portfolio Theory is not novel or untested. Its principal theorists have received Nobel Prizes.⁴⁴ It has been subjected to decades of peer review and critique, and although thoughtful critics remain, it has been widely accepted as a viable investing strategy for managing risk and return. Thus, it has been embraced by the Uniform Prudent Management of Institutional Funds Act (UPMIFA),⁴⁵ the Uniform Prudent Investor Act (UPIA),⁴⁶ and the

44. Press Release, The Royal Swedish Academy of Sciences (Oct. 16, 1990), http://nobelprize.org/nobel_prizes/economics/laureates/1990/press.html (last visited Sept. 2, 2014) (stating that the 1990 Alfred Nobel Memorial Prize in Economic Sciences Nobel Prize in Economic Sciences was being awarded to "Harry Markowitz . . . for having developed the theory of portfolio choice; [to] William Sharpe, for his contributions to the theory of price formation for financial assets, the so-called, Capital Asset Pricing Model (CAPM); and [to] Merton Miller, for his fundamental contributions to the theory of corporate finance.").

45. The 1996 revisions to the UPMIFA included revisions to Section 3, entitled *Standard Of Conduct In Managing And Investing Institutional Fund*. The purpose of

Restatement (Third) of Trusts;⁴⁷ and its fundamental principals have been adopted and are used by major universities to manage their endowments.⁴⁸

the revisions was to “adopt[] the prudence standard for investment decision making. The section directs directors or others responsible for managing and investing the funds of an institution to act as a prudent investor would, using a portfolio approach in making investments and considering the risk and return objectives of the fund. The section lists the factors that commonly bear on decisions in fiduciary investing and incorporates the duty to diversify investments absent a conclusion that special circumstances make a decision not to diversify reasonable. *Thus, the section follows modern portfolio theory for investment decision making.*” NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, UNIFORM MANAGEMENT OF

INSTITUTIONAL FUNDS ACT (Draft, August 25, 2004) (emphasis added), http://listserv.fundsvcs.org/cgi-bin/wa?A3=ind0411&L=FUNDVCS&E=base64&P=217358&B=--_%3D_NextPart_000_01C4C36C.0C86AB85&T=application%2Fmsword;%20name=%22Aug2004draft%5B1%5D.doc%22&N=Aug2004draft%5B1%5D.doc&attachment=q (last visited Sept. 2, 2014). UPMIFA has been adopted in all States except Pennsylvania, as well as the District of Columbia and the Virgin Islands. See LEGISLATIVE FACT SHEET - PRUDENT INVESTOR ACT SUMMARY, THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS,

<http://uniformlaws.org/LegislativeFactSheet.aspx?title=Prudent%20Management%20of%20Institutional%20Funds%20Act> (last visited Sept. 2, 2014).

46. The Uniform Prudent Investor Act “does not encourage irresponsible, speculative behavior, but requires careful assessment of investment goals, careful analysis of risk versus return, and diversification of assets to protect them. It gives the trustee the tools to accomplish these ends. *UPIA requires trustees to become devotees of ‘modern portfolio theory’* and to invest as a prudent investor would invest ‘considering the purposes, terms, distribution requirements, and other circumstances of the trust’ using ‘reasonable care, skill, and caution.’” PRUDENT INVESTOR ACT SUMMARY, THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, <http://uniformlaws.org/ActSummary.aspx?title=Prudent%20Investor%20Act> (last visited Sept. 2, 2014). (emphasis added). The UPIA thus provides that the “trustee’s investment and management decisions respecting individual assets are evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.” UNIFORM PRUDENT INVESTOR ACT §2 (1994), http://www.uniformlaws.org/shared/docs/prudent%20investor/upia_final_94.pdf (last visited Sept. 2, 2014). Legislative Fact Sheet - The Uniform Prudent Investor Act has been adopted in 43 states and the District of Columbia. <http://uniformlaws.org/LegislativeFactSheet.aspx?title=Prudent%20Investor%20Act> (last visited Sept. 2, 2014).

47. RESTATEMENT (THIRD) OF TRUSTS § 227 (1990). See generally, Robert J. Aalberts & Percy S. Poon, *The New Prudent Investor Rule and the Modern Portfolio Theory: A New Direction for Fiduciaries*, 34 AM. BUS. L. J. 39 (1996).

NET OUT-OF-POCKET DAMAGES ARE “JUNK SCIENCE.”

A favorite position of the defense bar is that an aggrieved investor should only recover their “net out-of-pocket” (NOP) losses, i.e., the difference between all sums deposited with the investment advisor, less dividends/interest received, less the ending balance of the account. A similar defense strategy is to claim that profits and losses should be “netted,” so that any profits are offset against losses in the accounts.

An investor’s net out-of-pocket losses are neither a reliable nor relevant basis for assessing damages because the NOP calculation fundamentally ignores the essential legal requirement of damages analysis – to place the

48. “Modern Portfolio Theory is at the heart of the investment philosophy of the [the endowment funds of Harvard and Yale] and is the foundation upon which their portfolios are constructed.” Richard Brazenor, *Investing Like the Harvard and Yale Endowment Funds* (2008), ADVISOR PERSPECTIVES, http://www.advisorperspectives.com/newsletters08/Investing_Like_the_Harvard_and_Yale_Endowment_Funds.htm 1 (last visited Sept. 2, 2014). “Yale and Harvard divide their endowments into seven broad asset classes: domestic stocks, foreign stocks, fixed income, absolute return, private equity, real assets and cash [T]his aggressive move away from traditional assets was rooted in academic research suggesting that investors can earn a higher long-term rate of return with less risk by diversifying beyond the traditional mix of stocks and bonds.” James B. Stewart, *A League of Their Own*, SMARTMONEY MAG., (Sept. 26, 2007). While it is true that some of these endowments suffered significant losses in the 2008 financial crises, those losses were arguably due to a change in investment philosophy by those endowments that altered the Modern Portfolio Theory approach. See, e.g., CENTER FOR SOCIAL PHILANTHROPY TELLUS INSTITUTE, EDUCATIONAL ENDOWMENTS AND THE FINANCIAL CRISIS: SOCIAL COSTS AND SYSTEMIC RISKS IN THE SHADOW BANKING SYSTEM, A STUDY OF SIX NEW ENGLAND

SCHOOLS, (2010), <http://www.tellus.org/publications/files/endowmentcrisis.pdf> (last visited Sept. 2, 2014) (suggesting that by “embrac[ing] a *new model* of investing that relies on radical diversification of endowment portfolios into illiquid, riskier asset classes: private equity and venture capital, hedge funds, and various “real assets,” such as oil, gas, and other commodities, private real estate and timberland. . . . endowment managers generated high returns for a time—but at the cost of intensifying colleges’ exposure to the rampant volatility of the global capital markets.”) (emphasis added); THE YALE ENDOWMENT MODEL OF INVESTING IS NOT DEAD, KEATING INVESTMENTS, LLC (2009) (arguing that “the melt down at certain endowments had nothing to do with purported flaws in modern portfolio theory. Instead, the breakdown was caused by a failure to model for truly extreme events.”) http://bdcv.com/wp-content/uploads/2011/08/Yale_Endowment_Model_is_Not_Dead.pdf (last visited Sept. 2, 2014).

injured party in the position they would have been in “but for” the wrongdoer’s misconduct. Every investor is seeking whatever level of return is suitable for them – from the elderly widow whose level of risk merits only bank CD investments to the Gen-X investor who purchases to highly risky start-up IPOs. Certainly, if all of the interest earned on the CDs was lost due to an advisor’s malfeasance, there could be little serious debate that a full recovery would be not only the principal CD investment, but the expected interest as well. Losses sustained in equity, bond, or other investments due to advisor misconduct should be subject to the same damages analysis. Benchmarking actual returns to a Well Managed Portfolio will identify any capital appreciation and income the investor would have enjoyed “but for” the advisor’s defaults. ***In sum, the NOP calculation fails to acknowledge the fundamental reason people invest – to attempt to secure a return on principal.*** Instead, the NOP analysis wrongly asserts that a return *of* principal is a sufficient remedy.

Courts have rightly rejected NOPs as a legitimate basis for computing damages. As one court has observed with respect to a claim that profits and losses should be “netted,” (which would return the investor only their net out-of-pocket damages) “[i]f the . . . methodology espoused by [the brokerage firm] were adopted, it could serve as a license for broker-dealers to defraud their customers with impunity up to the point where losses equaled prior gains.”⁴⁹ Another court pointedly observed that such defense claims can rightly be characterized as “low risk larceny,” where “heads the dishonest broker-dealer wins and tails everyone breaks even.”⁵⁰

If the measure of damages were NOPs, a broker’s misconduct would be excused as long as the ending net value of the account did not fall below the amount originally invested.⁵¹ No brokerage firm, bank, insurance company or other financial institution would, if they (rather than the public investor) suffered damage, accept an analysis that rejected any possibility that they

49. Kane v. Shearson Lehman Hutton, Inc., 916 F.2d 643, 646 (11th Cir. 1990). See also City of San Jose v. Paine Webber Jackson & Curtis Inc., No. C 84-20601, 1991 WL 352485 , 1991 U.S. Dist. LEXIS 8318 (N.D. Cal. June 6, 1991) (“The cases seem to indicate, however, that the securities laws do not limit a plaintiff’s recovery to mere out of pocket losses...”).

50. Miley, 637 F.2d at 332 (5th Cir. 1981) (citing STUART C. GOLDBERG, FRAUDULENT-DEALER PRACTICES, § 6.5 (1978)) (damages for churning).

51. See Davis v. Merrill Lynch, 906 F.2d 1206, 1218 (8th Cir. 1990) (“securities brokers would be free to churn their customers’ accounts with impunity so long as the net value of the account did not fall below the amount originally invested.”).

would have enjoyed a return on invested capital. Such a methodology for assessing damages not only is violative of the fiduciary duties owed by a broker to his customer, and fails to place the investor in the financial position they would likely have been in but for the broker's misconduct, but it also severely undercuts the deterrent purposes served by the securities laws.⁵² If anything, those who dispute the legitimacy of a WMP analysis based on MPT are advocating that the fact finder accept "junk science."⁵³

USING MODERN PORTFOLIO THEORY AND THE WELLMANAGED PORTFOLIO TO PROVE DAMAGES.

Rolf, Miley, and their progeny approved the use of appropriate stock market benchmarks, such as the Dow Jones Industrial Average or the S&P 500, to determine damages caused by investment advisor misconduct. Modern Portfolio Theory, which was in its infancy when *Rolf* and *Miley* were decided, can be used to develop one or more hypothetical Well Managed Portfolio. Once an investor's level of risk tolerance is established, a portfolio can be logically and fairly constructed to effectively allocate the assets and diversify the investments consistent the investor's risk profile..⁵⁴ The WMP

52. In *Randall v. Loftsgarden*, 478 U.S. 647, 664 (1986), the Supreme Court rejected a netting analysis based on the deterrent purpose of the securities laws: "This deterrent purpose is ill-served by a too rigid insistence on limiting plaintiffs to recovery of their 'net economic loss'." See also *City of San Jose*, 1991 WL 352485 at *3 ("The cases seem to indicate, however, that the securities laws do not limit a plaintiffs recovery to mere out of pocket losses."); *Levine v. E. F. Hutton & Co.*, 636 F. Supp. 899 (N.D. Ill. 1986) (Gains in an account cannot be used to offset the losses where there is a breach of fiduciary duty or a fraud).

53. "In view of the widespread acceptance - by courts, fiduciaries, legal scholars, finance researchers, and the financial communities themselves - of market-adjusted damages and/or the use of indices or similar benchmarks for evaluating performance, it is the industry's defense which should "properly be viewed with skepticism" and which should have to undergo the trials of a *Kumho Tire* challenge, especially in the context of fraud or fiduciary related claims." C. Thomas Mason, *Challenging Experts In Securities Arbitration*, SECURITIES ARBITRATION 2000, 814 (Practicing Law Institute ed., 2000) (quoting *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579, 594 (1993)).

54. The exponential advances in computing also permit a more rigorous MPT analysis to take place, as large data sets can be easily analyzed. The Center for Research in Security Prices (CRSP), part of the University of Chicago's Graduate School of Business, has collected extensive historical data on securities prices.

can then be used as a benchmark to contrast with the portfolio created by the broker, and vividly illustrate that the actual portfolio was wholly inappropriate for the investor's particularized risk profile.⁵⁵

As an example, the claimant's expert, after an analysis of the investor's present and future needs, circumstances, net income, net worth, time horizon, investment knowledge, attitude toward risk, and other relevant factors, may conclude that a "60/40" portfolio (60% equities, 40% bonds/cash) would be appropriate.⁵⁶ Within the equity and bond allocations, the holdings would presumably be diversified among large capitalization equities, small capitalization equities, growth equities, value equities, international equities, real estate investment trusts, corporate bonds, government bonds, and cash equivalents, in accordance with what MPT suggests is the appropriate mix for that investor's risk profile. Generally, the more aggressive an investor – i.e., the more risk they are knowingly willing to take on – the proportion of equities securities in their portfolio will be higher.

Once the appropriate allocation and diversification is determined, a range of options are available to construct a "well managed" and suitable portfolio.⁵⁷ One approach is to construct a portfolio using index funds, such

CRSP provides six databases: CRSP US Stock Database; CRSP US Indices Database; CRSP US Treasuries Database; CRSP US Survivor-Bias-Free Mutual Funds Database; CRSP/COMPUSTAT Merged Database, and the CRSP/Ziman Real Estate Data Series. Center for Research in Security Prices, <http://www.crsp.com> (last visited Sept. 2, 2014).

55. See generally Charles Hunter & Lawrence Melton, *A Measure of Quality and Quantity - Market Adjusted Damages as Proof of the Broker's Failure to Diversify - a Casual Connection Between Malfeasance and Damages*, 14 PIABA B. J. 8 (Fall 2007); Jeffery Schaff & Michele Schaff, *Expert's Corner: Advanced Analytics - Effectively Portraying the Actual Risk and Return Profile of Your Client's Portfolio*, 10 PIABA B. J. 20 (Fall 2003).

56. Often, the large brokerage firms will have published their own recommended asset allocation models, which provide a useful benchmark of what the firm thought suitable with respect to an investor's risk profile. Not surprisingly, these asset allocation models often suggest an allocation vastly different than the advisor selected.

57. Widely accepted industry practices and regulatory publications call for the advisor to periodically review their customer's circumstances so that adjustments can be made to asset allocations to ensure a suitable investment strategy is being employed. See FINRA, REGISTERED REPRESENTATIVES, OBLIGATIONS TO CUSTOMERS, <http://www.finra.org/Industry/Compliance/Registration/Qualifications> Exams/RegisteredReps/Brochure/P009867# (last visited Sept. 2, 2014) ("Because a customer's financial status is constantly changing, account records should be updated

as those provided by Vanguard®, Fidelity®, Barclays®, and others.⁵⁸ Indeed, Wall Street firms often compare their own mutual funds or recommendations to the performance of an index such as the S&P 500, implicitly suggesting that such a benchmark is appropriate one against which to test a customer's actual returns. Alternatively, mutual funds can be used to construct the benchmark portfolio. For example, for an investor who wished to invest for growth (but not speculation), the analysis might utilize a well-established growth-oriented mutual fund. Another option is to use the brokerage firm's own "in-house" mutual funds as a benchmark against which to measure the actual performance of a client's account. Further, companies such as Morningstar and Thomson Financial have extensive historical data on index and mutual fund performance, which also can be used to develop a benchmark well managed and suitable portfolio.

The ready availability of software programs such as Microsoft Excel, as well as proprietary software – none of which was available in the pre-computer days of *Rolf* and *Miley* -- allows the chosen benchmark WMP data to be accurately compared to the actual performance of the account. The comparison should cover the same time frame as the period in which the advisor handled the account, so the WMP is subjected to the same market forces as existed during relevant time period. Further, the WMP should take into account any new deposits into the account, and any withdrawals made, again to replicate the actual cash flows occurring in the account, and any effect that would have had on performance of the portfolio.⁵⁹

whenever necessary. . . . Just as your customer's financial position may change, your customer's investment objectives may change as well. You should, therefore, review your customer's investment objectives periodically, and make a written record of any changes as they occur.”).

58. For example, Vanguard® has a “Balanced Fund Index Fund” (VBINX), that “invests roughly 60% in stocks and 40% in bonds by tracking two indexes that represent broad barometers for the U.S. equity and U.S. taxable bond markets. The fund's broad diversification is important, because one or two holdings should not have a sizeable impact on the fund.” Vanguard Balanced Index Fund, at <https://personal.vanguard.com/us/funds/snapshot?FundId=0002&FundIntExt=INT> (last visited Sept. 2, 2014).

59. It would be inappropriate to suggest that the WMP analysis “always” take into account deposits or withdrawals, since there might be fact patterns where to do so would be improper. For example, if the investor was convinced by their advisor to take the money out to invest in some speculative adventure promoted by the advisor, or if the advisor simply stole money from the account, then a WMP analysis ought not to reduce the benchmark portfolio by those withdrawals.

By developing one or more WMP benchmarks based upon an individual plaintiff's needs, goals, and risk tolerance, using actual historical data to plot the performance of those WMP's over the relevant time period, and recognizing the actual cash flows into and out of the account, any claim that the damages are "speculative" or are the result of a "cherry picked" portfolio, are objectively refuted. Coupled with *Daubert*-like challenges to the industry's misguided use of NOP's, an investor would have a rational and reasonable basis to claim that the damages suffered at the hands of the firm and advisor are the difference between the actual portfolio's results, and what a thoughtful Well Managed Portfolio would have accomplished.

WMP analysis will often provide a stark and vivid illustration of the damages caused by the advisor misconduct. Simply graphing the actual performance of the portfolio, compared to a WMP, will amply demonstrate for the fact finder the significant losses suffered at the hands of the advisor. (Illustration Nos. 1 and 2). When coupled with evidence showing the fees, commissions, and charges incurred by the investor for such gross mismanagement, as well as the often aggressive marketing and promotional materials used to convince investors that an advisor and firm have the knowledge and expertise to properly manage assets, WMP can provide a compelling argument for the recovery of the actual damages caused by advisor incompetence or misconduct.

IV. DAMAGES: HOW AND WHEN TO PRESENT THEM

By Robert Kantas, Esq.

WWSCOTUSD?

When it comes to presenting damages, let's remember our audience; the arbitrators. When my daughter was young, she used to say that she wanted to be a "bus driver, babysitter, pizza maker". Thankfully her professional aspirations took a turn for the better as she got older. I am mindful, however, that any one of those professions would have qualified my daughter to be a FINRA arbitrator. I believe that a big part of our job as advocates for our clients is to be an educator to the arbitrators. Take nothing for granted. Even if you have one or more lawyers on your panel, don't assume they know anything about securities laws. They might. They might not.

Now, if you have a legal issue unique to your case, such as a statute of limitations problem, then I suggest you will want to spend a fair amount of time educating the panel on that issue. Ahh... the discovery rule; fraudulent concealment; statutes of repose. Ick! Thankfully, this article is about *damages*, not statutes of limitation. Damages must be addressed in every case. The discussion need not be esoteric, and your damages claim should not be speculative. So how do we educate the arbitrators on damages? To begin with, you will have spent a considerable portion of your pre-hearing brief addressing damages. Right? But, can you assume that your arbitrators will have read your brief? No! In fact, you should assume quite the opposite, or at least assume that if they read it, they either did not understand it, or they may have forgotten what they read. Never miss an opportunity to educate your panel on your damages claims, *and* their authority to award them.

After pleading damages as specifically as possible in my Statement of Claim, briefing them in my pre-hearing brief, and presenting concrete evidence of them during the hearing, I like to start my

closing argument with a brief history lesson: a discussion of the Supreme Court's landmark decision in *Shearson/American Express v. McMahon*, 482 U.S. 220 (1987).⁴

It was in *McMahon* that the Supreme Court ruled in favor of arbitration of virtually all securities claims, finding agreements to arbitrate such claims to be binding and enforceable. My interest in bringing the case to the attention of the arbitrators is two-fold: First, I like to point out that this is the Claimant's "day in court". I note that appeals (Motions to Vacate) are rarely brought and even more rarely successful, so whatever the arbitrators decide is likely to be final and binding on the parties; Second, my real interest in the case lies in the dissent of Justice Blackmun. There, relegated to a footnote, is a pearl thrown at the feet of all Claimants' counsel. Pick it up. Use it. You see, the dissent expressed a distrust of the arbitrators' ability to get it right – right on the facts – right on the law. And while this may still be true, my biggest concern is that they get it right on damages.⁵ Justice Blackmun, writing for the dissent, reviewed certain statistics indicating that securities arbitration forums were fair, but then expressed concern that there was no way for the court to know if the Claimants received the damages to which they were entitled. "It is possible for an investor to "prevail" in arbitration while recovering a sum considerably less than the damages he actually incurred." *McMahon*, 482 U.S. at 261 n. 2/20. It is as if Justice Blackmun peered into his crystal ball thirty years ago and anticipated the fate of generations of securities claimants and their lawyers.

The message to the arbitrators is clear without saying it: SCOTUS would want them to award all damages to which the Claimants are entitled, and if they do so, it is unlikely that they will be

⁴ I intentionally do not refer to this case in my pre-hearing brief because I believe to do so would detract from the impact I want the discussion to have during my closing.

⁵ I assume for purposes of this discussion that you have been able to prove liability.

subject to appeal. Watch the arbitrators sit a little taller in their chairs as they imagine themselves wearing the black robes.

BEGIN AT THE BEGINNING

I suggest that if you wait until you get to a final hearing to start talking about your damages, you have waited about a year too long. You must start with your Statement of Claim. If your case is large enough to warrant the preparation of a full-blown damages report prior to filing, I highly recommend that you have one prepared. You will find it to be invaluable as you write your Statement of Claim. It is a picture of the scene of the crime; a roadmap to recovery. If your case is not big enough to warrant the expense up front, or if you have time constraints, pull out your calculator and get to work. You need to know where the money was lost. You need to know how much was lost.

If you are planning to ask for market adjusted damages, you should make that clear in your Statement of Claim. Even if you do not yet know a specific number, but feel you have a close estimate, you can allege on information and belief that “had the Claimant’s account been appropriately managed, in accordance with its stated objectives and risk tolerance, it would have gained (insert the appropriate number here), rather than losing any money.” Or, if at the time of the writing of the claim, you simply have no clue what the market adjusted damages model looks like, then you might say something generic like: “Due to Respondent’s wrongful conduct, the Claimant not only lost money, but missed out on one of the greatest bull markets in the history of bull markets.” Your goal here is to plant a seed with the arbitrators, and to do so early. I will often put such statements in my opening paragraph under “Summary of the Claim.”

If you plan to present a statutory damages model, I suggest you follow the advice of one of my law professors who said: “Before you set about to think great thoughts, first read the statute.”

Although the majority of states (thirty-nine plus the District of Columbia) have adopted some form of the Uniform Securities Act, there are subtle differences, and, of course, other states have not. Sorry, New York practitioners. You should be familiar with the conduct prohibited and the remedies available. Is there control person liability? Are attorney's fees available? What is the statutory interest rate? If you are claiming statutory damages, cite the statute in your Statement of Claim and tell the arbitrators what damages are available under that statute.

Finally, cases tend to take on a life of their own, and our understanding of the facts can change over time. Therefore, just the make sure that you have covered the waterfront on damages, I recommend that your prayer for relief include words to the effect of the following:

WHEREFORE, Claimants seek that an award be entered ordering Respondent to pay to Claimants an amount as will be proven at the hearing of this matter, but believed to exceed \$_____, including all direct and/or consequential damages and statutory and/or market adjusted damages and/or punitive damages; plus interest, costs, and attorneys' fees as provided by statute, in an amount which Claimants reserve the right to amend at any time, including during hearings held on these matters, as follows:

A. All sums lost in Claimants' accounts on any or all transactions made or not made; plus, additionally or alternatively,

B. All lost opportunities incurred as a result of Respondent's acts and/or omissions; plus, additionally or alternatively,

C. Rescission of any or all transactions as sought; plus, additionally or alternatively,

D. Statutory damages as provided by applicable law; plus, additionally or alternatively,

E. Punitive damages in an amount that the Panel shall deem appropriate; plus, additionally or alternatively,

F. Pre-award and pre-judgment interest on all sums invested from the date deposited until the date of the award and/or judgment and until such sums are paid, all at the highest rate allowed by law; plus, additionally or alternatively,

G. All costs of these proceedings and for recovery of damages incurred, including legal fees, including while on appeal, if any, and for collection; plus, additionally or alternatively,

H. Any and all other relief available to Claimants, in law or equity or otherwise, which may be granted to Claimants by this Arbitration Panel.

WHEN TO PRESENT YOUR DAMAGES AT THE FINAL HEARING

Your damages, like dessert, must come last, says conventional wisdom. Duty, breach, causation, injury, damages. We all learned it that way in first year Torts, and like religious fanatics, most lawyers cannot deviate from presenting their case in this order. Damages must come last, or so we think. I say you should refuse to conform to conventional wisdom on this topic.

Call your damages expert as your first witness! What? Sacrilege! Heresy! You must be joking! No, really. With the “win” rate for Claimants in FINRA arbitration hovering around 42% in recent years, it is time for a change. After all, it is said that the definition of insanity is doing the same thing over and over and expecting a different result. Now, if you’re winning 80-90% of your cases, and you are content with the damages your clients are awarded, please feel free to ignore this advice. If it ain’t broke, don’t fix it. But for everyone else, I suggest that while the traditional order of witnesses may be appropriate for a personal injury case, breach of contract case, employment case, or any case where your damages may be uncertain or the rules of evidence strict, it is not appropriate for securities arbitration. Why? Because if the parties have done a good job on their analysis, they should be able to agree on the performance of the Claimant’s account(s). No, I’m not talking about which index you should use for your market adjusted damages model, or whether the Claimant is entitled to attorney’s fees, or even whether the Respondent is liable. Respondent’s counsel will never agree with you on those issues. I’m referring to the math: Money in. Money out. How much was lost. How much was gained. How much is left. Math. What was the overall account performance? How much was lost (or gained) on individual securities? What was the asset allocation of the account? What was the turnover rate of the account? What was the cost/equity ratio of the account? What was the historical performance of the stock market, bond market, or an index during the same period? There are answers to these questions. They are

ascertainable. They are not speculative. They must be known before you get to a mediation or hearing, and preferably before you file your Statement of Claim. The answers are, or should be, irrefutable. It is math.

And yes, you may get an objection from Respondent's counsel, who is usually not prepared to cross examine your damages expert, but so what? I simply look at the Chairperson with an expression of pained disbelief and explain that apparently Respondent's counsel wants to dictate the order of my witnesses. It's an absurd objection. After all, I explain, IT'S JUST MATH! The objection will be overruled. You will start your case with an expert witness who will calmly and authoritatively explain to the arbitrators the elements of your damages report – a picture of the scene of the crime – and in the process explain what went wrong with Respondent's handling of the account. It is a powerful way to start your case. If done correctly, by the time your expert is done testifying, the arbitrators will have a clear picture of what happened in the case, and it will be up to the broker to try to explain it away. You have them in a hole.

JUST SAY “NO” TO NOP

The following steps should be taken to compute damages: 1) compute the market value of the plaintiff's portfolio when the fraud began; 2) adjust this amount by the average percentage increase or decrease of the value of the Dow Jones Industrial Average, the Standard & Poor's Index, or any other well recognized index of value, or combination of indices, of the national securities markets during the period of the fraud; and 3) subtract from the resulting figure the market value of the portfolio when the fraud ended.

Rolf v. Blyth Eastman Dillon & Co., 570 F.2d 38, 49 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978).

Net Out-of-Pocket Loss (“NOP”), as an appropriate measure of damages in every case, is a fiction created by the securities industry, sold to the arbitrators, and repeated with such frequency and fervor over the years that even some Claimants lawyers have bought into the concept. Don’t be fooled. NOP should be a starting point, a floor, for the calculation of your damages, and never the maximum recoverable.

The damages model you choose will be driven by the facts of your case, but in *every* case, there should be something more available to your clients. Something more than NOP. That is not to say that your clients will

receive the something more in every case, they won’t. But if you fail to plead the something more, brief the something more, present evidence of something more, and argue for something more during your closing, it is a certainty that you will never get something more for your clients.

Market Adjusted Damages

Have you noticed that the stock market has been going up, up, up over recent years? If your clients lost money in this market, they are probably entitled to Market Adjusted Damages. Note that I do not refer to these as “Well Managed Account Damages”, as I believe it sets too high a bar for the securities industry, and only serves to build ambiguity into the process. What is a “Well Managed” account? I think it is subject to many different interpretations. Market performance, on the other hand, is easily tracked via historical data. It is an easier concept to present, and an easier concept

for the arbitrators to embrace. That said, if you fail to ask for them properly, your chances of getting them are slim, and you will have done your clients a huge disservice.

There is so much caselaw on this topic, starting with the boxed quote from the *Rolf* case above, that I am surprised these damages are not awarded by FINRA arbitrators with greater regularity. Assuming you have asked for them in your Statement of Claim, covered this issue well in your pre-hearing brief, presented the evidence during your examination of your expert, clearly itemized your market adjusted ask in your damages report, and then empowered the arbitrators by reviewing the law during your closing argument, you will have an excellent chance of obtaining market adjusted damages.

For churning cases, the arguments against NOP as the appropriate measure of damages are especially strong. Here is a great quote from the 8th Circuit:

The implications of this argument are *disturbing*. If we were to adopt Merrill Lynch's view, securities brokers would be free to churn their customers' accounts with impunity so long as the net value of the account did not fall below the amount originally invested. [*] Under the law of this circuit, if an account earned \$50,000 but would have earned \$100,000 if it was not churned, the customer has sustained actual damages in the amount of \$50,000 plus excess commissions paid. See McGinn, 736 F.2d at 1257. Because Mrs. Davis paid over \$40,000 in commissions and would have earned over \$50,000 more than she did had her account not been churned, it is nonsensical to argue that she did not suffer actual damages as a result of the churning. *Davis v. Merrill Lynch*, 906 F.2d 1206, 1218 (8th Cir. 1990) (emphasis supplied).**

Davis should not be limited to churning cases. Since it is well-settled that churning is a species of fraud, it is easy to argue that *Davis* applies to any situation where fraud is present. And let's face it, it is present in most of our cases.

[Another churning case, *Miley v. Oppenheimer & Co.*, 637 F.2d 318 \(5th Cir.1981\)](#), is a Fifth Circuit gem where the court put its' finger on the pulse of the problem in its opening line: "For as

long as investment brokers have been remunerated on a commission basis, the potential has existed for brokers to excessively trade accounts in an effort to generate fees.” *Miley*, of course, is well-known for its guidance on the calculation of damages in a churning case.

The willful misconduct at the core of a churning complaint is the broker's excessive trading of an account in an effort to amass commissions. While excessive commissions represent the sole source of gain to the broker from his misconduct, **there are in fact two distinct harms which may be proximately caused by the broker's churning of an account. It is necessary to remedy both harms in order to fully compensate the victimized investor.**

First, and perhaps foremost, the investor is harmed by having had to pay the excessive commissions to the broker — the "skimmed milk" of the churning violation. The broker's wrongful collection of commissions generated by the intentional, excessive trading of the account constitutes a compensable violation of both the federal securities laws and the broker's common law fiduciary duty, regardless of whether the investor's portfolio increased or decreased in value as a result of such trading. **Second, the investor is harmed by the decline in the value of his portfolio** — the "spilt milk" of the churning violation — as a result of the broker having intentionally and deceptively concluded transactions, aimed at generating fees, which were unsuitable for the investor. **The intentional and deceptive mismanagement of a client's account, resulting in a decline in the value of that portfolio, constitutes a compensable violation of both the federal securities laws and the broker's common law fiduciary duty**, regardless of the amount of the commissions paid to the broker. **In sum, once a jury finds that the broker has churned an investor's account, it may also find that the investor would have paid less commissions and that his portfolio would have had a greater value had the broker not committed the churning violation.**

Miley, 637 F.2d at 326.

Additional Useful Damages Cases

Set forth below are additional cases addressing the damages that are available to Claimants in various jurisdictions, depending on the claims made.

- ***Randall v. Loftsgaarden*, 478 U.S. 647, 660-664 (1986)** (Defendant/Respondent may not offset tax benefits received by a defrauded investor against the investor's rescissory recovery, either as

"income received" or as a return of "consideration," and that this is so whether or not the security in question is classified as a tax shelter. "The deterrent purpose [of the securities laws] is ill served by a too rigid insistence on limiting plaintiffs to recovery of their "net economic loss."");

- ***Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972)** (In cases involving defrauded securities sellers, the correct measure of damages is "the difference between the fair value of all that the [Plaintiff] seller received and the fair value of what he would have received had there been no fraudulent conduct");
- ***J.I. Case Co. v. Borak*, 377 U.S. 426, 435 (1964)** (In case against stockbroker, federal courts have the power to grant all necessary remedial relief);
- ***Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir.), cert. denied, 382 U.S. 879 (1965)** (Where Defendant acquires securities by fraud, it is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them. "[I]t is simple equity that a wrongdoer should disgorge his fraudulent enrichment.");
- ***Donovan v. Bierwirth*, 754 F.2d 1049, 1054 (2d Cir. 1985)** (Where Defendants' conduct causes the plaintiffs to sell too cheaply or to buy too dearly, "it is appropriate to hold such defendants liable for the difference between what the plaintiffs paid or received in payment and what the stock was in fact worth.");
- ***Byrnes v. Faulkner, Dawkins & Sullivan*, 550 F.2d 1303, 1313 (2d Cir. 1977)** (equating actual damages with compensatory damages, courts have interpreted the statute as permitting all forms of loss-based relief, whether articulated under out-of-pocket, benefit-of-the-bargain, or other loss theories.);
- ***Osofsky v. Zipf*, 645 F.2d 107, 111 (2d Cir. 1981)** ("[W]e believe that the purpose of [the 1934 Act] is to compensate civil plaintiffs for economic loss suffered as a result of wrongs committed in violation of the 1934 Act, whether the measure of those compensatory damages be out-of-pocket loss, the benefit of the bargain, or some other appropriate standard.")
- ***John R. Lewis, Inc. v. Newman*, 446 F.2d 800, 805 (5th Cir. 1971)** (Where a violation of Section 10(b) and Rule 10b-5 results in injury to a purchaser or seller of securities, federal courts may use any available remedy to make good the wrong done, including benefit of the bargain damages.);
- ***Garnatz v. Stifel, Nicolaus & Co.*, 559 F.2d 1357, 1360 (8th Cir. 1977), cert. denied, 435 U.S. 951 (1978)** ("Of course, the out-of-pocket rule is not a talisman. Indeed, this court has shown no hesitation in varying that measure when necessary on the facts of a given case." Plaintiff's losses were natural, proximate, and foreseeable consequences of defendants' fraud.);
- ***Myzel v. Fields*, 386 F.2d 718, 745 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968)** (Out-of-Pocket loss is not the correct measure of damages in all securities cases.);

- ***McGinn v Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 736 F.2d 1254, 1257 (8th Cir. 1984)** (Reversing District Court that failed to permit jury to consider loss of value of account, together with commissions charged, in a churning case.);
- ***Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767, 774 (9th Cir. 1984)** (Jury verdict of compensatory and punitive damages affirmed. Trial court's grant of 33^{1/3} contingent fee affirmed. "[W]hen a securities broker engages in excessive trading in disregard of his customer's investment objectives for the purpose of generating commission business, the customer may hold the broker liable for churning without proving loss causation.");
- ***Cal. Ironworkers Field Pension Trust v. Loomis Sayles & Co.*, 259 F.3d 1036 (9th Cir. 2001)** (In breach of fiduciary duty case against Trustee, it is not appropriate to offset gains in the portfolio with losses caused by Trustee's wrongful conduct.);
- ***Hackbart v. Holmes*, 675 F.2d 1114, 1121 (10th Cir. 1982)** (Recklessness satisfies scienter requirement of 10b-5 claim. Damages for fraud in the purchase or sell of a security not limited to the "net-out-of-pocket loss," but may include benefit of the bargain.);
- ***In re Drexel Burnham Lambert Group, Inc.*, 161 B.R. 902, 909 (1993)** ("The measure of damages for unsuitability claims is the plaintiff's gross economic loss, adjusted for the overall market's performance.");
- ***In re Thomson McKinnon Sec., Inc.*, 191 B.R. 976, 987-988 (1996)** (Gain of \$270,000 did not preclude recovery in a churning case.);
- ***Kronfeld v Advest, Inc.*, 675 F. Supp. 1449, 1456 (1987)** (Correct measure of damages in bond cases.);
- ***Laney v American Equity Inv. Life Ins. Co.*, 243 F. Supp. 2d 1347, 1353-1356 (2003)** (In a Florida churning claim, plaintiff is entitled to excess commissions and expenses paid to the broker; any actual losses caused by the churning; and "benefit-of-the-bargain" consisting of well-managed account losses.);
- ***Winer v Patterson*, 644 F. Supp. 898, 900-901 (1986)**, vacated in part on other grounds 663 F. Supp. 723 (1987) (New Hampshire District Court permits investor in churning claim to present evidence of "lost profits" following the reasoning in *Miley v. Oppenheimer* and its progeny.);
- ***Lopez v Dean Witter Reynolds, Inc.*, 591 F. Supp. 581, 589-590 (1984)** (District court for the Northern District of California grants a Motion to Strike the Plaintiff's damages claim finding that "The law in the Ninth Circuit is that absent an assertion that the allegedly churned securities and commodities futures contracts were also unsuitable for the plaintiff, recoverable damages are limited to commissions and interest paid by plaintiff.");
- ***Medical Associates v. Advest, Inc.*, 1989 Lexis 11253 (W.D.N.Y. 1989)** ("The proper method of calculating damages is to take the initial value of plaintiff's portfolio, adjust it by a percentage

change in an appropriate index, during the relevant period, and subtract the value of the portfolio at the end of the period.”);

No NOP in Income/Bond Cases

The No NOP argument is even stronger for Claimants who are income investors, whose account objectives reflected that objective, and especially for those who were to be invested primarily in bonds.

A bond is a contract; a promise to pay. Income investors expect two things: return on their money; return of their money. Here, Benefit of the Bargain may be the appropriate measure of damages. Of course, Respondent’s expert will never agree with this. I am mindful of Professor Seth Lipner’s brilliant line of questioning on this issue while cross-examining Respondent’s expert. It goes something like this: “Imagine, Mr. Expert, that you are a bank president and these Claimants invested \$10,000 in a 10% CD with your bank. Imagine that the CD paid like clockwork every year for 10 years, such that the Claimants had then received \$10,000 in interest payments. Just before the Claimants went to the bank to redeem their CD, someone broke into the bank and stole it. But not to worry, says you, the bank president, because over the years we gave you back your \$10,000 in the form of annual interest payments, so you really didn’t lose anything. Now, Mr. Expert, please explain to the arbitrators why the bank does not owe its customer \$10,000.” Dumb silence. Point made. Income investors expect a return on their money, and the return of their money.

Claims for Attorneys’ Fees

Respondents would like the arbitrators to believe that they have no authority to award attorney’s fees and costs. The law is contrary to the Respondents’ position. Arbitrators have the authority to fashion an award that will make the Claimants whole. In the absence of such an award, the

Claimants are punished twice. First, by sustaining the losses in the accounts due to the acts and omissions of the Respondent, and again by having to seek out and pay for qualified legal counsel to help recover the funds. It is up to you to educate the panel on this issue, and to do so in your pre-hearing brief and again at closing.

It is well-settled that an arbitrator has the authority to grant legal fees and costs. *See, e.g., Synegy Gas Co. v. Sasso*, 853 F.2d 59 (2d Cir.), *cert. denied*, 488 U.S. 994 (1988). Courts around the nation are in harmony with *Sasso* and have held that arbitrators are empowered to award attorneys' fees where any one of the following four factors is present:

1. **The arbitration agreement explicitly provides for an award of attorneys' fees.** *Prudential Securities, Inc. v. Credon*, 52 F.3d 334 (9th Cir. 1995); *GPR, Inc. v. Phoenix Petroleum Co.*, Comm. Fut. L. Rep. (CCH) P 26,451 at 42,960 (S.D.N.Y. May 24, 1995); *David v. Abergal*, 54 Cal. Rptr. 2d 443 (Cal. Ct. App. 1996).
2. **The parties jointly submit the issue of attorneys' fees for decision, thereby creating a bilateral agreement to arbitrate the issue.** *First Interregional Equity Corp. v. Haughton*, 842 F. Supp. 105, 112 (S.D.N.Y. 1994); *In re U.S. Offshore, Inc.* (Seabulk Offshore, Ltd.), 753 F. Supp. 86 (S.D.N.Y. 1990); *Marshall & Co. v. Duke*, 941 F. Supp. 1207 (N.D. Ga. 1995); *Skip Kirchorfer, Inc. v. Fed. Ins. Co.*, 869 F.Supp. 387 (E.D.Va. 1994) (Arbitrators' award of legal fees was due special deference and was reasonable. Both parties claimed attorneys' fees.)
3. **The customer agreement provides for submission of "all disputes" between the parties to arbitration in conjunction with applicable substantive law which permits recovery of fees.** *First Interregional Equity Corp.*, 842 F.Supp. at 112-13; *Ierna v. Arthur Murray Int'l, Inc.*, 833 F.2d 1472, 1476-77 (11th Cir. 1987).
4. **Statutory authority under state law or under federal law or SRO rules contemplates an attorneys' fees award.** *Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767, 774 (9th Cir. 1984) (Court's award of contingent attorney's fee affirmed); *Rodriguez v. Prudential-Bache Sec. Inc.*, 882 F. Supp. 1202 (D.P.R. 1995) (award of attorneys' fees in a diversity action was governed by the NYSE Rule enabling arbitrators, in their discretion, to determine which parties shall bear costs and expenses related to the proceedings, *aff'd sub nom.*); *Prudential-Bache Sec. Inc. v.*

Tanner, 72 F.3d 234 (1st Cir. 1995). *Accord*, *Thomas v. Prudential Sec. Inc.*, 921 S.W.2d 847 (Tex. Ct. App. 1996).

In addition, both the FINRA Arbitrator Training Manual and the FINRA Chairperson Training Manual state that an award of attorney's fees may be assessed in those matters where "all of the parties request or agree to" the consideration of such fees.⁶ You need only point the arbitrators to the language in the Statement of Claim and Statement of Answer where both parties requested fees and argue that it created a bi-lateral agreement for the award of attorney's fees. Said another way, the parties jointly submitted the issue of attorneys' fees to the Panel for a determination. If you're feeling especially confident about your case, you state in your opening that "both sides asked for them; the panel is empowered to award them; so clearly someone here should get their attorneys' fees."

An award of attorneys' fees and costs is necessary to fully compensate the Claimants for their losses. These laws are in place for the protection of the investors. The law speaks to the fact that investors, like your Claimants, who have already been damaged due to the wrongful acts of the Respondent, should not be punished twice by having to pay for an attorney in order to get their money back.

Finally, on this topic, be sure to put your representation agreement, and affidavit of attorney's fees (if billing by the hour), your redacted billing records (if required in your jurisdiction), and a statement of case expenses into evidence. They should exactly match the damages summary page of your damages report. We typically enter these documents into evidence at the end of the

⁶ See, NASD Office of Dispute Resolution, *Arbitrator Training Preparation Guide*, Version 1.2, at pg. 193 (1999) and NASD Office of Dispute Resolution, *Chairperson Course Preparation Guide*, Version 1.1, at pg. 198 (1996).

Claimant's testimony. If the evidence has not been admitted into the record, it cannot be considered.

PIGS GET FAT. HOGS GET SLAUGHTERED!

I leave you with a word of caution: When it comes to presentation of your damages, greed kills. You must be the voice of reason. You must have a reasonable basis for the damages you seek. If not, you lose credibility and your clients lose their case.

Figures 1 and 2 below are hearing exhibits from a suitability case that had its genesis in the market crash of 2008 – 2009.⁷ *Figure 1* shows the performance of the Claimants' account as compared to various indices. *Figure 2* shows how those performance numbers were worked into the Claimants' Damages Summary. The Claimants were retired educators, and, gulp, honest to God lottery winners. Notwithstanding their multi-million-dollar lottery winnings, everything about these folks smacked of conservatism. They still lived in the same modest home that they lived in prior to winning the lottery. Their most extravagant purchase was Tom's dream car; a 1956 Ford Thunderbird. Who can blame him?

As shown in *Figure 1* below, the Claimants' account performed in lockstep with a portfolio made up of 100% Dow Jones Industrial Average stocks, which we argued was wholly unsuitable for these conservative retirees. To diffuse the Respondent's "everyone lost money" defense, we showed a number of different bond indices, all of which performed better than the Dow Jones Conservative model, and much better than the Claimants' account. We argued that the conservative allocation of stocks and bonds was the appropriate model, and we used that smaller number in our final damages claim. See, *Figure 2*. You see, had we argued for the higher, all

⁷ Damages exhibits prepared by Securities Analysis Group, Houston, Texas, and used with the permission of the clients.

bond portfolio damages, we would have been just as disingenuous as the Respondents were to argue that the all stock portfolio was suitable. We would have lost credibility. Note that we also calculated statutory interest and provided the arbitrators with that number and the cite to the statute, just in case the arbitrators were inclined to award interest rather than the Market Adjusted model. *Figure 3* is an excerpt from the actual award rendered in the case. As you can see, the arbitrators awarded full compensatory damages, including the more modest market adjusted damages, attorneys' fees, post-award interest, and costs.

Figure 1

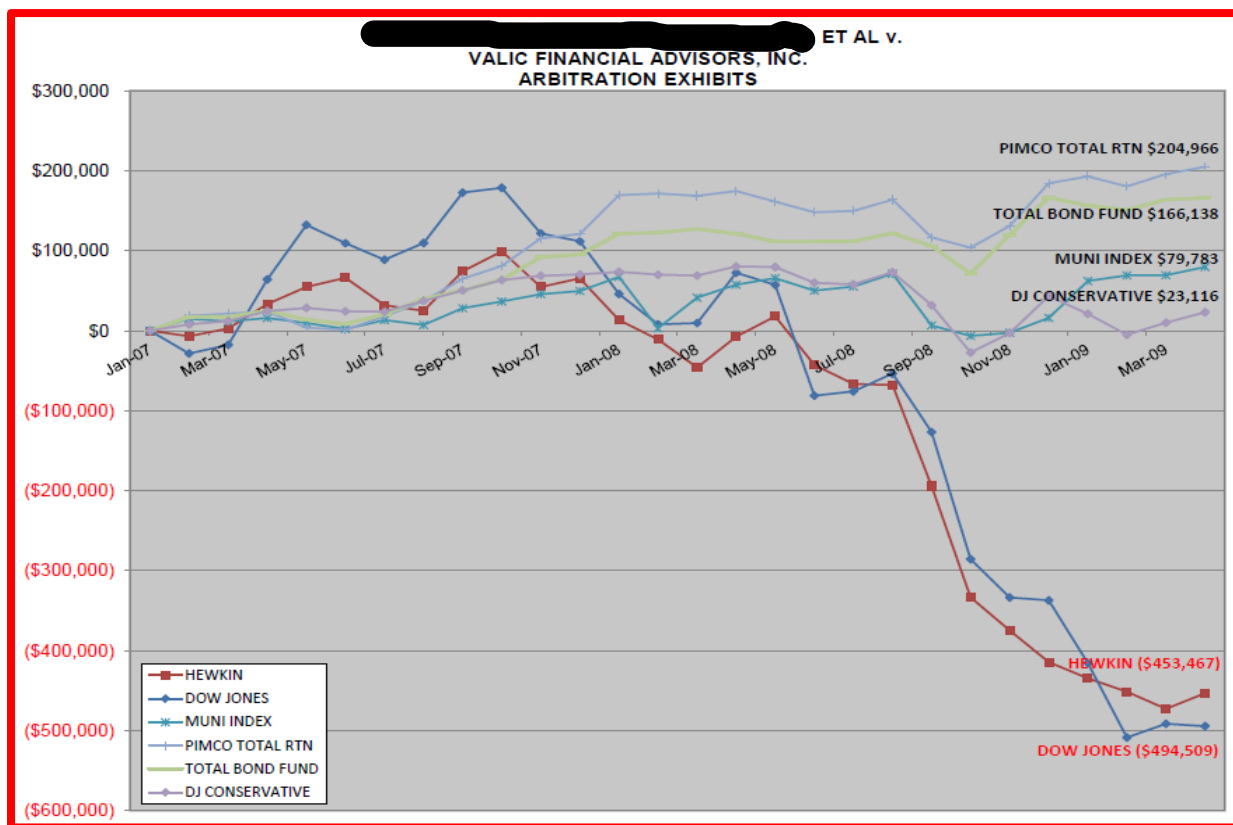


Figure 2

DAMAGES SUMMARY	
 INDIVIDUALLY AND ON BEHALF OF THEIR INDIVIDUAL RETIREMENT ACCOUNTS V. VALIC FINANCIAL ADVISORS, INC. FINRA CASE NO. 14-	
COMPENSATORY DAMAGES	
NET OUT OF POCKET LOSS	\$ 453,467
MARKET ADJUSTED DAMAGES (BASED ON DOW JONES CONSERVATIVE INDEX)	\$ 23,116
TOTAL COMPENSATORY DAMAGES	\$ 476,583
ADDITIONAL DAMAGES	
PREJUDGMENT INTEREST (9% PURSUANT TO OREGON STATUTE § 82.010(2) ON COMPENSATORY DAMAGES FROM FILING OF CASE TO ARBITRATION)	\$ 50,178
ATTORNEY'S FEE (35% OF COMPENSATORY DAMAGES)	\$ 166,804
OTHER LITIGATION EXPENSE (ARBITRATION FILING FEES, EXPERT WITNESS FEES, ETC)	\$ 24,035
TOTAL CONSEQUENTIAL DAMAGES	\$ 241,018
TOTAL DAMAGES	
TOTAL COMPENSATORY DAMAGES	\$ 476,583
TOTAL CONSEQUENTIAL DAMAGES	\$ 241,018
TOTAL DAMAGES	\$ 717,601

Figure 3

AWARD

After considering the pleadings, the testimony and evidence presented at the hearing, the Panel has decided in full and final resolution of the issues submitted for determination as follows:

1. Respondent Valic Financial is liable for and shall pay to Claimants compensatory damages in the amount of \$476,583.00.
2. Respondent Valic Financial is liable for and shall pay to Claimants interest at the rate of 9% per annum from March 13, 2015 until the award of \$476,583.00 is paid in full, pursuant to ORS 82.010(2).
3. Respondent Valic Financial is liable for and shall pay to Claimants attorneys' fees in the amount of \$166,804.00, pursuant to ORS 59.137 and the parties' contract.
4. Respondent Valic Financial is liable for and shall pay to Claimants costs in the amount of \$24,035.00.
5. Any and all relief not specifically addressed herein, including punitive damages, is denied.

The moral of the story is that you *must* have a good faith basis for the damages you seek, be they Market Adjusted or some other damages model. It must make sense. You must believe that your damages model is correct; grounded in reality; and supported by the law and the evidence. You must be able to ask for them with conviction, with a straight face, without blushing. If you can do all these things, and if your damages theme has been consistent throughout the hearing, the arbitrators will have confidence that if they do what you are asking, they are on safe footing, and you will have an excellent chance of getting your clients all the damages to which they are entitled.

V. Additional Materials



FINRA Dispute Resolution Arbitrator's Guide



This Guide contains important information about FINRA Dispute Resolution services, policies and procedures. For additional information, please go to our website: www.finra.org or call one of our regional offices.

FINRA Dispute Resolution attempts to present information to readers in a format that is easily understandable. However, please be aware that, in case of any misunderstanding concerning a rule in the Customer or Industry Code of Arbitration Procedure, the rule language prevails.

October 2015 Edition

PART ONE: OVERVIEW

About the Arbitration Process

“Equity is justice in that it goes beyond the written law. And it is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view, whereas the judge looks only to the law, and the reason why arbitrators were appointed was that equity might prevail.” —

Domke on Aristotle

Arbitration is a method of resolving a dispute between two or more parties. Parties agree in advance to abide by the decision of the arbitrators, who are impartial persons committed to rendering a fair and impartial decision after all parties have had an opportunity to present their cases.

The arbitrators' award is final and binding, subject to court review only under limited circumstances. There is no appeal process within FINRA under the Code of Arbitration Procedure for Customer Disputes or the Code of Arbitration Procedure for Industry Disputes (collectively referred to as Codes or Code).¹ However, the parties may file a motion to vacate the arbitration award in a court of competent jurisdiction. In short, arbitration is a quick, fair, and relatively inexpensive alternative to litigation.

There has been a dramatic increase in the use of arbitration for all types of disputes since the late 1980s. A sharp increase in the number of securities arbitrations was influenced by a U.S. Supreme Court decision (*Shearson v. McMahon*, 1987) that helped establish arbitration as the predominant procedure for resolving securities disputes. Prior to this decision, the binding nature of the arbitration agreement and the broad scope of an arbitrator's authority in securities cases were less clear. Since arbitration is the primary means of resolving disputes in the securities industry, the public perception of its fairness is of paramount importance. Arbitrators appointed to resolve securities controversies must continue to meet the challenge of maintaining fair and orderly arbitration proceedings.

¹ Because many of the rules in the Code of Arbitration Procedure for Customer Disputes (Customer Code) and the Code of Arbitration Procedure for Industry Disputes (Industry Code) are identical, this Guide focuses primarily on the Customer Code (12000 series). Where there is a significant difference between the Customer Code and the Industry Code, the Guide will refer to the appropriate rule in the 13000 series of FINRA's Industry Code.

Explained Decisions

[FINRA Rule 12904](#) provides that the parties may **require** the arbitrators to write an explained decision. If the parties submit a joint request for an explained decision at least 20 days before the first scheduled hearing date, the chairperson is required to draft an explained decision and will receive an additional honorarium of \$400. The explained decision is a fact-based award stating the general reason(s) for the panel's decision. Arbitrators are not required to include legal authorities and/or damage calculations in the decision.

Absent a joint request from the parties for an explained decision, arbitrators may still include a written decision to be published within the body of the award if they believe that an explanation for the award would benefit the parties. However, if the panel decides on its own to write an explained decision, or at the request of only one party, then no panel member will receive an honorarium for writing the decision.

Note that an award granting a motion to dismiss must be accompanied by a written explanation under [FINRA Rule 12504\(a\)](#), as must an award granting expungement of customer dispute information under [FINRA Rule 12805](#). For more information on writing an explained decision, view our [training course](#) available online.

Types of Remedies

Depending upon the relief parties request, there are several types of remedies arbitrators may consider. If the panel is satisfied by a preponderance of the evidence that the respondent is liable for the alleged loss, the panel should determine an appropriate remedy. Remedies may include:

Actual Damages and/or Statutory Damages

Actual damages, sometimes called compensatory damages, are a monetary sum required to compensate a party for their loss. These include:

Net Out-of-Pocket Losses

The calculation of a claimant's net out-of-pocket losses varies depending on whether the panel finds the wrongful conduct involves one or more specific trades or the management of an entire account. For specific trades, net out-of-pocket loss is the purchase price of the security plus commissions minus the total of the value of the security on the relevant date plus dividends or interest received. For wrongful conduct involving an entire account, net out-of-pocket losses are calculated by taking the beginning account value, plus money and securities deposited, minus money and securities withdrawn, less account value on the relevant date. Arbitrators should look to the parties for instructions on these issues.

In addition, some claimants may argue that to award "full compensatory damages" it is necessary to look beyond a claimant's net out-of-pocket loss. These "special" or consequential damages might include:

- lost profits in the form of dividends on stocks sold because of wrongdoing;
- taxes the claimant incurred because of the wrongdoing;
- loss of available funds in the claimant's business;
- loss of financing; and
- commissions paid.

Benefit of the Bargain

The benefit of the bargain measure seeks to give the claimant the expected value of the investment. For example, the claimant's measure of damages would be the amount the investment would have been worth if the respondent's misrepresentation had been true, less what the investment is actually worth. The difficulty with applying the benefit of the bargain measure of damages is determining, with some specificity, the profits that the claimant would have reasonably received.

Well-Managed Portfolio Account

This measure of damage allows the claimant to recover the difference between what the claimant's account made or lost versus what a well-managed account, given the investor's objectives, would have made during the same time period.

Statutory Damages

Sometimes, a claim will be based upon a statute that explains how damages should be calculated. If a claim is based upon such a statute, the panel should look to the parties for guidance on how the law requires damages to be calculated.

Other Remedies

Rescission

Rescission is designed to place the claimant in the same position occupied before the wrongful transaction. It may include the return of the securities at issue.

Disgorgement

The arbitration panel may require the respondent to disgorge profits or commissions. The goal of disgorgement is to make the wrongdoing unprofitable.

and therefore deter the wrongdoing. Disgorgement might be available even where the claimant has not suffered net out-of-pocket losses.

Specific Performance

Specific performance requires precise fulfillment of a legal or contractual obligation when monetary damages are inappropriate or inadequate. If the arbitrators determine that specific performance is an appropriate remedy for a case, the award should be specific and clear with respect to:

- the action to be taken;
- the individual who will take the action; and
- if appropriate, when the action will take place.

For example, a panel might determine that rescission of a transaction or agreement is the only way to place the parties back in the position they were before the wrongdoing. If the arbitrators award damages and the claimant has not yet sold the securities, the award should direct what happens to the securities—whether the claimant retains them, sells them, or returns them to the firm, and under what conditions.

Injunctive or Permanent Relief Available in Industry Cases

Temporary Injunctive Relief: Pursuant to [FINRA Rule 13804](#), parties who want a temporary injunction must file for such relief in court. The only related relief available in arbitration at FINRA is for a permanent injunction.

Permanent Relief: [FINRA Rule 13804](#) provides the legal standard an arbitration panel should apply when deciding a request for a permanent injunction. The panel should apply the choice of law as indicated in the parties' agreement, or the law of the state where the events occurred, if the parties do not have an agreement.

Under [FINRA Rule 13804](#), once the panel has heard all evidence on the request for a permanent injunction, it may prohibit the parties from seeking an extension of a court-issued temporary injunction. Arbitrators do not have the authority to modify or dissolve a court's order. However, arbitrators may order the parties to jointly move to modify or dissolve the temporary injunction. If a panel's order conflicts with a pending court order, the panel's order will become effective when the court's order expires.

Requests to Include Interest as Part of the Award

If a party requests the panel to include interest as part of the award, the panel should review the following issues:

- statutory or contractual basis that allows interest to be awarded;
- amount of or rate of interest;
- date interest begins; and
- date interest ends.

The interest rate can vary by jurisdiction and case. Some states specify the legal rate of interest that may be awarded in legal matters. Other jurisdictions use Internal Revenue Service rates or those on treasury bills. In some cases, panels select the rate of interest the broker applies to its own customers for outstanding debts. In general, when awarding interest a panel should apply a reasonable rate that is based on the facts of the case.

With respect to when interest begins to accrue, the arbitrators will generally apply interest from the date a contract was breached or the time the panel determines that a debt became due or payable.

Requests to Include Punitive Damages as Part of the Award

Upon a party's request, arbitrators may consider punitive damages as a remedy if a respondent has engaged in serious misconduct that meets the standards for such an award.

Punitive damages are not intended to right a wrong, but are intended to punish the wrongdoer and to deter future wrongdoing. The standards for awarding punitive damages vary from state to state. While most states permit punitive damages only for conduct that is malicious or intentional, some states permit punitive damages for reckless indifference to the rights of others or for gross negligence.

If punitive damages are awarded, the arbitrators should clearly specify what portion of the award is intended as punitive damages. In addition, arbitrators should include in the award the basis for awarding punitive damages. If the panel needs additional information to determine the basis for awarding punitive damages, it should ask the parties to brief the issue to help determine whether both factual and legal bases exist for such an award.

Awarding Sanctions, if Any

If the panel issues sanctions, pursuant to [FINRA Rule 12212](#), it must include this information in the award. Arbitrators should not make sanctions against parties payable to FINRA as FINRA is not a party to the proceeding. Awards containing monetary sanctions payable to FINRA are inappropriate. Please see the section of this Guide on Issuing Sanctions for additional information.

Awarding Fees and Costs

Arbitrations involve a number of fees and expenses, and the panel decides which party must pay these costs. The panel may ask FINRA staff to provide a summary of all fees that have been incurred as a result of the arbitration, as well as payments made by each party. This section addresses separately the following fees and costs: forum fees; attorneys' fees; witness and production fees; and other case-related costs.

Forum Fees

A party must remit a filing fee when it files a claim, counterclaim, third party claim or cross claim. The cost of the filing fee is based on the amount in dispute and the number of arbitrators assigned to hear a case. Schedules of fees can be found in FINRA Rules [FINRA Rules 12900 through 12903](#), and [FINRA Rules 13900 through 13903](#). Also see the [Award Information Sheet](#) for guidance on allocating hearing session fees.

FINRA may temporarily waive fees if the party shows that it is unable to pay the filing fee and/or hearing session deposit. However, FINRA will also inform the party that the panel may still assess arbitration costs at the close of the case.

The total amount of forum fees the arbitrators may assess against the parties is based on the number of hearing sessions needed to complete the hearing. A hearing session includes any meeting between the parties and arbitrator(s) that lasts four hours or less. For example, if a hearing runs two days—eight hours each day—the parties are subject to an assessment of four hearing sessions.

The panel has the discretion to assess forum fees among the parties. In deciding how to allocate the forum fees, arbitrators may consider the following factors:

- temporary waivers of filing fees or hearing session deposits granted because of financial hardship;
- actions by any party that may have prolonged the length of the hearing;
- the legitimacy of arguments made or positions taken;
- disruptions or time delays caused during hearing sessions; and
- the ultimate merits of the case (*i.e.*, who prevailed or substantially prevailed).

Arbitrators should remind the parties periodically that they may be assessed forum fees at the conclusion of the hearing. Although liability may be considered when deciding how to assess fees, it is not the only factor when deciding to assess forum fees.

If the panel elects to assess a postponement fee in its award, it should consider the same factors used in assessing forum fees when assessing this fee. For example, if a party requested and was granted a postponement because another party failed to produce documents, the panel might consider assessing the fee against the non-producing party in the award.

Attorneys' Fees

There are three situations when parties may pursue attorneys' fees:

- A contract includes a clause that provides for the fees.
- The fees are required as part of a statutory claim.
- All of the parties request or agree to such fees.

You must award reasonable attorneys' fees to claimants who prevail under statutes that provide for attorneys' fees, including, among others, Title VII actions for discrimination and many state securities statutes.

If a prevailing party requests reimbursement of attorneys' fees and you have questions regarding the panel's authority to award such fees, you may request briefs from the parties relating to an applicable statute or other basis for awarding the fees.

If the panel determines that a party has a contractual or statutory right to reimbursement, that party must prove the amount to the satisfaction of the panel.

Witness and Production Fees

Occasionally, parties may request that the arbitrators direct reimbursement for expenses of a witness, and the costs associated with producing documents. When reviewing witness fees, arbitrators should follow the rule in the applicable jurisdiction. If necessary, the panel should ask the parties to brief the issue.

Usually, each party is responsible for producing and copying documents that they intend to use. According to [FINRA Rule 12513](#) the party requesting the production of documents shall bear all reasonable costs of production, unless the panel directs otherwise. On larger cases, a party might ask that the requesting party come to the location of the documents and copy what is needed.

If the parties cannot agree on who should bear such fees, the panel must find a reasonable solution. After reaching a decision, the panel should memorialize it in an order or the award.

Other Case-Related Costs

The parties may request that the arbitrators direct reimbursement for other expenses, such as:

- cost of transcribing the record;
- travel costs—when the parties have traveled to the hearing and a party has caused the case not to go forward (last-minute postponement request);
- expert fees; and
- teleconference fees.

FINRA may also alert the panel to outstanding administrative costs such as:

- photocopying charges;
- mailing charges;
- unpaid postponement fees; and
- unpaid administrative costs.

A panel may assess each of these fees and costs in its award applying equitable principles.

Member Surcharge and Process Fees

Although arbitrators generally have wide latitude in determining how to assess fees and costs against the parties, they do not have discretion in allocating member surcharges and process fees.

[Rules 12901](#) and [12903](#) require a brokerage firm to pay a surcharge and process fees when the firm: 1) files a claim; 2) is named as respondent in a claim, counterclaim, cross claim or third party claim; or 3) employed an associated person at the time of the dispute who is named as a respondent in a claim, counterclaim, cross claim or third party claim.

Arbitrators may not reallocate any of the member surcharge or process fees paid by a firm to another party.

Expungement of Customer Dispute Information

Central Registration Depository

The Central Registration Depository (CRD[®]) is an online registration and licensing system that contains administrative and disclosure information about registered securities firms and brokers. FINRA maintains and operates the CRD system pursuant to FINRA rules and an agreement between FINRA and the North American Securities Administrators Association (NASAA), an association whose members include state and other securities regulators in the United States, as well as other securities regulators in North America.

The CRD system is used by members of the securities industry, state and federal regulators and self-regulatory organizations (SROs). FINRA works with NASAA, the Securities and Exchange Commission (SEC), other members of the regulatory community and brokerage firms to ensure that information in the CRD system is accurate and complete.



Office of Dispute Resolution



Version: October 2018

Office of Dispute Resolution Basic Arbitrator Training

Basic Arbitrator Training and Exam

Dear Arbitrator:

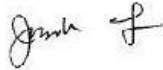
The following is a print version of the Basic Arbitrator Training. You may complete this course and exam either through this printable version (instructions below) or online, depending on your individual preference and/or computing environment. Most arbitrators will be able to review the material in eight hours.

After you have reviewed the course material, you may begin the exam. The exam consists of 25 multiple-choice questions, and you must answer at least 20 questions correctly (80 percent) to pass the course. If you do not pass the exam on the first attempt, you will have only **one** additional opportunity to retake it—for a maximum of two attempts.

You may complete the exam online or in a paper format. Please contact Luis Cruz at luis.cruz@finra.org or 212-858-4339 to request a paper version of the exam. You will have one hour to complete the exam and return it to Luis Cruz. After grading your exam, FINRA will send you an email with the results and instructions on your next steps in completing the training requirements.

Please contact me at jisook.lee@finra.org or 212-858-5121 with any questions about the content of the course or exam.

Very truly yours,



Office of Dispute Resolution Basic Arbitrator Training

Test Yourself

Mr. Creighton brings a claim against Penne Stock Brokers and one of its employees, John Linguini. You find that Linguini recommended unsuitable purchases in the course and scope of his employment and under his manager's supervision.

How might you allocate damages?

Question Feedback

You should find both Linguini and Penne liable for the full amount of the damages, jointly and severally.

Determine Liability

In this lesson, we began deliberations and learned a process to determine liability. Specifically, we discussed how you will:

- participate in panel deliberations;
- determine the facts of the case;
- apply the law to the facts; and
- reach a decision.

Now that you and other panel members have determined liability, you will need to determine the award.

Introduction to Lesson: Determine Award

Once you have determined the liability of the parties, the panel's next task is to determine the award.

FINRA staff will provide the panel with an Award Information Sheet to complete. The panel should use the worksheet to ensure that it considers all requests for relief, as it is the panel's duty to determine all claims. Failure to decide all claims may constitute a basis for a court of law to vacate the award.

In this lesson, we will look at the elements of an award and the various types of compensation you will consider. Specifically, we will review how you will:

- determine remedies; and
- determine costs.

We will begin our review with one of the primary reasons a party files a claim: to recover damages.

Determine Remedies

Depending on the relief the parties request, there are several types of remedies you may consider. They include:

- actual damages and/or statutory damages;
- punitive damages;
- specific performance;
- injunctive relief; and

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- expungements.

If the panel is satisfied by a preponderance of the evidence that the respondent is liable for the alleged loss, the panel should determine an appropriate remedy.

We will start our review with actual damages.

Actual Damages

Actual damages, sometimes called compensatory damages, are a monetary sum required to compensate a party for his or her loss.

While arbitrators have flexibility to award damages to suit the particular case, they should have a rational and understandable basis for their award. Furthermore, actual damages should not be based on speculation, but should be designed to make the claimant "whole" for losses suffered due to misconduct found to exist.

The claimant has the burden of proof as to damages, but absolute precision in actual damage calculation is not required. Because there are a number of ways to determine actual damages, the panel must closely listen to all parties to determine which method, if any, it will apply. In different states, different legal theories or other considerations apply to various damage theories. What follows is a listing of some of the ways that actual damages may be determined.

Damages

Click on each button below to learn more.

- **Net Out-of-Pocket Losses**
- **Benefit of the Bargain**
- **Well-Managed Portfolio Account**
- **Statutory Damages**

Net Out-of-Pocket Losses

The calculation of a claimant's net out-of-pocket losses varies depending on whether the panel finds the wrongful conduct involves one or more specific trades or the management of an entire account. For specific trades, net out-of-pocket loss is the purchase price of the security plus commissions minus the total of the value of the security on the relevant date plus dividends or interest received. For wrongful conduct involving an entire account, net out-of-pocket losses are calculated by taking the beginning account value, plus money and securities deposited, minus money and securities withdrawn, less account value on the relevant date. You should look to the parties for instructions on these issues.

In addition, some claimants may argue that to award "full compensatory damages" it is necessary to look beyond a claimant's net out-of-pocket loss. These "special" or consequential damages might include:

- lost profits in the form of dividends on stocks sold because of wrongdoing;
- taxes the claimant incurred because of the wrongdoing;
- loss of available funds in the claimant's business;
- loss of financing; and
- commissions paid.

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Benefit of the Bargain

The benefit of the bargain measure seeks to give the claimant the expected value of the investment. For example, the claimant's measure of damages would be the amount the investment would have been worth if the respondent's misrepresentation had been true, less what the investment is actually worth. The difficulty with applying the benefit of the bargain measure of damages is determining, with some specificity, the profits that the claimant would have reasonably received.

Well-Managed Portfolio Account

This measure of damage allows the claimant to recover the difference between what the claimant's account made or lost versus what a well-managed account, given the investor's objectives, would have made during the same time period.

Statutory Damages

Sometimes, a claim will be based upon a statute that explains how damages should be calculated. If a claim is based upon such a statute, you should look to the parties for guidance on how the law requires you to calculate damages.

Other Remedies

Click on each button below to learn more.

- **Rescission**
- **Disgorgement**

Rescission

Rescission is designed to place the claimant in the same position occupied before the wrongful transaction. In some instances, it may include the return of securities at issue.

Disgorgement

The arbitration panel may require the respondent to disgorge profits or commissions. The goal of disgorgement is to make the wrongdoing unprofitable and therefore deter the wrongdoing. Disgorgement might be available even where the claimant has not suffered net out-of-pocket losses.

"Mitigation" refers to the concept that a party should, when possible, take action to limit loss or avoid damage. The law varies as to when an injured party is required to mitigate damages. Some laws allow a respondent to raise the issue of mitigation, and require a claimant to act reasonably to avoid losses once the harm is discovered. Other laws, including some "blue sky" laws (state securities laws), do not recognize mitigation as a defense. If the issue of mitigation arises, ask the parties for guidance as to the role of mitigation in each theory of recovery.

Interest

Let's assume for the moment that you have awarded actual damages. If requested by the party, the panel will now determine whether the damages should include interest.

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The issues you will review when awarding interest are:

- statutory or contractual basis that allows interest to be awarded;
- amount of or rate of interest;
- date interest begins; and
- date interest ends.

The interest rate you select can vary by jurisdiction and case. Some states specify the legal rate of interest that may be awarded in legal matters. Other jurisdictions use Internal Revenue Service rates or those on treasury bills. In some cases, panels select the rate of interest the broker applies to its own customers for outstanding debts. In general, a panel should apply a reasonable interest rate that is based on the facts of the case.

With respect to when interest begins to accrue, you will generally apply interest from the date a contract was breached or the time the panel determines that a debt became due or payable.

That concludes our review of actual damages.

Punitive Damages

A party also might have requested punitive damages. Punitive damages are not intended to right a wrong, but are intended to punish the wrongdoer and to deter future wrongdoing.

Generally, you may award punitive damages if the claimant requests it, and the respondent has engaged in serious misconduct that meets the standards for such an award, as well as any arbitration forum rules on the subject. However, an award of punitive damages is discretionary with the panel.

The standards for awarding punitive damages vary from state to state. While most states permit punitive damages only for conduct that is malicious or intentional, some states permit punitive damages for reckless indifference to the rights of others or for gross negligence.

If you and the other panel members are considering a punitive damage award, you may ask that the parties brief the issue to help you determine whether both factual and legal bases exist for this determination.

Let's look at an example of a request for punitive damages in a jurisdiction that authorizes this type of award.

Punitive damages are generally grounded in the law of torts and are not permissible for actions alleging breach of contract.

Sanctions

If the panel issues sanctions, pursuant to [FINRA Rule 12212](#), it must include this information in the award. Arbitrators should not make sanctions against parties payable to FINRA as FINRA is not a party to the proceeding. Awards containing monetary sanctions payable to FINRA are inappropriate.

[FINRA Rule 12212:](#)
<http://www.finra.org/finramanual/rules/r12212>

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Test Yourself

Customer Dorothy Gale, a single parent, lost \$20,000 by investing in NYCO at the recommendation of registered representative Charlie Em. Mr. Em knew that Ms. Gale wanted the monies invested conservatively for her 12-year-old daughter's college fund.

At the hearing, Ms. Gale presented evidence that representative Em received a \$1,000 kickback for every \$10,000 that was invested in NYCO. His assistant testified that Mr. Em knew NYCO was experiencing financial difficulties but knowingly misrepresented this fact to his clients. In fact, the evidence showed Mr. Em prepared and showed false financial statements to Ms. Gale to induce her to purchase NYCO.

Because 50 people had invested in NYCO through representative Em, Ms. Gale argued that he should pay her \$20,000 in actual damages and punitive damages in the amount of \$30,000.

Would you award Ms. Gale punitive damages in this case? What steps would you take in making your determination?

Question Feedback

First, you should ask for briefs on the issue and determine whether the panel has the authority to award punitive damages. You should then consider whether the claimant presented sufficient evidence of wrongdoing by the respondent to justify an award of punitive damages.

If you determine that the above facts are true, and review of the briefs leads you to believe that you possess the authority to award punitive damages, you may award punitive damages.

Specific Performance

At times a claimant will ask for specific performance instead of, or in addition to, actual damages. Specific performance requires precise fulfillment of a legal or contractual obligation when monetary damages are inappropriate or inadequate. For example, a panel might determine that specific performance or agreement is the only way to place the parties back in the position they were before the wrongdoing.

If you award damages and the claimant investor has not yet sold the securities, the award should direct what happens to the securities—whether the claimant retains them, sells them or returns them to the firm, and under what conditions.

If you determine that specific performance is an appropriate remedy for a case, make sure the award is specific and clear with respect to:

- the action to be taken;
- the individual who will take the action; and
- if appropriate, when the action will take place.

Test Yourself

The panel on which you are sitting determines that claimant Clarence Kayo was defrauded out of his share of a family-owned brokerage firm by Melissa Kayo, his sister. Because of her actions, Ms. Kayo now controls the business.

Should you consider specific performance in this instance? Why or why not?

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Question Feedback

You would consider ordering Ms. Kayo to return the shares to her brother. Although monetary relief is a possibility, the only way to return control in the family business to Mr. Kayo is by ordering specific performance.

Injunctive Relief

Unlike specific performance, which requires a party to take action, injunctions require parties to refrain from certain acts. Claimants typically request injunctive relief if the alleged harm is immediate and would cause irreparable harm if continued.

According to Rule [13804](#) of the Code, parties to industry or clearing disputes that are required to be submitted to arbitration under the Code may seek a temporary injunctive order from a court of competent jurisdiction. A party seeking a temporary injunctive order must file simultaneously with FINRA a statement of claim requesting permanent injunctive relief. Expedited hearings often involve a request for injunctive relief.

[13804:](#)
<http://www.finra.org/finramanual/rules/r13804>

Test Yourself

Lyle, Len & Associates' Statement of Claim alleges that it has a contract with former employee Richard Dolan who is contacting its customers in violation of a non-compete clause in the contract. Lyle, Len has obtained a temporary injunctive order from a court and now asks you to grant a permanent injunction to prevent Mr. Dolan from contacting its customers.

Would you consider granting a temporary restraining order against Mr. Dolan? Why or why not?

Question Feedback

This is the type of case in which an injunction might be granted.

Based on the parties' briefs, you must determine whether the claimant has met the required standards for this relief as contained in Rule 13804 Injunctions.

Expungements

Information about expungement is being offered as a mandatory online training course to new arbitrators.

The course explains the role of the Central Registration Depository (CRD); gives a general overview of the expungement process; and discusses the specific findings arbitrators must make in order for FINRA to waive its right to oppose an expungement request in court. After successfully completing the online Basic Arbitrator training, you will be ready to take the mandatory online Expungement training. You must complete the Expungement training before participating in the classroom portion of the training. You can enroll for the course on our website at www.finra.org.

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Determine Costs

Arbitrations involve a number of fees and expenses. The panel decides which party, if any, must pay these costs. The panel may ask FINRA staff to provide a summary of all fees that have been incurred as a result of the arbitration, as well as payments made by each party.

In this section we will review a variety of fees that you may assess, including:

Click on each button below to learn more.

- **Forum Fees**
- **Attorneys' Fees**
- **Witness and Production Fees**
- **Other Case-related Costs**

Let's look first at how you will determine the amount and distribution of forum fees.

Determine Forum Fees

When a party files a claim, counterclaim, third party claim, or cross claim, he or she must remit a filing fee. The cost of the filing fee is based on the amount in dispute and the number of arbitrators hearing a case. Schedules of fees can be found in Rules [12900](#) through 12903 of the Code.

FINRA may temporarily waive fees if the party shows that he or she is unable to pay for the filing fee and/or hearing session deposit. However, FINRA will also inform the party that the panel may still assess arbitration costs at the close of the case.

The total amount of forum fees you may assess the parties is based upon the number of hearing sessions the case required. A hearing session includes any meeting between the parties and arbitrator(s) that lasts four hours or less.

For example, a hearing that runs two days—eight hours each day—is subject to a maximum forum fee assessment for four hearing sessions.

If a hearing is scheduled for four or more days, or if you determine that a hearing will require more days than are presently scheduled, you might consider requesting deposits of additional hearing session fees by the parties in equal amounts. Please see Rule [12902](#) of the Code.

The panel has the discretion to assess forum fees among the parties, except for hearings under Rule [12805](#) where expungement is the sole topic. In deciding how to divide the forum fees, you might consider the following factors:

- temporary waivers of filing fees or hearing session deposits granted because of financial hardship;
- actions by any party that may have prolonged the length of the hearing;
- the legitimacy of arguments made or positions taken;
- disruptions or time delays caused during hearing sessions; and
- the ultimate merits of the case (*i.e.*, who prevailed or substantially prevailed).

Some parties may be surprised when you assess the hearing session fees. To better prepare them, do not assume the parties—particularly pro se parties—are familiar with the forum fees they may be incurring. Remind them periodically. Liability is not the only factor to consider when deciding to assess forum fees.

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In addition to forum fees, a panel may elect to assess an adjournment fee in its award. You will consider the same principles in assessing this fee.

For example, if a party requested and was granted a postponement because another party failed to produce documents, you might consider assessing the fee against the non-producing party in your award.

Before we move onto attorneys' fees, please complete the following practice exercises on determining forum fees.

12900:
<http://www.finra.org/finramanual/rules/r12900>

12902:
<http://www.finra.org/finramanual/rules/r12902>

12805:
<http://www.finra.org/finramanual/rules/r12805>

Test Yourself

At the end of the proceeding, you note that a party's failure to produce a witness on time caused the hearing to be postponed for three hours.

What might the panel do?

Question Feedback

If you decide that the party was at fault, the panel might assess him or her with an additional session fee.

Test Yourself

During a hearing, it becomes clear that a party has a solid case. However, the party has caused numerous disruptions and time delays by interrupting and arguing with the witnesses.

On the other hand, the other party was cooperative and timely in its presentation of the evidence and the case law.

Would you take a party's behavior into account when assessing forum fees?

Question Feedback

Yes, even if a party prevails, you could consider the actions that prolonged the hearing.

Determine Attorneys' Fees

You may award attorneys' fees when, for example: 1) the parties' contract includes a clause that provides for attorneys' fees; 2) the governing law provides for attorneys' fees when all of the parties request or agree to such fees; 3) the fees are required or permitted as part of a statutory claim; or 4) as otherwise provided by law.

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FINRA does not provide guidance on whether arbitrators may award attorneys' fees. The law may vary widely and may require interpretation that FINRA, as a neutral forum, will not provide. In addition, you should not conduct your own legal research.

If a party requests the recovery of attorneys' fees and you have questions regarding the panel's authority to award such fees, you should request briefs from the parties that identify the basis for awarding attorneys' fees.

If the panel determines that a party has a right to recovery, that party must prove the amount to the satisfaction of the panel. The panel may permit testimony or evidence to be submitted during the case-in-chief, or in post-hearing written submissions.

In addition to attorneys' fees, parties might sometimes request witness and production fees. Let's look at these next.

Determine Witness and Production Fees

On occasion, parties request that the arbitrators direct reimbursement for:

- expenses of a witness; and
- costs associated with producing documents.

When reviewing witness fees, you will generally follow the rule in the applicable jurisdiction. If necessary, ask the parties to brief the issue for you.

The panel can also wait until the conclusion of the hearing to assess the fees. For example, if a witness is located a significant distance from the hearing site, you might decide to assess the cost of the witness' travel after you have heard the case.

Usually, each party is responsible for producing and copying documents that are relevant to the case. According to Rule [12513](#) the party requesting the production of documents shall bear all reasonable costs of production unless the panel directs otherwise.

On larger cases, a party might ask that the requesting party come to the location of the documents and copy what is needed.

If the parties cannot agree on who should bear such fees, your job is to find a reasonable solution. Whatever decision you and the other panel members make, however, memorialize it in an order or the award.

We have already reviewed some of the costs and fees that you will frequently review during an arbitration. In the next section, we will briefly review other costs parties may request.

[12513:](http://www.finra.org/finramanual/rules/r12513)
<http://www.finra.org/finramanual/rules/r12513>

Other Case-Related Costs

The parties may request that the arbitrators direct reimbursement for other expenses, such as:

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- cost of transcribing the record;
- travel costs—when the parties have traveled to the hearing and a party has caused the case not to go forward (last-minute postponement request);
- expert fees; and
- teleconference fees.

Also, FINRA may alert the panel to outstanding administrative costs such as:

- recording duplication fees;
- copying charges;
- mailing charges;
- unpaid postponement fees; and
- unpaid administrative costs.

A panel may assess each of these fees and costs in its award using the equitable principles described throughout this lesson.

Member Surcharge and Process Fees

Although arbitrators generally have wide latitude in determining how to assess fees and costs against the parties, they do not have discretion in allocating member surcharges and process fees.

Rules [12901](#) and [12903](#) require a brokerage firm to pay a surcharge and process fees when the firm: 1) files a claim; 2) is named as respondent in a claim, counterclaim, cross claim or third party claim; or 3) employed an associated person at the time of the dispute who is named as a respondent in a claim, counterclaim, cross claim or third party claim.

Arbitrators may not reallocate any of the member surcharge or process fees paid by a firm to another party.

That completes our review of costs and fees. In the next lesson, we will review the documentation you will need to prepare to complete the arbitration proceeding.

Before we move on, however, test your knowledge of awards by completing the exercises that follow.

[12901:](#)
<http://www.finra.org/finramanual/rules/r12901>

[12903:](#)
<http://www.finra.org/finramanual/rules/r12903>

Test Yourself

Elliott & Lee Securities filed a claim against registered person George Arrington. Elliott & Lee claims that when Mr. Arrington joined the firm, he executed a promissory note and in return was provided "up front" money consisting of a forgivable loan in the amount of \$250,000.

The loan said that \$50,000 would be forgiven for every six-month period that Mr. Arrington remained employed. However, if Mr. Arrington left his employment early, he would pay the balance on the note. In addition, the note stated that if Mr. Arrington left the firm without paying the balance and Elliott & Lee had to file an arbitration to collect, the firm should receive attorneys' fees.

If you find for Elliott & Lee at the hearing, can you award attorneys' fees? Why or why not?

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Question Feedback

Yes. In view of the contract, if Mr. Arrington did not have a valid defense to an award of attorneys' fees, you could award them against him.

Test Yourself

Jim and Mary Gold brought an action against MP Investments Co., a small broker-dealer. The Golds spent 18 days putting on their case to prove MP Investments was negligent with their account.

During this time, the case was postponed seven times due to the unavailability of the Golds, their attorney, or their witnesses. The parties and panel spent much time off the record waiting for the Golds, their attorneys, and their witnesses to show up.

You and the other panel members determine that the Golds proved their case by a preponderance of the evidence. How might you assess forum fees and costs in this case?

Question Feedback

You might decide to assess against the Golds that proportion of forum fees and costs caused by their delays.

Determine Awards

In this lesson, you learned how to determine awards. Specifically, we reviewed how you will:

- determine remedies; and
- determine costs.

In the next lesson, we will review how you will document your determination of liability in the corresponding award.

Introduction to Lesson: Complete the Appropriate Documentation

Now that you have determined liability, remedies, additional fees and costs (if any), your next role as a panel member is to communicate the results of the hearing to FINRA.

In this lesson, we will look at the documentation you will prepare to complete the award. Specifically, we will review how you will:

HOW TO BRING RIA CASES

1. Primer on Investment Adviser Regulation

This primer on investment adviser regulation renders basic parameters of the regulatory scheme. An investment adviser, as defined,¹ must register with the Securities and Exchange Commission (Commission) if its assets under management exceed \$110 million. With assets between \$110 and \$90 million,² an adviser is eligible but does not have to register with the Commission. The registration requirements are subject to a multiple of exceptions and exclusions, depending on the type of adviser, as for example, an adviser to a registered investment company, a private fund adviser, and family offices.³ Advisers ineligible for registration with the Commission register with their state securities administrator.⁴

Registration with the Commission requires the completion and filing of a Form ADV with the Commission, and the Form ADV may be reviewed and comments issued by the Commission. Form ADV consists of two parts: Part 1 contains check-the-box answers, relating to statistical and other objective information; and Part 2 contains a narrative disclosure about the adviser's business, strategies, rendering of advisory services, and conflicts.

If registering with the state securities administrators, additional documents may be required, depending on the state, such as a copy of the client agreement, written supervisory procedures, the agreement with the custodian, and a balance sheet. States may also conduct more thorough reviews of the Form ADV and documents submitted. Each state adopts its own securities statutes, and for the most part, follow a version of the Uniform Securities Act with modifications. Reference is made to the Uniform Securities Act (2005)⁵ for ease and simplicity as representative of state laws, and to the Model Rules promulgated by the North America Securities Administrators Association.⁶

Individuals rendering advice on behalf of investment advisers are referred to as investment adviser representatives, and most states require these persons to register if they maintain a place of business in the state or have more than five clients in the state⁷. An individual must file a Form

¹Investment Advisers Act, Section 202(a)(11) Definitions. The Investment Advisers Act commences at 15 USC §80b-1, at <http://legcounsel.house.gov/Comps/Investment%20Advisers%20Act%20Of%201940.pdf>.

²*Id.* Section 203A State and Federal Responsibilities; Rule 204A-1 Eligibility for SEC Registration: Switching to or from SEC Registration. Rules promulgated under the Investment Advisers Act commence at 17 CFR 275.0-2 *et seq.*, at <https://www.ecfr.gov/cgi-bin/text-idx?node=17:4.0.1.1.22&rgn=div5>.

³*E.g.*, Rule 202(a)(11)(g)-1 Family offices; Rule 203(m)-1 Private fund adviser exemption; Rule 203A-2 Exemptions from prohibition on Commission registration., *supra* note 2.

⁴Some states do not have registration requirements, and advisors in those states, must register with the Commission.

⁵Uniform Securities Act, at [DownloadDocumentFile.ashx \(uniformlaws.org\)](#)

⁶NASAA model rules may be found at <http://www.nasaa.org/1325/adopted-model-rules/>.

⁷Section 404(b)(2) of the Uniform Securities Act of 2005.

U4 and pass a qualifying examination or have a professional designation recognized by the state as acceptable in lieu of the qualifying examination.

Regulations promulgated by the Commission and the state securities administrators vary little. Any variations occur in more sensitive areas, such as the custody rule, financial condition and disclosure requirements particular to a state's own concern. Regulations are extensive. Interpretation of the regulations promulgated by the Commission emanates from a variety of sources, primarily enforcement actions, examination priority pronouncements, FAQ's and staff interpretative releases. The state securities administrators offer minimal interpretation of their rules, and reference can be made to the Commission's interpretation of the regulatory requirements for clarification.

Although the Investment Advisers Act prohibits states imposing regulations on advisers registered with the Commission, the state securities administrators maintain authority to investigate and bring enforcement actions with respect to fraud or deceit against an investment adviser or person associated with an investment adviser.⁸

2. Case Selection and Review

Actions against investment advisers contain their own considerations, distinct and separate from actions against broker-dealers and registered representatives. Beyond a different set of statutes and regulations governing their conduct, the relationship as between the adviser and the client varies. Most relationships are longer-term and involve a high degree of trust and faith by the client in the adviser.

a. Parties

An action against an investment adviser involves an action against the entity and its registered investment adviser representatives. The control persons of the firm maintain liability for malfeasant conduct under state securities statutes, unless the control person sustains the burden of proof that the person did not know, and in the exercise of reasonable care could not have known, of the wrongful conduct.⁹ However, given the requirements for supervisory policies and procedures, it becomes the obligation of control persons to detect and to deter wrongful conduct.¹⁰

Form ADV contains information about the investment adviser, its structure and practices. Despite requirements that disclosures be particular to an adviser and its business, disclosures may be "cut and paste" and differ from an adviser's actual practices. Certain basic information may still be found. Form ADV's may be found through the Investment Adviser Public Disclosure, as well as Form U4's for investment adviser representatives if required to register.¹¹

⁸Investment Advisers Act, Section 203A(b)(3) State and Federal Responsibilities, Limitations, *supra* note 1.

⁹Uniform Securities Act, Section 509(g) Civil Liability, imposes joint and several liability on control persons, pp. 134-135, *supra* note 4,

¹⁰*E.g.*, Rule 206(4)-7 Compliance procedures and practices; Rule 204A-1 Investment adviser codes of ethics, *supra* note 2; Subsection (19) of NASAA Recordkeeping Requirements for Investment Advisers Model Rule USA 2002 411(c)-1 Adopted 9/17/2008; Amended 9/11/2011, p. 19 at www.nasaa.org/wp-content/uploads/2011/07/IA-Model-Rule-Definition-Under-2002-Act.pdf.

¹¹Investment Adviser Public Disclosure website, at <https://adviserinfo.sec.gov>.

In most instances, an adviser places custody of client assets with a broker-dealer who maintains a “platform” for investment advisers. The broker-dealer provides custodial services, brokerage, and many back-office functions, including without limitation provision of account statements and other reports.

b. Damages

A reference to damages in case selection and review seems obvious, except with investment advisers the difficulty may arise because of the length of the relationship and the tendency for a damage review to be based on net out-of-pocket. With a longer relationship, unless extenuating circumstances exist, the net out-of-pocket may be minimal when measured over the life of the relationship, oftentimes being very lengthy. However, because of the fiduciary duty, greater leeway exists to push damage issues.

c. Recovery Potential

Many advisory firms are smaller, with minimal if any net capital requirements. Some states impose minimum net capital requirements. Under the Uniform Securities Act, a rule *may* require an investment adviser that has custody of or discretionary authority to obtain insurance or post a bond, but the amounts are comparatively minimal.¹²

Advisers registered with the Commission have no net capital requirements. The Commission only requires disclosure in Form ADV if the financial condition of the adviser would be material to the advisory relationship.¹³ This disclosure obligation goes beyond the enumerated list of financial matters that must be disclosed, such as bankruptcies within the last ten years.¹⁴

If an adviser maintains custody, additional financial disclosures exist, and may extend to audited financial statements and a surprise examination.¹⁵ Most advisers avoid custody.

Despite their size as “smaller,” firms who maintain sufficient assets should not be dismissed as uncollectible. For example, assuming a smaller firm maintains \$50 million under management, if that firm charges 1% of assets under management, the firm would gross \$500,000 annually. This gross is offset with minimal expenses, primarily salaries and rent. Many operational expenses are undertaken by the custodian broker-dealer within the provision of services under its platform, leaving a profitable ongoing enterprise and net worth with the principals, albeit possibly protected.

¹²See NASAA Minimum Financial Requirements for Investment Advisers Model Rule USA 2002 411(a)-1 Adopted 9/17/2008; Amended 9/11/2011, at <http://www.nasaa.org/wp-content/uploads/2011/07/IA-Model-Rule-Minimum-Financial-Requirements.pdf>.

¹³General Instructions for Part 2 of Form ADV, No. 3 Disclosure Obligations as a Fiduciary, p.1 at <https://www.sec.gov/about/forms/formadv-part2.pdf>.

¹⁴Form ADV, Part 1, Item 11 Disclosure Information. The Form ADV may be found at <https://www.sec.gov/about/forms/formadv.pdf>.

¹⁵Rule 206(4)-2 Custody of funds or securities of clients by investment advisers, *supra* note 2.

d. Insurance Considerations

Many firms maintain insurance, and some of the custodian, broker-dealer platforms require insurance as a precedent to allowing an adviser to use the platform and to custody its clients' assets. Also, with advisers acting as financial planners, they may place a higher value on insurance and will maintain insurance for claims. Some states require an adviser to disclose on its Form ADV if it maintains insurance.¹⁶

With insurance coverage, care should be exercised to avoid denial of coverage. Typical errors and omissions insurance excludes intentional acts, such as gross negligence and common law fraud.¹⁷ Although these claims may be included in the causes of actions claimed, drafting of facts involving intentional acts and gross conduct must carefully avoid the potential for denial of coverage. These issues become accentuated when statutes of limitations issues exist, with a need to claim an affirmative defense of fraudulent concealment to toll the statute.

e. Exculpatory Clauses

Simply put, exculpatory clauses are void.¹⁸ Any language that purports to create the impression that an individual has waived any rights is void as against public policy and further evidences a breach of fiduciary duty by the adviser.¹⁹

3. Prefiling Demands

A demand letter prior to filing may serve numerous purposes. It may attempt to determine if an arbitration agreement exists and to resolve a poorly drafted arbitration agreement that either fails to reference a forum or references a defunct forum. A prefiling demand may also garner information about insurance coverage, either from the type of law firm responding or upon hopeful inquiry of the law firm responding.

¹⁶For example, the Kansas Securities Commissioner requires advisers to disclose whether they maintain liability insurance under Item 19 of Part 2 of Form ADV. See *supra* note 12.

¹⁷Copies of form contracts of insurance are available through the state departments of insurance in the SERFF Filing website. SERFF (System for Electronic Rates and Forms Filing) is maintained by the National Association of Insurance Commissioners and made available through the state insurance departments. An insurance company is required to file all forms of insurance policies, and if the name of the insurance company is known, a form of the policy may be found. However, the system is difficult to navigate. See <http://www.serff.com/>.

¹⁸Investment Advisers Act, Section 215 Validity of Contracts, *supra* note 1; Uniform Securities Act, Section 215(l) Validity of Contracts; No contractual Waiver, *supra* note 4.

¹⁹The use of a hedge clause or other exculpatory provision in an investment advisory agreement which is likely to lead an investment advisory client to believe that he has waived non-waivable rights of action against the adviser provided by federal or state law violates Sections 206(1) and 206(2) as a device, scheme, or artifice to defraud, or a transaction, practice, or course of business that operates as fraud or deceit on clients or prospective clients. *In the Matter of William Lee Parks*, Release No. IA-736 (Oct. 27, 1980); *In the Matter of Olympian Financial Services, Inc.*, Release No. IA- 659 (Jan. 16, 1979).

4. Causes of Action

An investment adviser's duties arise under the Investment Advisers Act of 1940 and state blue sky laws. The Investment Advisers Act was created to regulate investment advisers' actions and to protect investors. It is a remedial statute and interpreted accordingly.

a. Liability

i. Investment Advisers Act

Generally, the only remedy available under the Investment Advisers Act of 1940 is under Section 215 of the Act, which states that contracts that violate the Act "shall be void . . . as regards to the rights of the person who has violated the Act."²⁰ The U.S. Supreme Court in *Transamerica Mortgage Advisers, Inc. v. Lewis*²¹ stated:

When Congress declared in Section 215 that certain contracts are void, it intended that the customary legal incidents of voidness would follow, including the availability of a suit for rescission or for an injunction against continued operation of the contract and for restitution."

Therefore, only under §215 does the limited private right of action to void a contract against a violator of the Investment Advisers Act exist.

The Court in *Transamerica Mortgage Advisers, Inc. v. Lewis* also determined the phrase in Section 206 of the Investment Advisers Act, which makes it unlawful for an investment adviser "to employ any device, scheme, or artifice to defraud . . . [or] engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client," does not establish a private cause of action upon violation of the phrase; the words are merely "designed to protect investment adviser's clients."²²

Due to the inadequacy of the federal statutory remedies under which an investor may bring a private cause of action against an investment adviser, most causes of action are brought under general common law rights of action or blue-sky laws. The most common suits are brought under the following theories under common law: breach of fiduciary duty, negligence, breach of contract and common law fraud.

ii. Statute Securities Statutes

Most state statutes impose liability on investment advisers and prohibit conduct that operates as "a device, scheme, or artifice to defraud another person; . . . an act, practice, or course of business that operates or would operate as a fraud or deceit upon another person, or conduct defined by a rule."²³

²⁰Investment Advisers Act of 1940, Section 215 Validity of Contracts, *supra* note 1.

²¹*Transamerica Mortgage Advisers, Inc. v. Lewis*, 444 U.S. 11, 18-19 (1979).

²²*Id.* 19-24. See also Investment Adviser Act, Section 206 Prohibited Transactions by Registered Investment Advisers, *supra* note 1.

²³Uniform Securities Act, Section 502 Prohibited Conduct in Providing Investments Act, pp. 124 – 145, *supra* note 4.

Rules adopted under the Uniform Securities Act are typically quite extensive in listing the conduct deemed to be prohibited. Generally, any malfeasant conduct will be covered by a rule if the state's securities administrator has adopted rules.²⁴

Short statutes of limitations with state securities statutes cause this remedy to be less useful. Individuals engaging an investment adviser do so because they desire to have someone else manage their money, and they trust that person implicitly. These individuals infrequently review account statements and believe the investment adviser when assurances are rendered as to poor performance of an account.

iii. Employee Retirement Income Security Act of 1974

Under the Employee Retirement and Income Security Act of 1974 (ERISA), investment advisers fall within the definition of a fiduciary and are held to the standards imposed on fiduciaries in accordance with ERISA.²⁵ A fiduciary must discharge its duties solely in the interests of the client with the "care, skill, prudence, and diligence then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims."²⁶

iv. Breach of Fiduciary Duty

A fiduciary relationship is defined in Black's Law Dictionary as one "in which one person is under a duty to act for the benefit of the other on matters within the scope of the relationship."²⁷ As a fiduciary, an investment adviser owes the client a fiduciary duty to act in the client's best interests and with the utmost care, integrity and loyalty, and the highest degree of care and loyalty.²⁸

A fiduciary relationship is also described as a relationship where there is a duty of trust, utmost loyalty and good faith to another. When a fiduciary relationship is deemed to be present, the law imposes an obligation to act in the best interest of the party to whom the duty is owed and to place that person's interests above the fiduciary's own interests.

An investment adviser owes the client a duty to manage the accounts according to the individual investment needs, objectives, goals and desires for the accounts. This duty requires an adviser to have a reasonable basis for its recommendations meeting the client's investment needs, objectives and desires.²⁹ The adviser has a further duty to disclose all material facts relevant to

²⁴E.g., NASAA Model Rule on Unethical Business Practices of Investment Advisers, Investment Adviser Representatives, and Federally Covered Advisers (NASAA Model Rule 102(a)(4)-1), at <http://www.nasaa.org/1325/adopted-model-rules/>.

²⁵29 USC §1002(21), at <https://www.law.cornell.edu/uscode/text/29/1002>. See also 29 CFR §2510.3-21.

²⁶29 USC §1104, at <https://www.law.cornell.edu/uscode/text/29/1104>.

²⁷Black's Law Dictionary p. 640 (7th ed. 1999).

²⁸Cf. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963); *Transamerica Mortgage Advisers, Inc. v. Lewis*, 444 U.S. 11 (1979); *Santa Fe Industries, Inc. v. Stone*, 430 U.S. 462, 471, n. 11 (1977). See also Investment Advisers Act of 1940, Section 206 Prohibited Transactions by Registered Investment Advisers, *supra* note 1.

²⁹*In the Matter of Jamison, Eaton & Wood, Inc.*, Investment Advisers Act Release No. 2129 (May 15, 2003);

its engagement.³⁰

The Investment Advisers Act of 1940 indicates that Congress recognized the nature of a fiduciary relationship and intended to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser to act in his own interests rather than those of the investor. The Commission promulgates a series of rules establishing standards of care to which an investment adviser must adhere, including disclosures, conflicts of interests, compliance programs, codes of ethics and designating chief compliance officers.³¹

v. Negligence

Actions may be brought based on negligence in providing advice. In doing so, reference may be made to a multitude of standards of care, including state statutes regarding unfair financial planning practices,³² senior financial exploitation statutes,³³ and state regulations defining prohibited conduct by investment advisers.³⁴

If an individual maintains a professional designation, the maintenance of that professional designation requires certain standards of care, as follows:

Designation	Standards
Chartered Financial Analyst (CFA®)	Code of Ethics and Standards of Professional Conduct ³⁵
Certified Financial Planner (CFP®)	Certified Financial Plan Board of Standards of Professional Conduct ³⁶

In the Matter of Mark Bailey & Co., and Mark Bailey, Investment Advisers Act Release No. 1105 (Feb. 24, 1988); *In the Matter of Kidder, Peabody & Co., Incorporated, Edward B. Goodnow*, Investment Advisers Act Release No. 232 (Oct. 16, 1968).

³⁰*Id.*

³¹*E.g.*, Rule 204A-1 Investment adviser code of ethics; Rule 206(4)-7 Compliance procedures and practices, *supra* note 2.

³²*E.g.*, Revised Missouri Statutes §375.936(12). Unfair practices defined, unfair financial planning practices, at <http://revisor.mo.gov/main/OneSection.aspx?section=375.936&bid=20427&hl=>.

³³NASAA Model Legislation or Regulation to Protection Vulnerable Adults from Financial Exploitation, at <http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/07/NASAA-Model-Seniors-Act-adopted-Jan-22-2016.pdf>.

³⁴NASAA Model Rule on Unethical Business Practices of Investment Advisers, Investment Adviser Representatives, and Federally Covered Advisers (NASAA Model Rule 102(a)(4)-1), at <http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/07/NASAA-Model-Seniors-Act-adopted-Jan-22-2016.pdf>.

³⁵<https://www.cfapubs.org/toc/ccb/2014/2014/6>.

³⁶<https://www.cfp.net/about-cfp-board/ethics-enforcement/standards-of-professional-conduct>

Certified Public Accountant (CPA®)	AICPA Code of Professional Conduct ³⁷

These standards of care present exhaustive requirements. In addition to providing required standards of care as the basis for a negligence claim, the organizations granting these professional designations pursue disciplinary actions against individuals violating the standards. Given the difficulty in obtaining these designations, most individuals prefer to avoid the potential for a disciplinary action that may impede the use of these designations.

Unsuitable investment advice is indicia of breach of fiduciary duty, negligence and goes toward the element of causation. The Commission promulgated a suitability rule which was never adopted.³⁸ Instead, it pursues suitability claims under the general anti-fraud provisions of the Investment Advisers Act.³⁹ The only suitability rule is the one for broker-dealers.¹³ Although investment advisers are not regulated by FINRA, FINRA's rule on suitability may be referenced as a minimum standard of conduct to make suitable recommendations.⁴⁰

vi. Breach of Contract

Many investment management contracts contain language that the investment adviser will provide investment supervisory services. "Investment supervisory services' means the giving of continuous advice as to the investment of funds on the basis of the individual needs of each client."⁴¹ When a client experiences losses, in all likelihood, the adviser failed to provide the investment supervisory services promised. Additionally, investors may bring breach of contract actions if the investment adviser does not follow the clients' instructions or if the investment adviser breaches the implied covenant of good faith and fair dealing.

vii. Common Law Fraud

Common law fraud, including misrepresentations and omissions, are common causes of action brought against investment advisers. The requisite elements in common include: false representation of a material fact, knowledge of the falsity, purpose of the falsity to induce the

³⁷<https://www.aicpa.org/research/standards/codeofconduct.html>.

³⁸Proposed Rule, Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406 (March 16, 1994), *cited by* Commissioner Louis A. Aguilar, Speech by SEC Commissioner: A Shared Responsibility: Preserving the Fiduciary Standard, note 6 (March 26, 2010), ("Investment advisers are fiduciaries who owe their clients a series of duties, one of which is the duty to provide only suitable investment advice. This duty is enforceable under the antifraud provisions of the Advisers Act, section 206, and the Commission has sanctioned advisers for violating this duty."), at <https://www.sec.gov/news/speech/2010/spch032610laa.htm>.

³⁹*Id.* See Investment Advisers Act, Section 206 Prohibited Transactions by Registered Investment Advisers, *supra* note 1.

⁴⁰FINRA Rule 2111. Suitability, at http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=15663&element_id=9859&highlight=suitable#r15663.

⁴¹Investment Advisers Act Section 202(a)(13) Definitions, *supra* note 1.

investor to act, the investor relies on the falsity and believes it to be true, and the investor acts on the falsity to his or her detriment.⁴² The conduct must be intentional by the adviser.⁴³

b. Statutory Damages

Statutory provisions provide for damages beyond a net out-of-pocket measure. These statutory provisions are contained in the state securities statutes and ERISA.

Section 509(f) of the Uniform Securities Act⁴⁴ provides for damages equal to the following:

Consideration paid for the advice and the amount of any actual damages caused by the fraudulent conduct, interest [at the legal rate of interest] from the date of the fraudulent conduct, costs, and reasonable attorneys' fees determined by the court, less the amount of any income received as a result of the fraudulent conduct., interest at the legal rate, costs and reasonable attorneys' fees determined by the court, less the amount of any income received as a result of the fraudulent conduct.

The statutory remedies under ERISA⁴⁵ provide damages measured as follows:

- Losses incurred;
- Restoring profits made by the adviser;
- Reasonable attorneys' fees and costs; and
- Such other appropriate equitable relief to redress such violations or to enforce ERISA.

The Employee Benefits Security Administration, under the Department of Labor, has extensive materials on what is considerations to be violations of ERISA, including example violations. A multitude of articles exist on statutory remedies under ERISA.

5. Statute of Limitations

Because of the relationship of trust and confidence, however misplaced, statutes of limitations present themselves with possibly more frequency than a claim against a broker-dealer. If an individual engages an investment adviser to manage his assets on a discretionary basis, from the beginning, the engagement implies a high degree of faith and trust, as well as the lack of time to allot for investment management oversight. Consequently, claimants seem to realize their losses much later, or to act much later because they believe whatever the adviser tells them about the losses being experienced.

a. State Securities Statutes

Claims under state securities statutes are barred "unless the action is instituted within the earlier of two years after discovery of the facts constituting the violation and five years after the

⁴²*Golden Atlanta Site Dev. v. Nahai*, 683 S.E.2d 166, 171 (Ga. App.2009).

⁴³See Restatement (Second) of Torts § 531.

⁴⁴*Supra* note 4, pp 134-135.

⁴⁵29 U.S.C. § 1132, at <https://www.law.cornell.edu/uscode/text/29/1109>.

violation.”⁴⁶ Seemingly this longer statute of limitations recognizes the unique nature of the advisory relationship. The typical antifraud statutory limitation of one-year, three-year limitation does not govern. Notwithstanding, governing state law must be reviewed to determine the actual statute of limitations under that state’s statute. State statutes may vary substantially.

b. ERISA

ERISA bars an action with respect to a fiduciary’s breach of any responsibility, duty, or obligation, after the earlier of

(1) six years after (A) the date of the last action which constitute a part of the breach or violation, or (B) in the case of an omission the latest date on which the fiduciary could have cured the breach or violation, or

(2) three years after the earliest date on which the plaintiff had actual knowledge of the breach or violation;

except that in the case of fraud or concealment, such action may be commenced not later than six years after the discovery of such breach or violation.⁴⁷

c. Common Law Claims

Each state will have its own statute of limitations for common law claims of breach of fiduciary duty, negligence, breach of contract, fraud and similar claims. With these common law claims, tolling provisions may allow an extension of the statute of limitations, such as the continuing tort doctrine, fraudulent concealment and equitable tolling.

The “continuing tort doctrine” acts as a tolling provision. A continuing tort is one inflicted over a period of time. It involves wrongful conduct that is repeated until desisted.⁴⁸

The doctrine of fraudulent concealment tolls or suspends the running of limitations after it has begun if the facts necessary to know that a cause of action has accrued is concealed. It tolls the statute until the fraud is discovered or could have been discovered with reasonable diligence.⁴⁹ Courts characterize fraudulent concealment as an affirmative defense and require it be pled accordingly.⁵⁰

Some courts distinguish fraudulent concealment from the discovery rule, which may be applied categorically to instances in which the nature of the injury incurred is inherently undiscoverable

⁴⁶Uniform Securities Act, Section 509(j), Civil Liability, Statutes of Limitations, *supra* note 4.

⁴⁷29 USC §1113 – Limitations of actions, at <https://www.law.cornell.edu/uscode/text/29/1113>.

⁴⁸*Dickson Const., Inc. v. Fidelity and Deposit Co. of Md.*, 960 S.W.2d 845, 851 (Tex. App-Texarkana 1997).

⁴⁹*Shell Oil Co. v. Ross* 357 S.W.3d 8, 17 (Tex. App. 2010); *Sauceda v. Kerlin* 164 S.W.3d 892, 917 (Tex. 2005). *See also*, *DeLuna v. Burciaga*, 857 N.E. 2d 229, 242-43 (Ill. 2006).

⁵⁰*Arnold V KPMG LLP*, 543 F Supp. 230, 237 (S.D.N.Y. 2008); *Achee v. Port Drum Co.*, 197 F. Supp. 723, 737 (E.D. Tex. 2002).

and the evidence of an injury is objectively verifiable.⁵¹ An injury is not inherently undiscoverable when it is the type of injury that could be discovered through the exercise of reasonable diligence.⁵²

Additionally, the fiduciary relationship tilts application of the discovery rule, as an injury being inherently undiscoverable because of the relationship.⁵³ The courts will apply the discovery rule when it is otherwise difficult for the injured party to learn of the wrongful acts.⁵⁴

Some courts apply an equitable tolling doctrine, which focusses on excusable ignorance of the wrongful conduct.⁵⁵ In limited instances, this equitable tolling may even toll statutes of repose.⁵⁶

These concepts of fraudulent concealment, the discovery doctrine and equitable tolling depend highly on the jurisdiction and the court's inclination. The cases cited are for reference only. Further research on current law in any particular jurisdiction must be conducted and within the facts presents.

6. Forum Considerations

Forum considerations first depend on any contractual language to arbitrate. If an agreement to arbitrate exists, courts will in all likelihood enforce such an agreement.⁵⁷ Of course if no agreement exists, the parties may proceed and file in local courts. In some instances, however, a party may prefer to arbitrate a matter. A successful businessperson may prefer the privacy of arbitration. The dynamics of a local forum may provide minimal sympathy for a someone losing substantial sums while still having a considered fortune left. And in general, there may be issues that arise when state courts and judges are generally unfamiliar with securities laws.

⁵¹ *Computer Assoc. Int'l, Inc. v. Altai, Inc.*, 918 S.W.2d 453, 455-56 (Tex. 1996).

⁵² *Wagner & Brown, Ltd. v. Horwood*, 58 S.W.3d 732, 734-35 (Tex.2001); *Hays v. Hall*, 488 S.W.2d 412, 414 (Tex.1972) (negligence in performing vasectomy confirmed by subsequent pregnancy; held discovery rule applies).

⁵³ *West v. Proctor*, 353 S.W.3d 558 (Tex. App, 2011); *Hagney v. Lopeman*, 590 N.E.2d 466, 469 (Ill. 1992); *Vogel v. A. G. Edwards & Sons, Inc.*, 801 S.W. 2d 746, 755 (Mo. App. E.D. 1990), citing *Burr v. Nat'l Life & Acc. Ins. Co.*, 667 S.W.2d 5, 7 (Mo. App.1984) (relationship creates a sense of security which may be false, only actual discovery of the fraud serves to begin the period). See also *Cohen v. S.A.C. Trading Corp.*, 711 F.3d 353, 363 (2nd Cir. 2013) (reasonable diligence in discovery).

⁵⁴ *S.V. v. R.V.*, 933 S.W.2d 1, 6 (Tex. 1996).

⁵⁵ Cf., *Rhodes v. Guiberson Oil Tools Div.*, 927 F.2d 876, 878 (C.A.5 (La) 1991), citing *Felty v. Graves-Humphreys, Co.*, 785 F.2d 516, 519 (4th Cir.1986).

⁵⁶ *First Interstate Bank of Denver, N.A. v. Central Bank & Trust Co. of Denver*, 937 P.2d 855, 860 (Colo. App., 1996); *Cange v. Stotler and Co., Inc.*, 826 F.2d 581, 587 (C.A. 7 (Ill.) 1991), citing *Glus v. Brooklyn Eastern Dist. Terminal*, 359 U.S. 231, 232-233 (1959) (not permit a party to asset a defense if the defense would enable the party to take advantage of his own wrongdoing).

⁵⁷ *Gilmore v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 26 (1991); *Rodriquez de Quijas v. Shearson/American Express, Inc.* 490 U.S. 477 (1989).

If investment adviser is also a registered broker-dealer and member of FINRA, or another self-regulatory organization, FINRA rules allow a customer to request arbitration under the Code of Arbitration Procedures if the dispute arises in connection with the business activities of the member.⁵⁸ FINRA also allows disputes between investors and non-member registered investment advisers under certain conditions.⁵⁹ The consideration then shifts to the advantages, if any, of arbitration administered by FINRA over proceeding in court or another arbitration forum.

a. Arbitration

If the agreement to arbitrate fails to designate a forum or designates a defunct forum, the parties may proceed in private arbitration, such as JAMS or the American Arbitration Association (AAA). A private arbitration contains advantages of being able to select a qualified and knowledgeable arbitrator. However, some arbitrators may prefer the structure and assistance offered by JAMS or AAA. The costs of JAMS and AAA present a strong consideration to pursue a private arbitration.

With a private arbitration, the parties agree upon an arbitration and that the arbitrator determines the rules of arbitration, with reference to rules promulgated by FINRA, JAMS or AAA. Care needs to be taken in referencing any forum's rules because of the potential for dispositive motions, limited discovery, depositions, and other similar matters that denigrate the advantages of arbitration. One forum may favor dispositive motions, while another forum does not.

For example, JAMS arbitration rules allow at least one deposition and the arbitrator may determine the necessity of additional depositions.⁶⁰ Both JAMS and AAA allow dispositive motions, but AAA requires a showing of "substantial cause that the motion is likely to succeed and dispose of or narrow the issues in the case."⁶¹

b. Court

Proceeding in court will be an individual determination depending on the claims, the issues in controversy and similar matters. It is a debate unique to any individual case, the facts, and preferences of the parties and their counsel. Further considerations of federal and state court forum choices exist, depending on the parties and claims.

⁵⁸FINRA Code of Arbitration Procedure for Customer Disputes, Rule 12200 Arbitration Under an Arbitration Agreement or the Rules of FINRA, at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4105.

⁵⁹FINRA, Guidance on Disputes between Investors and Investment Advisers that are Not FINRA Members, at https://www.finra.org/arbitration-and-mediation/investment_advisers.

⁶⁰JAMS Comprehensive Arbitration Rules & Procedures, Rule 17(b) Exchange of Information (July 1, 2014), at <https://www.jamsadr.com/rules-comprehensive-arbitration/>.

⁶¹American Arbitration Association, Consumer Arbitration Rules (February 21, 2018), R-33 Dispositive Motions, at https://www.adr.org/sites/default/files/Consumer_Rules_Web.pdf.

7. Discovery Tools

The Commission and state securities administrators require investment advisers to maintain certain books and records.⁶² The books and records rules are substantially similar and may form the bases for a discovery request.

Form ADV's are maintained for the current year on the Investment Adviser Public Disclosure website. Prior years Form ADV's must be maintained by investment advisers, and if an adviser claims exculpatory disclosures in a prior year's Form ADV, the adviser must maintain that copy and produce it.

Adviser's websites provide a valuable resource, albeit limited, as well as general internet searches. Many financial planners advertise extensively, and oftentimes, their television advertisements or radio talk shows are captured on YouTube or a similar media. When investment advisers are seeking new clients, the representations they make if committed to writing in some format prove incredulous.

8. Conclusion

The number of registered investment advisers continues to increase, from 10,511 in 2012 to 12,172 in 2017.⁶³ In 2020, the number of registered investment advisors reached 13,494. In comparison, FINRA reports a decrease in registered representatives from 643,322 in 2015 to 635,902 in 2016, a net decrease of about 1.2%.⁶⁴ This year, the number of registered representatives continued to decrease and reached 617,549.

The cases against investment advisers provide a distinct advantage of having a claim for fiduciary duty, without question. That same fiduciary duty may cause statute of limitations problems, in clients relying too much on their trusted adviser.

⁶²Rule 204-2 Books and records to be maintained by investment advisers, *supra* note 2; NASAA Recordkeeping Requirements for Investment Advisers Model Rule 203(a)-2, amended 9/11/2011, at <http://www.nasaa.org/wp-content/uploads/2011/07/IA-Model-Rule-Recordkeeping.pdf>.

⁶³Number of Registered Investment Advisers (RIAs)* employed in the United States from 2012 to 2017, The Statistics Portal, Statista 2018, at <https://www.statista.com/statistics/614815/number-of-rias-employed-usa/>.

⁶⁴FINRA, Registered Representatives Statistical Review 2002 – 2016, at <https://www.finra.org/newsroom/statistics#repsform>.

LEGAL ETHICS HOUR

LAW OFFICE SUCCESSION PLANNING: WHERE DO WE GO FROM HERE

“He who fails to plan is planning to fail”

Winston Churchill

Introduction

The ABA and State bars recognize the ethical importance of succession planning.

Many lawyers do not want to think about the day they will stop practicing law or temporarily stop practicing law. You may consider your law practice as your legacy. Will it continue after your retirement, disability, disappearance or death or will it end? That depends on you. Many do not think about their own mortality or death. Succession planning is not only for retirement or the unexpected, it is a valuable plan if a firm is in danger of insolvency or dissolution. Many firms do not anticipate the possibility of dissolution. It is also useful if a lawyer is moving to an in-house counsel situation or even a judgeship.

There is no minimum age to begin succession planning or planning for unforeseen life events. In today's world, with COVID-19, its variants and other potential viruses yet to come, there are more and more unforeseen events. Are you ready for them? Succession planning will look different depending if you are a sole practitioner, work in a small mid-size or large firm.

Succession planning is essential to every lawyer's practice, proactively protecting clients and colleagues in the event of the lawyer's disability whether short term or long term, retirement or death. We have to be ready for the unexpected though it not always on the top of our minds. There are hundreds of books and handbooks on succession planning in every type of business including farms, government entities and universities because of the disruption without one.

As lawyers, we guide clients and ourselves to have financial assets planning, disaster planning, health insurance, life insurance, disability insurance, estate planning documents in order. We try to plan for unanticipated life events and the what if scenarios to insure we are prepared. Our employees and our own families rely on us for their own financial well-being and to put food on their tables. Without a

succession plan, it puts everyone in financial danger. Your family will have to deal with these issues without the benefit of your proper input.

For the firm in which the attorney or partner is forced out by mandatory retirement age that attorney or partner has now a loss of purpose, loss of income and loss of comradery. The retiring lawyer or partner has built the client relationships, built a book of business, has an office to go to every day. That will now come to a crashing stop.

That lawyer or partner maybe is being forced out due to the onset of dementia or dementia in full gear. That brings an array of other issues – the duty to protect the clients and the firm. Review of past legal work to make sure that that lawyer was properly preparing the work due to the dementia. Intelligent people are able to hide dementia with their social graces.

Your Next Stage of Life

Have you thought about your next stage of life if retirement is your next step? If you don't have a plan to fill your time in act two of your life, it will be more difficult considering a succession plan. Take out a notebook. Write down what your ideal day, month and year will look like. What are your hobbies? What do you like doing? Who are your friends? What family do you want to be with? What makes you happy? Where do you want to live when you retire? Do you have the funds for this? If not, what alternatives do you have?

Your What-If Scenarios

Once you have figured out what your retirement or addressed the “what-if” scenarios look like, consider the following: Have you considered your exit strategy? If you are temporarily out of the office due to illness, do you have a plan in place for someone to keep your office operating? You will have some of the same type issue as you do for death but more so because you want to return to a viable business. What is your timeline to retirement? Who will finish your cases? Who has your passwords to get into your accounts? Who has passwords to get into your computer and software programs? Who has the password to get into your Smart Phone or Pad? Does each of your files have your due dates on it and what has been done to complete the files? Does your engagement letters have a back-up person named on it? Will you hire and train a successor to take over the firm's management? Do you want to

spend part of your retirement training your replacement? Do you have a broker to sell your business to an outsider? Do they understand the law business? Will you sell your book of business to a competing firm? Are your file records up to date for each file and the value of each file? Have you considered a phased retirement? Do you have an inventory of cases? Is there money available to pay your non legal staff to assist with the files? Do you have Account Receivables? Do you have a client base of returning clients? Do you have client referrals that you can calculate? Is your good will too personal to sell? If not, you are likely to receive little money as the future value is speculative? Is your client relationships and trust of your clients transferable to a replacement as retirement news may cause your clients to work with a new lawyer?

Suggestions for Your To Do Succession Planning List for the Solo Practitioner and Very Small Law Firm

As highlighted in the list below, recommended items for an effective succession plan for solo practitioners and small law firms completed in conformity with applicable Bar Association rules include, but are not limited to:

*Choose an assisting attorney and have that contact information updated and available to next of kin and chief office staff. That lawyer will assist in taking over the IOLTA account, locate the lawyers to take over client files, wind up the assets and liabilities of the firm. You should have a successor assisting attorney in case your first choice is not available when the time come or there is a conflict of interest with a client file. You should have detailed information as to how the assisting attorney will be compensated. This ensures that clients will have continuity, promptly receive their files promptly receive back their Escrow fund monies in the event the lawyer is unable to continue as the client's counsel, such as if they have died, disappeared, become disabled, or been disbarred. Without such lawyer, a client would have to wait until a judge is assigned and a conservator appointed to handle the client files. If you fail to make these arrangements, fee incurred by the designated conservator may be billed to your estate.

* Instructions for family and personal representative of your estate about the responsibilities of the assisting attorney. If a plan has not been put in place, and a conservatorship is required, often the courts will look to the State Bar who will locate a conservator. The conservator will inventory the lawyer's files and contact each of the client's in an attempt to return the files. This process delays the continuity of the client's legal matters.

*Add this assisting attorney or another as an additional authorized signer to your IOLTA account who does not need to be the assisting attorney in the event you are unable to provide consent for access.

*Copy of bank's forms for trust account access for the assisting attorney.

*Power of Attorney authorizing the assisting attorney to run the business as needed, including as trust account signatory.

*Written instructions concerning how and where client information is stored, including bank and other account details (e.g., operating and trust account information).

*Chose an assuming lawyer. These lawyers will take over your cases. Chose lawyers in similar law practice areas so that the clients will have competent representation. This will be the list that the assisting attorney can look to in distributing files.

*Create an active file list and keep it up to date. This list should contain the name of the client, contact information, case number, opposing counsel information, judge assigned to case with court contact information, status of case including what has been done and is left to be done, upcoming hearings, trial dates, statute of limitations and other deadlines. This should be updated weekly.

*Information concerning disposition of closed client files, Information regarding payment of current liabilities.

*Create a case file index showing past and current files and when the files are located if they are in paper format and for closed files, when they need to be destroyed.

*Chart the office. Create a file which contains online bank passwords, computer passwords, email passwords, smart phone and tablet passwords, voicemail passwords, contact information of staff, tech support contact information, software programs where information is located, insurance information, contracts, equipment, software and other leases, vendor records, bank account locations and numbers, and important that is specific to your law practice.

*Always keep files up to date including contact information, correspondence and pleadings and work towards finalizing/closing files timely. Establish a back-up plan of having someone transition files in the event of a sudden disability or illness.

*Notify clients about your plan and obtain consenting signatures to authorize access by your successor counsel. This may be done within the fee agreement or in a standalone document.

*If a file cannot be transitioned to a new lawyer who can take it over, the client with an active file must be contacted to advise of the unavailability of representation and the need to retain new counsel. Advise the client of any deadlines.

*For cases with court or hearing dates, deposition deadlines, discovery deadlines, motion deadlines, obtain extensions, continuances and reset court/hearing dates.

*Obtain the client's permission to submit a motion to withdraw as counsel. If the client has obtained new counsel, then make sure a substitution of counsel is filed.

*Calendar a date that you will check to confirm that the motions for substitute counsel or withdrawal has been approved.

*Retain the original file. Original documents should be returned to the client. Make a copy of the file for the client to pick up. Have them sign a receipt of file.

*Clients should be told where their closed files will be stored (that have not yet been destroyed) and where they can pick them up. If a closed file will be stored by a different lawyer, get the client's permission to allow the attorney to store the file. If the client does not respond, note it to the file.

*If you have a website, inform viewers that your office has closed with the date it was closed and provide the new contact information. Ask your phone provider to list the new phone number of the assisting lawyer or have that number forwarded to the assisting lawyer. Same with fax number.

*Consider grooming a new associate to take over in a few years who you will be able to impart your legal skills and who will understand your practice areas and clients.

*Consider bringing in a new experience partner who you could immediately entrust your practice to. It will allow you to slow down in a manageable way.

*Consider merging with a similarly sized law firm even if the plan is not implemented for a number of years.

*Bring your book of business to a larger law firm as an of counsel. They can assist you in transitioning your clients to that firm knowing that you are dealing with a group of lawyers that can take care of your clients' needs.

*If you have younger lawyers working for you, they may need more seasoned lawyers to assist them to finish up the work or take over client cases.

* As part of a succession plan, has a buy out or key person insurance been put in place so that the dying partner's share can be bought out.

Succession Planning for the Small and Smaller Midsize Firm.

The small or smaller midsize firm has similar but also some different succession planning issues than the solo practitioner. If the firm does have a mandatory cut off age, it may be losing talent that cannot easily be replaced. Not all 65 or 70 years olds are made equally.

If there is no cut off age, who is about to tell the rainmakers in the corner offices that it is time to retire. And the attorney that should be retiring that is not may cause the firm to not bring in the new associate or lateral partner or expand the law practice because that rainmaker is still bringing in enough revenue to not disrupt a good thing. This will eventually cause a disruption in the law practice if that partner must quickly depart due to age or health or death and there has to be a last minute suitable replacement rather than a smooth transition.

More than just the partners are affected by a retiring partner. Plans need be made from the perspective of the firm, the partner, and the clients which has a different set of concerns. While there is much overlap, the clients want to know they will continue to receive great service and that they are seen as not just a commodity that can be shifted around within a firm. The solo or very small law firm general has clients that know the other partners but with a small or midsize firm, that is not necessarily the case. The retiring partner may have had a long term connection with the clients and wants to make sure they will continue to have good relations with the partner they are being transferred to. It is important to get the clients involved early in the transition process so they do not feel left out and put at a surprise. Depending upon the type and size of the client and the nature of its business, the transition could take months or years. A transition period will facilitate a smoother transition.

As part of succession planning, leadership of the firm needs to be addressed. Are the leaders all aging out? Has there been a path to leadership positions for the next generation of lawyers? A firm that wants a next generation of leaders has to have those a path for them to be groomed for those leadership positions. They should be rewarded with lucrative work to keep them there. Increased lateral moves can make that not as feasible. Firms want business and they will buy that business with lateral moves who have a book of business rather than building talent from within. The partner that has been groomed for the last five years to eventually take over as chair of litigation may decide to jump ship for a better offer leaving the grooming firm without that potential successor.

Selling Your Law Practice

The ABA Model Rules of Professional Conduct allow for the sale of a law practice. The valuation of a law practice relies heavily on the personal goodwill the selling attorney has maintained with their clients. As well whether the practice is the type that has clients returning for future services as opposed to a one time need. Also if there are account receivables. A sale in which the attorney simply walks away does not necessarily have a good outcome. And that will be calculated into the price of a buyout. Capital for a buyout may be hard to come by. An earn-out of some type may be a more practical solution.

The lawyer buying your law practice is looking for like any business purchase a return on investment. They are also seeking to avoid a start-up business as well having to develop a client base. They are buying your law practice for a return on investment and to avoid a difficult start-up of a business or developing relationships themselves. They will need a minimum income stream, referral sources, marketing materials, and your availability as a consultant. The purchaser will generally need you to serve as a consultant or stay in the business for a certain amount of time. They will need your marketing materials, referral sources an introductions to your clients.

ABA Model Rules of Professional Conduct:

Rule 1.3: Diligence---Client-Lawyer Relationship:

A lawyer shall act with reasonable diligence and promptness in representing a client.

Comment:

[1] A lawyer should pursue a matter on behalf of a client despite opposition, obstruction or personal inconvenience to the lawyer, and take whatever lawful and ethical measures are required to vindicate a client's cause or endeavor. A lawyer must also act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf. A lawyer is not bound, however, to press for every advantage that might be realized for a client. For example, a lawyer may have authority to exercise professional discretion in determining the means by which a matter should be pursued. See Rule 1.2. The lawyer's duty to act with reasonable diligence does not require the use of offensive tactics or preclude the treating of all persons involved in the legal process with courtesy and respect.

[2] A lawyer's work load must be controlled so that each matter can be handled competently.

[3] Perhaps no professional shortcoming is more widely resented than procrastination. A client's interests often can be adversely affected by the passage of time or the change of conditions; in extreme instances, as when a lawyer overlooks a statute of limitations, the client's legal position may be destroyed. Even when the client's interests are not affected in substance, however, unreasonable delay can cause a client needless anxiety and undermine confidence in the lawyer's trustworthiness. A lawyer's duty to act with reasonable promptness, however, does not preclude the lawyer from agreeing to a reasonable request for a postponement that will not prejudice the lawyer's client.

[4] Unless the relationship is terminated as provided in Rule 1.16, a lawyer should carry through to conclusion all matters undertaken for a client. If a lawyer's employment is limited to a specific matter, the relationship terminates when the matter has been resolved. If a lawyer has served a client over a substantial period in a variety of matters, the client sometimes may assume that the lawyer will continue to serve on a continuing basis unless the lawyer gives notice of withdrawal. Doubt about whether a client-lawyer relationship still exists should be clarified by the lawyer, preferably in writing, so that the client will not mistakenly suppose the

lawyer is looking after the client's affairs when the lawyer has ceased to do so. For example, if a lawyer has handled a judicial or administrative proceeding that produced a result adverse to the client and the lawyer and the client have not agreed that the lawyer will handle the matter on appeal, the lawyer must consult with the client about the possibility of appeal before relinquishing responsibility for the matter. See Rule 1.4(a)(2). Whether the lawyer is obligated to prosecute the appeal for the client depends on the scope of the representation the lawyer has agreed to provide to the client. See Rule 1.2.

[5] To prevent neglect of client matters in the event of a sole practitioner's death or disability, the duty of diligence may require that each sole practitioner prepare a plan, in conformity with applicable rules, that designates another competent lawyer to review client files, notify each client of the lawyer's death or disability, and determine whether there is a need for immediate protective action. Cf. Rule 28 of the American Bar Association Model Rules for Lawyer Disciplinary Enforcement (providing for court appointment of a lawyer to inventory files and take other protective action in absence of a plan providing for another lawyer to protect the interests of the clients of a deceased or disabled lawyer).

Rule 1.17: Sale of Law Practice---Client-Lawyer Relationship:

A lawyer or a law firm may sell or purchase a law practice, or an area of law practice, including good will, if the following conditions are satisfied:

(a) The seller ceases to engage in the private practice of law, or in the area of practice that has been sold, [in the geographic area] [in the jurisdiction] (a jurisdiction may elect either version) in which the practice has been conducted;

(b) The entire practice, or the entire area of practice, is sold to one or more lawyers or law firms;

(c) The seller gives written notice to each of the seller's clients regarding:

(1) the proposed sale;

(2) the client's right to retain other counsel or to take possession of the file; and

(3) the fact that the client's consent to the transfer of the client's files will be presumed if the client does not take any action or does not otherwise

object within ninety (90) days of receipt of the notice. If a client cannot be given notice, the representation of that client may be transferred to the purchaser only upon entry of an order so authorizing by a court having jurisdiction. The seller may disclose to the court in camera information relating to the representation only to the extent necessary to obtain an order authorizing the transfer of a file.

(d) The fees charged clients shall not be increased by reason of the sale.

Comment:

[1] The practice of law is a profession, not merely a business. Clients are not commodities that can be purchased and sold at will. Pursuant to this Rule, when a lawyer or an entire firm ceases to practice, or ceases to practice in an area of law, and other lawyers or firms take over the representation, the selling lawyer or firm may obtain compensation for the reasonable value of the practice as may withdrawing partners of law firms. See Rules 5.4 and 5.6.

Termination of Practice by the Seller

[2] The requirement that all of the private practice, or all of an area of practice, be sold is satisfied if the seller in good faith makes the entire practice, or the area of practice, available for sale to the purchasers. The fact that a number of the seller's clients decide not to be represented by the purchasers but take their matters elsewhere, therefore, does not result in a violation. Return to private practice as a result of an unanticipated change in circumstances does not necessarily result in a violation. For example, a lawyer who has sold the practice to accept an appointment to judicial office does not violate the requirement that the sale be attendant to cessation of practice if the lawyer later resumes private practice upon being defeated in a contested or a retention election for the office or resigns from a judiciary position.

[3] The requirement that the seller cease to engage in the private practice of law does not prohibit employment as a lawyer on the staff of a public agency or a legal services entity that provides legal services to the poor, or as in-house counsel to a business.

[4] The Rule permits a sale of an entire practice attendant upon retirement from the private practice of law within the jurisdiction. Its provisions, therefore, accommodate the lawyer who sells the practice on the occasion of moving to another state. Some states are so large that a move from one locale therein to another is tantamount to leaving the jurisdiction in which the lawyer has engaged in the

practice of law. To also accommodate lawyers so situated, states may permit the sale of the practice when the lawyer leaves the geographical area rather than the jurisdiction. The alternative desired should be indicated by selecting one of the two provided for in Rule 1.17(a).

[5] This Rule also permits a lawyer or law firm to sell an area of practice. If an area of practice is sold and the lawyer remains in the active practice of law, the lawyer must cease accepting any matters in the area of practice that has been sold, either as counsel or co-counsel or by assuming joint responsibility for a matter in connection with the division of a fee with another lawyer as would otherwise be permitted by Rule 1.5(e). For example, a lawyer with a substantial number of estate planning matters and a substantial number of probate administration cases may sell the estate planning portion of the practice but remain in the practice of law by concentrating on probate administration; however, that practitioner may not thereafter accept any estate planning matters. Although a lawyer who leaves a jurisdiction or geographical area typically would sell the entire practice, this Rule permits the lawyer to limit the sale to one or more areas of the practice, thereby preserving the lawyer's right to continue practice in the areas of the practice that were not sold.

Sale of Entire Practice or Entire Area of Practice

[6] The Rule requires that the seller's entire practice, or an entire area of practice, be sold. The prohibition against sale of less than an entire practice area protects those clients whose matters are less lucrative and who might find it difficult to secure other counsel if a sale could be limited to substantial fee-generating matters. The purchasers are required to undertake all client matters in the practice or practice area, subject to client consent. This requirement is satisfied, however, even if a purchaser is unable to undertake a particular client matter because of a conflict of interest.

Client Confidences, Consent and Notice

[7] Negotiations between seller and prospective purchaser prior to disclosure of information relating to a specific representation of an identifiable client no more violate the confidentiality provisions of Model Rule 1.6 than do preliminary discussions concerning the possible association of another lawyer or mergers between firms, with respect to which client consent is not required. See Rule 1.6(b)(7). Providing the purchaser access to detailed information relating to the representation, such as the client's file, however, requires client consent. The Rule

provides that before such information can be disclosed by the seller to the purchaser the client must be given actual written notice of the contemplated sale, including the identity of the purchaser, and must be told that the decision to consent or make other arrangements must be made within 90 days. If nothing is heard from the client within that time, consent to the sale is presumed.

[8] A lawyer or law firm ceasing to practice cannot be required to remain in practice because some clients cannot be given actual notice of the proposed purchase. Since these clients cannot themselves consent to the purchase or direct any other disposition of their files, the Rule requires an order from a court having jurisdiction authorizing their transfer or other disposition. The court can be expected to determine whether reasonable efforts to locate the client have been exhausted, and whether the absent client's legitimate interests will be served by authorizing the transfer of the file so that the purchaser may continue the representation. Preservation of client confidences requires that the petition for a court order be considered in camera. (A procedure by which such an order can be obtained needs to be established in jurisdictions in which it presently does not exist).

[9] All elements of client autonomy, including the client's absolute right to discharge a lawyer and transfer the representation to another, survive the sale of the practice or area of practice.

Fee Arrangements Between Client and Purchaser

[10] The sale may not be financed by increases in fees charged the clients of the practice. Existing arrangements between the seller and the client as to fees and the scope of the work must be honored by the purchaser.

Other Applicable Ethical Standards

[11] Lawyers participating in the sale of a law practice or a practice area are subject to the ethical standards applicable to involving another lawyer in the representation of a client. These include, for example, the seller's obligation to exercise competence in identifying a purchaser qualified to assume the practice and the purchaser's obligation to undertake the representation competently (see Rule 1.1); the obligation to avoid disqualifying conflicts, and to secure the client's informed consent for those conflicts that can be agreed to (see Rule 1.7 regarding conflicts and Rule 1.0(e) for the definition of informed consent); and the obligation to protect information relating to the representation (see Rules 1.6 and 1.9).

[12] *If approval of the substitution of the purchasing lawyer for the selling lawyer is required by the rules of any tribunal in which a matter is pending, such approval must be obtained before the matter can be included in the sale (see Rule 1.16).*

Applicability of the Rule

[13] *This Rule applies to the sale of a law practice of a deceased, disabled or disappeared lawyer. Thus, the seller may be represented by a non-lawyer representative not subject to these Rules. Since, however, no lawyer may participate in a sale of a law practice which does not conform to the requirements of this Rule, the representatives of the seller as well as the purchasing lawyer can be expected to see to it that they are met.*

[14] *Admission to or retirement from a law partnership or professional association, retirement plans and similar arrangements, and a sale of tangible assets of a law practice, do not constitute a sale or purchase governed by this Rule.*

[15] *This Rule does not apply to the transfers of legal representation between lawyers when such transfers are unrelated to the sale of a practice or an area of practice.*

Rule 28: Model Rules for Lawyer Disciplinary Enforcement

- A. Inventory of Lawyer Files.** If a respondent has been transferred to disability inactive status, or has disappeared or died, or has been suspended or disbarred and there is evidence that he or she has not complied with Rule 27, and no partner, executor or other responsible party capable of conducting the respondent's affairs is known to exist, the presiding judge in the judicial district in which the respondent maintained a practice, upon proper proof of the fact, shall appoint a lawyer or lawyers to inventory the files of the respondent, and to take such action as seems indicated to protect the interests of the respondent and his or her clients.
- B. Protection for Records Subject to Inventory.** Any lawyer so appointed shall not be permitted to disclose any information contained in any files inventoried without the consent of the client to whom the file relates, except as necessary to carry out the order of the court which appointed the lawyer to make the inventory.

Commentary:

In any situation in which the lawyer is not available to protect clients, the agency has an obligation to protect them. When such information comes to the attention of the agency, it need not await the determination that misconduct has occurred before acting.

The cost of the inventory may be paid from the fees owing to the lawyer whose files are inventoried. The cost may also be paid by funds made available for that purpose by state and local bar associations. Often the lawyer appointed as trustee will waive all or part of his or her fee as a public service.

The trustee is appointed to inventory the files of the lawyer's clients, not to represent them. The trustee should review each file and recommend to the judge who appointed him or her a proposed disposition. The trustee may take only such action with respect to each client's file as is authorized by the judge who appointed him or her.

The lawyer-client privilege must be extended so that review of the file by the trustee is not deemed to be disclosure to a third party, which would waive the privilege.

RESOURCES

[Succession Planning \(americanbar.org\)](http://americanbar.org) ABA

[sbasuccessionplanninghandbookrev11-9-18.pdf \(azbar.org\)](http://sbasuccessionplanninghandbookrev11-9-18.pdf) Arizona Bar

[Succession Planning | Colorado Lawyer \(cobar.org\)](http://cobar.org) Colorado Bar

[succession_planning_guide.pdf \(idaho.gov\)](http://idaho.gov) Idaho State Bar

[Contingency Planning – Death or Disability of the Sole Practitioner \(ymaws.com\)](http://ymaws.com)
Iowa Bar

[KENTUCKY BAR ASSOCIATION \(ymaws.com\)](http://ymaws.com) Kentucky Bar

[Microsoft Word - KBA Succession Planning.Oct2020.docx](http://KBA Succession Planning.Oct2020.docx) Knoxville Bar

[You Are Never Too Young and Healthy To Have A Firm Emergency Plan In Case Of Unexpected Death, Illness, Or Disability. - Lawyers Mutual Insurance Company \(lawyersmutualinc.com\)](http://lawyersmutualinc.com) Lawyers Mutual

LSBAPracticeTransitionHandbook.pdf Louisiana Bar

[Succession Planning for Solo and Sm Firms Rewards for Retiring Attys.pdf \(mebaroverseers.org\)](http://mebaroverseers.org) Maine Bar

[Succession Planning in Nevada \(nvbar.org\)](http://nvbar.org) Nevada Bar

[SuccessionHandbook.pdf \(sbnm.org\)](http://sbnm.org) New Mexico Bar

[Succession Planning - North Carolina Bar Association \(ncbar.org\)](http://ncbar.org) North Carolina Bar

[sp-SP Guide.pdf \(oregon.gov\)](http://oregon.gov) Oregon Government

[Opinion2014-100_21.pdf \(philadelphiabar.org\)](http://philadelphiabar.org) Philadelphia Bar

[State Bar of Texas | Succession Planning \(texasbar.com\)](http://texasbar.com) Texas Bar

[Succession Planning | Texas Bar Practice](http://Texas Bar Practice) Texas Bar

[Virginia State Bar - Planning Ahead: Protecting Your Client's Interests in the Event of Your Disability or Death \(vsb.org\)](#) Virginia Bar

[Succession Planning Toolkit \(uw.edu\)](#) University of Washington

[planning-ahead-handbook-071709a.pdf \(wsba.org\)](#) Disaster Planning Washington Bar

[Microsoft Word - 2011 SPL Survey REPORT.doc \(altmanweil.com\)](#) AltmanWeil Survey

[Planning Ahead: Succession Planning Guide – Wyoming State Bar \(wyomingbar.org\)](#) Wyoming Bar

HOW YA GETTING' PAID:

SUCCESSOR BROKER DEALER LIABILITY AND CONTROL PERSON LIABILITY

MODERATOR:
PETER MOUGEY

PRESENTERS:
FRANK CUCCIO
PETER FRUIN
JOSEPH PEIFFER

2021 PIABA Annual Meeting
Thursday October 28, 2021

PRE-FILING DUE DILIGENCE

■ Considerations:

- Which brokerage firm was the broker registered with at time of the sale of the investments at issue?
 - *Possible there are multiple brokerage firms to name in a claim*
- Are the relevant broker dealer(s) still registered with FINRA?
 - *If not, were they absorbed into or merged with another brokerage, and is that brokerage firm registered with FINRA?*
- Was the Broker dealer duly registered as a broker and an investment advisor?
 - *Is the Investment Advisory still registered?*
- Does the broker dealer have funds to pay if you are successful?
 - *Look to the most recent Focus Report filed by the Brokerage firm with the SEC via the Edgar system*
 - *Look to the detailed report on the Brokerage firm's Broker Check site*
 - *If the brokerage firm has an affiliated RIA firm, look at the latest ADV filed on the Investment Advisor Public Disclosure sight*

FOCUS REPORT – SEC FORM X-17A-5

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

**ANNUAL AUDITED REPORT
FORM X-17A-5
PART III
FACING PAGE**

Information Required of Brokers and Dealers Pursuant to Section 17 of the
Securities Exchange Act of 1934 and Rule 17a-5 Thereunder

REPORT FOR THE PERIOD BEGINNING 01/01/20 AND ENDING 12/31/20
MM/DD/YY MM/DD/YY

A. REGISTRANT IDENTIFICATION

NAME OF BROKER-DEALER:
Cetera Advisor Networks LLC

ADDRESS OF PRINCIPAL PLACE OF BUSINESS: (Do not use P.O. Box No.)

200 North Sepulveda Boulevard, Suite 1300

(No. and Street)

El Segundo

CA

90245-5672

(City)

(State)

(Zip Code)

NAME AND TELEPHONE NUMBER OF PERSON TO CONTACT IN REGARD TO THIS REPORT

Theodore Horwith

(310) 257-7782

(Area Code - Telephone No.)

B. ACCOUNTANT IDENTIFICATION

INDEPENDENT PUBLIC ACCOUNTANT whose opinion is contained in this Report*

Deloitte & Touche LLP

(Name - if individual, state last, first, middle name)

555 W 5th Street, Suite 2700

Los Angeles

CA

90013

(Address)

(City)

(State)

(Zip Code)

OMB APPROVAL

OMB Number: 3235-0123
Expires: October 31, 2023
Estimated average burden
hours per response... 12.00

SEC FILE NUMBER

8-29577

OFFICIAL USE ONLY

FIRM I.D. NO.

CETERA ADVISOR NETWORKS LLC

**STATEMENT OF FINANCIAL CONDITION
AS OF DECEMBER 31, 2020**

ASSETS

Cash and cash equivalents	\$ 41,952,580
Fees and commissions receivable	36,586,610
Receivable from clearing broker	1,394,663
Related party receivables	8,542,756
Other receivables	4,952,086
Prepaid expenses	621,790
Deferred charges	6,744,066
Operating lease assets	1,789,430
Intangible assets, net of accumulated amortization of \$4,923,119	50,094,925
Goodwill	29,815,465
Other assets, net of allowance of \$322,300	1,898,762
Total assets	\$ 184,393,133

LIABILITIES AND MEMBER'S EQUITY

LIABILITIES

Fees and commissions payable	\$ 38,769,607
Accrued expenses and accounts payable	630,185
Accrued compensation	3,043,488
Deferred revenue	885,997
Deferred credit	4,208,522
Regulatory and legal reserves	3,933,750
Contingent liability	2,530,798
Operating lease liabilities	1,791,639
Other liabilities	3,331,633
Total liabilities	59,125,619

RECENT FINRA ACTIVITY - UNPAID AWARDS

- FINRA Rule 4111 (Restricted Firm Obligations) and FINRA Rule 9561 (Procedures for Regulating per 4111)
 - July 30, 2021 - SEC Order approved – FINRA to issue NTM and rule will become effective 180 days after
 - Rule establishes numeric thresholds based on firm-level & individual-level disclosure events to identify members with higher levels of disclosures compared to peers
 - Rule permits FINRA to impose a “Restricted Deposit Requirement” on high risk firms which requires high risk firms to establish a separate bank account which cannot be accessed without FINRA’s consent.

RULE 4111 LIMITATIONS

- A step in the right direction – but Rule 4111 will not establish a broad fund for unpaid awards
- Limits “Restricted Deposit Requirement” (RDR) to amounts that would “not significantly undermin[e] the firm’s continued financial stability and operational capability”
- How strictly will it be enforced? Numerous exceptions could swallow rule or limit effectiveness
 - Firms allowed to appeal and demonstrate why they should not be designated restriction
 - Firms allowed to reduce staffing levels to remove themselves from the category
 - Firms allowed to show RDR will cause “undue financial hardship”
 - Unclear procedures on how RDR funds would be used to pay unpaid awards

SIPC COVERAGE

- SIPC provides limited insurance coverage for insolvent brokerage / clearing firms, for instance:
 - Insolvent / Bankrupt Firm and customer cannot access cash / securities or assets are missing.
 - Unauthorized Trading
 - Proof may be tricky, SIPC previously demanded contemporaneous written notice (within 10 days of transaction)
 - Theft
- SIPC Coverage Does NOT Apply to
 - Market Risk / Losses Value of Securities
 - Anything over \$500,000 per customer
 - Unregistered products (securities, investment contracts, limited partnerships, fixed annuity contracts, interests in commodities generally)

NAMING FINANCIAL ADVISORS

Big Picture:

- Will it benefit and strengthen your claim?
- Will it maximize recovery for your client?
- Does it help or hinder the case to name the advisor?
- Will it kick you out of FINRA and into AAA or JAMS?
- Will the advisor be named in addition to or instead of the Brokerage firm?
- Was the advisor registered with multiple brokerage firms during the relevant time period?
- Did the client work with one or multiple advisors?

Additional Considerations:

- Is the Brokerage firm defunct?
 - *Naming the financial advisor may be the only path to recovery in these instances*
- Does the financial advisor have an insurance policy?
 - *More likely if they are a RIA in addition to a broker*
- Is the advisor a high net worth individual?
- Does the advisor have any disclosures on their broker check
 - Have they settled any customer disputes
- Review the clients' contracts with advisor when possible
 - *Keep an eye out for an arbitration clause*

NAMING & IDENTIFYING CONTROL PERSONS

- Firm Brokercheck

Name	Position
OFG BANCORP	PARENT COMPANY , MEMBER
FERNANDEZ MARTINEZ, JOSE RAFAEL (CRD#:1556546)	OPTIONS PRINCIPAL, AND DIRECTOR
KUMAR, GANESH (CRD#:6120016)	DIRECTOR
MARBARAK, SONIA EMILIA (CRD#:1498281)	CHIEF COMPLIANCE OFFICER
MUNOZ GALARZA, GLENDA L. (CRD#:5037917)	FINANCIAL AND OPERATIONS MANAGER
SANTIAGO MARRERO, JUAN JOSE (CRD#:3155562)	PRESIDENT
SOUFFRONT, CARLOS O. ESQ. (CRD#:6272950)	DIRECTOR

- SEC Form BD / Form ADV – Uniform Applications for Registration

[illegible]

BLUE SKY CONTROL PERSON LIABILITY (USA)

- Section 410(c) of the Uniform Securities Act (USA) of 1956 extends liability to “[e]very person who directly or indirectly controls” a primary violator, in addition to others such as principals, officers, directors, or those holding similar positions or functions.
- Most states that have statutes based upon the USA impose secondary liability on the “control persons” of a primary violator

BLUE SKY CONTROL PERSON LIABILITY - ALABAMA

- Alabama, Section 8-6-2(24) defines control broadly:
 - “CONTROLLING PERSON, CONTROL, CONTROLLING, CONTROLLED BY, UNDER COMMON CONTROL WITH. The possession, directly, or indirectly, or the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract or otherwise.”
- Alabama, Section 8-6-19: Broad control person liability for underlying violation; rebuttal presumption standard “could not have known” of violation
 - Every person who **directly or indirectly controls** a person liable under subsections (a) or (b) of this section, including every partner, officer, or director of such a person, every person occupying a similar status or performing similar functions, every employee of such a person who materially aids in the conduct giving rise to the liability, and every dealer or agent who materially aids in such conduct **is also liable jointly and severally with and to the same extent as the person liable** under subsection (a) or (b), **unless** he is able to **sustain the burden of proof that he did not know**, and in exercise of reasonable care **could not have known**, of the existence of the facts by reason of which the liability is alleged to exist.

BLUE SKY CONTROL PERSON LIABILITY - GEORGIA

2010 O.C.G.A. Section 10-5-58(g),

(g) The following persons **are liable jointly and severally** with and to the same extent as persons liable under subsections (b) through (f) of this Code section:

(1) A person that **directly or indirectly controls a person liable** under subsections (b) through (f) of this Code section, **unless the controlling person sustains the burden of proof that the person did not know, and in the exercise of reasonable care could not have known**, of the existence of conduct by reason of which the liability is alleged to exist;

(2) An individual who is a managing partner, executive officer, or director of a person liable under subsections (b) through (f) of this Code section, including an individual having a similar status or performing similar functions, unless the individual sustains the burden of proof that the individual did not know and, in the exercise of reasonable care could not have known, of the existence of conduct by reason of which the liability is alleged to exist;

BLUE SKY CONTROL PERSON LIABILITY - FLORIDA

- Section 517.021, Fla. Stat. defines control broadly:
 - "Control," including the terms "controlling," "controlled by," and "under common control with," means the possession, directly or indirectly, of the power to direct or cause the direction of the management or policies of a person, whether through the ownership of voting securities, by contract, or otherwise."
- Section 517.211, Fla. Stat. – Liability for personally aiding or participating in the sale
 - Each person making the sale and every director, officer, partner, or agent of or for the seller, if the director, officer, partner, or agent has **personally participated or aided in making the sale**, is jointly and severally liable to the purchaser in an action for rescission, if the purchaser still owns the security

CONTROL PERSON LIABILITY

Companion Statutes

- Mostly arises in a fraud context – commonly associated with § 10(b) (Securities Act) and 10(b)(5) (Securities Exchange Act) fraud cases.

SECTION 20(a) OF THE SECURITIES EXCHANGE ACT OF 1934

15 U.S.C. § 78t

Liability of controlling persons and persons who aid and abet violations

(A) JOINT AND SEVERAL LIABILITY; GOOD FAITH DEFENSE

Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable (including to the Commission in any action brought under paragraph (1) or (3) of section 78u(d) of this title), unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

SECTION 15 OF THE SECURITIES ACT OF 1933

15 U.S.C. § 77o(a)

Liability of controlling persons

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

DEFENSES UNDER THE STATUTE OF CONTROL PERSON LIABILITY

- Showing the controlling person:
 - i. acted in good faith
 - ii. did not directly or indirectly induce the act constituting the violation, and
 - iii. no knowledge of or reasonable ground to believe in the existence of the facts ...alleged to have constituted the violation

“CULPABLE PARTICIPATION” AS AN ELEMENT OF CONTROL PERSON LIABILITY

- Certain jurisdictions have interpreted the Private Securities Litigation Reform Act (1995) as requiring a plaintiff to plead and prove “culpable participation” as an element of control person liability.
- Defined: a showing that the controlling person was in some meaningful sense a culpable participant in the unlawful act perpetrated by the controlled person
 - *SEC v. First Jersey Securities Inc.*, 101 F.3d 1450, 1472-73 (2d Cir. 1996).

Circuit	Requirement for Plaintiff to Plead Culpable Participation	Notes	Citations
1 st Circuit	No	Defendants have the burden to show good faith as an affirmative defense.	
2 nd Circuit	Split	The majority of the districts will require it; requiring “some level of culpable participation at least approximating recklessness in the section 10(b) context”	<i>SEC v. Yorkville Advisors, LLC</i> , 2018 U.S. Dist. LEXIS 57587
3 rd Circuit	Yes	Requires a plaintiff to plead and prove culpable participation showing either (i) knowledge of or substantial participation in the wrongdoing or (ii) inaction with the intent to further the fraud or prevent its discovery	<i>In re Suprema Specialties, Inc. Sec. Litig.</i> , 438 F.3d 256, 284 n.16 (3d Cir. 2006)
4 th Circuit	No	Defendant must show lack of culpable participation or knowledge	<i>In re MicroStrategy, Inc. Sec. Lit.</i> , 115 F. Supp. 2d 620, 659–661 (E.D.Va 2000)
5 th Circuit	Split		
6 th Circuit	Split		
7 th Circuit	No	Federal control person liability is based on control, not fraud	<i>Harrison v. Dean Witter Reynolds, Inc.</i> , 79 F.3d 609, 614 (7th Cir. 1996)
8 th Circuit	No	Defendant must show lack of culpable participation or knowledge	<i>Metge v. Baehler</i> , 762 F.2d 621, 631 (8th Cir. 1985)
9 th Circuit	No	Defendant must show lack of scienter and culpable participation to establish a “good faith” defense	<i>Howard v. Everex Sys., Inc.</i> , 228 F.3d 1057, 1065 (9th Cir. 2000)
10 th Circuit	No	Defendant must show lack of culpable participation or knowledge	<i>Adams v. Kinder-Morgan, Inc.</i> , 340 F.3d 1083, 1109 (10th Cir. 2003)
11 th Circuit	No	Defendant has the burden of establishing good faith by showing he did not act recklessly in failing to do something to prevent the violation	<i>Laperriere v. Vesta Ins. Group</i> , 526 F.3d 715, 723–725 (11th Cir. 2008)
D.C. Circuit	Yes	Plaintiff must plead culpable participation with particularity, and some conduct greater than negligence is required to establish control person liability	

DISCOVERY GUIDANCE FOR PRODUCT CASES

Christine Lazaro¹

In 2011, FINRA redesigned its Discovery Guide, to expand the guidance it provided to parties and to restructure the Document Production Lists.² At the time, a number of commenters expressed concern that the Discovery Guide did not adequately address the increase in “product cases.”³ FINRA stated it would have its “Discovery Task Force,” working under the auspices of the National Arbitration and Mediation Committee, consider the topic further.⁴

In 2013, following the Task Force’s review of the issue, FINRA proposed to further amend the Discovery Guide to address the issues with “product cases.”⁵ Following the proposal, FINRA adopted new guidance within the Discovery Guide, directed at addressing the unique aspects of these cases.⁶

The Discovery Guide now has a section within the guidance at the beginning directed wholly at Product Cases:

Product Cases

Product cases are cases in which one or more of the asserted claims center around allegations regarding the widespread mismarketing or defective development of a specific security or specific group of securities. Product cases are different from other customer cases in several ways:

1. The volume of documents tends to be much greater
2. Multiple investor claimants may seek the same documents
3. The documents are not client specific
4. The product at issue is more likely to be the subject of a regulatory investigation
5. The cases are more likely to involve a class action with documents subject to a mandatory hold

¹Christine Lazaro is a Professor of Clinical Legal Education at St. John’s University School of Law and is the Director of the Securities Arbitration Clinic.

²See Securities Exchange Act Rel. No. 64166 (Apr. 1, 2011), 76 FR 19155 (Apr. 6, 2011) (File No. SR-FINRA-2010-035).

³*Id.* at 19158.

⁴*Id.*

⁵See Securities Exchange Act Rel. No. 69761 (June 13, 2013), 78 FR 37261 (June 20, 2013) (File No. SR-FINRA-2013-024).

⁶See Securities Exchange Act Rel. No. 70419 (Sept. 16, 2013), 78 FR 57916 (Sept. 20, 2013) (File No. SR-FINRA-2013-024).

6. The same documents may have been produced to multiple parties in other cases involving the same security or to regulators
7. Documents are more likely to relate to due diligence analyses performed by persons who did not handle the claimant's account.

In a product case, parties typically request documents relating to, among other things, a firm's: creation of a product; due diligence reviews of a product; training on or marketing of a product; or post-approval review of a product. The Document Production Lists may not provide all of the documents parties usually request in a product case. Pursuant to this Discovery Guide, parties are not limited to the documents enumerated in the Document Production Lists. As stated earlier in this Discovery Guide, where additional documents may be relevant in a particular case, parties can seek them in accordance with the time frames provided in the 12500 series of rules.

Parties do not always agree on whether a claim centers around a product as defined above and may ask the arbitrators to make that determination. The arbitrators may ask the parties to explain their rationale for asserting that a claim is, or is not, a product case. Parties may also ask the arbitrators to resolve disputes concerning which additional documents they must produce, and the scope of the additional documents.⁷

This expanded guidance has worked to provide greater notice to the parties and to the arbitrators that product cases may raise discovery issues that are unique and not otherwise addressed by the Document Production Lists.

In addition to revising the Discovery Guide, FINRA has also provided additional guidance to the arbitrators focused on issues that may arise with product cases. Within the Arbitrator's Guide, there is a section wholly related to Product Cases. The Arbitrator's Guide references the additional guidance within the Discovery Guide. In addition, the Arbitrator's Guide provides guidance with respect to other issues that may arise with respect to discovery in product cases.

For example, the Arbitrator's Guide provides instruction on the cost and burdens of production:

For example, discovery in product cases is document intensive and therefore can become costly. Parties potentially may raise issues of cost and burden in this regard. If a party demonstrates that the cost or burden of production is disproportionate to the need for the documents, the Discovery Guide provides that the arbitrators should determine if the documents are relevant or likely to lead to relevant evidence. If the arbitrators determine that the documents are relevant or likely to lead to relevant evidence, they should consider whether there are alternatives that can lessen the impact, such as narrowing the time frame or scope of an item, or determining whether another document or documents can provide

⁷FINRA Discovery Guide (2013), pp. 6-7, available at <https://www.finra.org/sites/default/files/ArbMed/p394527.pdf>.

the same information. The arbitrator can also refer any unresolved discovery issue to the full panel for a determination.⁸

With product cases, there may be a series of arbitration claims related to the same product. The Arbitrator's Guide recognizes that there may be questions about the production obligations in other cases:

When considering discovery issues in product cases, it is possible that parties will make the arbitrators aware that other panels have considered and decided similar disputes. Arbitrators should be aware that prior arbitration decisions are not binding on other panels.

Parties sometimes argue that documents they are requesting were produced in another customer case or pursuant to a regulatory inquiry and, therefore, the arbitrators should order their opponent to produce the documents in their case. In this situation, the panel should consider the context of production in the other case or inquiry when deciding whether to order production in the case currently before the panel. If the prior production was to a regulatory authority, parties preserve the right to make whatever objections they deem appropriate, for example, that documents produced to regulators contain customer information that is proprietary, confidential and/or subject to privacy rights. Arbitrators should balance any arguments about the burden of reviewing and removing confidential material with the customer's need for the documents. The arbitrators may ask the parties to brief them on the law relating to production issues.⁹

The guidance also discusses concerns that may be raised because of privacy or confidentiality concerns, especially in light of the fact that there may have been many customers affected by the alleged misconduct:

If a party objects to document production on grounds of privacy or confidentiality, the arbitrators or one of the parties may suggest a stipulation between the parties that the documents in question will not be disclosed or used in any manner outside of the arbitration of the particular case, or the arbitrators may issue a confidentiality order. When deciding contested requests for confidentiality orders, arbitrators should consider the competing interests of the parties. The party asserting confidentiality has the burden of establishing that the documents in question require confidential treatment. In deciding questions about confidentiality, arbitrators should, taking into account the facts of a particular case, consider factors such as the following:

⁸FINRA Arbitrator's Guide, pp. 35-36, available at <http://www.finra.org/sites/default/files/arbitrators-ref-guide.pdf>.

⁹*Id.* at 36.

1. Whether the disclosure would constitute an unwarranted invasion of personal privacy (e.g., an individual's Social Security number, or medical information).
2. Whether there is a threat of harm attendant to disclosure of the information.
3. Whether the information contains proprietary confidential business plans and procedures or trade secrets.
4. Whether the information has previously been published or produced without confidentiality or is already in the public domain.
5. Whether an excessively broad confidentiality order could be against the public interest or could otherwise impede the interests of justice.
6. Whether there are legal or ethical issues which might be raised by excessive restrictions on the parties.¹⁰

Finally, FINRA provides guidance with respect to the potentially inequality in production obligations for product cases:

In product cases, the issue of unequal production may arise. Due to the nature of these claims, broker-dealers will generally have significantly more potential documents to produce compared to customers. Again, when determining whether to order production, arbitrators should determine if the documents are relevant or likely to lead to relevant evidence as described above.¹¹

FINRA encourages the arbitrators to speak with the parties about developing a discovery plan early in the case to deal with the document intensive nature of product cases.¹²

FINRA provided additional guidance in its Neutral Corner, telling arbitrators and parties:

Since product cases are different from other customer cases, arbitrators may see unique discovery-related issues, which may not be included in the Document Production Lists in FINRA's Discovery Guide. For example, in a product case, parties may request documents relating to a firm's:

- creation of a product;
- due diligence reviews of a product;
- training or marketing of a product; or
- post-approval review of a product.¹³

¹⁰*Id.*

¹¹*Id.* at 37.

¹²*Id.*

¹³FINRA Neutral Corner, Volume 4 – 2015, p. 8, available at http://www.finra.org/sites/default/files/The_Neutral%20Corner_Volume_4_2015.pdf.

In product cases, it may be possible to develop a comprehensive discovery plan which will address the anticipated concerns. For example, if the same firms are representing the brokerage firm and multiple customers across several cases, it may be possible to develop streamlined production of the product specific documents so that the brokerage firm does not bear the burden of producing the same documents multiple times. Additionally, the parties may agree to carve-outs to the confidentiality agreement, to ensure that the documents may be used in certain cases, but not others.

If the case also qualifies for the Large Case Pilot Program, i.e. cases with damages in excess of \$10 million, the parties may set other discovery protocols. For example:

FINRA understands that large cases may have additional discovery requirements that a smaller case may not have. The parties can agree to use interrogatories, depositions, requests for admissions, or any other discovery method. The parties can also agree to use a discovery arbitrator whose sole role on the case is to decide discovery issues. As is the case in the appointment of the panel, the parties can use a FINRA arbitrator in this role or can suggest a non-FINRA arbitrator for the role.¹⁴

The parties should determine the best procedures, and to the extent possible, stipulate to the discovery procedures that will govern the case.

¹⁴Large Case Pilot – FAQ, Q. 16, available at <http://www.finra.org/arbitration-and-mediation/faq-large-case-pilot>.

GETTING THE GOOD STUFF THROUGH LIST 1 OF THE DISCOVERY GUIDE

Michael S. Edmiston¹

List 1 of the FINRA Discovery Guide makes numerous documents in the possession, custody, and/or control of a broker-dealer presumptively discoverable.² A full production of the List 1 documents would likely achieve the goal of fast and efficient dispute resolution.³ The ideal of efficiency in arbitration, however, rarely fares well in reality. It is nowhere to be found in actual compliance or practice with FINRA's discovery mandates. Despite FINRA's pronouncement that Discovery Guide Items are *presumptively* discoverable, broker-dealers and their counsel view the list as suggestive rather than mandatory. This is because there is no incentive in the FINRA Code of Arbitration Procedure ("FINRA Code") for Respondents to produce the "Good Stuff" until Claimant's counsel applies sufficient pressure to do so.

List 1's "Good Stuff" consists of the documents and information that focus the case on the broker, firm and product. They are the documents that put Respondents' actions and inactions at issue and make their counsel play defense rather than attack the customer-Claimant.

The Good Stuff rarely appears in Respondents' first production. Instead, the initial production usually consists of documents that the Claimant already received or should have received in the course of the account relationship such as account statements, trade confirmations, correspondence and e-mails between the firm and/or broker and Claimant, and the occasional prospectus or offering documents. Generally missing from the initial production are all the internal documents, internal communications and regulatory documents related to the securities, products, broker, and firm. From a defense philosophy, the initial production accomplishes the its goal: make the case about the Claimant.

Obtaining production of missing documents is a critical, if numbingly repetitive, exercise in a customer case. Such documents are often withheld behind walls of obfuscating responses, objections, claims of privilege, and tricky unilateral limitations of promises to produce selections of responsive documents. Getting the Good Stuff requires knowing what documents exist or should exist, and then whittling through the obfuscations and objections, and the generous sounding, but functionally useless, promises to produce the Claimant-related selections of responsive documents.

The Discovery Guide and FINRA Code of Arbitration Procedure ("Code") provide the tools to get those documents. This article will discuss several Items from List 1 of the FINRA Discovery Guide and the categories of documents which often exist but firms do not want to produce; addressing the objections and claims of privilege; the use of affirmations of search; and meet and confer tactics.

¹Laura S. Dunning and Moshe Y. Singer contributed greatly to this article and are both given a hearty "Thank You" for helping us all get the Good Stuff. Another "Thank You" goes to PIABA founding member, Stuart C. Goldberg, for his *PIABA'S 2001 Practice Guide to NASD Discovery and Pre-Hearing Proceedings*. This massive guide dissected the then-operative NASD Discovery Guide and related rules and remains an excellent source of information about key documents; objections; privileges; and why and how to argue for production of the Good Stuff.

²FINRA, Regulatory Notice 11-17 (2013) [hereinafter Discovery Guide].

³FINRA states arbitration is "faster, cheaper and less complex than litigation." <https://www.finra.org/arbitration-mediation/overview> (last visited Dec. 28, 2020).

I. THE DISCOVERY GUIDE'S GOOD STUFF RESPONDENTS DON'T WANT YOU TO HAVE

List 1, Item 5(a) – Due Diligence, Research, and Testing Data

Item 5(a) requires production of “All materials the firm and/or associated persons prepared or used and/or provided to the customer parties relating to the transactions or products at issue, including research reports, sales materials, performance or risk data, prospectuses, other offering documents, and copies of news articles or outside research, including documents intended or identified as being ‘for internal use only.’”

The Respondents’ standard tactic is to agree to produce the responsive documents limited to those that were *provided to the Claimant*. The key phrase Respondents seek to avoid is “[a]ll materials the firm and/or associated persons prepared or used...” There is no limitation in this Item to just documents provided to the Claimant. Item 5(a) opens the door to due diligence documents, third-party due diligence, internal and external research sources, and performance testing. Generally, these are documents not given to a customer. In product cases, Item 5 holds the key to what the firm knew about the product, its risks, and its problems.

List 1, Item 7(a) – Supervisory Notes and Memoranda About the Broker

Item 7(a) requires production of the documents showing what the firm’s supervisors knew about both the customer and the broker.

Specifically, it requires production of all notes or memoranda evidencing supervisory, compliance, or managerial review of:

- 1) the customer parties’ accounts or transactions therein or
- 2) of the associated persons assigned to the customer parties’ accounts for the period at issue.

The Respondents’ typical tactic is to promise production of only the documents indicating supervisory review of the customer’s account.

While sometimes the Claimant-specific documents are helpful, what is being excluded is the information the firm had about the overall supervision of the broker. This would include supervisory documents such as heightened supervision documents, written warnings, accumulated risk scores for multiple exception reports, internal e-mails about the broker’s activities and practices, and outside business activities which Respondents do not want revealed. For a failure to supervise case, Item 7(a) is a treasure trove of documents showing what the firm knew about, and whether it properly supervised, the broker.

List 1, Item 9 – Communications with the Compliance Department

Item 9 requires production of internal communications between the broker and his/her compliance department about the customer (claims, accounts, and/or transactions) and/or the securities/products at issue. Respondents often unilaterally limit the scope of this request to e-mail communications to/from the broker about the Claimant and Claimant’s account(s).

Item 9 discovery can be a gift in product cases because it opens the door to every communication between the broker and the personnel in the “compliance department” about the securities or

products at issue. Additionally, where there are claims involving more complex investments which often receive additional regulatory attention, this discovery can be quite fruitful. Where the case involves investments such as non-traded REITs, private placements or structured products, this can be very valuable, particularly when such communications highlight changes to supervisory and compliance manuals to meet regulatory requirements or mandates.

List 1, Item 13(b) – Broker-Specific Exception Reports

Item 13(b) cuts to the heart of what the firm knew about its broker's day-to-day sales activities—the *really* Good Stuff. The documents required to be produced are "...all exception reports, supervisory activity reviews, concentration reports, active account runs, and similar documents produced to review for activity in customer accounts handled by associated persons and related to the allegations in the Statement of Claim that were generated not earlier than one year before or not later than one year after the transactions at issue."

13(b) is often met with outright objections (e.g., relevancy, burden, and privacy) and Respondents frequently unilaterally try to limit the scope of documents to just those documents related to Claimant and Claimant's account(s). Such a proposed limitation is a rehash of what is already presumptively discoverable under Item 13(a).

Along with revealing a broker's patterns and practices which alert the firm supervisors and compliance officers, the documents often contain the names of such supervisors and compliance personnel, the frequency which a given supervisor sees and/or responds to an exception report, notes and comments about the response, and sometimes "scores" which are weighted by the type of conduct, the frequency with which it occurs, and set time period used to measure the frequency (e.g., six months or one year). The information contained in the 13(b) documents is the reason to pursue discovery early as it may be necessary to propound additional discovery requests based on the information gleaned from that production. 13(b) is also the most likely Item that Respondents will force to a motion to compel because the materials are often so very rich.

List 1, Item 14 – Branch Audit Reports

Item 14 requires production of "[t]hose portions of internal audit reports for the branch in which the customer parties maintained accounts that: (a) concern associated persons or the accounts or transactions at issue..." Respondents often will seek to limit the scope of Item 14 to just those audit reports which mention Claimant or Claimant's accounts. Rarely do such reports mention a particular Claimant of account. What is important is whether the broker was the focus of an internal audit.

Like 13(b), Item 14 can be a jackpot of internal information about the broker's practices coupled with written conclusions by the auditor. Unlike 13(b), the audits may only look at a select few of the broker's accounts in an annual inspection.

Item 14 is particularly valuable in cases against independent broker-dealers with their numerous remote one- and two-person offices. The scheduled annual visit from a compliance officer is often an exercise in how well the auditor checks the boxes on a lengthy checklist and how well the broker, usually having seen a copy of the checklist, has prepared the office to give the "right" answers. Results of an unscheduled audit or follow-up audit are often more revealing about the broker's practices and procedures in independent firms.

Behind the audits are almost always internal e-mails from the auditor to the firm's management about the audit results as well as e-mails exchanged between the broker, supervisor and/or auditor addressing discrepancies found as a result of the audit. These can go a long way in proving improper supervision claims.

List 1, Item 15 – Disciplinary Actions Against Broker

Item 15 requires production of “[r]ecords of disciplinary actions taken against associated persons by any regulator... or employer for all sales practice violations or conduct similar to the conduct alleged in the Statement of Claim.”

The Respondents will likely offer to produce those disciplinary actions in which the Claimant or Claimant’s accounts were involved. This unilateral limitation makes Item 15 almost useless except for the rare situation where FINRA has already brought an enforcement action based on what occurred to the Claimant.

There is a second level of gamesmanship engaged in by Respondents for this Item because the phrase “conduct *similar* to the conduct alleged” is not more precisely defined in the Discovery Guide.

Item 15 documents can be particularly valuable when their date of creation is earlier than the alleged wrongful conduct in the Statement of Claim. A suspension, heightened supervision, or even cautionary memorandum gives evidence of the firm’s supervisors possessing first-hand awareness of the broker’s issues. Coupled with Item 13(b) exception reports and Item 14 audit reports, the firm’s supervision system and its reasonableness, or lack thereof, in implementation or execution becomes much easier to establish.

Item 15 requires some thoughtful consideration to avoid being trapped by a narrow definition of “conduct similar” and an earmark on the response to save for a meet and confer discussion. Conduct similar does not mean that it has to involve the same product or transaction. Rather, a more broad definition can be argued on behalf of the Claimant. For example, a pattern of unsuitable trading, even if it is in different products, could clearly fall within the definition of “similar conduct.”

List 1, Item 16 – Regulatory Investigations, Charges, or Findings and Responses Thereeto

Item 16 is a valuable source of documents due to the information flow between the regulator and regulated entity or person. While the fact that an investigation ensued is itself good for a Claimant’s case, the responses and documents that the firm and/or broker made to the regulators can yield very helpful material. The FINRA (or other regulatory agency) investigation generally seeks production of documents such as the trade blotters and exception reports. These are same documents Respondents do not want to produce in the arbitration, but are routinely produced to regulators. Additionally, there are often written responses to questions asked by the regulators which also be helpful to the case.

Although Respondents also generally argue that such production is overly burdensome, because these documents have already been collected and previously produced, there is little burden beyond redaction of non-party information for Respondents to make the same production in the arbitration. As a result, Respondents’ effort to keep the documents out of the arbitration falls to the standby of limiting the production to Claimant and Claimant’s account, and then usually claiming some sort of “regulatory privilege.”

Importantly, there is no “regulatory privilege” prohibiting production of the responsive documents, and the only privilege that does exist belongs to the regulator itself for its investigative files. FINRA

particularly does not promise and will not agree to keep the documents submitted to it in a confidential form.⁴

Like Item 15, this Item puts a nexus on the documents, where all that needs to be produced are the documents for “...the associated persons’ alleged improper behavior similar to that alleged in the Statement of Claim.”

Another obfuscating tactic used by Respondents’ counsel is the objection that they will only produce the types of “investigations” and “charges” as defined in the Form U-4 Explanation of Terms. The Form U-4 Explanation of Terms⁵ defines an “Investigation” as:

(a) grand jury investigations; (b) U.S. Securities and Exchange Commission investigations after the “Wells” notice has been given; (c) FINRA. investigations after the “Wells” notice has been given or after a person associated with a member, as defined by The FINRA By-Laws, has been advised by the staff that it intends to recommend formal disciplinary action; (d) NYSE Regulation investigations after the “Wells” notice has been given or after a person over whom NYSE Regulation has jurisdiction, as defined in the applicable rules, has been advised by NYSE Regulation that it intends to recommend formal disciplinary action; (e) formal investigations by other SROs; or (f) actions or procedures designated as investigations by jurisdictions. The term investigation does not include subpoenas, preliminary or routine regulatory inquiries or requests for information, deficiency letters, “blue sheet” requests or other trading questionnaires, or examinations.

The most problematic part of the use of the Form U-4 definition of “investigations” is the final sentence, “The term investigation does not include subpoenas, preliminary or routine regulatory inquiries or requests for information, deficiency letters, ‘blue sheet’ requests or other trading questionnaires, or examinations.” Most FINRA investigations start with a regulatory inquiry, 8210 letter requesting documents, or more recently, a FINRA “Gateway Request”⁶ for documents. If left unaddressed, the definition removes everything but the most severe and rare regulatory investigations from the scope of discoverable documents.

The FINRA Discovery Guide does not define the terms “investigations” or “charges.” Thus, there is no support for Respondents’ narrow U-4 definition. Rather, a plain meaning of these terms should be read into the definition, covering the panoply of documents which is provision was meant to capture.

List 1, Item 17 – Examination Reports

Item 17 considers regulatory examination reports that focused on the associated persons or the customer parties’ claims, accounts or transactions, or the product or types of products at issue or that discussed alleged improper behavior in the branch against other individuals similar to the conduct alleged in the Statement of Claim to be discoverable. Once again, the usual response from Respondents is to agree to produce those examination reports *which mention* Claimant and/or Claimant’s account.

⁴Order at 3, Bussing v. COR Clearing, LLC, et al., No. 8:12CV238 (D. Neb. Oct. 16, 2015), https://www.govinfo.gov/content/pkg/USCOURTS-ned-8_12-cv-00238/pdf/USCOURTS-ned-8_12-cv-00238-18.pdf (last visited Dec. 28, 2020).

⁵<https://www.finra.org/sites/default/files/AppSupportDoc/p468051.pdf> (last visited Dec. 28, 2020).

⁶<https://www.finra.org/filing-reporting/finra-gateway> (last visited Dec. 28, 2020).

It is the rare case in which a Claimant or a Claimant's account is mentioned in an examination report. However, with FINRA, the SEC, and state regulators all conducting various routine exams and "for cause" exams, the probability of an examination report existing is great.

The examination reports often identify not only the problematic conduct but also may reveal in-the-moment or post-examination responses from the firm about the conduct and efforts to mitigate or remedy it.

List 1, Item 19 – Broker's Compensation for Client's Accounts

Item 19 is designed to answer how much the broker made from the Claimant's transactions. Sometimes the answer is simple, a single commission for a single product. Other times, hundreds or thousands of trades are at issue, creating a challenging situation to total up the commissions. There are often year end or quarterly commission reports which tally up the commissions per client.

It is important to look at each account at issue and determine whether it is a commission-based or fee-based account. Not only is the compensation different, but the duties owed by the broker or investment adviser representative are different as are the defenses.

Item 19 is also an opportunity to test whether Respondents will try to avoid producing documents in reasonably usable format (e.g., an excel spreadsheet).

List 1, Item 20 – Broker's Overall Compensation (Trade Blotter)

Item 20(a) documents, more *really* Good Stuff, can tremendously help a customer-Claimant's case. It provides for the production of the broker's complete commission run and contains much of the data required to be reported in the broker's trade blotter. It shows what the broker was soliciting, the dates, quantities, compensation, and a minimal detail of account numbers to sort the data but not reveal non-party private data.⁷

Item 20(a) almost always meets with a litany of objections and an attempt to limit the production to the commissions related to Claimant's accounts (duplicative of List 1, Item 19's scope).

The underlying reason for the objections is often that Respondents do not want the broker's patterns and practices revealed. Once introduced, the data in Item 20 can shift the case from the narrow, cornered, customer-specific analysis to an inquiry focused on the basis of the broker's recommendation and pattern of recommendations.

If the Item 20(a) material is voluminous, and it almost always is, a second and equally important goal is getting the data produced in reasonably usable format, an Excel spreadsheet. If the data is produced in pdf format, it will likely be two or three pages wide and likely hundreds of pages long. A pdf production denies two benefits of the document: 1) performing mathematical calculations; and 2) sorting the data.

The ability to use Excel's formula functions allows for efficient and accurate computation of the amount of commissions earned by the broker.

The ability to sort the data by multiple levels, for example, by security name and then by date of transaction, can reveal when a broker grew hot or cold on a security, as well as the commissions earned. A sort by net commissions can reveal higher paying products and even a pattern of

⁷See MICHAEL S. EDMISTON, *Investors, Cornered*, 22 PIABA B.J. 337 (2015).

certain accounts generating larger commissions. Sorting by product and whether the trades were solicited or unsolicited often contradicts the defense of “the client wanted it” when a large portion of the same broker’s clients “wanted” the same obscure product. Sorting by product and commission often defangs the “market-went-down” defense when the broker’s commissions reveal the true basis for the recommendations. Finally, if the commissions charged to Claimant make up a large portion of the broker’s total commissions, this fact can be extremely helpful.

Like 13(b), Item 20(a) is so data-rich that Respondents may be unwilling to produce it under any circumstances without an order from the Panel.

List 1, Item 21 – Compensation Plan

Item 21 requires production of “record[s] of all agreements pertaining to the relationship between the associated persons and the firm, summarizing the associated persons’ compensation arrangement or plan with the firm.”

Often the Respondents will offer to produce the “grid” or compensation schedule for the broker showing the split between the firm and broker on commissions.

Obtaining the complete employment and/or independent contractor agreement can be very useful for the case. The Agreement often identifies requirements to carry errors and omissions insurance and whether the broker must indemnify the firm for losses as a result of customer complaints and arbitration claims, and even production goals or references thereto.

Another important compensation item are bonuses paid in the form of forgivable loans. Most commonly seen in recruiting scenarios, the bonuses put immediate pressure on the broker to start producing in order to avoid having to repay the loan. Marrying up the dates of the forgivable loans and trade blotter (Item 20) often may show increased production soon after the loans were funded.

II. READING THE DISCOVERY GUIDE IN REVERSE ORDER MAKES THE GOOD STUFF EVEN BETTER

Looking at the Discovery Guide’s “good stuff” in reverse order creates the “follow the money” trail. Obtaining this Good Stuff through artful negotiation and, if necessary, motion practice, can uncover a chain of documents explaining how and why Claimant was damaged and how the broker and firm allowed it to happen from a monetary perspective. Item 21 shows the motivation the broker had to sell the particular investment or strategy. Item 20 shows how much the broker earned and the nature of the broker’s business. Items 14, 15, 16, and 17 show the risks and conduct the broker and firm engaged in to make the commissions. Item 13(b) shows what the firm knew about the broker’s conduct while producing the commissions. Item 9 reveals what the firm told the broker about the risks and conduct related to this production. Item 7 reveals how the firm allowed the broker to operate while producing. Item 5 reveals what the firm knew about the securities and products the broker was selling in order to produce.

III. MEET AND CONFER TACTICS – GET THE GOOD STUFF WITHOUT A MOTION

FINRA Code of Arbitration Procedure Rule 12503(a)(1) requires counsel to meet and confer prior to filing a motion. Based on the initial production of documents and litany of objections, unilateral limitations, and agreements to produce only slices of the Discovery Guide, a meet and confer effort is necessary in virtually every case.

Embrace the meet and confer requirement. Invest the time at the start of the meet and confer process, and the remaining steps will be easier. A thorough and well-written meet and confer letter sent prior to the actual meeting will serve as the guide to the meet and confer conference, an outline to memorialize the agreements and disagreements, a checklist to track production of documents from Respondents, a summary of the arguments for a Motion to Compel, and will become Exhibit A to any Motion to Compel. As an added bonus, the detailed meet and confer letter plus the follow-up memorialization and subsequent correspondence will ensure compliance with Rule 12505, which instructs that "...parties must cooperate to the fullest extent practicable in the exchange of documents and information to expedite the arbitration."

A. BURN THROUGH THE GENERAL OBJECTIONS AND ITEM SPECIFIC OBJECTIONS

FINRA Code of Arbitration Procedure Rule 12508(a) sets the standards for making objections to the Discovery Guide List Items and other discovery requests. "If a party objects to producing any document described in Document Production Lists 1 or 2 or any document or information requested under Rule 12507, it must specifically identify which document or requested information it is objecting to and why." Rule 12508(a) goes on to state the consequence of not being specific in the objection: "Parties must produce all applicable listed documents or other requested documents or information not specified in the objection..."

Respondents' general objections, which serve as a preamble to their Item specific objections, never meet the Rule 12507 standard since they are not specific to any List Item and do not identify which document or information is being objected to and why. Similarly, Respondents rarely identify or describe the documents they are objecting to producing for each specific List Item. Rule 12508(a) provides the remedy for sweeping and lazy objections: mandatory production. Strategically, Respondents usually wait until the last day of the deadline to file their responses (or last day of an extended deadline). Rule 12508(b) provides that any objection not made within the required time is waived absent a Panel finds substantial justification for the failure to make the objection. Thus, when Respondents serve their responses on the last day possible, they cut off their ability to amend their objections, absent a showing of good faith.

In the meet and confer letter, along with identifying Rule 12508 setting forth the standard for objections, ask Respondents' counsel to describe each document withheld for each General Objection. Rule 12505 requires a good faith compliance with discovery, there is nothing wrong with asking Respondents to comply with their good faith obligation.

B. AGREEMENTS TO PRODUCE SELECTIONS OF NON-PRIVILEGED DOCUMENTS

Respondents usually agree to produce only the "non-privileged" responsive documents and generally further limit that and only those related to Claimant. A claim of privilege, like an objection, is governed by Rule 12508(a). If the privilege is not identified and the withheld document not described, the remedy is production of the document.

Additionally, any asserted privilege must be a legally recognized one. Respondents' claims of privilege are usually the non-existent self-critical analysis privilege,⁸ a Graham-Leach-Bliley Act

⁸E.g., *Uniformed Fire Officers Ass'n v. City of New York*, 955 N.Y.S.2d 5 (App Div. 1st Dept. 2012) ("[T]his privilege has never been recognized under New York law..."); *Lamitie v. Emerson Elec. Co.*, 535 N.Y.S.2d 650, 653-54 (App. Div. 3rd Dept. 1988).

privacy privilege,⁹ or a regulatory investigative privilege.¹⁰ Often pointing out the non-existence of these “non-privileges” is sufficient to move the meet-and-confer discussion forward and resolve the issue before filing a motion to compel.

Asking for Respondent to identify the documents governed by claims of privilege is asking Respondent’s counsel to create an Item-specific privilege log. Respondent’s counsel has the ability to ask for the same from Claimant’s counsel. Within the issue of the privilege log, there lurks a mutually assured destruction issue, attorney-client privileged documents. While a run can be made at Respondents not providing a privilege log of such documents, the reverse can be done to Claimant. Strategically, it may be worth clarifying or excluding claims of attorney-client privilege to avoid the laborious creation and exchange of privilege logs.

C. AFFIRMATIONS OF SEARCH

In 2013, when FINRA revised the Discovery Guide, it changed the rules for affirmations of search. Under the old Discovery Guide, the standard for obtaining an affirmation of search required no documents be produced. The new rule provides:

If a party does not produce a document specified in a List item on the applicable Document Production List, upon the request of the party seeking the document that was not produced, the customer or the appropriate person in the brokerage firm who has knowledge, must: 1) affirm in writing that the party conducted a good faith search for the requested document; 2) describe the extent of the search including, but not limited to, stating the sources searched; and 3) state that, based on the search, the party does not have the requested document in the party’s possession, custody, or control.¹¹

Respondents’ lazy discovery responses may, once again, be a gift. They may reveal the existence of documents they are not producing. For example, Item 13(b)’s objections and claims of privilege create a fair assumption that there are responsive documents that have not been produced. If there are no responsive documents, why was it necessary to object? If Respondents will not drop the nonsensical objections and claims of privilege, ask for the affirmation of search. There is no requirement in the affirmation that it be limited to non-privileged documents. At a minimum it will reveal the existence of the withheld documents and provide a description of the documents being withheld. If there truly are no responsive documents, someone in the Respondent’s firm will lock the firm into a signed statement affirming that no documents were found and they do not have the documents.

Some Respondents try to have their counsel or an employee in the General Counsel’s office execute the affirmation of search rather than the person who “has knowledge” or actually

⁹15 U.S.C § 6801 (YEAR). Gramm-Leach-Bliley Act, 15 U.S.C. § 6801 et seq. focuses on protecting client data from sale or other unrelated commercial use by a financial institution. Subsection (e)(5) of section 6802 specifically allows disclosure of private customer information to “self-regulatory organizations” such as FINRA, and subsection (e)(8) of section 6802 specifically permits disclosure of private customer information in response to subpoenas and other judicial process.

¹⁰PHILIP M. AIDIKOFF ET AL., *Discovery of Regulatory Documents: Debunking the Myth of an “Sec Privilege” in Securities Arbitration*, 18 PIABA B.J. 187 (2011); *Kirkland v. Superior Court (Guess? Inc.)*, 115 Cal. Rptr. 2d 279 (Ct. App. 2002) (holding that investigatory documents and responses thereto are business records and are neither privileged nor confidential).

¹¹ Discovery Guide, *supra* note 2, at 5.

conducted the search. Read that affirmation carefully and seek the signature(s) of the firm-level staff or officers who actually conducted the search.

D. THE E-MAIL AND ELECTRONIC RECORDS SEARCH

There is often a treasure trove of information in e-mail exchanges, many of which have never been sent to the Claimant. Respondents' initial e-mail production is usually limited to the e-mails exchanged between the broker and Claimant. Those e-mails, while responsive to parts of various List Items, are an incomplete universe of the documents. Firms may use electronic communication software beyond just e-mail, and there are certainly other employees of the firm ("repositories") who have sent or received e-mails related to the Claimant, the accounts, product, or broker. Identifying the electronic communications systems from the outside is virtually impossible. Identifying the repositories can be a challenge, the obvious ones are the broker, the broker's supervisor, the broker's assistant(s), and the "compliance department." Less obvious repositories may be due diligence committee members, human resources, Anti-Money Laundering personnel, research personnel, and other firm-specific departments identified in the manuals. Creating a chart of each repository, job title, and relation to the case (e.g., name appears in a previously produced document) helps to explain to Respondents why a search of that given person's e-mail (or other communications system) account is reasonable for the purposes of discovery.

Often, Respondents will ask Claimants to identify the particular search terms to use in an email search. Identifying the search terms can be difficult. Start with the easy terms, Claimants' names and account numbers. From there, expand to product names, CUSIPS, customer numbers, family members' names, FINRA investigation file numbers, and terms found in the prior discovery production(s). This may also be a chance to review the firm and broker's Brokercheck and CRD reports to look for outside business activities, other customers' complaints and claims, and settlement contributions. It may also be an opportunity to search the filings with the SEC and state securities regulators for more terms.

The problem with search terms often becomes one of scope. Asking for all e-mails from all repositories which mention "AAPL" will be so broad that it will be objectionable, add a significant redaction burden to the firm, and even if produced, the documents would be overwhelming in their irrelevancy. Go back to Rule 12505 and make a good faith and thoughtful request for search terms, and use Boolean connectors to limit the probability of false positives.

Also be clear on what is to be searched, the subject lines, e-mail text, and attachments. Some firms will try to keep the Good Stuff in attachments to e-mails.¹²

Well prepared search terms and reasonable identification of repositories communicate Claimant's counsel's knowledge of the case, shows respect and reasonableness for the discovery process, force Respondents' counsel to consider the issue from Claimant's standpoint, gets Respondents' decision-makers involved in deciding whether to retain an outside vendor to conduct discovery, and often gets an insurance carrier involved in looking at the costs of the defense.

E. THE INDIVIDUAL LIST ITEMS

For each List Item in dispute, identify the List Item, and ask a few questions (or make a few requests):

¹²On November 17, 2016, FINRA sanctioned Oppenheimer & Co., Inc. for failing to produce discoverable spreadsheets contained in e-mail attachments in response to discovery requests propounded in seven arbitration claims. FINRA Acceptance, Waiver & Consent, Case No. 2015046355401 (Nov. 17, 2016).

- A. Please identify all documents responsive to this List Item which are being withheld by a claim of privilege, and the specific privilege claimed for each document withheld.
- B. Please identify all documents responsive to this List Item which are being withheld by an objection asserted in response to this List Item and the specific objection claimed for each document being withheld.
- C. Please confirm Respondents have completed their search for documents responsive to this List Item.
- D. Please confirm all documents other than those being withheld by a claim of privilege or objection have been produced.
- E. Please provide the affirmation of search for this List Item.

Depending on the List Item two additional instructions may be helpful:

- F. Claimant consents to the redaction of all PCI of non-parties contained in the documents responsive to this List Item. Claimants request that only the last four digits of any account number, contract number, or policy number associated with any brokerage account, investment or insurance product be left intact.
- G. For all spreadsheets produced responsive to this List Item, please produce the spreadsheet in Excel format with full functionality enabled.

The alphabetized checklist of requests will efficiently narrow the issue, and make it very easy to track any agreements to produce documents or provide additional information.

F. A GAME OF TELEPHONIC CAT-AND-MOUSE

A well-written meet and confer letter may knock loose a supplemental production, mainly of documents that were not ready to be produced at the time of the initial production. Often, the Good Stuff still will not be produced.

The meet and confer letter will usually result in a written response explaining why Respondents are objecting (without actually identifying any documents) and a perhaps a polite suggestion to have a call to meet and confer. Translated and summarized, the response letter often reads: "Please go commit a physiologically improbable act, but maybe call me first before risking injury."

The meet and confer call is where all the work put into a detailed meet and confer letter sent prior to the call will result in getting some or all of the Good Stuff produced. The call requires good note taking to memorialize the agreements

1. General Objections and Claims of Privilege

For the General Objections, ask outright whether documents are being withheld pursuant to any General Objection. If the answer is "no," it is usually qualified with a statement that the Item-specific objections control. Make a note for the memorialization.

For the claims of privilege, ask whether documents are being withheld on a claim of privilege other than attorney-client. The answer is oftentimes, "no." If "yes," ask for counsel to identify the List Item, describe the document, and the specific privilege claimed. Other than attorney-client, the

claims of privilege will normally evaporate. Make a note for the memorialization. If a claim of privilege is still asserted chase it down to a specific privilege and document description.

2. Affirmations of Search

For affirmations of search, ask for them. Most Respondents' counsel will argue that there is no way their client can search behind every bookcase, under file cabinets, and in the coffee filter drawer for responsive documents. If Respondents' counsel claims "some" documents have been produced wrongly arguing under the old Discovery Guide standard there is no need for an affirmation, ask what documents are being withheld. The response will reveal more documents, confirm all documents have been produced, or most likely send Respondents' counsel back to the client to ask about more documents. Some Respondents' counsel will take the position "Respondents will not provide affirmations." If that occurs, the ability to identify one or two missing documents will often give sufficient support to the meet and confer for Respondents' counsel to reconsider the extreme position.

Insistence and "compromising" that the affirmation only requires a good faith search effort, not a thorough gutting of the building, is often enough to bring Respondents' counsel to agreement. Regardless of what occurs, make a note.

Depending on the response, level of trust with Respondents' counsel, and the case, it may not be necessary to pursue affirmations of search for each List Item. If that is the case, dropping the request for affirmations can reward good behavior of promising to produce and actually producing the full scope of documents. In addition, the use of the threat of asking for affirmations of search may become a negotiation tool to obtain other discovery.

3. The Individual Requests

Getting the documents from the individual List Items will take the majority of time.

The Cat and Mouse game involves using the five to seven questions/requests for each part of the meet and confer letter.

The initial step is to learn whether responsive documents exist. A blunt but polite question based on the specific List Item such as, "are there internal discipline documents for the broker" (Item 15) is not out of line. The usual response from Respondents' counsel is "I don't know." While it may be tempting or sometimes necessary to test the veracity of such an answer, the goal is to get the documents. Fighting over what Respondent's counsel may or should know does little to get the documents produced. The follow up is to ask Respondents counsel to confirm with the client(s) whether there are any responsive documents at all, and then offer to have a discussion if such documents exist. This approach side-steps finger-pointing, puts the onus of Respondent's counsel to go ask its client to search for documents, makes the client's in-house counsel and business people think about the case, and inescapably educates Respondent's counsel on the issue of whether the desired documents exist.

For the Items which have a "conduct similar" qualifier, ask if documents are being withheld subject to the interpretation of "conduct similar."

Once the documents are confirmed to exist, the discussion often becomes easier as Respondents' counsel generally wants to avoid a motion on the Item. Quite often with the existence of the document known and no reasonable basis for an objection, it will be produced. If Respondents still want to fight the issue, enough groundwork has been made to show the document exists, and if necessary, its relation to "conduct similar" to succeed on a motion to compel.

Of course, if the Respondent's response is no such documents exist, consider asking for the affirmation of search.

When Respondents' counsel refuses to waive the Item specific objections, will not identify the documents being withheld, and says words to the effect, "you will need to get an order from the panel for Respondents to produce those documents," there is one last step. Ask Respondents' counsel "to confirm whether there are actually responsive documents being withheld in order to avoid unnecessary motion practice." It is a reasonable request made in an effort of efficiency. The Request puts Respondents in the position of having to admit whether documents exist or look like they are obstructing discovery and hiding some Good Stuff. No matter the response, make a note for the Meet and Confer memorandum.

4. Set Deadlines to Get the Good Stuff

Usually the discussion of List Items involves representations from Respondents' counsel that it is necessary to check with the client whether there are more documents. Set a deadline for Respondents' counsel to confirm the existence of documents. There will be documents. Set a second deadline for production of those documents. Set a deadline for Respondents to provide the affirmations of search.

5. Is There Anything You Need from Claimant?

Towards the end of the call, it may be worth asking Respondents' counsel if there are documents they are still awaiting from Claimant. Whatever the response, memorialize it. It gives a jump on any disputed issue, helps to meet that Rule 12505 "good faith" standard, and often avoids what just happened to Respondents' counsel from occurring to Claimant's counsel. If there is something Respondent wants in discovery, a little horse-trading might be just the solution for both sides to resolve a contested Item or two.

6. The Meet and Confer Memorialization

After an hour or two on the phone, there is always a long list of notes, agreements, agreements to disagree and more. Take the laboring oar and offer (or just inform) Respondents' counsel that Claimant will memorialize the meet and confer effort. Be as detailed as possible for each topic and List Item. This is a working document and is not the place for zealous advocacy. Neutral reporting will keep the issues on track, make follow-up easy, and not invite pointless counter-fire from Respondents. The memorialization of the meet and confer will become Exhibit B to the Motion to Compel if necessary.¹³

Once completed, send a copy of the memorandum to Respondents' counsel and ask for counsel's review and correction of any errors. Sometimes nothing comes back, other times it is a chance to clarify a good faith error, or learn Respondents are still not finished qualifying their discovery responses and another meet and confer is necessary.

7. Outside Research on the Respondent Firm's Vendors – Free Discovery!

Sometimes Respondents' counsel does not know or claims not to know much about Respondents' procedures, file architecture, document storage and electronic file architecture. It can be beneficial to ask about the Respondent firm's vendors. Along with being a potential third-party to seek discovery from, vendors usually provide a wealth of resources about their services on their

¹³RICHARD A. LEWINS & BIRGITTA SIEGEL, *Discovery in Securities Arbitration: Toss Out a Tennis Ball; Get Back a Chewed-Up Slipper*, 16 PIABA B.J. 289, 297 (2009).

website. Everything from compliance and supervision reports, to e-mail archives, to training materials, to procedures to responding to regulatory and litigation document requests may potentially be found on a vendor's website and/or promotional brochures.¹⁴ Knowing the titles of reports and related documents makes supporting a request for affirmations of search much easier. Giving Respondent's counsel an excerpt of the manual for its client's e-mail archival system may make the e-mail search much less burdensome than initially claimed. If the vendors are FINRA Member Firms, obtaining an Order to Produce the same documents listed in List 1 of the Discovery Guide is always a potential solution to getting around noisome objections.

8. SEC Record Creation and Retention Rules

Sometimes meet and confer responses from Respondents are that documents were not created or were destroyed in a file purge. There are two sources of information to test the veracity of such statements. The first is the firm's procedures and compliance manuals. A section on document retention policies is a good place to begin. The second are SEC Rules 17a-3¹⁵ and 17a-4.¹⁶ Rule 17a-3 addresses the documents a brokerage firm must create and maintain. Rule 17a-4 gives the time periods for retaining the documents. Rule 17a-4 assists in the production process by requiring many of the documents, including trade blotters to be maintained *in an easily accessible place*.¹⁷ The "easily accessible place" requirement can significantly change the burden argument, and associated effort to cost-shift discovery to Claimant.

IV. CONCLUSION

Getting the Good Stuff requires planning, early scheduling for discovery work, patience, attention to detail, follow-up, more patience, and solid memorialization. Generally, Respondents want to avoid a motion to compel except for the really Good Stuff (Item 13(b) and Item 20)). By persistent, gentle advocacy, many of the issues can be resolved, the Good Stuff produced, and most importantly through the judicious use of affirmations of search, undesirable surprises at the time of hearing can be avoided.

¹⁴E.g., Smarsh makes training materials available on-line for its electronic data record storage system. <https://central.smarsh.com/s/article/How-Do-I-Search-Content-by-Keywords> (last visited Dec. 28, 2020).

¹⁵17 C.F.R. § 240.17a-3 (2020).

¹⁶*Id.* § 240.17a-4.

¹⁷*Id.* § 240.17a-4(a). "Every member, broker or dealer subject to § 240.17a-3 must preserve for a period of not less than 6 years, the first two years in an easily accessible place, all records required to be made pursuant to § 240.17a-3(a)(1) through (3), (5), and (21) and (22), and analogous records created pursuant to § 240.17a-3(d)."

WORKING WITH A WHISTLEBLOWER WHO IS AN INSIDER OF A BROKER-DEALER FIRM

You receive an inquiry from an individual who saw an investment product referenced in a blog on your website and has some questions. The investment product has been plagued by allegations of misconduct, and while the company that issued it is still in business it has substantially reduced the periodic distribution payments to investors. In the blog you posted on your website, you indicated you are investigating the product and any potential allegations of misconduct, and invited investors who purchased that product as well as any other individuals who may have useful information that could help your investigation to call you. In the blog, you also mentioned that investors may have potential claims against the brokerage firm who sold them that product.

Upon speaking with the individual who contacted you, you learn that (1) she is an advisor who (2) works for a broker-dealer firm that sold that investment product, (3) in a supervisory capacity, overseeing a few branch offices comprised of several advisors all of which sold that investment product, (4) she recommended that investment product herself to several of her customers, and (5) is concerned about issues ranging from potential liability to loss of business from her customers who invested in that product, to the fact that she believes the broker-dealer firm engaged in serious misconduct in the course of acting as a placement agent for that investment product.

Specifically, the advisor tells you that she recently learned from her supervisor that the firm's due diligence was slap-dash and consisted of little more than a couple of trips by two representatives of the broker-dealer to the company's headquarters, with golf played during the day, long steakhouse dinners at night, and barely any time spent in the company's office to review its business and records. The advisor also tells you she recently discovered that a corporate investment vehicle owned by the same individuals who control the brokerage firm received "back-end" compensation from the program's sponsor in the form of a 5% interest in the program conditioned upon the brokerage firm raising at least \$50 million from investors, but the brokerage firm failed to disclose that deal to investors. This prompted her to dig deeper and upon doing so she also learned that the two broker-dealer representatives who conducted the "due diligence" were aware of problems concerning the company's finances that were not disclosed in its offering documents. She disclaims any personal knowledge of any problems surrounding the company or investment product at the time she recommended it and tells you that she relied on his superiors' assurances that they thoroughly checked the program before giving her and other advisors the green light to recommend it to customers.

She indicates she is not an investor in the product but is fed up with the firm's lax practices, has started looking for new employment, and the reason she told you all these is because she's looking for you to potentially represent her in a whistleblower case against her employer, to be filed with the Securities and Exchange Commission.

How do you proceed from this point on?

ABA Model Rules of Professional Conduct Rule 1.18: Duties to Prospective Client

Client-Lawyer Relationship

(a) A person who consults with a lawyer about the possibility of forming a client-lawyer relationship with respect to a matter is a prospective client.

(b) Even when no client-lawyer relationship ensues, a lawyer who has learned information from a prospective client shall not use or reveal that information, except as Rule 1.9 would permit with respect to information of a former client.

(c) A lawyer subject to paragraph (b) shall not represent a client with interests materially adverse to those of a prospective client in the same or a substantially related matter if the lawyer received information from the prospective client that could be significantly harmful to that person in the matter, except as provided in paragraph (d). If a lawyer is disqualified from representation under this paragraph, no lawyer in a firm with which that lawyer is associated may knowingly undertake or continue representation in such a matter, except as provided in paragraph (d).

(d) When the lawyer has received disqualifying information as defined in paragraph (c), representation is permissible if:

(1) both the affected client and the prospective client have given informed consent, confirmed in writing, or:

(2) the lawyer who received the information took reasonable measures to avoid exposure to more disqualifying information than was reasonably necessary to determine whether to represent the prospective client; and

(i) the disqualified lawyer is timely screened from any participation in the matter and is apportioned no part of the fee therefrom; and

(ii) written notice is promptly given to the prospective client.

Communicating with Adverse Parties

You are working with a group of clients who invested in a fraudulent investment program promoted and sold by a brokerage firm. You recently filed claims on their behalf against the brokerage firm in FINRA arbitration. In your case, you also named as respondents a few individuals who were affiliated with the brokerage firm in various capacities that, you believe, made them control persons at the time when the investments were sold to your customers. One of those individuals you named as respondents is a former officer of the brokerage firm and was also a 10% shareholder in the brokerage firm at the time those investments were sold. That individual is no longer registered with a brokerage firm, and you serve him directly.

A few days later, you receive a call from that individual. He tells you that he's broke and asks you to dismiss him from the case. You tell him that he needs to hire a lawyer and put you in contact with his lawyer, but he insists that he can't even afford to hire a lawyer and is willing to cooperate with you in exchange for your dismissing him from the case.

He indicates that he parted ways with the brokerage firm and his former business partners amidst what amounted to an acrimonious business divorce, and has a lot of "dirt" on his former partners that he is willing to share with you if you dismiss the claims you filed against him. He volunteers that the dirt consists of emails he has exchanged with his ex-partners about that fraudulent investment program, as well as conversations with the program sponsor in which he participated, which conversations will show that his partners failed to conduct adequate due diligence as to the program at the time when they agreed to promote it. He doesn't tell you anything specific about

those conversations, and you don't ask. You urge him again to hire a lawyer and tell him that you're adverse to him. He responds that he simply won't be able to and if you want to make a deal you have to deal with him, and if you continue to litigate he just won't respond or participate in the case and you won't be able to collect a penny from him.

How do you proceed from this point on?

ABA Model Rules of Professional Conduct Rule 4.3: Dealing with Unrepresented Person.

Transactions With Persons Other Than Clients

In dealing on behalf of a client with a person who is not represented by counsel, a lawyer shall not state or imply that the lawyer is disinterested. When the lawyer knows or reasonably should know that the unrepresented person misunderstands the lawyer's role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding. The lawyer shall not give legal advice to an unrepresented person, other than the advice to secure counsel, if the lawyer knows or reasonably should know that the interests of such a person are or have a reasonable possibility of being in conflict with the interests of the client.

Receiving Attorney-Client Communications

You represent a few investors in a Ponzi scheme who was recently exposed. The Securities and Exchange Commission filed securities fraud claims against the fraudster, who disappeared with the money and is nowhere to be found. Rumors are he fled the country. The business has imploded, the employees have stopped coming to work, and the door to the office is now locked. Following an article published in the local news that mentioned you as those investors' attorney, you receive a call from an individual who tells you that she used to work for the scheme as their IT support person, maintaining their computers and server located on the company's premises. She assures you she had no idea this was going on, never spoke with any investor, and all she did was help them troubleshoot any technology issues and also show up once a week to their office to back up the server and take home the portable drive with the backed-up data.

She tells you she has a question: she has a portable hard drive to her house with all of the company's data and doesn't know what to do with it. Upon inquiring, you learn that the hard drive contains all the emails sent and received through the company's server as well as all the documents its employees saved on the server. The tech support person wants to help and is willing to share that data with you and let you make a copy of the back-up hard drive. That same day you send a tech service to her house to make a mirror image of the hard drive. Upon making the copy, you advise her she should turn over the original hard drive to the Securities and Exchange Commission and give her the contact information for the Commission lawyer who is handling the case.

You start reviewing the information on the hard drive and realize it's a gold mine. It contains the names and contact information of all the scheme's investors, the scheme's marketing materials, as well as each and every email sent or received by the fraudster and his staff. Upon reviewing the emails, you come across emails between the fraudster and the company's lawyer at a prestigious regional firm that make it immediately apparent that the lawyer, who was preparing the offering documents to be distributed to investors, was clearly aware that the scheme was insolvent and the fraudster was using investor money to prop up his other failing businesses. In one of the emails, the company's lawyer (1) tells the fraudster that he can't continue to use

investor money for his personal purposes and (2) attaches a marked-up prospectus for a new securities offering by the company and asks the fraudster for any feedback before finalizing it.

How do you proceed from this point on?

“We emphasize that our analysis does not mean that there is or should be any broad duty owed by an attorney to an opposing party to maintain that party's confidences in the absence of a prior attorney-client relationship. The imposition of such a duty would be antithetical to our adversary system and would interfere with the attorney's relationship with his or her own clients. The courts have recognized repeatedly that attorneys owe no duty of care to adversaries in litigation or to those with whom their clients deal at arm's length.” *In re Complex Asbestos Litig.*, 232 Cal. App. 3d 572, 588 (1991). “[T]he rule against attorneys using client confidences in representing an adverse party can lead to disqualification, but not when an attorney-client relationship never existed between the party and the attorneys sought to be disqualified.” *Id.* at 589. “Mere exposure to the confidences of an adversary does not, standing alone, warrant disqualification. Protecting the integrity of judicial proceedings does not require so draconian a rule. *Id.*”

“Standing [to file a motion to disqualify] arises from a breach of the duty of confidentiality owed to the complaining party, regardless of whether a lawyer-client relationship existed.” *DCH Health Servs. Corp. v. Waite*, 95 Cal. App. 4th 829, 832 (2002). “[A] lawyer owes no general duty of confidentiality to nonclients. ... Absent the existence of a lawyer-client relationship or other relationship imposing a duty of confidentiality, neither [movants] were entitled to seek [plaintiff's counsel's] disqualification.” *Id.* at 833. “California authorities have consistently concluded that disqualification is inappropriate for mere exposure to information by an attorney to confidential information.” *Neal v. Health Net, Inc.*, 100 Cal. App. 4th 831, 843 (2002).

But: “Rather than disqualification of counsel, other sanctions can suffice. ... Client confidences can be protected from unwarranted public disclosure by less drastic measures such as: protective orders, limiting the admission of evidence; in camera proceedings; the use of sealed records; payment of attorney fees and costs; and disciplinary sanctions through the State Bar of California in appropriate circumstances.” *UMG Recordings, Inc. v. MySpace, Inc.*, 526 F. Supp. 2d 1046, 1063 (C.D. Cal. 2007).

“[W]e believe it is impossible to articulate a bright-line standard for disqualification where a lawyer, through no wrongdoing of his or her own, receives an opponent's privileged materials. For example, situations may exist where the attorney does everything within his or her power to mitigate the harm from the disclosure, yet the privileged information is so sensitive that disqualification is necessary to ensure a fair trial. On the other hand, there may be situations where the disclosure may cause some prejudice to movant's claim, yet other factors, such as the movant's fault contributing to the disclosure or the harm to the nonmovant from disqualification of his or her attorney, may justify denial of the motion to disqualify. In sum, the trial court, giving due consideration to the importance of our discovery privileges, must consider all the facts and circumstances to determine whether the interests of justice require disqualification. In this exercise of judicial discretion, a trial court should consider, among others, these factors:

- 1) whether the attorney knew or should have known that the material was privileged;
- 2) the promptness with which the attorney notifies the opposing side that he or she has received its privileged information;
- 3) the extent to which the attorney reviews and digests the privileged information;

- 4) the significance of the privileged information; i.e., the extent to which its disclosure may prejudice the movant's claim or defense, and the extent to which return of the documents will mitigate that prejudice;
- 5) the extent to which movant may be at fault for the unauthorized disclosure;
- 6) the extent to which the nonmovant will suffer prejudice from the disqualification of his or her attorney.

In re Meador, 968 S.W.2d 346, 351–52 (Tex. 1998).

“A different case is presented where an attorney is directly involved in improperly obtaining the other side's confidential information. However ... we disapprove of the court of appeals' decision in *Contico* to the extent that it holds that an attorney must be disqualified when, through no wrongdoing on the attorney's part, he or she gains possession of an opponent's confidential information, without regard to the significance of the information or the other circumstances surrounding the disclosure.” *Meador* at 354.

Drafting a Rule 11-Compliant Complaint

You are hired by an investor who invested in an investment program organized by a large company that has been the subject of recent litigation, has significantly reduced the payment of dividends to investors and indicated that it plans to restate its financial results over the past few years once it retains a new auditor to conduct a comprehensive audit, but is otherwise still in business. You are evaluating a case against the brokerage firm that sold the product to your client.

Upon further investigating, you locate a class action case filed by a group of investors against the company and certain other defendants including the company's underwriter and its older accounting firm, as well as a complaint filed by the Securities and Exchange Commission against that same company and its principals. The company is defending itself against both cases, has retained a large regional law firm to represent it, and has distributed a release to its investors indicating that there is no merit to the allegations against it, it plans to vigorously defend itself in both cases, and is certain that in the end it will be vindicated.

You prepare a statement of claims against the broker-dealer that sold the investment at issue to your customer. You organize the “Facts” section of your complaint in several subsections: one deals with the scheme, its background, and the description of the misconduct; another one deals with the relationship between the scheme and the brokerage firm; and one deals with the interactions between your client and the brokerage firm and the scheme. For the first subsection – the background of the scheme and the description of the misconduct – you rely heavily on the Securities and Exchange Commission's complaint, which was focused almost exclusively on the securities violations committed by the company and its principals. For the second subsection – the relationship between the scheme and the brokerage firm – you rely primarily on the class action complaint, which described in detail the improper relationship between the scheme and the underwriter and indicated that similar relationships were established with members of the selling syndicate for the scheme. For the latter section – the interactions between your client and the brokerage firm and issuer – you use your client's records and oral description of her interactions with her advisor as well as the scheme's principal in connection with her investment.

Upon filing your statement of claims against the broker-dealer firm in FINRA arbitration, you receive a very aggressive Rule 11 letter from the broker-dealer's counsel, who (1) points to specific sections of the two complaints (the SEC's and the class action lawyers'), (2) contends

that you obviously copied key portions of those sections almost verbatim in your statement of claims, (3) indicates that those sections that you copied were mere allegations that have yet to be proven in a court of law, and (4) demands that you immediately withdraw your baseless complaint or they will countersue your client and also initiate Rule 11 civil proceedings against you for filing a frivolous case against his client.

How do you proceed from this point on?

Rule 11. Signing Pleadings, Motions, and Other Papers; Representations to the Court; Sanctions

(b) Representations to the Court. By presenting to the court a pleading, written motion, or other paper—whether by signing, filing, submitting, or later advocating it—an attorney or unrepresented party certifies that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances:

(1) it is not being presented for any improper purpose, such as to harass, cause unnecessary delay, or needlessly increase the cost of litigation;

(2) the claims, defenses, and other legal contentions are warranted by existing law or by a nonfrivolous argument for extending, modifying, or reversing existing law or for establishing new law;

(3) the factual contentions have evidentiary support or, if specifically so identified, will likely have evidentiary support after a reasonable opportunity for further investigation or discovery; and

(4) the denials of factual contentions are warranted on the evidence or, if specifically so identified, are reasonably based on belief or a lack of information.

(c) Sanctions.

(1) *In General.* If, after notice and a reasonable opportunity to respond, the court determines that Rule 11(b) has been violated, the court may impose an appropriate sanction on any attorney, law firm, or party that violated the rule or is responsible for the violation. Absent exceptional circumstances, a law firm must be held jointly responsible for a violation committed by its partner, associate, or employee.

(2) *Motion for Sanctions.* A motion for sanctions must be made separately from any other motion and must describe the specific conduct that allegedly violates Rule 11(b). The motion must be served under Rule 5, but it must not be filed or be presented to the court if the challenged paper, claim, defense, contention, or denial is withdrawn or appropriately corrected within 21 days after service or within another time the court sets. If warranted, the court may award to the prevailing party the reasonable expenses, including attorney's fees, incurred for the motion.

(3) *On the Court's Initiative.* On its own, the court may order an attorney, law firm, or party to show cause why conduct specifically described in the order has not violated Rule 11(b).

(4) *Nature of a Sanction.* A sanction imposed under this rule must be limited to what suffices to deter repetition of the conduct or comparable conduct by others similarly situated. The sanction

may include nonmonetary directives; an order to pay a penalty into court; or, if imposed on motion and warranted for effective deterrence, an order directing payment to the movant of part or all of the reasonable attorney's fees and other expenses directly resulting from the violation.

(5) *Limitations on Monetary Sanctions.* The court must not impose a monetary sanction:

(A) against a represented party for violating Rule 11(b)(2); or

(B) on its own, unless it issued the show-cause order under Rule 11(c)(3) before voluntary dismissal or settlement of the claims made by or against the party that is, or whose attorneys are, to be sanctioned.

(6) *Requirements for an Order.* An order imposing a sanction must describe the sanctioned conduct and explain the basis for the sanction.

A federal district court found a Rule 11 violation where a plaintiff's attorneys relied on the SEC's allegations to substantiate a fraud claim due to the heightened pleading requirements for fraud. See *Geinko v. Padda*, No. 00 C 5070, 2002 U.S. Dist. LEXIS 3316, at *20-23 (N.D. Ill. Feb. 26, 2002).

When deciding "whether to impose Rule 11 sanctions, a district court must apply an objective standard; it must determine whether a reasonable and competent attorney would believe in the merit of an argument." *Dodd Ins. Servs., Inc. v. Royal Ins. Co. of America*, 935 F.2d 1152, 1155 (10th Cir. 1991). Rule 11(b) "imposes ... an affirmative duty to conduct a reasonable inquiry into the facts and the law before filing." *Bus. Guides, Inc. v. Chromatic Commc'ns Enters., Inc.*, 498 U.S. 533, 551, 111 S.Ct. 922, 112 L.Ed.2d 1140 (1991). "Because our adversary system expects lawyers to zealously represent their clients, [the Rule 11] standard is a tough one to satisfy; an attorney can be rather aggressive and still be reasonable." *Predator Int'l, Inc. v. Gamo Outdoor USA, Inc.*, 793 F.3d 1177, 1182 (10th Cir. 2015). However, Rule 11 "does not impose a duty to do perfect or exhaustive research." *Barnard v. Sutliff*, 846 P.2d 1229, 1236 (Utah 1992).

If a party were to prevail on a motion for Rule 11 sanctions, the applicable standard of review for an appeal is "abuse of discretion." Fed. R. Civ. Pro. 11(b); *Mendez-Aponte v. Bonilla*, 645 F.3d 60, 68 (1st Cir. 2011).

A motion for Rule 11 sanctions "must be made separately from any other motion and must describe the specific conduct that allegedly violates Rule 11(b)." Fed. R. Civ. Pro. 11(c). The motion "must be served under Rule 5, but it must not be filed or be presented to the court if the challenged paper, claim, defense, contention, or denial is withdrawn or appropriately corrected within 21 days after service or within another time the court sets." *Id.* This 21-day delay prior to filing is referred to as the "safe harbor" provision, and it is mandatory. *Lamboy-Ortiz v. Ortiz-Velez*, 630 F.3d 228, 244-45 (1st Cir. 2010) (finding Rule 11 motion disqualified for failing to comply with the safe harbor requirement). This defect, however, must be presented in response to the motion and cannot be raised for the first time on appeal. See *Nyer v. Winterthur Int'l*, 290 F.3d 456, 460 (1st Cir. 2002). The moving party must file the motion "promptly" after discovering the alleged violation. See Rule 11 Advisory Committee Notes. If delayed too long, a Rule 11 motion may be viewed as untimely. *Id.* A party cannot delay serving its Rule 11 motion until conclusion of the case or judicial rejection of the offending contention. *Id.* In *State of Conn. v. Ins. Co. of Am.*, 121 F.R.D. 159, 162-63 (D. Conn. 1988), the plaintiff moved for Rule 11 sanctions based on defendant's groundless removal a year after removal and nearly eight months after the case was

remanded. The court denied the motion as untimely. *Id.*; see also *Gen. Motors Acceptance Corp. v. Bates*, 954 F.2d 1081, 1086–87 (5th Cir. 1992) (33-month delay in filing a Rule 11 motion rendered the motion untimely); *Trevino v. Holly Sugar Corp.*, 811 F.2d 896 (5th Cir.1987) (affirming the district court's denial of Rule 11 sanctions because such motions – filed two years and three months after original suit was filed – were not timely).

BROKER DEALER OBLIGATIONS TO SUPERVISE DUALY REGISTERED BROKERS

Adam Gana¹

The Securities and Exchange Act Section ("Exchange Act") 15(b)(4)(E) provides that the SEC can sanction or revoke the registration of any member firm:

"if it finds...that such broker or dealer...has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any person of any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Commodity Exchange Act, [the Securities Exchange Act of 1934], the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, ***or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision.***"

(emphasis added).

The Exchange Act requires broker-dealers to supervise a representative's investment activities, no matter how the activity is executed, providing a prophylactic approach to supervision designed to prevent violations of the securities laws. FINRA implemented Rule 3110 to comply with the Exchange Act's supervisory requirements.² FINRA and SEC have focused on the high number of investment frauds perpetrated through outside business activities ("OBAs") and the fact that off-site locations may be used by brokers to conceal OBAs and securities fraud.³

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² The duty to supervise is violated where either: (1) awareness of 'red flags' are not followed up with proper supervision; or (2) policies and procedures are deficient resulting in failure to detect 'red flags.' See *In the Matter of the Application of Michael H. Hume* ("Hume"), Exchange Act Rel. No. 35608, 52 S.E.C. 243, 1995 SEC LEXIS 983, at*5 (Apr. 17, 1995). (liability imposed "where a supervisor was aware only of 'red flags' or 'suggestions' of irregularities" and fails to follow up.); *Kernweis*, 2000 WL 33299605 at *13 (*quoting In re Scudder Investments, Inc.*, Investment Act Rel. No. 24218, 1999 SEC LEXIS 2737, at *18 (Dec. 22, 1999). ("[l]iability for failure to supervise may be imposed when a supervisor '[fails] to learn of improprieties when diligent application of supervisory procedures would have uncovered them.'").

³ *Staff Legal Bulletin No. 17: Remote Office Supervision*, S.E.C. Release No. SLB-3A (CF), 2004 WL 5698359, at * 1 (Mar. 19, 2004) ("Some broker-dealer firms have geographically dispersed offices staffed by only a few people, and many are not subject to onsite supervision. Their distance from compliance and

If the OBA involves private securities transactions FINRA Rule 3040(c) requires that:

the *transaction shall be recorded on the books and records of the member and the member shall supervise the person's participation in the transaction as if the transaction were executed on behalf of the member.*⁴

(emphasis added).

Regardless of where the broker executes a trade for compensation, either at the firm itself or through a registered investment advisory firm, such transactions must be recorded on the broker-dealer's books and records and the broker-dealer must supervise the activity as if the activity occurred through the firm. FINRA has warned firms that it is their responsibility to "review their supervisory procedures to make sure that they are reasonably designed to achieve compliance with [FINRA] Rules 3030 and 3040 regarding outside business activities and private securities transactions..." NTM 01-79: Selling Away and Outside Business Activities.

These obligations are mandatory regardless of whether a broker is separately licensed and registered as an investment advisor ("IA"). In NASD NTM 91-32⁵ the NASD stated that NASD Rule 3040 "**should apply to all investment advisory activities conducted by registered representatives other than their activities on behalf of the member** that result in the purchase or sale of securities by the associated person's advisory clients." (emphasis added). According to NASD NTM 91-32, "to conclude otherwise would permit registered persons to participate in securities transactions outside the scope of the oversight and supervision of the employer member and of a self-regulatory organization to the potential detriment of customers."

In NASD Notice to Members (NTM) 94-44⁶, the NASD again addressed that brokerage firms must supervise their broker's IAs as if the activity took place through the firm. NASD NTM 94-44 describes an example of where the transaction of a registered representative acting as a registered investment advisor would trigger the requirements of NASD Rule 3040:

An example of a RR/RIA clearly participating in the execution of trades is where he or she enters an order on behalf of the customer for particular securities transactions either with a brokerage firm other than the member they are registered

supervisory personnel can make it easier for registered representatives (representatives) and other employees in these offices to carry out and conceal violations of the securities laws."); *see also* NTM 98-38 ("[t]o be effective...[supervision] must be designed to monitor securities-related activities and detect and prevent regulatory compliance problems of such associated persons working at unregistered offices...").

⁴ FINRA Rule 3040(e)(1) defines "Private securities transaction" as "any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission."

⁵ *Request for Comments on Compensation Arrangements for Activities of Registered Representatives Who Are Also Registered with the Securities and Exchange Commission as Investment Advisers*

⁶ *Board Approves Clarification on Applicability of Article III, Section 40 of Rules of Fair Practice to Investment Advisory Activities of Registered Representatives, and NASD NTM 96-33, NASD Clarifies Rules Governing RR/IAs [(Registered Representative/Investment Advisors)]*

with, directly with a mutual fund, or with any other entity, including another adviser, and receives any compensation for the overall advisory services.

In yet a third notice, NASD NTM 96–33 specifically reiterates that a dually licensed registered representative and investment advisor must provide prior written notice to the member before engaging in any investment advisory activity for a fee. NASD NTM 96–33 states, in pertinent part, “A member must receive prior written notice from an RR/IA requesting approval to conduct investment advisory activities for an asset-based or performance-based fee on behalf of each of his or her advisory clients.”

NASD NTM 96–33 states, in pertinent part:

Only after written approval from the NASD member may the RR/IA engage in the disclosed activities. If there is a change in the RR/IA's proposed role or activities for any customer from what the member initially approved, the RR/IA must provide the member with a subsequent written notice that details the changes and requests the member's further approval to conduct advisory activities on behalf of the customer. **The employer member must thereafter record subsequent transactions on its books and records and supervise activity in the affected accounts as if it were its own.**

(emphasis added).

FINRA has sanctioned numerous firms for failing to supervise a broker's outside advisory firm transactions. In December 2020, FINRA sanctioned Cetera Advisors – one of the largest independent broker-dealers in the country - \$1 million for failing to supervise the RIA business of the firm's brokers. *FINRA v. Cetera Advisor Networks LLC, et al*, AWC No. 2015046716901 (Dec. 9, 2020). FINRA found that Cetera failed to supervise an astonishing “\$80 billion in customer assets across more than 47,000 accounts.” *Id.* FINRA noted that “the SEC issued examination findings on three occasions, between July 2013 and September 2017, citing the firms for failing to supervise representatives' private securities transactions conducted through outside RIAs.” *Id.* In sum, FINRA determined that Cetera “could not satisfy its supervisory obligations including, but not limited to, a suitability review of all account transactions.” *Id.* Numerous other FINRA cases highlight the exact same failure at other firms including:

- *FINRA v. MidAmerica Financial Services, Inc.*, AWC No. 2012034475001 (FINRA, Jun. 2, 2014). FINRA found that “two registered representatives of MFS conducted private securities transactions through registered investment advisors (“RIAs”).” The brokers had substantial RIA assets with one having “216 investment-advisory accounts with over \$54 million in assets under management” and the other having “580 customer accounts and over \$153 million in assets under management.” *Id.* FINRA found that MFS approved the RIAs but “MFS did not receive customer account statements for the two representatives' RIA customers.” *Id.* Accordingly, FINRA determined that “MFS also did not record the representative's private securities transactions on its books and records or ‘supervise the person's participation in the transaction as if the transaction were executed on behalf of the member,’ as it was required to do.” *Id.*
- *FINRA v. VFG Securities, Inc.*, 2014038997601 (Jan. 26, 2017). FINRA found that “by treating the registered representatives' investment activities through the RIA as outside business activities rather than as private securities transactions, VFG failed to establish and maintain a supervisory system that was reasonably designed to achieve compliance

with NASD Rule 3040, and thereby violated NASD Rule 3010(a).” FINRA reiterated that Rule 3040(c) “apply ‘to all investment advisory activities conducted by [individuals dually registered as registered representatives and registered investment advisors]...”

- *FINRA v. NFP Advisor Services, LLC*, AWC No. 2011025618702 (Jul. 16, 2015) (“in October 2009, [broker] disclosed to the firm that he was managing an investment fund...as an outside business activity. The Firm did not adequately investigate red flags or follow-up on the October 2009 disclosure to ensure that DM was not engaging in private securities transactions...”).
- *FINRA v. Boenning & Scaltergood, Inc.*, AWC No. 2014038906401 (Jul. 18, 2016). “[NTM] 94-44 and NASD NTM 96-33 clarified that member firms must supervise the securities activity of registered representatives who engage in investment advisory activities away from the firm where those registered representatives participate in the execution of securities transactions on behalf of their investment advisor clients.” In addition, “the Firm’s written supervisory procedures failed to address the approval process for private securities transactions or provide procedures for their ongoing supervision.”
- *FINRA v. ProEquities, Inc.*, AWC No. 2014039418801 (Jun. 28, 2016). “Notice to Members 96-33, providing further guidance to member firms about their supervisory and recordkeeping obligations in regards to RR/IAs...FINRA cautioned that recordkeeping systems that simply record transactions will not suffice as adequate supervision under Rule 3040...supervisory procedures, must enable the member to properly supervise the RR/IA by aiding the member’s understanding of the nature of the service provided by an RR/IA, the scope of the RR/IA’s authority, and the suitability of the transactions.”
- *FINRA v. Beaconsfield Financial Services, Inc.*, AWC No. 2016047658101 (Feb. 27, 2017). “[NTM] 94-44 and NASD NTM 96-33 clarified that member firms must supervise the securities activity of registered representatives who engage in investment advisory activities away from the firm where those representatives participate in the execution of securities transactions on behalf of their investment advisor clients.” Finding that the firm “did not record these securities transactions on the Firm’s books and records or otherwise supervise these activities, as required.”
- *FINRA v. Investment Professionals, Inc.*, AWC No. 2014039093501 (Jun. 14, 2016). “IPI treated RIA activities as outside business activities, and merely required registered representatives to disclose their association with unaffiliated RIAs. Accordingly, IPI did not supervise the RIA activities of nine registered representatives who were dually I registered with three unaffiliated RIAs. These nine representatives had more than \$500 million in assets under management. In each instance, the dually-registered I representatives participated in the execution of private securities transactions on behalf of their advisory clients. IPI failed to comply with its responsibilities under NASD Rule 3040(c)(2) to supervise these representatives’ ‘participation in the transaction[s] as if the transaction[s] were executed on behalf of the member.’”
- *FINRA v. UVEST Financial Services Group, Inc.*, AWC No. 2008012048601 (Feb. 18, 2011). Rule 3040 applies to the securities activities of individuals who are both registered with a FINRA member firm and registered as an investment adviser (“RR/IA”)...FINRA further advised firms in NTM 96-33 that: ‘Recordkeeping systems that simply record all transactions will not result in adequate supervision... Rather, the records created and recordkeeping system used, together with relevant supervisory procedures, must enable

the member to properly supervise the RR/IA by aiding the member's understanding of the nature of the services provided by an RR/IA, the scope of the RR/IA's authority, and the suitability of the transactions." FINRA found that "During 2006, the dually registered representatives who operated these RIA programs participated in the execution of 18,816 securities transactions through broker-dealers other than UVEST involving mostly equity investments. Because UVEST viewed these RIA programs as outside business activities, UVEST did not comply with its obligations under Rule 3040."

- *In re Commonwealth Equity Services, LLP*, SEC Rel. No. 56362, 2007 WL 3071391 (Sept. 6, 2007). Bleidt misappropriated over \$31 million from more than 100 victims. Bleidt was dually registered with Commonwealth and was the owner of IA firm Allocation Plus Asset Management Company ("APAM"), "an independent investment adviser registered under the Advisers Act and not affiliated with or controlled by Commonwealth." *Id.* at *2. The SEC stated that "[u]nder Section 15(b)(4)(E) of the Exchange Act, broker-dealers are responsible for reasonably supervising, with a view to preventing violations of the federal securities laws, persons subject to their supervision." *Id.* at *3. The SEC stated that the firm "failed to establish reasonable policies and procedures for responding to red flags related to Bleidt's outside business activities." *Id.*

In short, it is not reasonable for broker-dealers to allow a representative to engage in securities trading without any supervision. NASD NTM 96-33 specifically states that the "relevant supervisory procedures, must enable the member to properly supervise the RR/IA" by among other things evaluating the "suitability of the transactions." In order to evaluate the suitability of transactions FINRA requires broker-dealers to document and supervise:

- dated notifications from the RR/IA detailing the services to be performed by the RR/IA and the identity of each RR/IA customer serviced at another firm in a private securities transaction;
- dated responses from the NASD member to the RR/IA acknowledging and approving or disapproving the RR/IA's intended activities;
- a list of RR/IA customers, including those that are customers of both the member firm and the RR/IA, with a cross reference to the RR/IA;
- copies of customer account opening cards to determine, among other things, suitability;
- copies of discretionary account agreements;
- duplicate confirmation statements;
- duplicate customer account statements;
- a correspondence file for RR/IA customers;
- investment advisory agreements between the RR/IA and each advisory client;
- advertising materials and sales literature used by the RR/IA to promote investment advisory services...

- exception reports, where feasible, based on various occurrences or patterns of specified activity, such as frequency of trading, high compensation arrangements, large numbers of trade corrections, and cancelled trades;

NASD NTM 96–33 specifically requires supervisory procedures to properly supervise the suitability of transactions Mr. Shaw engaged in through TFA. In order to conduct a suitability analysis on a complex options trading strategy like ACRP firms must conduct due diligence and make a reasonable investigation into the investment's prospects, risks, and the type of investor such a strategy would be appropriate for. *Dep't of Enforcement v. Cody*, No. 2005003188901, 2010 FINRA Discip., 2011 SEC LEXIS 1862, at *30-32 (NAC May 10, 2010) *aff'd*, Exchange Act Rel. No. 64565, 2011 SEC LEXIS 1862 (May 27, 2011) (stating that a broker can violate reasonable-basis suitability by failing to perform a reasonable investigation of the recommended product and to understand its risks even though the recommendation is otherwise suitable); *Michael F. Siegel*, Exchange Act Rel. No. 58737, 2008 SEC LEXIS 2459, at *28-30 (Oct. 6, 2008) (finding violation for failing to perform reasonable diligence to understand the security); *see also* NTM 03-71, at 767 (Nov. 11, 2003) (“[T]he reasonable-basis suitability analysis can only be undertaken when a [broker-dealer] understands the investment products it sells. Accordingly, a [firm] must perform appropriate due diligence to ensure that it understands the nature of the product, as well as the potential risks and rewards associated with the product.”).

In 2018, FINRA had addressed the supervisory contours of broker-dealer responsibility with regard to disclosed RIAs. In NTM 18-08, FINRA proposed eliminating supervision requirements including record keeping for all outside business activities with two exceptions. First, if a member imposes conditions or limitations on participation in an investment-related activity the member would be required to reasonably supervise compliance with those limitations but the member would not have to actually supervise the underlying activities. Second, an approved private securities transaction would have to be supervised only where the person would otherwise need to register as a broker or dealer under the Exchange Act if not for the member's registration. However, this proposal was appropriately rejected by FINRA and never passed.

BROKER THEFT

Jeff Sonn, Esq.¹

Theft by financial advisors has occurred in the last ten years on numerous occasions despite the historical rise in the stock market since 2009.² In fact, at least one study revealed that there were at least 548 brokers banned for life by FINRA between 2012 and 2017 over accusations of theft, conversion, or misappropriation.³ Further, a review of the FINRA disciplinary database between March, 2009 and August, 2021, show 539 cases that mention the word “misappropriated,” 369 cases that mention the word “forgery,” 427 cases that mention the word “forged,” and 1020 cases that mention the word “converted.”⁴ This article will review typical broker aka financial advisor theft cases, remedies, and the use of handwriting analyses in forgery cases. This article also suggests that artificial intelligence technology now exists to monitor financial activities of all financial advisors sufficient to provide early detection to prevent theft and forgeries.

I. Typical Broker Theft Cases

In the author’s experience of the past thirty-three years of practicing securities litigation, probably the most common financial advisor theft cases involve misappropriation of client assets via unauthorized withdrawals initiated by forgery of client names on various authorization forms to transfer money by wire, check, letter of authorization, or by impersonating the client.⁵ Further, in order to cover up the theft, cases often show that financial advisors forged customer statements or portfolio summaries that are provided to the customer, along with various fraudulent explanations.

In a recent case, for example, Merrill Lynch financial advisor Christopher Hibbard committed multiple acts of forgery of client signatures to make unauthorized withdrawals in the millions of dollars, while also creating fraudulent brokerage statements used to lull at least one client in to

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² See <https://www.businessinsider.com/personal-finance/average-stock-market-return> (“[Per] Goldman Sachs, 10-year stock market returns have averaged 9.2% over the last 140 years. Between 2010 and 2020, however, the investing firm notes that the S&P 500 has done slightly better than the historic 10-year average, with an annual average return of 13.6% in the past 10 years.”)

³ See Broker Theft Allegations Lead to Hundreds of Lifetime Bans, Verbrigghe and Newman, for FundFire, March 13, 2017.

⁴ See, e.g., https://www.finra.org/rules-guidance/oversight-enforcement/finra-disciplinary-actions?search=converted&firms=&individuals=&field_fda_case_id_txt=&field_core_official_dt%5Bmin%5D=2009-03-01&field_core_official_dt%5Bmax%5D=2021-08-15&field_fda_document_type_tax=All.

⁵ See e.g., U.S. vs. Christopher Hibbard, <https://www.justice.gov/usao-wdky/pr/former-louisville-investment-advisor-sentenced-8-years-federal-prison>.

believing the client's account held as much as \$4 million.⁶ According to the office of the U.S. Attorney, "between January 10, 2011, and December 20, 2017, Hibbard initiated over 300 unauthorized ACH transfers by wire" transfers "from client accounts... to an American Express account controlled by Hibbard."⁷ Further, the Justice Department said that "Hibbard caused the transfers...without the knowledge, permission, or other authorization of the account holder(s) thereby misappropriating and embezzling more than \$3 million in client monies" and used the money for "personal expenditures."⁸ The Justice Department further reported that "[i]n order to effectuate his scheme to defraud, the Defendant engaged in unauthorized trading and liquidation of clients' investments, made unauthorized withdrawals from client annuity accounts, and committed acts of forgery."⁹ In December, 2020, Hibbard was sentenced to 97 months in prison, 3 years of supervised release, and a \$1,000 fine.¹⁰ Hibbard was barred from the industry on April 16, 2021.¹¹ According to Hibbard's CRD, approximately \$6,950,000 was paid to customers who were the victims of Hibbard's fraudulent scheme.¹²

In a similar recent case, broker Gerald Eaton plead guilty to one count of wire fraud, one count of mail fraud and one count of aggravated identity theft, arising out of his theft of \$3.7 million from various customers.¹³ Eaton was a Certified Financial Planner doing business as Heritage Financial Group and licensed with Commonwealth Financial Network.¹⁴ Eaton, like Hibbard, forged clients' signatures on documents, or caused clients to sign documents "by falsely representing that the proceeds of transactions would be used for the clients' benefit."¹⁵ Eaton was accused of selling his customers' securities, insurance policies and annuities without their consent, and then sending the proceeds "to accounts he owned or controlled."¹⁶ Like Hibbard, Eaton "Eaton caused proceeds to be sent to his own credit card accounts," as well as paying his personal expenses and a home equity loan.¹⁷ Eaton preyed on customers who were unlikely to discover his scheme, purportedly because they were elderly or in poor mental or physical health.¹⁸ In March, 2021, Eaton was sentenced to 102 months in prison and three years of supervised

⁶ Id.

⁷ Id.

⁸ Id.

⁹ Id.

¹⁰ Id. He was sentenced December 17, 2020.

¹¹ <https://brokercheck.finra.org/individual/summary/3176484>.

¹² The author represented many of the victims.

¹³ <https://www.justice.gov/usao-ma/pr/acton-investment-advisor-pleads-guilty-stealing-more-37-million-clients-funds>.

¹⁴ <https://brokercheck.finra.org/individual/summary/2279093>.

¹⁵ Id.

¹⁶ Id.

¹⁷ Id.

¹⁸ Id.

release, and was ordered to pay \$3,824,930 in restitution and an additional \$1,698,701 in pre-judgment interest.¹⁹

In August, 2021, investment advisor Martin Ruiz was charged with stealing \$8 million from his customers.²⁰ Ruiz created the “RAM Fund” and sold over \$10 million in limited partnership interests to his customers, but failed to disclose that he controlled the RAM Fund and planned to misappropriate his customers’ money.²¹ Ruiz took the RAM Fund investments, “transferred those funds through a series of entities RUIZ also controlled, and spent the vast majority of the funds on personal expenses, including the purchase of a home, rent payments on several apartments, and the payment of his personal credit card bills.”²² Ruiz provided false portfolio reports to his customers representing that the RAM Fund had been used for investments such as real estate, or commercial loans.²³ As an SEC Registered Investment Advisor, he “violated his fiduciary duty to act in his clients’ best interest and avoid self-dealing.”²⁴

In another similar theft, former Morgan Stanley financial advisor Michael B. Carter was accused of stealing \$6 million from customers between 2007 and 2019 by “falsifying internal forms” to make at least “60 unauthorized cash wire transfers from customers’ and client’s accounts to his personal bank account.”²⁵ Carter, like Hibbard, concealed the fraud by creating false account statements. Carter also diverted the real customer account statements to locations he controlled, such as using a Post Office Box that he put as the client address on new account forms.²⁶ Carter also used funds from one customer account to deposit in another customer’s account to meet a large customer withdrawal request.²⁷ This type of Ponzi payments between customers to cover up thefts was something this author found in many cases over the years.

In SEC vs. Hector A. May, the SEC charged Hector May with theft of \$8 million from his customers.²⁸ May was a Securities America financial advisor, and he solicited his customers to purchase bonds away from the firm, claiming he could get his customers a better price and avoid

¹⁹ <https://www.justice.gov/usao-ma/pr/acton-investment-advisor-sentenced-stealing-more-37-million-clients-funds>.

²⁰ <https://www.justice.gov/usao-sdny/pr/new-york-investment-adviser-charged-defrauding-clients-and-misappropriating-their-money>.

²¹ Id.

²² Id.

²³ See Complaint, SEC vs. Martin Adrian Ruiz, Case No. 21CF06622(SDNY 2021).

²⁴ <https://www.justice.gov/usao-sdny/pr/new-york-investment-adviser-charged-defrauding-clients-and-misappropriating-their-money> and fn 23 infra.

²⁵ See SEC vs. Michael Barry Carter, Case No 20-cv.02112 (D.MD 2020).

²⁶ Id.

²⁷ Id.

²⁸ See Securities and Exchange Commission v. Hector A. May, et al., Case No. 18-CV-11668-VB (S.D.N.Y.).

some fees by doing so.²⁹ May instructed his clients to transfer money out of Securities America to their personal bank accounts, and then to transfer the monies to the "ECP Custodial Account."³⁰ Instead of buying bonds, May appropriated the money for himself. May forged and distributed phony consolidated account statements that purported to show all of the customer's investments, both at Securities America and the fake bonds, as well as valuations.³¹ In some cases, May used some customer funds to make payments to other customers to hide his theft.³² Hector May was eventually caught, prosecuted, and received a 13 year jail sentence, pay \$8,041,233 in restitution, and forfeit \$11,452,185.³³ Also, May's daughter, and former controller of Executive Compensation Planners (ECP) was charged with conspiracy.³⁴

In all of these cases, the financial advisor concealed the theft for a time because each forged client signatures, presented false account statements, and/or diverted customer account statements to cover up the theft. This is why securities litigation practitioners must become familiar with working with handwriting experts, and learn to look for certain documents that often assist customers prove that the brokerage firm or investment advisory firm was negligent for not detecting and preventing the fraud or detecting "red flags" sooner than the day that the fraud was disclosed or uncovered by the customer.

II. FINRA Rules, NTM's and SEC Regulations Relating to Broker Theft and Forgeries

1. **Rule 2020.** FINRA Rule 2010 is perhaps the single most important securities industry regulation. The rule requires that "[a] member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."³⁵ "Signing another person's name to documents without authority constitutes forgery."³⁶ "Reusing a

²⁹ See <https://www.sec.gov/litigation/admin/2021/ia-5762.pdf>.

³⁰ Id.

³¹ Id.

³² <https://www.justice.gov/usao-sdny/pr/former-president-investment-adviser-firm-sentenced-and-former-comptroller-charged>.

³³ Id.

³⁴ May's case is pending. See US vs. Vania May Bell, Case 19CR2020 (SDNY). The government charged that Vania May Bell served as Comptroller at ECP and "had the responsibility of keeping track of all money that into and left ECP, including the money that came from the Victims." (ECF No. 23 at 10.) "[Defendant] processed Victims' payments for what were represented to be purchases of bonds, entered those payments into a computerized accounting program and, through that program, kept track of how [Defendant] and May received and spent the Victims' stolen money." (Id.) Defendant routed Victims' money into the ECP Custodial Account instead of using it to purchase bonds and spent it on "ECP business expenses, personal expenses and to make payments to certain Victims in order to perpetuate the scheme and conceal the fraud." (Id.).

³⁵ <https://www.finra.org/rules-guidance/rulebooks/finra-rules/2010>.

³⁶ Department of Enforcement vs. Sacco, NO. 2018060494701 (September 9, 2020); https://www.finra.org/sites/default/files/fda_documents/2018060494701%20Lori%20Ann%20Sacco%20CRD%205527270%20AWC%20sl%20%282020-1602375571423%29.pdf.

customer's signature or initials from another document, including by cutting and pasting, constitutes falsification. Forging and falsifying signatures or initials on customer account documents is unethical conduct that violates FINRA Rule 2010.”³⁷

2. **Rule 4511.** FINRA Rule 4511 requires each member to “make and preserve books and records as required under the FINRA rules, the Exchange Act and the applicable Exchange Act rules.”³⁸ Inherent in this requirement is that firm books and records must be accurate.³⁹ “When an associated person forges or falsifies a firm's books and records, he or she violates FINRA Rule 4511. A violation of FINRA Rule 4511 is also a violation of FINRA Rule 2010.”⁴⁰

3. **Rule 3110.** It goes without saying that all broker dealers have a duty to supervise. FINRA Rule 3110 (Supervision) requires firms to “establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules.”⁴¹ These supervisory responsibilities by rule, include the following:

- (1) The establishment and maintenance of written procedures as required by this Rule.
- (2) The designation, where applicable, of an appropriately registered principal(s) with authority to carry out the supervisory responsibilities of the member for each type of business in which it engages for which registration as a broker-dealer is required.
- (3) The registration and designation as a branch office or an office of supervisory jurisdiction (OSJ) of each location, including the main office, that meets the definitions contained in paragraph (f) of this Rule.
- (4) The designation of one or more appropriately registered principals in each OSJ and one or more appropriately registered representatives or principals in each non-OSJ branch office with authority to carry out the supervisory responsibilities assigned to that office by the member.
- (5) The assignment of each registered person to an appropriately registered representative(s) or principal(s) who shall be responsible for supervising that person's activities.
- (6) The use of reasonable efforts to determine that all supervisory personnel are qualified, either by virtue of experience or training, to carry out their assigned responsibilities.
- (7) The participation of each registered representative and registered principal, either individually or collectively, no less than annually, in an interview or meeting conducted by persons designated by the member at which compliance matters relevant to the activities of the representative(s) and principal(s) are discussed.⁴²

³⁷ Id.

³⁸ See FINRA Rule 4511 and Section 17(a) of the Exchange Act and Rule 17a-3 promulgated thereunder.

³⁹ See Department of Enforcement vs. Sacco, NO. 2018060494701 (September 9, 2020); https://www.finra.org/sites/default/files/fda_documents/2018060494701%20Lori%20Ann%20Sacco%20CRD%205527270%20AWC%20sl%20%282020-1602375571423%29.pdf.

⁴⁰ Id.

⁴¹ <https://www.finra.org/rules-guidance/rulebooks/finra-rules/3110>.

⁴² Id at 3110(a)(1-7).

One of the key supervisory rules that can be used to detect forgery or theft is the requirement that a firm review all correspondence and communications:

(4) Review of Correspondence and Internal Communications

The supervisory procedures required by this paragraph (b) shall include procedures for the review of incoming and outgoing written (including electronic) correspondence and internal communications relating to the member's investment banking or securities business. The supervisory procedures must be appropriate for the member's business, size, structure, and customers. The supervisory procedures must require the member's review of:

(A) incoming and outgoing written (including electronic) correspondence to properly identify and handle in accordance with firm procedures, customer complaints, instructions, funds and securities, and communications that are of a subject matter that require review under FINRA rules and federal securities laws.

(B) internal communications to properly identify those communications that are of a subject matter that require review under FINRA rules and federal securities laws.⁴³

Those communications reviews, for example, could detect the furnishing of fake account statements, fake summaries, or other atypical activity by the broker. For example, in one case, there were "red flags" that the firm should have detected, such as where the broker submitted three requests to wire money from the same customer's account to a bank account that appeared to be under the broker's control.⁴⁴

Under FINRA Rule 3310(a), the Anti Money Laundering (AML) program must, at a minimum, "establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of transactions required under 31 U.S.C. § 5318(g) and the implementing regulations thereunder."

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

Notice to Members 02-21

Further, NASD Notice to Members (NTM) 02-21, issued in April 2002, provided detailed guidance to the industry regarding the obligation of a broker-dealer to monitor for and report suspicious transactions. In NTM 02-21, the NASD advised each broker-dealer that when developing an AML program, it should tailor the program to fit its business, taking into consideration, among other factors, "the types of transactions in which its customers engage." NTM 02-21 further reminded broker-dealers of their duty to look for "red flags," i.e., signs of suspicious activity that suggest money laundering or other violative activity, and provided broker-dealers with a non-exhaustive

⁴³ Id at FINRA Rule 3110(b)(4).

⁴⁴ See e.g. Department of Enforcement vs. Ameriprise, No. NO. 2010025157301.

list of such red flags, including, among others, that the customer wishes to engage in transactions that lack business sense or apparent investment strategy or that the customer, for no apparent reason or in conjunction with other red flags, engages in transactions involving certain types of securities, such as penny stocks, which although legitimate, have been used in connection with fraudulent schemes. In August 2002, FINRA issued NTM 02-47, which described the suspicious activity reporting rule promulgated by the Department of the Treasury for the securities industry. NTM 02-47 further advised broker-dealers of their duty to file a suspicious activity report (SAR) for any transaction raising suspicions of illegal activity occurring after December 30, 2002.

Regulation S-P

Per Regulation S-P, FINRA member firms must create written policies and procedures to address “administrative, technical, and physical safeguards for protecting customer records and information”—under what is commonly referred to as the Safeguards Rule.⁴⁵ Such policies and procedures must be “reasonably designed” to protect customer information, and ensure confidentiality through protections against any threats to the security and integrity of customers’ non-public personal information (“NPPI”), or against any unauthorized access of such information. Reg S-P requires that these policies must be actually implemented. And, Reg S-P requires broker-dealers, investment advisers, and investment companies to notify customers of their privacy policies. The text of Reg S-P is as follows:

§248.30 Procedures to safeguard customer records and information; disposal of consumer report information.

(a) Every broker, dealer, and investment company, and every investment adviser registered with the Commission must adopt written policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information. These written policies and procedures must be reasonably designed to:

- (1) Insure the security and confidentiality of customer records and information;
- (2) Protect against any anticipated threats or hazards to the security or integrity of customer records and information; and
- (3) Protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer.

(b) *Disposal of consumer report information and records*—(1) *Definitions* (i) *Consumer report* has the same meaning as in section 603(d) of the Fair Credit Reporting Act (15 U.S.C. 1681a(d)).

(ii) *Consumer report information* means any record about an individual, whether in paper, electronic or other form, that is a consumer report or is derived from a consumer report. Consumer report information also means a compilation of such records. Consumer report information does not include information that does not identify individuals, such as aggregate information or blind data.

⁴⁵ The “Safeguards Rule” under Reg S-P is found at 17 C.F.R. § 248.30(a).

(iii) *Disposal* means:

(A) The discarding or abandonment of consumer report information; or

(B) The sale, donation, or transfer of any medium, including computer equipment, on which consumer report information is stored.

(iv) *Notice-registered broker-dealers* means a broker or dealer registered by notice with the Commission under section 15(b)(11) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(b)(11)).

(v) *Transfer agent* has the same meaning as in section 3(a)(25) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(25)).

(2) *Proper disposal requirements*—(i) *Standard*. Every broker and dealer other than notice-registered broker-dealers, every investment company, and every investment adviser and transfer agent registered with the Commission, that maintains or otherwise possesses consumer report information for a business purpose must properly dispose of the information by taking reasonable measures to protect against unauthorized access to or use of the information in connection with its disposal.

(ii) *Relation to other laws*. Nothing in this section shall be construed:

(A) To require any broker, dealer, or investment company, or any investment adviser or transfer agent registered with the Commission to maintain or destroy any record pertaining to an individual that is not imposed under other law; or

(B) To alter or affect any requirement imposed under any other provision of law to maintain or destroy any of those records.

4. **Rule 4512** Customer account and trading supervision includes compliance obligations such as FINRA Rule 4512 (Customer Account Information), which specifies the categories of customer account information firms must maintain. This includes the customer's name, address, and tax identification number, for example. Importantly, the supplementary notes to the rule suggests that a firm should also maintain the number of a "trusted contact person" to "address possible financial exploitation, to confirm the specifics of the customer's current contact information, health status, or the identity of any legal guardian, executor, trustee or holder of a power of attorney, or as otherwise permitted by Rule 2165."⁴⁶

5. **Rule 2231**. Also, FINRA Rule 2231 (Customer Account Statements) generally requires that firms

"send a statement of account ("account statement") containing a description of any securities positions, money balances, or account activity to each customer whose account had a security position, money balance, or account activity during the period since the last such statement was sent to the customer. In addition, each general securities member shall include in the account statement a statement that advises the customer to report

⁴⁶ FINRA Rule 4512; See Supplementary Material 06; <https://www.finra.org/rules-guidance/rulebooks/finra-rules/4512>.

promptly any inaccuracy or discrepancy in that person's account to his or her brokerage firm. (In cases where the customer's account is serviced by both an introducing and clearing firm, each general securities member must include in the advisory a reference that such reports be made to both firms.) Such statement also shall advise the customer that any oral communications should be re-confirmed in writing to further protect the customer's rights, including rights under the Securities Investor Protection Act (SIPA)."

FINRA rule 2231.

6. Forgery of Customer Statements and Changes of Addresses of the Customer

The Broker's forgery of statements or summary valuation reports is the most common form of fraud used to cover up broker theft and forgeries. Also, in some cases, the fraudulent broker changes the client's address in the firm's client account records so that the real statements are mailed to an address controlled by the broker, or the broker enters a "hold all statements" entry in the client's account information, so that the statements are never sent. This is why it is so important for every brokerage firm to notify the customer anytime a customer's address was changed in the firm's account records. In fact, SEC Rule 17a-3(a)(17) requires must notify the old customer of any update to change to the name or address on the account, "on or before the 30th day after the date the member, broker or dealer received notice of the change."⁴⁷ This requirement to send the notice of a change in address was suggested "to prevent misdirection of account information."⁴⁸

But, this author suggests thirty (30) days is too long a delay to notify the customer of an address change. The technology currently exists to provide a notice of a change of address to the customer almost instantaneously by email, text or automated voice calls. Thirty days is more than enough time for a firm to permit its financial advisor to wipe out any customer with a typical theft scheme.

On a related note, under Rule 3010(c), firms must also conduct "internal inspections" at least once per year, and issue a "written report" that shows "the testing and verification of the member's policies and procedures, including supervisory policies and procedures" relevant to the "changes of customer account information, including address and investment objectives changes and validation of such changes."⁴⁹ Practitioners should be sure to request those written reports in discovery.

Timely monitoring of customer address changes cannot be understated. In one case, Ameritas Investment Corp. failed to timely detect that one if its financial advisors changed a customer's address of record to the address of the representative's branch office, and subsequently entered disbursement requests from the customer's account.⁵⁰ The financial advisor successfully conducted the transfer and misappropriated \$34,000 over a period of fifteen months.⁵¹ In 2016,

⁴⁷ SEC Rule 240.17a-3(a)(17)(i)(B)(2), Records to be made by certain exchange members, brokers, dealers.

⁴⁸ See <https://www.sec.gov/rules/final/34-44992.htm> (account record information).

⁴⁹ Rule 3010(c)(2)(A)(5).

⁵⁰ Department of Enforcement vs. Ameritas, No. 2014043064701.

⁵¹ Id.

FINRA sanctioned Ameritas, and in doing so, found violations of NASD Rules 2110, 3010(a) and (b), and 3012(a)(2)(8).⁵²

Interestingly, at that time, Ameritas' "written procedures stated that "client mail cannot be addressed in care of AIC or in care of an associate of AIC at ANY address, nor be handled by an associate or RR of AIC.""⁵³ Yet, the procedures "did not specifically prohibit using a branch's address as a customer's address of record."⁵⁴ So, the financial advisor found the hole in Ameritas' procedures by changing the address to the branch where she worked.⁵⁵ But, Ameritas did not have any procedure to monitor or validate changes to addresses "before disbursing funds to a new address."⁵⁶

7. RED FLAGS

Unusual conduct by financial advisors are "red flags" that a reasonably designed supervisory system should detect, that could and should lead to theft by financial advisors.⁵⁷ The SEC has held that "[t]he duty of supervision includes the responsibility to investigate 'red flags' that suggest that misconduct may be occurring and to act upon the results of such investigation." *Id.* (quoting Michael T Studer, 57 S.E.C. 1011, 1023-24 (2004), *aff'd*, 260 F. 342 (2d Cir. 2008)). "Once indications of irregularity arise, supervisors must respond appropriately." *La Jolla Capital Corp.*, 54 S.E.C. 275,285 (1999). Failure to tailor a firm's AML procedures to its business and customer base and failure to monitor, analyze, and investigate red flags of suspicious activity to determine whether it is appropriate to file a SAR violates FINRA Rule 3310(a).⁵⁸ Under 31 C.F.R. § 1023.320(a)(2), a FINRA firm is required to file a SAR for any transaction that it knows, suspects,

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ Ameritas did mail the customer a notice of the address change but she did not respond. *Id.*

⁵⁶ *Id.*

⁵⁷ See NTM 0-21, where FINRA published a list of "money laundering red flags" . "Guidance detailing additional red flags that may be applicable to the securities industry have been published by a number of U.S. government agencies and international organizations." See <https://www.finra.org/rules-guidance/notices/19-18>; citing, Financial Action Task Force (FATF), Guidance for a Risk-Based Approach for the Securities Sector , October 2018; FATF, Money Laundering and Terrorist Financing in the Securities Sector , October 2009; FATF, Guidance for Financial Institutions in Detecting Terrorist Financing , April 2002; FATF Report, Laundering the Proceeds of Corruption , July 2011; FATF Report, Risk of Terrorist Abuse in Non-Profit Organizations , June 2014; FinCEN Advisory FIN2010-A001: Advisory to Financial Institutions on Filing Suspicious Activity Reports regarding Trade Based Money Laundering , February 2010; U.S. Department of State, Money Laundering Methods, Trends and Typologies , March 2004; Securities and Exchange Commission (SEC) National Exam Risk Alert on Master/Sub-accounts , September 2011; SEC National Exam Risk Alert on Broker-Dealer Controls Regarding Customer Sales of Microcap Securities , October 2014; and SEC Responses to Frequently Asked Questions about a Broker/Dealer's Duties When Relying on the Securities Act Section 4(a)(4) Exemption to Execute Customer Orders , October 2014. See also Regulatory Notices 09-05 (January 2009) and 10-18 (April 2010); and Federal Financial Institutions Examination Council Bank Secrecy Act/Anti-Money Laundering, Money Laundering and Terrorist Financing "Red Flags ."

⁵⁸ Department of Enforcement vs. Precision Securities, FINRA NO. 2020067467601.

or has reason to suspect “has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage.”⁵⁹ A violation of FINRA Rule 3310 also constitutes a violation of FINRA Rule 2010, which requires FINRA members, in the conduct of their business, to observe “high standards of commercial honor and just and equitable principles of trade.”⁶⁰

In the SEC action against Painewebber, for example, the SEC found that Painewebber’s supervisory system should have detected “red flags” that would have lead it to discovery forgeries on customer documents in not less than three offices of Painewebber. See, SEC v. PaineWebber Inc., 96 Civ 0331(SDNY 1996); In the Matter of Painewebber Inc., Admin Proceeding File 3-8928 (Order Instituting Public Administrative Proceedings, Making Findings, Imposing Remedial Sanctions, January 17, 1996).

In Painewebber, supra, the SEC opined that broker dealers have a duty to detect forgeries where the signatures were “obviously different” than the “signatures in the firm’s customer account records.” Id. In that case, the SEC said, “With regard to the LOAs[Letters of Authorization], many bore signatures that were **obviously different** from the signatures in PaineWebber customer account records. Moreover, many of the LOAs authorized transfers of substantial amounts of money to accounts of other customers of the RR, or to entities controlled by the RR.-[5]- The BOM should have given these transfers special scrutiny. Such scrutiny would have uncovered the RR’s forgeries, and his unauthorized trading and misappropriation. “ Id. [bold added]

The SEC fined Painewebber, in part, for failing to have reasonable systems to supervise and detect forgeries. Id. At a minimum, this standard of care imposes a duty on all broker dealers to compare signatures of customers to the customer’s account records on file with the firm. It is reasonable to impose that duty by, at a minimum, using the original signature of the customer when the account was first established, and at least where the questioned signature appears to be “obviously different” than the firm’s customer account records.⁶¹

Another standard of care imposed on broker dealers is having a reasonable system of supervision to detect red flags, such as unusual account activity. Today, broker dealers must use some sort of trade monitoring or other system that will issue anti-money laundering (AML) alerts that will flag suspicious disbursements from client accounts. See, e.g. In re: Securities America, Release No. 5762.⁶² In Securities America, the SEC said in part: “SAA failed to implement its policies requiring AML analysts to review automatically generated surveillance alerts for suspicious client disbursements. SAA also failed to implement the signature requirements delegated to Cashiering and the call-out requirements for Trade Support. Thus, SAA willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.” Id.

⁵⁹ Id.

⁶⁰ Id.

⁶¹ On January 1, 2011, the Federal Trade Commission (FTC) began enforcing its Fair and Accurate Credit Transactions Act of 2003 (FACT Act) Red Flags Rule. The Red Flags Rule requires that each “financial institution” or “creditor”—which includes most securities firms—implement a written program to detect, prevent and mitigate identity theft in connection with the opening or maintenance of “covered accounts.” These include consumer accounts that permit multiple payments or transactions, such as a retail brokerage account, credit card account, margin account, checking or savings account, or any other accounts with a reasonably foreseeable risk to customers or your firm from identity theft.

⁶² SEC vs. Securities America, File NO. 3-20381 (Release 5762 June 30, 2021).

In Securities America, for example, AML related supervisory failures allowed financial advisor Hector May to steal \$8 million from his clients by perpetrating a Ponzi scheme where he solicited funds for bond investments, but then diverted the money for his own use. See SEC vs. Hector May.⁶³ May covered up his thefts by creating fraudulent account statements showing fictitious purchases of bonds for his clients and grossly inflated the customer's account holdings. Id. He also used customer money to make Ponzi payments to other customers when they withdrew funds from their accounts. Id.

The supervisory failures described in the Hector May case revealed Securities America policies that are indicative of industry procedures that many firms utilize, though other firms' policies may differ in terms of when certain procedures are triggered, or the amount of money sought to be transferred from a customer account. In the Hector May action, Securities America supervisory policy failures were described as follows:

Cashiering

13. Cashiering staff failed to implement SAA Policies regarding the review of outgoing client disbursements for possible misappropriation. During the Relevant Period, client signatures were required for disbursement requests as follows: once a signed form was on file for a disbursement request, multiple disbursements could be made to the same outside account using this signed form for a maximum of twelve months. After that, a new signed request was required. Yet, Cashiering staff failed to implement this signature policy. On January 22, 2015, Client A submitted a signed disbursement request for \$50,000 that, according to SAA Policies, was effective for one year. Nonetheless, from February through December 2016, after the signed wire request was no longer in effect, Cashiering staff disbursed six outgoing wires of \$50,000 apiece to Client A.

Trade Support

14. SAA Policies required the Trade Support staff to review outgoing wire requests in amounts of \$50,000 or greater for possible misappropriation. First, SAA Policies required Trade Support staff to contact the client's adviser to confirm that she or her staff had verbally confirmed the wire request with the client. Next, they were required to speak to the client to confirm that the request had been made. Upon reaching the client, Trade Support staff was required to confirm the client's full name, last four digits of the client's social security number, date of birth, and the amount and destination of the wire. Finally, SAA Policies required Trade Support staff to administer a Verification ID test designed to confirm the client's identity. After the above was satisfactorily complete, Trade Support staff was required to complete the Representative Verification and Client Verification section of the brokerage disbursement verification checklist.

15. Trade Support staff failed to implement the SAA Policies above by failing to contact some of May's clients as required. For example, twenty outgoing wires to Client A met the threshold for a client call, but Trade Support made only eleven calls. In addition, disbursements were approved in at least five cases where Clients A and B were unable to identify the amount or the destination of the wire.

⁶³ SEC vs. Hector May, File No. 3-18998 (Release 5112 (February 14, 2019)).

17. SAA failed to implement its policies requiring AML analysts to review automatically generated surveillance alerts for suspicious client disbursements. SAA also failed to implement the signature requirements delegated to Cashiering and the call-out requirements for Trade Support.

See SEC vs. Hector May, Release 5762.

8. Duty to Report Customer Complaints of Broker Theft

FINRA RULE 4530 requires member firms to report broker theft within 30 days of any “written complaint” alleging theft or misappropriation, even if by a text message or a tweet:

Section 2: Customer Complaints

2.1 Are text messages and tweets received from member firm customers complaining about the member firm or its associated persons subject to reporting under FINRA Rule 4530?

Yes. FINRA Rule 4530(a)(1)(B) requires that a member firm report within 30 calendar days after the firm knows or should have known that it or an associated person is the subject of any written customer complaint alleging theft or misappropriation of funds or securities or forgery. FINRA Rule 4530(d) requires that a member firm also report quarterly statistical and summary information regarding written customer complaints that have been received. Received text messages and tweets are in a written format. Thus, a member firm must report text messages and tweets received from firm customers expressing complaints about the firm or its associated persons consistent with the requirements of FINRA Rules 4530(a)(1)(B) and 4530(d). For example, if a firm customer sends a tweet to the firm alleging that an associated person sold him unsuitable securities, the firm must report it pursuant to FINRA Rule 4530(d).⁶⁴

By the same token, a firm must report a complaint where there is an allegation of unauthorized use of the customer’s credit card:

2.16 A member firm received a written customer complaint alleging that there was an unauthorized charge on a debit card. The debit card is issued by a third-party bank and linked to the customer’s cash management account. The complaint does not allege that the member firm or an associated person of the member firm made the unauthorized charge. The customer is a person with whom the member firm has engaged in securities activities. Does the member firm have an obligation to report the complaint pursuant to FINRA Rule 4530(a)(1)(B)?

No. FINRA Rule 4530(a)(1)(B) requires a member firm to report when the member firm or an associated person of the member firm “is the subject of” any written customer complaint involving allegations of theft or misappropriation of funds or securities or of forgery. Here, because the

⁶⁴ <https://www.finra.org/filing-reporting/regulatory-filing-systems/rule-4530-reporting-requirements/faq> at 2.1.

complaint does not allege that the member firm or an associated person of the member firm made the unauthorized charge, the member firm does not have to report the complaint under FINRA Rule 4530(a)(1)(B). However, the member firm may want to inform the third-party bank of the complaint so the bank can address it.

2.17 In Question 2.16 above, does the member firm have an obligation to report the written customer complaint pursuant to FINRA Rule 4530(d)?

Yes. For purposes of FINRA Rule 4530(d), a person with whom the member firm has engaged in securities activities is considered a customer of the member firm, and the firm must report “any written grievance by such person *involving* the member or a person associated with the member.”¹⁰ Here, for purposes of Rule 4530(d), the complainant is considered a customer of the member firm, and there is a written grievance involving the member firm because the complaint involves a debit card linked to the customer’s cash management account. Thus, the member firm has an obligation to report the complaint under FINRA Rule 4530(d).

III. FINRA’S EXAMINATION REPORT COMMENTS ON RISKED BASE REVIEWS USED TO DETECT BROKER THEFT

According to a 2019 FINRA Examination Findings Report, FINRA found some firms failed to “have reasonable processes to detect or prevent various forms of forgeries, including “accommodation forgery,” where registered representatives and associated persons asked customers to sign blank, partial or incomplete documents.”⁶⁵ FINRA found that “[s]ome firms expanded risk-based reviews of associated persons’ communications to cover requests for customer signatures or enhanced firm reviews of customer complaints for issues relating to forgery or falsification of documents.”⁶⁶ But FINRA also found that “some firms did not follow their protocols relating to notarization and medallion stamp guarantees, or did not have any supervisory procedures for supervising the use of such stamps.”⁶⁷

“Another crucial area of concern is the verification of customer addresses. In some broker theft cases, the financial advisor will set up a PO Box or other address to use to divert the real customer account statements and then create the false account statements that they will mail to the customer. FINRA mandates that as part of the AntiMoney Laundering obligations of a firm is to “analyze whether there is a logical consistency between the identifying information provided, such as the customer’s name, street address, zip code, telephone number (if provided), date of birth, and Social Security number (e.g., zip code and city/state are consistent).”⁶⁸ “Firms must confirm the mailing address directly with the customer, independent of the financial advisor, to prevent improper diversion of customer statements. This can be done by email, text or automated phone

⁶⁵ <https://www.finra.org/rules-guidance/guidance/reports/2019-report-exam-findings-and-observations/supervision>.

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ <https://www.finra.org/rules-guidance/key-topics/aml/faq> FAQ 17.

calls to the client's cell number to record the customer's voice and information to verify the authenticity of the client's mailing address for client statements."⁶⁹

IV. THE USE OF ARTIFICIAL INTELLIGENCE TO PREVENT BROKER THEFT

In 1990, about three years after IBM introduced its P/2 personal computer and during the relative infancy of the development of personal computers, one court rejected the notion that broker dealers could not detect unauthorized trading, suggesting that broker dealers could and should develop procedures to detect unauthorized trading by looking for unusual account activity, the way that banks monitor credit card activity:

Although Merrill Lynch argues that it is impossible to detect unauthorized trading absent customer notification, we do not take such a dim view of the review process. Perhaps different procedures can be developed and implemented which will be more effective in detecting churning. For instance, several bank card companies telephone their customers to guard against unauthorized use when their computer records indicate an unusual increase in the number of charges made on the customer's credit card accounts. Perhaps such a policy could be implemented by Merrill Lynch. Other security measures and review procedures are also likely to be developed over time as technology advances.

See *Davis vs. Merrill Lynch*, 906 F2d1206 at fn 10(8th Cir 1990).

Today, technology has advanced to the point that Artificial Intelligence is being used in compliance and risk management systems at broker dealers.⁷⁰ According to FINRA, "In conversations with FINRA staff, industry participants noted that they are spending significant time and resources in developing AI-based applications to enhance their compliance and risk management functions. This is consistent with FINRA's 2018 research on the use of regulatory technology (RegTech), where FINRA observed that "market participants are increasingly looking to use RegTech tools to help them develop more effective, efficient, and risk-based compliance programs."⁷¹ "According to an April 2018 research study conducted by Chartis Research and IBM, which surveyed more than 100 relevant risk and technology professionals, 70% of respondents noted using AI in risk and compliance functions."⁷²

Thus, the Court's commentary in *Davis vs. Merrill Lynch* strongly suggests that broker dealers no longer have the excuse that they cannot detect red flags that lead to the detection of theft, misappropriation and forgery, as technology permits them to fulfill their supervisory functions to

⁶⁹ *Id.*

⁷⁰ See <https://www.finra.org/rules-guidance/key-topics/fintech/report/artificial-intelligence-in-the-securities-industry/ai-apps-in-the-industry>.

⁷¹ FINRA, Technology Based Innovations for Regulatory Compliance ("RegTech") in the Securities Industry, Sept. 2018, https://www.finra.org/sites/default/files/2018_RegTech_Report.pdf [hereinafter FINRA RegTech White Paper].

⁷² IBM and Chartis Research, AI in RegTech: A Quiet Upheaval, 2018, <https://www.ibm.com/downloads/cas/NAJXEKE6>.

detect and prevent theft. FINRA found that “[c]onsequently, firms have started incorporating AI technologies, such as ML, NLP, and biometrics, to make their programs more effective and risk based. Firms indicated that these tools enable them to identify and track customer activity with greater accuracy and efficiency, and to conduct more holistic and detailed analysis of customer transactions.”⁷³ To be more specific, FINRA found that firms have begun using applications that “incorporate CV and NLP to...review signatures.”⁷⁴

Today, there are Artificial Intelligence software solutions used by banks to “enable compliance and identify fraud for financial institutions regardless of channel, such as remote deposit, teller, Web, ATM or mobile device,” such as that offered by Parascript machine learning software.⁷⁵ Parascript software, for example, “detects counterfeit documents, signature forgery, content alteration, duplicate presentment, CAR/LAR mismatch and payee match discrepancies.”⁷⁶ Further, Parascript claims that it “auto-verifies and auto-detects signature discrepancies through online applications to help businesses and organizations fight signature fraud.”⁷⁷

Because artificial intelligence is now sufficiently advanced, there is no more excuse not to deploy it to detect and prevent broker theft. In almost all broker theft cases, the financial advisors stole the money for their personal use, such as paying their credit cards, homes, cars, loans, private school and other personal expenses. Which begets the question, “why don’t brokerage firms better monitor their financial advisors’ credit card accounts, loans, and other personal expenditures using artificial intelligence to detect financial activities inconsistent with their known employment earnings?” First, it is a generally accepted industry standard that broker dealers require their financial advisors to conduct all of their personal securities transactions at their employer’s firm, so that activity can be supervised. Second, broker dealers can require that financial advisors given regular access to their credit reports, credit card accounts, and other financial data that is normally reported on their credit reports. Further, broker dealers could require that all financial advisors cause copies of all credit card statement data be sent to their employer. By using all of this financial data, and cross referencing it against banking activity, employment earnings, outside business activities, brokerage firms can use artificial intelligence to detect financial anomalies in the financial data of their employees to detect broker theft.

Given that financial advisors are often entrusted with tens of millions, hundreds of millions, and sometimes billions of dollars of customers’ life savings, and are almost always required to conduct their securities transactions at their employer’s brokerage firms, why don’t brokerage firms fully monitor financial advisors’ personal financial lives to detect financial anomalies? Broker dealers already have duty to report suspicious activity of their customers. So too, do they have the responsibility to supervise their financial advisors. Given today’s technology, which includes artificial intelligence, broker dealers, using each financial advisor’s credit reports, now have the ability to fully and completely monitor all financial activities of their financial advisors to detect and prevent broker theft. The technology exists; so now, there is no excuse not to use it on all financial advisors who are trusted with their customers’ savings.

⁷³ https://www.finra.org/rules-guidance/key-topics/fintech/report/artificial-intelligence-in-the-securities-industry/ai-apps-in-the-industry#_ftnref7.

⁷⁴ Id. See “Administrative Functions, Automation of manual, paper based processing.”

⁷⁵ <https://www.parascript.com/products-technology-solutions/fraud-prevention/>.

⁷⁶ Id.

⁷⁷ Id.

V. Remedies

A. 10b5 Claims

Originally, Federal Claims under Section 10b claims were “directed at preventing buyers and sellers of securities from deliberately misleading each other for the purpose of inducing a transaction”, SEC vs. Pirate Investor, LLC 580 F.3d 233 (4th Cir. 2009)(citing SEC v. Tambone, 550 F.3d 106, 122 n. 20 (1st Cir.2008) et al), but “§ 10(b) now covers a variety of fraudulent activity, including...a broker's theft of the proceeds from sales of his clients' securities, See SEC v. Zandford, 535 U.S. 813, 822, 122 S.Ct. 1899, 1904 (2002).

Section 10(b) of the Securities Exchange Act of 1934 [15 USC § 78j(b)] provides that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange... [to] use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

SEC Manipulative and Deceptive Devices and Contrivances Rule, 17 C.F.R. § 240.10b-5, provides in part:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, To employ any device, scheme, or artifice to defraud,

To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

“To succeed on a Rule 10b-5 fraud claim [based on an untrue statement or omission of a material fact], a plaintiff must establish (1) a false statement or omission of material fact; (2) made with scienter; (3) upon which the plaintiff justifiably relied; (4) that proximately caused the plaintiff's injury.” Robbins v. Koger Props., Inc., 116 F.3d 1441, 1447 (11th Cir. 1997) (citing Bruschi v. Brown, 876 F.2d 1526, 1528 (11th Cir. 1989)).

Note that § 10(b)/Rule 10b-5 claims are governed by the PSLRA. The PSLRA provides in relevant part that,

[i]n any private action arising under this title [15 U.S.C. § 78a et seq.] in which the plaintiff alleges that the defendant –

(A) made an untrue statement of a material fact; or (B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading;

the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

15 U.S.C. § 78u-4(b)(1).

The PSLRA further provides that,

in any private action arising under this title [15 U.S.C. § 78a et seq.] in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

Id. § 78u-4(b)(2).

Lastly, Section 20(a) of the Securities Exchange Act creates so-called “control person liability,” meaning that “a person who controls a party that commits a violation of the securities law may be held jointly and severally liable with the primary violator.” *Maier v. Durango Metals, Inc.*, 144 F.3d 1302, 1304–05 & n.7 (10th Cir. 1998) (citing 15 U.S.C. § 78t(a)).

B. State Statutes for Theft

In addition to § 10(b) claims [15 U.S.C.A. § 78j(b)], many states have statutory remedies geared towards civil remedies for criminal practices, which include broker theft, some of which provide for treble damages, punitive damages, and/or attorneys fees. See, e.g., FL§ 772.11 (treble damages and fees); Colo. Stat. § 18-4-405 (treble damages); MN § 604.14 (punitive damages); TX § 41.008(c)(13)(no punitive damages cap where plaintiff seeks recovery based on certain felonious conduct, including theft punishable as a third-degree felony or higher.); Cal.Penal Code § 496(treble damages and fees); CN§ 52-564 (treble damages); WI 895.446(up to treble damages for violating theft statute 943.20, actual or replacement value of property stolen, all costs of investigation and litigation that were reasonably incurred, including the value of the time spent by any employee or agent of the victim.); UT § 76-10-1605 (double damages and fees); MI §600.2919a (treble damages and fees).

Also, some states award treble or special damages and/or attorney’s fees to the elderly that are victimized by theft, conversion, or embezzlement, which is beyond the scope of this article. See Jeff Aidikoff and Ashley Rivkin, *States with a Civil Right of Action for Financial Elder Abuse and Exploitation*, 24 PIABA B.J. 29(2017); Jeffrey Sonn, Jennifer P. Farrar, Kirk Reasonover, Jeffrey Erez *Elder Abuse Issues and the Securities Industry* (PIABA 22nd Ann Mtg 2013); Timothy A. Canning, “Elder Abuse Remedies in Securities Arbitration,” (2d Cal. Mtg. 2004).

C. Vicarious Liability

“It is well established that traditional vicarious liability rules ordinarily make principals or employers vicariously liable for acts of their agents or employees in the scope of their authority or employment.” *Meyer v. Holley*, 537 U.S. 280, 285, 123 S.Ct. 824, 154 L.Ed.2d 753 (2003)⁷⁸;

⁷⁸ The Supreme Court would not impose liability on an owner or officer, declaring in part, “[I]n the absence of special circumstances it is the corporation, not its owner or officer, who is the principal or employer,

Restatement (Second) of Agency §§ 216, 265. “An agent's authority may be either actual or apparent.” *Sphere Drake Ins. Ltd. v. Am. Gen. Life Ins. Co.*, 376 F.3d 664, 672 (7th Cir.2004). “A principal also may be liable where an agent acts outside the scope of its actual or apparent authority but the principal subsequently ratifies the agent's acts.” See *Gondeck v. A Clear Title and Escrow Exchange, LLC*, 2012 WL 3638321 (N.D.IL 2012); See *Speher Drake*, *supra*, at 677; Restatement (Second) of Agency § 82.

“Between a principal and a third party, the principal must bear the burden of an agent who has acted improperly.” *Davis v. Merrill Lynch*, 688 F.2d 1193 (8th Cir. 1982), citing, *Rosebud Sioux Tribe v. A & P Steel, Inc.*, 733 F.2d 509, 518 (8th Cir.) (*Rosebud*), cert. denied, 469 U.S. 1072, 105 S.Ct. 565, 83 L.Ed.2d 506 (1984). Yet, Broker Dealers often assert that they cannot be held vicariously liable for the unauthorized actions of their financial advisors during their employment because the tortious conduct was purportedly “outside the scope of their employment.” See *eg Freeney vs. Bank of Am. Corp* 2015 WL 12535021 (CDCA 2015).⁷⁹

To determine whether an employee is acting within the scope of his employment, some courts consider whether the “risk of such an act is typical of or broadly incidental to the employer's enterprise,” and the “employee's activities must be inherent in, typical of or created by the work so that it is a foreseeable risk of the particular employment.” *Sunderland v. Lockheed Martin Aeronautical Sys. Support Co.*, 130 Cal. App. 4th 1, 9 (2005).

Although vicarious liability is not appropriate when the tortious conduct arises from a personal dispute, when the employee combines personal and employment business or “attend[s] to both at substantially the same time,” the employee is acting within the scope of his employment “unless it clearly appears that neither directly nor indirectly could he have been serving his employer.” See *Farmers Ins. Grp. v. Cty. of Santa Clara*, 11 Cal. 4th 992, 1006 (1995). In California, the doctrine of vicarious liability has been interpreted broadly. See e.g., *See Farmers Ins. Group v. County of Santa Clara*, 11 Cal. 4th 992, 1004 (1995).

The 5th Circuit Court of Appeals also imposed vicarious liability on the employer of a financial advisor for unauthorized actions. Although theft, forgery and misrepresentations will always violate company policies at brokerage firms, “conduct may be within the ‘scope of employment’ even if it is unauthorized, if it is of the same general nature as, or sufficiently similar to, authorized conduct, taking into consideration the various factors relevant to the master-servant relationship.” See *eg Lewis v. Walston & Co., Inc.*, 487 F.2d 617 (5th Cir.1973)); See generally, *Padgett v. Sch. Bd. of Escambia County*, 395 So.2d 584, 586 (Fla.1st DCA 1981).

In *Lewis v. Walston & Co., Inc.*, *supra*, “the Fifth Circuit rejected the theory that respondeat superior could not apply in a case involving unauthorized trading by a registered representative not executed through the employer brokerage house and from which the employer derived no financial benefit. The Court noted that brokers take many actions not executed through their

and thus subject to vicarious liability for torts committed by its employees or agents.” *Id.* at 286. The principal must not only have the right to control the agent's actions, but the agent must consent to act on the principal's behalf and the principal must consent to have the agent act on his behalf. *Id.* The Supreme Court noted that a “corporate employee typically acts on behalf of the corporation, not its owner or officer.” *Id.*

⁷⁹ See generally, *Sybedon Corp. v. Bank Leumi Trust Co. of N.Y.*, 224 A.D.2d 320, 638 N.Y.S.2d 50 (1996)(The risk of loss from the unauthorized acts of a dishonest agent falls on the principal that selected the agent.).

brokerage houses. The Court found that the employee's regular use of the brokerage firm's facilities and the employee's position as a registered representative justified a finding that the instrumentality used to cause the harm was furnished by the master to the servant and thus the employee's actions were found to be within the scope of employment." *Federal Savings and Loan Ins. Corp. v. Shearson–American Express, Inc.*, 658 F.Supp. 1331 (D.P.R.1987), citing *Karlen v. Ray E. Friedman & Co. Commodities*, 688 F.2d 1193, 1198 n. 5 (8th Cir.1982).

Some states limit vicarious liability to only those acts that were in furtherance of the employer's business or is shown to benefit the employer. For example, "[i]n New York, 'an employer may be vicariously liable for the tortious acts of its employees ... if those acts were committed in furtherance of the employer's business and within the scope of employment.' " *A.W. by E.W. v. New York Dep't of Educ.*, No. 19-CV-7011 (MKB), 2021 WL 611409, at *7 (E.D.N.Y. Feb. 16, 2021) (citations omitted); see also *In re Ivan F. Boesky Sec. Litig.*, 36 F.3d 255, 265 (2d Cir. 1994) (discussing New York respondeat superior doctrine in the context of breach of fiduciary duty claims; noting that "[a]n employer may be liable for [tortious] acts committed by its employee, [so long as] those acts ... in some way further the interests of the employer, and not solely benefit the employee"). Similarly, in *In United Technologies Corp. v. Mazer*, the Eleventh Circuit noted:

"Under the doctrine of respondeat superior, an employer cannot be held liable for the tortious or criminal acts of an employee, unless the acts were committed during the course of the employment and to further a purpose or interest, however excessive or misguided, of the employer." *Iglesia Cristiana La Casa Del Senor, Inc. v. L.M.*, 783 So.2d 353, 356 (Fla. 3d DCA 2001). Under Florida law, an action falls within the scope of employment if the conduct: 1) is of the kind the employee was employed to perform; 2) occurred within the time and space limits of the employee's employment; and 3) was activated at least in part by a purpose to serve the employment. *Spencer v. Assurance Co. of Am*, 39 F.3d 1146, 1150 (11th Cir. 1994); *Iglesia Cristiana*, 783 So.2d at 357."

United Technologies Corp. v. Mazer, 556 F.3d 1260 (11th Cir. 2009).

So for example, a cable company was found not liable for theft of an engagement ring when the cable installers allegedly stole the ring during a visit to the customer's house to install cable TV. *Synergies3 Tec Services, LLC v. Corvo*, 319 So.3d 1263 (AL 2020). Yet, the cable company was held liable for negligent supervision. *Id.* In most cases of theft by the financial advisor, the advisor is actually providing financial information and advice to the customer, in furtherance of the scheme to defraud. Hence,

Also, a "corporate employer of the perpetrator of a theft or conversion is vicariously liable for punitive damages or treble damages when (a) the theft or conversion was committed by a managerial employee of the corporation within the scope of the latter's employment; or (b) the theft or conversion was committed by a non-managerial employee of the corporation within the scope of the latter's employment, provided further that the management of the corporation was guilty of some fault which foreseeably contributed to the plaintiff's injury." *Regions Bank v. Kaplan*,) 2017 WL 5178754 (M.D.FL 2017), citing *McArthur Dairy, Inc. v. Original Kielbs, Inc.*, 481 So.2d 535, 540 (Fla.3d DCA 1986).⁸⁰

⁸⁰ In Florida, "an employer should [not] be vicariously liable for an intentional tort of its employee committed outside the scope of employment." See *Goss v. Human Servs. Assocs, Inc.*, 79 So.3d 127, 132 (Fla. 5th DCA 2012).

Customers often allege tortious acts by the financial advisors as part of the theft, such as (1) false statements to or withholding material information from the customer; and (2) using access to customer funds to divert monies to their accounts or the accounts of their associates. Whether that type of employees' conduct is within the scope of employment is "generally ... a question of fact" not appropriate for resolution in the context of a motion to dismiss or even a summary judgment motion. See e.g. *Inter Mountain Mortg., Inc. v. Sullivan*, 78 Cal.App.4th 1434, 1441 (2000). "The risk that a money manager will commit fraud in managing a client's funds, and the risk that a financial adviser will intentionally give a client false information to divert the client's funds or obtain a larger commission are "risks inherent in or created by the enterprise" of managing money or providing financial advice." See *Freeney v. Bank of Am. Corp.*, 2015 WL 12535021 (C.D. Cal. Nov. 19, 2015) citing, *Farmers Ins. Group v. County of Santa Clara*, 11 Cal. 4th 992, 1004 (1995). Such purported acts by the broker-advisors were "outgrowth[s] of [their] employment, inherent in the working environment, typical of or broadly incidental to [BAC's and MLPFS's] business, or, in a general way, foreseeable from the [broker-advisors'] duties." *Freeney*, supra, citing, *Purton v. Marriott Internat., Inc.* 218 Cal.App.4th 499, (2013).⁸¹

"Stated differently, abuse of a position of power and influence over a client's money is not "so unusual or startling that it would seem unfair to include the loss resulting from it among other costs of the employer's business." *Freeney v. Bank of Am. Corp.*, 2015 WL 12535021 (C.D. Cal. Nov. 19, 2015); citing *Xue Lu v. Powell*, 621 F.3d 944, 949 (9th Cir. 2010) ("Like the loan broker, Powell was part of a process in which he was expected to participate in a lawful way, reviewing the documentation of the asylum applicant, interviewing her, and assessing the credibility of her claims. Like the loan broker, Powell abused his powers for his own benefit. In doing so, he acted within the scope of his employment as defined by California. To compensate his victims, spread the loss, and stimulate the government to greater vigilance in controlling aberrant behavior, California law makes the United States bear the cost of Powell's conduct, unauthorized but incidental to the asylum system"); See also *Inter Mountain Mortg., Inc. v. Sullivan*, 78 Cal.App.4th 1434, 1441 (2000) ("According to this evidence, the alleged fraudulent loan transaction occurred during Baskaron's employment with defendants as a loan representative. And, according to Escutia, Baskaron led her to believe that when he submitted the Brown loan to Inter Mountain Mortgage, he was performing his job duties as an American Frontier loan representative. Under such circumstances, a nexus existed between Baskaron's alleged tort, the fraudulent loan transaction, and his employment as a loan representative. The risk of one of defendants' loan representatives submitting a fraudulent loan application, such as the Brown loan application, was a generally foreseeable risk inherent and incidental to defendants' mortgage loan brokerage business. Baskaron's employment as a loan representative placed him in the position of being able to submit fraudulent loan applications. Such an occurrence was 'not so unusual or startling that it would seem unfair to include the loss resulting from it among other costs of the employer's business.' While defendants may not have known of his alleged fraudulent conduct, they are vicariously liable for such conduct if Baskaron committed the fraud while holding himself out as an American Frontier loan representative", quoting *Lisa M. v. Henry Mayo Newhall Mem'l Hosp.*, 12 Cal. 4th 291, 298 (1995); see also *Avila v. Palo Alto Comm. Fed. Credit Union*, 2002 WL 399510 (Cal. App. Mar. 15, 2002) ("In the instant case, when Joyner entered 'Miranda Jones' as a beneficiary in plaintiff's account file, she was employed by defendant as a teller to handle money transactions for Credit Union members and to sell traveler's checks. She entered the false information into plaintiff's account file using knowledge and equipment defendant made available to its tellers and she had access to blank traveler's checks because of her employment. This evidence indicates that she was acting within the scope of her employment even though her

⁸¹ "[A]n employer may be liable for an employee's tort if the employee's conduct was foreseeable or if it was required by or incident to his duties." *Id.*

actions were criminal. The risk of a teller falsifying account information and stealing money or traveler's checks is a generally foreseeable risk inherent and incidental to defendant's credit union business").

Alternatively, one may argue liability under the applicable Restatement of Torts. Under Restatement (Second) of Agency § 219(2), "there are four exceptions to the general rule that a principal is liable for the torts of an agent only if the agent was acting within the scope of his or her employment." See, e.g., *Hass v. Wentzlaff*, 816 N.W.2d 96 (S.D.2012) (insurance agent's theft of annuitant's funds). One exception says that a principal may be liable for the torts of an agent acting outside of the scope of his or her employment if "the [agent] ... was aided in accomplishing the tort by the existence of the agency relation." *Id.*; Restatement (Second) of Agency § 219(2)(d) (1958). "In those cases, liability attaches because the tortfeasor's employment enabled or endowed him with a unique advantage to perpetrate the tortious acts." *Iverson v. NPC Int'l, Inc.*, 801 N.W.2d 275, 280 (S.D. 2011).⁸² The comment to Section 219(2)(d) explains that "the [agent] may be able to cause harm because of his position as agent, as where a telegraph operator sends false messages purporting to come from third persons[.]" (citing Restatement (Second) of Agency, § 261 (1958)).⁸³

⁸² As a side note, *Iverson* also suggests that a proper background check must be performed on employees expected to have material contact with the public. " 'When an employee comes into minimum contact with the public or those in a special relationship with the employer, the employer need not perform a background investigation.' " *McGuire v. Curry*, 766 N.W.2d 501, 507 (S.D. 2009)). "But, '[t]he opposite is true when the employee makes frequent contact with the public and those in a special relationship with the employer.' " *Id.*

⁸³ Foreseeability is also an issue. Restatement (Second) of Agency § 229(2) contains more helpful criteria in analyzing foreseeability as it relates to vicarious liability. Restatement (Second) of Agency § 229(2) lists ten factors relevant to the scope of employment inquiry:

- (a) whether or not the act is one commonly done by such servants;
- (b) the time, place and purpose of the act;
- (c) the previous relations between the master and the servant;
- (d) the extent to which the business of the master is apportioned between different servants;
- (e) whether or not the act is outside the enterprise of the master or, if within the enterprise, has not been entrusted to any servant;
- (f) whether or not the master has reason to expect that such an act will be done;
- (g) the similarity in quality of the act done to the act authorized;
- (h) whether or not the instrumentality by which the harm is done has been furnished by the master to the servant;
- (i) the extent of departure from the normal method of accomplishing an authorized result; and
- (j) whether or not the act is seriously criminal.

D. Negligent Supervision

Negligent supervision is the most common claim in theft and forgery cases. In the event an arbitration panel may reject a various liability claim, they will often closely look at the level of supervision. Assuming that the money was stolen from the brokerage account, via wires, forged checks, or forged letters of authorization, the panel will focus on the written supervisory procedures and whether the procedures were sufficient, and whether they were actually implemented.

Department of Enforcement vs. Ameriprise, for example, Ameriprise processed forged wire transfer requests without any further inquiry.⁸⁴ Also, at least three other wire requests were initially rejected by Ameriprise, including one that had “signature discrepancy.”⁸⁵ Those rejected wire requests were simply resubmitted on the same or next day, and Ameriprise approved the wires from the customer’s account to the broker’s bank accounts.⁸⁶ To make matters worse, even after Ameriprise detected a suspicious wire request, the broker submitted two more forged wire requests, and Ameriprise yet again transferred funds from customers to the broker’s bank account.⁸⁷ Even after the broker was terminated, Ameriprise processed yet another forged wire transfer request and transferred funds, but this time, Ameriprise realized the mistake and had the funds returned to the customer’s brokerage account.⁸⁸ Needless to say, Ameriprise was fined \$750,000 for its negligent supervision in an Acceptance, Waiver and Consent Order. In the AWC, FINRA found in part in part:

Respondents' supervisory systems did not have policies or procedures requiring an adequate review to detect or prevent multiple transmittals of funds going to third-party accounts. Rather, Respondents' systems relied on a manual review of wire requests without the benefit of exception reports that could help to discern suspicious patterns of requests. Respondents' systems also lacked any adequate tracking or further investigation of rejected wire transfer requests. Without a centralized system for compiling information about the requests and any potential issues relating to the requests, Respondents could not detect a pattern of misconduct involving multiple wires of customer funds to third-party accounts, such as that perpetrated by Guelinas. Based on the above, from December 2006 through October 2010, Respondents failed to establish, maintain and enforce supervisory systems that were reasonably designed to review and monitor the transmittals of funds from customer accounts to third-party accounts. Through this conduct, Respondents violated NASD Conduct Rules 3010, 3012 and 2110 and FINRA Rule 2010.

See Department of Enforcement vs. Ameriprise, No. 2010025157301.

⁸⁴ See e.g. Department of Enforcement vs. Ameriprise, FINRA No. 2010025157301.

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *Id.*

As an aside, FINRA conducted a separate investigation of Ameriprise, and found that Ameriprise had failed to block computer access for 100 of 200 representatives that had been terminated during a five month time frame. Indeed, five of those terminated representatives were able to access Ameriprise computers data that contained customer information protected by Regulation S-P, though none of the terminated representatives processed any transactions during their unauthorized access.

In a similar theft case, to steal customer funds, a Northwestern Mutual Securities (“Northwestern”) financial advisor (FA) forged customers' signatures on variable annuity distribution requests, and submitted them to Northwestern.⁸⁹ The distribution requests falsely stated that funds were to be wired to the customer's bank account.⁹⁰ The FA also submitted to Northwestern several fictitious blank checks containing the customers' names and addresses, but the bank account number and bank routing number for his own bank account; the same bank account where the FA was paid his commissions.⁹¹ FINRA found that Northwestern “did not take reasonable steps to verify that the customers actually controlled the transferee bank accounts.”⁹² The Northwestern FA purportedly “told some of his customers that he was re-investing their funds in a non-existent foreign currency fund at the Firm.”⁹³ The FA also “created fictitious Firm documents purporting to reflect their investments in the non-existent fund.”⁹⁴

The Northwestern FA also stole a total of \$121,123 from variable annuities owned by two customers and used that money to pay to another customer's bank account.⁹⁵ To do this, the FA forged signatures on variable annuity distribution requests and gave them to Northwestern to process.⁹⁶ “The distribution requests falsely stated that funds would be electronically transferred to the customer's bank account.”⁹⁷ Again, FINRA found that Northwestern “did not take reasonable steps to verify that the relevant customers actually controlled the recipient bank accounts.”

Further, FINRA found that,

The Firm's supervisory system failed to include a policy or procedure to review and monitor for multiple transmittals of funds from multiple customers going to the same third party accounts. The Firm's system also failed to include exception reports or any other means to monitor and review patterns of multiple wire requests and checks by multiple customers to the same third party bank account or for requiring comparison of customer signatures

⁸⁹ Department of Enforcement vs. Northwestern Mutual Securities, FINRA NO. 2017054642101.

⁹⁰ Id.

⁹¹ Id.

⁹² Id.

⁹³ Id.

⁹⁴ Id.

⁹⁵ Id.

⁹⁶ Id.

⁹⁷ Id.

on request forms to signatures on file. Consequently, the Firm failed to detect that Representative X made 23 transfers totaling \$473,496 to his own bank account, the same bank account where he received his Firm commissions.

Department of Enforcement vs. Northwestern Mutual Securities, FINRA No. 2017054642101.

Both the Ameritas and Northwestern cases, *supra*, demonstrate that broker dealers must verify that bank accounts or brokerage accounts receiving the transfers actually belong to the customers, and not to the financial advisor. They also show how firms must confirm with the customer the actual reasons for the purported transfers.

E. Aiding and Abetting Liability

Broker Dealers may be subject to liability for theft under a theory of aiding and abetting liability. To prevail on a claim for aiding and abetting fraud and aiding and abetting breach of fiduciary duty, “[l]iability may ... be imposed on one who aids and abets the commission of an intentional tort if the person (a) knows the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other to so act or (b) gives substantial assistance to the other in accomplishing a tortious result and the person's own conduct, separately considered, constitutes a breach of duty to the third person.” *In re Woodbridge Invs. Lit.*, 2020 WL 4529739, (C.D.C.A. 2020), citing *Casey v. Bank Nat'l Ass'n*, 127 Cal. App. 4th 1138, 1144, 26 Cal.Rptr.3d 401 (2005) (quoting *Sanders v. Superior Court*, 27 Cal. App. 4th 832, 846, 33 Cal.Rptr.2d 438 (1994)).⁹⁸

Knowledge

Courts have found that a defendant's “decision to ignore suspicious activity or red flags is sufficient to demonstrate actual knowledge” for aiding and abetting liability. *In re Woodbridge Invs. Litig.*, No. CV 18-103-DMG (MRWX), 2020 WL 4529739, at *7 (C.D. Cal. Aug. 5, 2020); see *In re First All. Mortg. Co.*, 471 F.3d 977, 999 (9th Cir. 2006) (noting that coming “upon red flags which were seemingly ignored was enough to establish actual knowledge under the California aiding and abetting standard”). “Courts have also considered allegations concerning a defendant's knowledge and familiarity with the structure and operation of an alleged fraudulent scheme to be relevant to the actual knowledge inquiry.” *Tan vs. Quick Box*, 2021 WL 1293862 (CDCA 2021); See *Gonzales v. Lloyds TSB Bank, PLC*, 532 F. Supp. 2d 1200, 1208 (C.D. Cal. 2006) (“In further support of their allegation that Defendant had knowledge of the Ponzi scheme, Plaintiffs allege that Defendant knew the hallmark characteristics of a Ponzi scheme, and identified these characteristics in the Midland Entities’ accounts.”); But see, *Lamm v. State Street Bank and Trust*, 749 F.3d 938, 950 (11th Cir. 2014) (“Alleging that a bank disregarded ‘red flags’ such as ‘atypical activities’ on a customer's account is insufficient to establish knowledge.”); *Lerner v. Fleet Bank, N.A.*, 459 F.3d 273, 294 (2d Cir. 2006) (“As discussed above, these ‘red flags,’ as alleged, were insufficient to establish a claim for aiding and abetting fraud because, although they may have put the banks on notice that some impropriety may have been taking place, those alleged facts do not create a strong inference of actual knowledge”).

⁹⁸ See also, *In re Agape Litig.*, 681 F. Supp. 2d 352, 362 (E.D.N.Y. 2010), further proceedings, 773 F. Supp. 2d 298 (E.D.N.Y. 2011); *Anwar v. Fairfield Greenwich Ltd.*, 728 F. Supp. 2d 372, 442 (S.D.N.Y. 2010).

Substantial Assistance

The second element, substantial assistance, “requires that the defendant's actions be a ‘substantial factor’ in causing the plaintiff's injury.” *Facebook, Inc. v. MaxBounty, Inc.*, 274 F.R.D. 279, 285 (N.D. Cal. 2011) (quoting *Impact Warehouse Lending Group v. Credit Suisse First Boston LLC*, 270 Fed. Appx. 570, 572 (9th Cir. 2008)). “[O]rdinary business transactions” can satisfy the substantial assistance element of an aiding and abetting claim “if the [defendant] actually knew those transactions were assisting the [principal] in committing a specific tort. Knowledge is the crucial element.” See *In re First All. Mortg. Co.*, 471 F.3d 977, 993 (9th Cir. 2006).

For example, in *Chang v. Wells Fargo Bank, N.A.*, 2020 WL 1694360 (N.D. Cal. 2020), the court found Plaintiffs sufficiently alleged the bank provided substantial assistance in the Equitybuild Ponzi scheme in the form of: (1) receiving investor money in Equitybuild's accounts. (2) permitting and helping Equitybuild to commingle investor money (3) divesting and misdirecting a significant portion of the investors' money to the Cohens' personal accounts and (4) permitting and helping Equitybuild misuse investor money for Ponzi payments to earlier investors. *Id.* The court also noted that Plaintiffs also alleged “more than Defendant's inaction: they allege active conduct in the form of, for instance, “modifying and/or accepting and using modified Direct Deposit Authorization forms,” “divesting and misdirecting a significant portion of the investors' money to the Cohens' personal accounts,” and “transferring Ponzi scheme payments to investors.” *Id.* at 6.

Similarly, broker dealer firms may be found to provide substantial assistance by one or more of many activities, such as for example, the advisor uses the brokerage firm offices to sign up investors; the financial advisor's assistant helps with filling out paperwork to invest in the Ponzi scheme fund; the firm accepts and processes forms directing customer funds be transferred to the Ponzi entity, and follows those instructions to help fund the Ponzi scheme; the firm agrees to custodian the Ponzi scheme fund shares or membership interests in the customer's IRA or other account; the firm misdirects funds from customers to the financial advisor's account or third party account fund set up by the advisor or issuer; the firm permits payments from the advisor's account or the third party account to be used to pay the advisor or the fund; and finally, permitting Ponzi payments from later investors to earlier investors.

DOCUMENT DISCOVERY IN RIA CASES

Michael S. Edmiston, Timothy J. O'Connor, Jeffery Schaff

I. Introduction

The discovery process involving Registered Investment Advisors (“RIAs”) involves broad areas of inquiry with many different from the tradition customer/broker-dealer disputes. The broad sweep of documents is important since RIAs owe an established fiduciary duty of care to their clients.

Initial discovery on an RIA targets documents that are common to all RIA firms. For most RIA cases, these common documents will form the core of discovery about the RIA.

Beyond the core discovery items, there will be other documents that are particular to the relationship pattern involved. The majority of cases for which special lists are appropriate fall into the following relationship patterns:

1. The investment adviser representative (“IAR”) is dually registered with a FINRA-registered Broker-Dealer and an RIA; and
2. The Respondent is a FINRA-registered Broker-Dealer that provided brokerage services to the RIA that caused the losses.

When planning discovery on an RIA, the traditional discovery requests used in customer disputes with broker-dealers are incomplete and insufficient to obtain the documents in the possession, custody, and control of an RIA. While there is some overlap, the discovery process in RIA cases involves considerably different areas of inquiry. Additionally, document maintenance requirements vary by the regulator with whom the RIA is registered. Larger RIAs are SEC-registered advisers are required to maintain additional documents than smaller state-registered advisers.

II. The RIA Discovery Guide

Delving into eight separate areas is essential to successfully proving an RIA claim. These categories can be categorized as: client-specific; regulatory disclosure; compliance; supervision; marketing; business operations; advice-related materials; and third-party relationships. The following sections and bullet points are an “RIA Discovery Guide.”¹

A. Client-Specific Documents

- Investment Advisory Agreement and updates.
- Investor (Client) Questionnaires.
- Investment Policy Statement.

¹In cases involving RIAs before FINRA arbitration or where the parties selected the FINRA Code of Arbitration to govern their case, the FINRA Discovery Guide remains available and applicable. Further, the FINRA Discovery Guide should be considered in creating a discovery plan for an arbitration involving an RIA party.

- Account record information for the client including name, tax identification number, address, telephone number, date of birth, employment status, annual income, net worth, investment objectives, and risk tolerance.
- Account Application(s) with Custodial Broker-Dealer.
- Supporting documents (e.g., trusts, family partnerships, etc.).
- Updates to client documents.
- All written correspondence between RIA and IAR(s) and customer.
- All electronic correspondence between RIA and IAR(s) and customer including, but not limited to, email, text messages, and electronic messaging app communications.
- All written communication between the RIA and any third-parties regarding the client and/or client's account(s).
- Account Statements.
- Performance reports.
- Annual Reports.
- Fee calculations, amounts invoiced, and amounts collected.
- Written financial analysis and advice provided to client, including financial plans.
- Newsletters and blogs.
- Investment due diligence files, research reports, sales materials, performance or risk data, prospectuses, other offering documents and copies of news articles or outside research, including documents intended or identified as being "for internal use only" for the securities and products purchased and/or sold on behalf of the client.
- All notes the RIA and/or IAR made about the client, client's accounts, claims, and/or transactions including, but not limited to, entries in any diary or calendar, relating to the claims or products at issue.
- All notes or memoranda evidencing supervisory, compliance, or managerial review of the client's account(s) or transactions therein or of the IAR assigned to the client's account(s) for the period at issue.
- All correspondence between the client and the RIA and/or IAR relating to the client's claims, accounts, transactions, or products or types of products at issue bearing indications of managerial, compliance, or supervisory review of such correspondence.
- Phone records (recordings, phone logs, and audio files).
- All writings reflecting communications between the IAR assigned to the client during the time period at issue and members of the RIA compliance department relating to the securities/products at issue and/or the client's claims, accounts or transactions.

B. Regulatory Disclosure Documents

- Form ADV, in its entirety, for the RIA.
- Annual filings with the SEC and/or state regulators.
- Responses to SEC and/or state audits, correspondence with auditors, and results of audits.
- Responses to SEC and/or state regulatory inquiries, investigations, and/or charges, and responses thereto.
- SEC filings not available on EDGAR.

- Records of disciplinary action taken against the RIA and/or IAR by any regulator (state, federal or self-regulatory organization) or employer for all sales practice violations or conduct similar to the conduct alleged.

C. Compliance Documents

- Internal compliance procedures and periodic compliance reviews and reports.
- Records of securities held by RIA firms when acting as principal.
- Continuing education seminars, training seminars for Investment Advisor Representative(s).
- Publications, bulletins, memoranda and notices regarding regulatory notices and requirements.
- Ethics manual.
- Compliance manual (sometimes termed Policies and Procedures manual).

D. Supervisory Documents

- Supervisory manual.
- Documents evidencing supervision of IAR (including reviews of branch, e-mails, advice, trading, custody, outside business activities, etc.).
- Customer complaints and responses thereto.
- Resumes/CVs of investment advisor representatives.
- Cross-reference holding pages of all client holdings.
- Internal communications with IARs pertaining to the client or related practices.
- Documents identifying supervisor of IAR.
- All exception reports, supervisory activity reviews, concentration reports, active account runs and similar documents produced to review for activity in the client's accounts or in which the claims, transactions, products or types of products at issue are referenced or listed.
- Organizational chart of RIA.
- Branch office audits.
- Logs evidencing that the client was provided requisite disclosure documents (e.g., Form ADV parts 2a and 2b, and form CRS).
- A record of all agreements pertaining to the relationship between the IAR and the RIA, summarizing the IAR's compensation arrangement or plan with the firm.
- Identifications of rep's social media and message board handles (Twitter, Reddit, Seeking Alpha)

E. Marketing Documents

- Promotional brochures and investment style marketing materials.
- Sales brochures.
- Archived RIA website (current and historic).
- Archived social media (LinkedIn, Facebook, et al.).

F. Business-Related Documents

- Advisory fee billing software manuals.
- Compliance and supervision software manuals.

- Account management software manuals.
- Errors and omissions liability insurance policies.
- Officers and directors' liability insurance policies.
- RIA entity formational documents, including bylaws, articles of organization, and meeting minutes.

G. Advice Related Materials

- Evidence that private placements have been notice-filed with SEC as exempted securities.
- Due diligence on advice generally including, but not limited to, investments and strategies.
- Due diligence on advice to the client including, but not limited to, the use of electronic analysis (financial plans, Monte Carlo projections, hypotheticals, etc.) prepared for the client, whether provided to the client or not.
- Minutes of the RIA's Due Diligence committee meeting(s) discussing and approving the investment(s) at issue for offering to clients.
- Minutes of any and all RIA committee meetings discussing the investment(s) at issues.

H. Agreements with Third-Parties

- The RIA Money Manager Contract.
- Mutual fund selling agreements.
- Broker-dealer account agreements.
- Buy-in agreements with mutual funds.
- Buy-in agreements with money managers.
- Variable annuity marketing agreements.
- All other third-party agreements, directly or indirectly pertaining to advisor's services to client.

III. **SPECIAL SITUATION DISCOVERY LISTS**

There are two special situations where a broker-dealer may be involved with an IAR. The first situation is where the IAR is registered with an unrelated broker-dealer. This is seen in situations where the registered representative is registered with an independent firm without an RIA subsidiary or related company and the broker-dealer has approved the registered representative's outside business activity to act as an RIA. The second situation is where the IAR is registered with a related broker-dealer.

In both instances, the broker-dealer may be a party or potential third-party source of documents. In either situation, List 1 of the FINRA Discovery Guide should be a consideration to obtain discovery from the broker-dealer (whether as an adverse party or through third-party discovery orders to produce or subpoenas).

A. SPECIAL LIST 1: THE INVESTMENT ADVISER REPRESENTATIVE (“IAR”) IS DUALLY REGISTERED WITH A FINRA-REGISTERED BROKER-DEALER AND AN RIA

In some cases, broker-dealers will allow their registered representatives to work for unaffiliated RIAs. Whether affiliated or not, the broker-dealer should maintain all of the following documentation relevant to its registered representative’s investment advisory activities:

- Outside Business Activities approval.
- Basis for determining that the fee program was appropriate (NASD Notice to Members 03-68).
- Client file (new account form, IRA application, options, margins, etc.).
- Client statements.
- Agreements
 - Between RIA and Broker-Dealer and
 - Between RIA and Client.
- Payments/compensation between RIA and Broker-Dealer.
- Compensation from client account (including trailers, etc.).
- Supervision by Broker-Dealer supervisors of IAR.
- Supervision of account (risk management, options, trading, AML, etc.).
- Exception reports
 - List of all reports that can be generated;
 - The reports that were generated and who reviewed them;
 - All exception reports generated specifically for client’s account(s);
 - Communications with the client;
 - Letters;
 - Calls (recordings, call logs and audio files); and
 - E-mails.
- FINRA correspondence, including responses to audits, 8210 letters, responses to requests regarding customer complaints and AWC matters.
- IAR’s other Outside Business Activities, disclosure documents given to the RIA, and all approvals, denials, or other RIA generated documents related to the IAR’S Outside Business Activities.

B. SPECIAL LIST 2: THE RESPONDENT IS A FINRA REGISTERED BROKER-DEALER THAT PROVIDED BROKERAGE SERVICES TO THE RIA THAT CAUSED THE LOSSES

C.

Broker-dealers like Schwab, Fidelity and Interactive Brokers offer brokerage services for RIAs, and are sometimes named as respondents/defendants for their roles in the alleged bad acts.

- Initial due diligence on RIA when onboarding.
- Client file (new account form, IRA application, options, margins, etc.).
- Client statements.
- Agreements
 - Between RIA and Broker-Dealer and
 - Between RIA and Client.
- Payments/compensation between RIA and Broker-Dealer.
- Supervision of RIA (institutional services).
- Supervision of account (risk management, options, trading, AML, etc.).
- Exception reports

- List of all reports that can be generated;
- The reports that were generated and the persons in the RIA responsible for reviewing them; and
- All exception reports generated specifically for client's account(s).
- Communications with the brokerage firm custodialing the client's assets, pertaining to the client or related practices of the RIA.
- Communications with the client
 - Letters;
 - Calls (recordings, call logs and audio files); and
 - E-mails.
- FINRA correspondence, including responses to audits, 8210 letters, responses to requests regarding customer complaints and AWC matters.

IV. NON-DISCOVERY DOCUMENT AVAILABILITY

- Filings found on the SEC's EDGAR database (e.g., Reg. D, 13f and 13g filings).
- Bulletin board postings (e.g., SeekingAlpha and Reddit).
- Review notes from regulators, including FINRA's Brokercheck, and states' corporate filings, plus securities and insurance regulators.
- The IAR's published books and writings.
- The IAR's other professional credentials to review (including ones that may have been withdrawn or revoked).
- If the IAR is insurance licensed, research the various states in which the IAR was licensed.
- The RIA and/or IAR court records.
- The RIA and/or IAR may own other business entities (related and otherwise).
- Published works (magazine articles, books).
- Quotes and interviews.

V. DISCUSSION OF KEY DOCUMENTS

A. FORM ADV

The registered part of a "registered" investment adviser is the filing and maintenance of standardized disclosure documents that are common to every RIA, collectively known as "Form ADV". Those documents can be found publicly at the Investment Adviser Public Disclosure ("IAPD") website, <https://adviserinfo.sec.gov/>. ADV disclosures are required to be updated annually, along with periodic updates to reflect material changes. RIAs are required to provide the current disclosures directly to the client at the outset of the relationship, and then to provide (or at least offer) the updates. The publicly available sources for the Form ADV do not provide public access for prior (archived) versions. It is therefore necessary to request that the RIA produce each complete Form ADV for the time period at issue, as well as any evidence that the documents were provided to the client.

Form ADV consists of three “Parts,” each with additional schedules and supplements where necessary.²

Part 1A consists of disclosures about the RIA’s business practices, ownership, control persons, and the Investment Adviser Representatives (“IARs”). Supplementing Part 1A, where necessary, are Disclosure Reporting Pages (“DRPs”) which disclose disciplinary events about the firm’s personnel.³ For larger RIA firms with multiple employees and locations, the form ADV is often an “Umbrella Registration.”⁴

Part 1B are questions asked by state securities regulators, and are only applicable if the RIA is registered with a state securities regulator.⁵

Part 2A is a Plain English brochure of Part II of the adviser’s Form ADV, describing the RIA’s services and disclosures.

Part 2B is a Plain English brochure that describes the IAR in the same way that the 2A brochure describes the RIA. Small RIAs do not have to produce 2B brochures for their IARs if the 2A and 2B forms would be materially identical.

Part 3 is the Form CRS (“Relationship Summary”). Since June 30, 2020, SEC-registered RIAs are required to give their retail investor customers Form CRS.⁶ Form CRS is meant to provide a brief summary of the RIA-customer relationship in plain English. “The relationship summary is intended to inform retail investors about: the types of client and customer relationships and services the firm offers; the fees, costs, conflicts of interest, and required standard of conduct associated with those relationships and services; whether the firm and its financial professionals currently have reportable legal or disciplinary history; and how to obtain additional information about the firm.”⁷ For dual-registrants, their Form CRS will include both their brokerage and investment adviser practice information.

RIAs must update their Form ADV each year, within 90 days of the end of the firm’s fiscal year.⁸ For a multi-year advisory relationship, this means there are multiple Form ADVs.

²FORM ADV (Paper Version) Uniform Application For Investment Adviser Registration and Report Form By Exempt Reporting Advisers <https://www.sec.gov/about/forms/formadv-instructions.pdf> (last visited Aug. 15, 2021).

³Id. at 2.

⁴Id. at 5.

⁵Id. at 2.

⁶Id. at 3.

⁷Securities And Exchange Commission, Form CRS Relationship Summary; Amendments to Form ADV, Release Nos. 34-86032; IA-5247; File No. S7-08-18 at p. 1. <https://www.sec.gov/rules/final/2019/34-86032.pdf>. Last visited Aug. 16, 2021.

⁸Id. at 3.

Out-of-cycle updates of Form ADV are required when an IAR is added or removed, there are disclosable disciplinary events, changes in investment strategies or philosophies, or if the disclosures in Part 2B brochure becomes *materially* inaccurate.⁹

B. CUSTOMER COMPLAINTS

RIAs are subject to public disclosure requirements for customer complaints which are available on the Investment Adviser Public Disclosure (IAPD) website.¹⁰ These complaints can reveal supervisory issues with the firm, IAR, products, due diligence and/or strategies used by the RIA.

C. RIA FINTECH AND REG TECH

The emergence of Fintech and Regtech software has made the transition from the traditional retail securities brokerage relationship to that of a Registered Investment Advisor relationship easier, simpler, and efficient. Individual RIAs now manage books of business well in the hundreds of millions of dollars for an individual RIA out of the privacy of their home offices, given the incredible functionality and ease of operation of this emergent software in this arena.

Wholesale categories of documents and information formerly kept on paper records, such as cross-reference holding pages, position pages, account reviews, account rebalancing, sector concentration, individual position concentration, due diligence files, account notes, and client contact notes and correspondence are now routinely formatted in these software programs and require specific demands that the RIA firm generate printouts of these various categories of documents and information from their software programs.

D. CONTRACTUAL RELATIONSHIPS WITH BROKER-DEALERS AND OTHER THIRD-PARTIES

Registered Investment Advisory firms enter into contractual relationships with FINRA registered broker-dealers, clearing firms and other third-parties. These documents can include custodial agreements, clearing broker agreements, soft-money agreements, indemnification/hold-harmless agreements, independent contractor-type agreements, agreements to maintain books and records, 12b-1 fee splitting, insurance policies, coverages, and contractual relationships with other third-party money managers, analysts, and support-type services.

These relationships should be disclosed on Part 2A of the Form ADV if they may or affect the advice the Investment Advisor provides the client.

E. BROKER-DEALER DUE DILIGENCE AND APPROVALS RECORDS

Many RIAs enter into contractual and promotional relationships with brokerage firms whereby they become approved money managers for customers of FINRA member firms. This process generates documents and information relating to the relationships and can include all categories of documents associated with the vetting process which broker-dealers maintain with these continuing relationships.

⁹Id. at 4

¹⁰<https://adviserinfo.sec.gov/>

F. DOCUMENTS AND INFORMATION IDENTIFYING RIA CONTROL PERSONS

SEC Form ADV identifies the control persons of an RIA firm. This information can be useful in identifying individual respondents in RIA claims and claims involving officer, executive, and control person liability. However, the designated roster of control persons specified on a Form ADV lists only those officers, executives, and control persons as of the date of the Form ADV. There may be other individuals who may have acted as officers, executives, and/or control persons during the time period at issue, but whose names no longer appear in the current Form ADV, thus seeking the firm's prior Form ADV filings is necessary to identify key witnesses and parties.

In addition, corporate filings, articles of incorporation, and organizational charts of the RIA may exist throughout the contested time period and provide relevant information to identify witnesses and possibly other responsible parties.

G. THE INVESTMENT ADVISORY AGREEMENT (CLIENT AGREEMENT)

RIAs managing client monies are required to enter into a written contractual relationship with their customers. The client agreement is an important source for assessing contractual representations of investment and management style, client investment objectives and standards of care presumably associated with the RIA/client relationship.

H. PROFESSIONAL LIABILITY INSURANCE AND ERRORS AND OMISSIONS POLICIES

There is no requirement that RIAs maintain liability insurance coverage. Nonetheless, many RIAs maintain liability insurance coverage for various categories of civil claims. State and federal court discovery procedures almost uniformly mandate the disclosure of insurance coverages in liability cases and reluctance on the part of an RIA firm to disclose insurance coverages may be addressed the relevant discovery rules requiring the production of this information.

I. CORRESPONDENT BROKER-DEALER ACCOUNT PLATFORM AGREEMENTS IN CONTRACTUAL RELATIONSHIPS

RIA firms, including independent RIA firms and RIA firms affiliated with broker-dealers, maintain contractual agreements with broker-dealers evidencing the contractual terms of their platforming agreement for client accounts and churning activity. These agreements and all ongoing updates, as well as the internal compliance and supervisory procedures associated with RIA platform relationships, are essential discovery items as they will reveal the division of supervision and compliance responsibilities, the existence of key reports and documents, and the use of software to manage the compliance, supervision, and client account responsibilities.

J. INVESTMENT ADVISORY FEE CALCULATIONS AND RELATED SOFTWARE FUNCTIONALITY

Investment advisory fees are typically taken through quarterly automatic withdrawals of monies from customer accounts. Few firms opt for quarterly billing anymore. It is important to assess the accuracy and legitimacy of periodic cash deductions from client accounts and how they are calculated. Some firms' fee arrangements afford them the ability to charge an investment advisory fee on the basis of total assets under management. The "total assets" calculation may tend to incentivize an investment adviser to leverage customer accounts with excess margin borrowing to enhance the fees which can be charged based upon *total* assets under

management, as opposed to net assets under management less the margin debit balance in the customer account.

K. PAYMENTS MADE BY RIAS TO BROKER DEALERS AND OTHER THIRD-PARTIES
NOT REFLECTED ON RIA CUSTOMER ACCOUNT STATEMENTS

There are oftentimes money flows between RIAs, the broker-dealers through whom they platform customer accounts and/or third-party vendors (e.g., mutual funds, private placement vendors, market makers and other financial institutions) with cash payments for any number of cloaked or described services they might contend or otherwise package. These payments may influence the provision of financial advice or service to the client. Exploring the existence of these money flows is necessary to determine if the RIA breached its fiduciary obligations to its clients by putting its own interests first.

L. DUE DILIGENCE FILES

Given that RIA firms are acting in a fiduciary capacity, there is a profound obligation to engage in thorough due diligence and continued monitoring of securities selected for customer accounts. Some RIA firms consider themselves special situation experts versed in finding and selecting investment opportunities for customer accounts, with the same positions being purchased across the board in the accounts of many customers. In circumstances where concentrated positions in customer accounts have sustained devastating and disproportionate losses, the discovery of these due diligence files may go towards ascertaining the extent to which an RIA performed its fiduciary obligations for the client.

This is all the more essential in circumstances where positions in thinly traded companies are involved. The area of inquiry includes the extent to which the investment advisor was involved with any Form 13D filings with the SEC and other filings related to concentrated positions in individual securities.

M. CRM SOFTWARE AND DOCUMENTS AND INFORMATION EVIDENCING PERIODIC
REVIEW OF HOLDINGS IN CUSTOMER ACCOUNTS

One of the most important areas of discovery is ascertaining the extent to which an RIA firm engaged in prudent, periodic assessment of client holdings and asset allocations to assure that they are in line with the stated investment objectives or investment policy statement of a customer account. Recent years have seen the emergence of a number of very effective client relationship management software programs. Additionally, documents and information memorializing client in-person meetings and teleconferences relative to the status of an account and its holdings can likewise provide essential information when assessing RIA account management.

N. INVESTMENT ADVISORY AFFILIATES OF BROKER-DEALERS

Virtually all of the top 30 broker dealer wire houses have formed their own separate investment advisory subsidiaries or affiliates created in large part to stem the flow of customer accounts to independent RIAs offering fee-based account management services. Some of these affiliate entities are structured in a franchise format whereby franchise owners actually own an individual office in either the broker dealer format, the investment advisory format or both. Discovery of these franchise and correspondent agreements can identify additional parties, the types of services exchanged between the entities, and the respective obligations which may exist in these relationships.

O. RESULTS OF PERIODIC SEC AND STATE REGULATOR RIA OFFICE AUDITS

The SEC and state regulators conduct periodic audits of RIA firms, as well as audits conducted pursuant to specific events of alleged customer victimization. In this regard, all such audits, reviews, recommendations, and related correspondence exchanged between the RIA and regulator(s) are essential items to seek in the discovery phase of claims against RIA firms.

P. DOL FIDUCIARY RULE (PROHIBITED TRANSACTION EXEMPTION 2020-02)

With the US Department of Labor's ("DOL") new Fiduciary Rule,¹¹ RIAs must also comply with DOL regulations pertaining to investment advice given to ERISA plan assets and IRAs, including:

- Acknowledge fiduciary status in writing;
- Disclose services and material conflicts of interest;
- Adhere to Impartial Conduct Standards;
- Adopt policies and procedures prudently designed to ensure compliance with Impartial Conduct Standards and to mitigate conflicts of interest;
- Document and disclose specific reasons that any rollover recommendations are in the retirement investor's best interest; and
- Conduct an annual retrospective compliance review

These documents are necessary to define the scope of the relationship and services and compare them to the services provided by an RIA to its client where a retirement account is at issue.

VI. THIRD-PARTY SUBPOENAS TO PRODUCE DOCUMENTS

Subpoenas in aid of arbitration if properly fashioned can be an effective tool to access essential witnesses, documents and information.

The procedural mechanisms to compel the appearance of witnesses and production of documents and information in arbitration proceedings can require considerable patience. Unlike FINRA arbitration proceedings where member firms and associated persons are subject to discipline for failing to cooperate in the discovery process, there is no similarly effective internal mechanism induce RIA firms and their advisers to cooperate with the discovery process in the arbitration context. The only remedy to enforce an arbitrator-ordered subpoena is pursuit of state (where available) or federal court-venued proceedings to compel compliance.¹² The turnaround time on such discovery-related filings with the whole submission, deliberation and decision process could easily take up to a year's time or more.

¹¹Prohibited Transaction Exemption 2020-02, *Improving Investment Advice for Workers & Retirees*, December 18, 2020.

¹²See, 9 U.S.C. § 7.

VII. DOCUMENT DISCOVERY IN FINRA, AAA, AND JAMS

The procedure for asking for the production of documents and information in an arbitration varies by the rules selected by the parties or mandated by a pre-dispute arbitration agreement.

In an arbitration proceeding with an RIA, it is possible to see FINRA, JAMS, or AAA rules selected regardless of the arbitration provider.

FINRA's discovery rules are the closest to self-executing, requiring the production of documents and information pursuant to the FINRA Discovery Guide, and permitting additional discovery requests for production and requiring at least the serving of responses without the need to seek the arbitrator or panel's permission to do so.

With AAA and JAMS arbitration rules, the document discovery process is dependent on the consent or voluntary participation of the parties or by order of the arbitrator.

A. THE FINRA CODE OF ARBITRATION PROCEDURE

FINRA'S Code of Arbitration Procedure allows for discovery of documents and information in two layers. The first layer is the Discovery Guide documents which are considered presumptively discoverable¹³ and governed by Rule 12506. The second layer is case-specific requests for production of documents and information propounded by a party. The FINRA Discovery Guide should be considered as only the start of document discovery.

Rule 12506 Document Production Lists¹⁴

Within 60 days of the date the answer to the statement of claim is due, the parties must "Produce to all other parties all documents in their possession or control that are described in Document Production Lists 1 and 2..."¹⁵ and/or "[o]bject as provided in Rule 12508 and serve this response on all parties and file this response with the Director."¹⁶

In the context of a FINRA arbitration case involving an RIA, there may be documents responsive to List 1 of the FINRA Discovery Guide in the possession, custody, and/or control of the RIA. However, List 1 of the FINRA Discovery Guide was designed for disputes between a customer and FINRA Broker-Dealers and their Associated Persons. As a result, some documents may bear different titles or otherwise not exist in the possession of the RIA.

¹³"While the parties and arbitrators should consider the documents described in the Lists presumptively discoverable, the parties and arbitrators retain their flexibility in the discovery process." FINRA Discovery Guide (2013) (<https://www.finra.org/arbitration-mediation/discovery-guide>) Last visited Jul 31, 2021.

¹⁴FINRA Code of Arbitration Procedure (<https://www.finra.org/rules-guidance/rulebooks/finra-rules/12000>) Last visited Jul. 31, 2021.

¹⁵FINRA Code of Arbitration Procedure Rule 12506(b)(1)(A).

¹⁶FINRA Code of Arbitration Procedure Rule 12506(b)(1)(C).

Rule 12507 Other Discovery Requests¹⁷

“Parties may also request additional documents or information from any party by serving a written request on the party. Requests for information are generally limited to identification of individuals, entities, and time periods related to the dispute... [s]tandard interrogatories are generally not permitted in arbitration.”¹⁸

“[D]iscovery requests may be served... 45 days or more after the Director serves the statement of claim....”¹⁹ Responses to discovery requests are due 60 days after the date of the Request(s).²⁰

Under the FINRA Rules, a party can propound requests for production of documents without obtaining either the consent of the opposing party or permission from the arbitrator or panel. The RIA Discovery Guide provided herein may form the basis of many Rule 12507 requests for production.

B. AAA COMMERCIAL RULES²¹

AAA Commercial Rules R-22

The AAA Commercial Rules leave document discovery in the hands of the arbitrator and parties. There is no set standard for the making or responding to document discovery requests. Instead, under R-22(b), the arbitrator may on “application of a party or on the arbitrator’s own initiative...” “(iii) require the parties, in response to reasonable document requests, to make available to the other party documents, in the responding party’s possession or custody, not otherwise readily available to the party seeking the documents, reasonably believed by the party seeking the documents to exist and to be relevant and material to the outcome of disputed issues...”

Key to this Rule is the phrase “relevant and material to the outcome of disputed issues.” The Commercial Rules appear to set a higher threshold than the “reasonably calculated to lead to admissible evidence” standard in federal courts and many state courts. The AAA Commercial Rules address issues of electronic discovery,²² the obligation to update discovery productions,²³ and leaves the resolution of discovery disputes and enforcement of orders to the arbitrator.²⁴

¹⁷Id.

¹⁸FINRA Code of Arbitration Procedure, Rule 12507(a).

¹⁹FINRA Code of Arbitration Procedure, Rule 12507(a)(2).

²⁰FINRA Code of Arbitration Procedure, Rule 12507(b).

²¹American Arbitration Association, Commercial Arbitration and Mediation Procedures, Rules Amended and Effective October 1, 2013. <https://adr.org/sites/default/files/Commercial%20Rules.pdf>. Last visited Jul. 31, 2021.

²²American Arbitration Association, Commercial Arbitration and Mediation Procedures, R-22(b)(iv).

²³American Arbitration Association, Commercial Arbitration and Mediation Procedures, R-22(b)(ii).

²⁴American Arbitration Association, Commercial Arbitration and Mediation Procedures, R-23.

C. AAA CONSUMER RULES²⁵

AAA Consumer Rules R-22

The AAA Consumer Arbitration R-22 provides a much skinnier arbitrator-controlled discovery process. R-22(a) provides, “[i]f any party asks or if the arbitrator decides on his or her own, keeping in mind that arbitration must remain a fast and economical process, the arbitrator may direct (1) specific documents and other information to be shared between the consumer and business.” On its face, the AAA Consumer Rule R-22 excludes third-party documents (e.g., the agreement between the RIA and broker-dealer) that may be relevant to how and why the RIA and/or IAR served the client as they did.

R-22(c) limits discovery to just R-22(a) unless the “...arbitrator determines further information exchange is needed to provide for a fundamentally fair process.”

The scope of document requests under the AAA Consumer rules is left to either the parties’ agreement or the arbitrator’s control.

D. JAMS COMPREHENSIVE ARBITRATION RULES & PROCEDURES

JAMS Comprehensive Rules Rule 17

The JAMS Comprehensive Arbitration Rules and Procedures split the difference between FINRA and AAA by directing a good faith “...voluntary and informal exchange of all non-privileged documents and other information (including electronically stored information (“ESI”)) relevant to the dispute or claim.”²⁶ The time frame for the initial exchange is short, just 21 calendar days after all pleadings have been received.²⁷ The arbitrator is given the discretion to “...modify these obligations at the Preliminary Conference.”²⁸

JAMS Rule 17 imposes an on-going production obligation on the parties. “As they become aware of new documents or information... all Parties continue to be obligated to provide relevant, non-privileged documents to supplement their identification of witnesses and experts and to honor any informal agreements or understandings between the Parties regarding documents or information to be exchanged”

²⁵American Arbitration Association, Consumer Arbitration Rules, Rules Amended and Effective September 1, 2014. <https://www.adr.org/sites/default/files/Consumer-Rules-Web.pdf>. Last visited Jul. 31, 2021.

²⁶JAMS Comprehensive Arbitration Rules & Procedures, Rule 17. <https://www.jamsadr.com/rules-comprehensive-arbitration/#Rule-17> Last visited Jul. 31, 2021.

²⁷Id.

²⁸Id.

E. JAMS STREAMLINED ARBITRATION RULES & PROCEDURES (CLAIMS LESS THAN \$250,000)

JAMS Streamline Rules Rule 13

For claims less than \$250,000, the JAMS Streamlined Arbitration Rules & Procedures apply. Under the Streamlined rules, “[t]he Parties shall cooperate in good faith in the voluntary and informal exchange of all non-privileged documents and information (including electronically stored information (“ESI”)) relevant to the dispute or claim.”²⁹ The time frame for the initial exchange is even shorter, just 14 calendar days after all pleadings have been received.³⁰

Any discovery sought beyond the initial voluntary exchange is left to the arbitrator. “The necessity of additional information exchange shall be determined by the Arbitrator based upon the reasonable need for the requested information, the availability of other discovery options and the burdensomeness of the request on the opposing Parties and the witness.”³¹

The Streamlined Rules also impose an on-going duty of production. “As they become aware of new documents or information, including experts who may be called upon to testify, all Parties continue to be obligated to provide relevant, non-privileged documents.”³²

F. CONCLUSIONS ABOUT REQUESTING DOCUMENTS IN RIA CASES

Know the rules before making the discovery plan! The FINRA Code of Arbitration Procedure contemplates and allows written requests for production of documents. AAA leaves all the control to the arbitrator and/or party agreement. JAMS splits the difference with a voluntary production of documents, and leaves the rest to the arbitrator. Ultimately at a non-FINRA arbitration provider, developing a discovery plan prior to or at the initial scheduling conference with the arbitrator is a key requirement to requesting the documents necessary for trying an arbitration case involving an RIA.

²⁹JAMS Streamlined Arbitration Rules & Procedures, Rule 13(a). <https://www.jamsadr.com/rules-streamlined-arbitration/#Rule-13>. Last visited Jul. 31, 2021.

³⁰Id.

³¹Id.

³²JAMS Streamlined Arbitration Rules & Procedures, Rule 13(b).

A CHECK LIST FOR “REASONABLE” DUE DILIGENCE “THE SCORECARD”

Mason Alan Dinehart III, RFC

The year was 1972 and I had been with a real estate syndication firm known as Carlsberg Securities, Inc. for 3 years. I was the Branch Manager and Director of Due Diligence and Compliance. We syndicated all forms of real estate. Publicly, we specialized in mobile home parks and distributed our offerings through well known wire-houses including Walston & Co. and Francis I. DuPont & Co. We were, in fact, the second real estate syndicator on Wall Street, only preceded by Pacific Plan in northern California and immediately followed by Prudential Bache. Privately, we marketed raw land along with income properties including industrial, multi-family apartments and commercial office buildings. With regard to private placements, we were always sure to provide private placement memoranda (PPMs) to accredited investor's with full treatment of all material facts (private offerings are exempt from registration, not disclosure) and to avoid any general solicitation i.e. dropping PPM's out of helicopters.

Earlier that year, I was contacted by the Practicing Law Institute (PLI) to request my participation in a 5 person panel to be made up of 4 securities attorneys and myself, the only non-attorney on the panel. Its purpose was to travel to 5 U.S. cities to introduce and explain real estate syndication to members of the bar and bench. Included on the panel was Brad Cook, then Chairman of the SEC. My participation was needed to provide PLI attendees with an evaluation tool or arithmetic formula to quantifiably evaluate and analyze the working aspects and deal points of a real estate syndication offering to better understand what could go wrong with these sponsored programs. After we returned from traveling, PLI asked me to write an article for the Fall 1972 issue of Real Estate Review on Real Estate Syndication. I entitled the article “Selling Syndication Shares Successfully”.

I took the opportunity given to me at PLI, for **analyzing Real Estate Direct Participation Programs, to develop the Real Estate ScoreCard (Exhibit A)**. As a securities expert witness, I have been using the ScoreCard in arbitrations and mediations to evaluate literally hundreds of private placement limited partnerships, LLC's, TICS, non-traded REITS along with all types of Public Offerings including REITS and L.P.'s. In addition to real estate offerings, I discovered it works very well for equipment leasing and oil and gas programs as well. I have found that an arbitration panel has a much better and more organized grasp of the offering by walking them through the ScoreCard.

The ScoreCard naturally breaks down into two sections. The first section, deal points 1 to 3, evaluates the Sponsor or program manager. The next section, deal points 4 to 15, analyzes the structure of the offering itself.

So, of the 15 deal points or questions, each one has 5 possible answers, with up to 5 points possible for each, or 75 total points possible. Each deal point is graded with 5 points being best and 1 point being worst as shown on the ScoreCard master template. After the grading, the points are added up. A passing grade is 52 points or 70% of the possible 75 points. Passing is to say, that based upon the PPM or Prospectus and marketing brochure only, the program qualifies to enter the formal diligence process. In other words, the deal passes muster to the extent that it should meet “reasonable basis suitability”, i.e. it should be suitable for at least some investors.

Remember, then, that the ScoreCard is a precursor to formal due diligence, not a substitute for it. It is the initial independent due diligence done by the broker-dealer.

If an offering fails to meet the minimum grade, the ScoreCard should be forwarded to the sponsor in order to improve the program so that it can be improved to qualify to enter the formal due diligence process at some future date.

When you think about it, to conduct a full due diligence review on every direct participation program that comes in the door would be a very inefficient process. Only those that, on their face, have a chance to succeed should enter that process.

It is important to note that the ScoreCard is *“for broker-dealer use only”*. It is not to be given to investors under any circumstances. It is primarily for the due-diligence department of the broker-dealer. It is an example of meeting the FINRA requirement for independent due diligence. It can also be used for the training of registered representatives on a password protected website. Once on the Website, after logging in, the AE can review the ScoreCard on a “read-only” basis.

Since we have been using the term “due-diligence” in this article repeatedly, maybe it’s about time to define it. This is especially important since the Securities Act provides no specific definition other than to call it an “independent investigation”. FINRA adds that the investigation must be “reasonable”. My definition is this: “Due-diligence is the process of reasonable investigation that independently evaluates and verifies a sponsor’s accuracy, competency, financial strength and organizational depth. It is adversarial in nature and utilizes quantitative and intuitive means. It includes a comprehensive analysis that challenges the deal points, assumptions and projections used in each direct participation program (DPP) examined. The process examines and determines the probability of the transaction achieving its stated objectives”.

Let me just for a moment describe what independent due diligence is not! It is not a collection of 3rd party due diligence reports. This is because these reports are paid for by the Sponsor, and on their face are not independent. One provider, Snyder Kearny, LLC stated, “We specifically note that given the limited scope of our representation, we may not have independently verified factual statements contained in the PPM. Further our review is subject to the budgeted hours and may or may not be sufficient to consist of a “reasonable investigation” or “reasonable care” as such terms are defined in Sections 11 and 12 of the Securities Act of 1933, as amended. Unless expressly indicated in a separate legal opinion identified as such, we will not provide any opinion or legal advice regarding the adequacy of any investigation performed by us or the adequacy of the Offering disclosure”. With such disclaimer’s, broker-dealers should never rely solely on these firms to visit the property. Rather, they should do it themselves. Further, these reports are outsourced and not considered to be part of the broker-dealers own reasonable independent investigation.

With that background, let’s examine the ScoreCard one deal point at a time.

Question 1 – Sponsor/Manager Experience - Here, we analyze the sponsor or manager’s syndication experience. While it is helpful to know that the principals of the sponsor have “cumulatively” had many years of productive real estate experience, there simply is no substitute for a promoter’s direct experience dealing with acquisition and financing of properties in a packaged program where investors pool their capital and receive tax-deferred cash flow, equity buildup and growth of principal.

Further, it is helpful to know that the syndicator has had experience dealing with a large number of investors, reporting on the programs progress from an investor services perspective.

So, what I am looking for here is the number of years a sponsor or manager has in syndicating, acquiring, financing, managing and selling direct participation programs for investors. This kind of experience rises well above merely buying and selling properties by one's self.

You will note that it takes 20 years to earn 5 points in question #1. However, one point can be added to the score of this deal point with some extensive personal real estate acquisition and management experience of one or more of the key principals of the company.

Question 2 – Financial Strength - With this deal point, I am looking for tangible net worth of the sponsor or manager backing the deal. It is important to note, I would give little credit to would-be sponsors who are undercapitalized affiliates of a separate, main company sponsor, or parent company, which is not backing the deal but has simply loaned money to the affiliate in the form of a note to inflate the would-be sponsor's net worth. Again, what I am measuring here is the tangible net worth of a sponsor on a GAAP basis, where 20% or more of its assets are liquid and not an empty shell number! To meet this requirement, many sponsors provide financial statements that are not audited. This is true especially in private placements. However in the mid-2000's when deals by the carload were being offered, several large sponsors did provide audited financials. Examples were American Realty Capital, Vertical Financial Group (Mortgage Funds), DMMS and Argus, who all provided audited financials during that time period. Noted Ponzi schemes like Provident (Shale Royalties), Med-Cap and DBSI provided unaudited financials only. While audited, certified or reviewed financial statements help, they are no guarantee against fraudulent activities but they're better to have than not, and it should be mandatory for sponsors raising millions of dollars to provide them. Note that it takes \$15 million of tangible net worth to obtain 5 points on the ScoreCard, and as a rule of thumb, I feel that the sponsor should have a net worth of no less than 10% of the sum it has raised in outstanding deals to date, including the one you're considering.

Question 3 - Resale Activity – Here, I am looking for the sponsor's track record of re-sales and refinancing. What is usually listed in the profile of weaker sponsors is the number of programs, the number of investors and the total dollar amount of monies raised along with the cash flow distributions of prior programs and the cumulative number of years of experience of the firm's principals. Clearly, these items do not constitute "track record". Track record breaks down to two items only; re-sales and refinancing of the properties syndicated as shown in the PPM, nothing more! It is always helpful to list the re-sales and refi's of the principals and one point can be added when warranted. Please note that it takes 30% if the sponsor's properties syndicated to have been sold or refinanced to warrant the top score of 5 points.

Question 4 – Sponsor/Manager Compensation – In this question, I am looking for all the sources of compensation the sponsor receives and whether it is reasonable or not. Then I look for subordinations. I am not so concerned with how much the sponsor or manager receives as long as he gets it after we do. That's called subordinated compensation. While profits to the offering are usually subordinated, most other fees are not. It is refreshing when a sponsor subordinates some of its compensation to the projected investor return.

Examples would be selling commissions, leasing commissions, construction management fees or project management fees. Score it up if the sponsor requires a cash distribution target to be met before he gets his share of compensation. Most sponsors charge both a property

management fee and an asset management fee. I increase the score if there is only one of those fees are charged.

Question 5 – Load Factors – Here we look to determine what percentage of the equity capital raised goes into the property(s). This can usually be found in the “Use of Proceeds” section of the offering document. Many sponsors want to call “load”, only the dollars that go directly to the sponsor. One sponsor of a large REIT, in the “Use of Proceeds” section, failed to show any acquisition fees in the front-end load. This was because the deal was a “blind-pool” and the acquisition fees (6%) would only be incurred when the sponsor actually purchased the properties later on. Hence, all acquisition fees were shown as ongoing operational expenses. Nonsense! These are clearly one-time, front end load expenses and would be incurred on every property purchased. They are not like management fees that are paid annually.

I suggest that load includes the following: Sales commissions, organization and offering costs, non-accountable marketing and due diligence expenses, acquisition fees, loan placement and other fees along with closing costs. The remainder goes into the property. One chairman of an arbitration panel once asked me if large wire houses were selling these private placement TIC real estate deals. I explained that they did not because of the loads involved. Typically, it is the independent broker-dealer community that sells these deals whereby only 73 – 76% of dollars raised goes into the property(s). The public funds like REITS have lower loads whereby 84 – 88% goes into the ground. Total compensation (commissions plus non-accountable marketing and due diligence fees) are in the 5 – 6% range as opposed to 7 - 9% range for the private offerings the independent’s sell. (Exhibit B)

Question 6 – Guarantees – In looking for some kind of operational guarantee for the property(s), a Master Lease or strong personal guarantee would be examples. Then there is the repurchase account. In larger funds, after one year or 18 months, the program will accept repurchase requests, in writing, of up to say 5% of the capital raised on a first come, first served basis. Then there is the small print buried deep in the PPM! It will say under no uncertain terms that the sponsor will honor these requests only if they will not endanger the program financially. Further, this repurchase account may be terminated at any time by the sponsor. Clearly, these types of accounts are illusory at best and should never be counted on, especially in emergencies. You can be sure that if there are any clouds on the horizon, the repurchase account will vanish in a heartbeat! Anything that increases the investor’s protection would add to the score.

Question 7 – Self-Dealing – What I am talking about in this question is of course, conflicts of interest. It is critical to know how many services the sponsor is selling to himself. At the top of the list is a sponsor that purchases properties from itself or its affiliates. This is especially egregious if there is a mark-up on these purchases. Then, some sponsors will have an insurance subsidiary who sells property and casualty insurance to the program at inflated rates. Finally, if the original property acquisition comes from an independent third party seller, it is important to know what the percentage mark-up is to the investors. Typical mark-ups range between 10 – 12% but I have seen them as high as 25% – 30%.

While the numbers are usually disclosed in the PPM, only by subtracting the third-party purchase price from the loaded cost (equity raised plus the debt) will you know the true total of the mark-up. Finally, unsubordinated compensation is a conflict, and the tax opinion backing the offering must have at least a “should” opinion by counsel. In an LLC, the weakest of opinions is “more-likely-than-not” and a “will” opinion is best. The minimum standard is that the offering “should” not be treated as a real estate partnership, tax-wise.

Question 8 – Investor Voting Rights – While the investors are passive and have no real voice in management, there are always some voting rights preserved even for passive investors. TICs, for example, require unanimous consent of all the investors for most voting rights

One other “passive investor” voting right would be the percentage needed to remove the LLC Manager. The real question to determine is, must you have “for cause” only to remove him. This is usually very difficult to prove. Typically, willful misconduct must be demonstrated. Bad faith, fraud or gross negligence of the manager under the definition of cause are examples and must be demonstrated as well.

Short of being a convicted felon, the manager is probably going to be able to tie the investors up in extended litigation for many years if they try to remove him. The best of all scenarios is to have an offering that only requires a simple majority to amend the operating agreement, approve the sale of all or substantially all of the properties, approve any “roll-up”, approve any change in the deal’s investment objectives, approve any refinancing of the property or fire the manager.

Question 9 – Leverage - Most importantly, the percentage of leverage is the debt related to the original purchase price from the 3rd party seller. That is actual leverage at the real estate level. Then of course there is the ‘loan to value’. That is the debt divided by the appraised value and should also be determined. On my ScoreCard, an all cash purchase or debt of no more than 39% would achieve the top score of 5.

Question 10 - Financing – Here we are looking at the terms of the loan. Fixed 30 year loans are virtually non-existent in real estate offerings currently. What we look for are 7 - 10 year loans with as many years of interest only payments as possible. The ability to prepay the loan after some period is additionally important. We also like to determine if there are any cross default or cross collateralization requirements by the lender on the part of the sponsor. Here, we would like to avoid having to deal with the sponsor’s problems related to other properties that would affect our property(s). Finally, we should determine the “bad-boy” carve-outs (recourse guaranty’s) on any non-recourse loans obtained. These provide for personal liability against the borrower and principals of the borrower upon the occurrence of certain enumerated bad acts committed by the borrower and its principals.

Question 11 - Valuation Ratio – This important question deals with the percentage of the appraisal amount to the loaded cost of the offering. Take the “as-is” appraisal amount and divide it by the loaded cost to the investors (equity raised plus the debt). Many times I see this ratio at under 85%, which is unacceptable. So it must be scored down. What we like to see is a ratio of 95% to 100%, appraisal to loaded cost, which is the fairest to the investors.

This ratio is one of the most important elements on the ScoreCard. Finally, always be sure that the appraisal is honest and straight forward and not made as instructed (MAI).

Question 12 – Assumptions - This question is the very heart of the ScoreCard. First, it tests the projections by determining if any legal or accounting firm signed off on them, or if they were just un-reviewed as prepared by the sponsor? The latter is usually the case. Are the yearly rental rate increases realistic? A projection of annual rental increases of say, 5% every year is abnormally high and unrealistic.

Sometimes I see just that. The next thing we look at is the cap rate on acquisition. That percentage is gleaned by taking the projected first year Net Operating Income (NOI) and dividing it by the loaded cost.

What I usually find is a cap rate below 6% at acquisition. Given the speculative nature of most real estate offerings, this number should be at least 2 – 3 basis points higher than a quality corporate bond rate due to the high risk involved. Next we look to the terminal cap rates on resale. It is fundamental that these should be the same as the purchase cap rates, but they never are. They are backed into by sponsors, many times. Since the lower the cap rate, the higher the price, lower terminal cap rates, differing from the purchase cap rates are often chosen which are unrealistic.

This is especially true when interest rates are clearly projected to rise over the next 7 – 10 years. That's the next thing we look at – the holding period. During that time, I always give extra points to a sponsor that puts a limitation on the number of years of reinvestments. An example of a 'good deal' for investors pertaining to the holding period is, after 7 years, the reinvestment period ends. In other words, no more reinvestments in new properties with sales and refinancing proceeds, i.e., capital events, are possible. The deal stops here. After 7 years, all monies from capital transactions begin to be distributed back to the investors in a self liquidating fashion. Score it up as being most fair to the investors. Further, it's in accord with the NASAA Guidelines. Finally we look for any "yield enhancements" or financial engineering used by sponsors. Examples would be interest rate buy-downs, deferred management fees, rental credits, negative master lease spreads, sponsor leased-back space/units, paying cash flow from reserves or an unsupported basis for projections/assumptions. These games played by sponsor's will be exposed by the ScoreCard.

Question 13 - Percentage of Supply to Demand – This question begins with determining what percentage of leases with tenants would expire within say, the next 5 years, 6 years, and so on. Then it is important to analyze tenant termination options for lease stability. Most important is to check with local real estate brokers to learn the actual vacancy rate for the same type of property you have within the specific sub-market you're located in. Many sponsors tend to pick a number off a bus in stating what the occupancy percentage is, both current and projected. Finally, it is critical to determine what the competition is with respect to the type and location of the property you have. From the answers to these questions, you can easily determine a percentage grade for the offering you're analyzing.

Question 14 – Consideration per sq. ft. vs. the Competition – This is a simple comparison. We know that if we were a direct real estate investor, we should consider buying a suitable property with moderate risk at the highest. An example would be a triple net leased property guaranteed for 10 – 15 years by a Walgreens, CVS or Jared's Jewelry.

We could buy it for a fee that compares to a simple negotiated real estate commission, i.e., 5% on average. We wouldn't actually pay the commission since the seller would pay that. The fee we would pay would cover the appraisal, property inspection, environmental study, engineering report and the loan fee and costs. The total expense would be approximately 2.5% of the equity invested and with 50% leverage, that would equate to 5% of the selling price.

However, if we were buying a direct participation program through a broker-dealer, we would be paying a load of much more than that. Simply add the load from Question #5 to 100% and you have your answer. If the load is 25%, you score 1 point (125%) on the ScoreCard compared to 105% in the direct real estate marketplace.

Question 15 – Risk Factors – Unquestionably there is risk in every real estate transaction. The question here is whether the risks in your particular transaction are greatly magnified above the norm.

Examples would be an extraordinarily high mark-up on acquisition, an abnormally high load, unrealistically aggressive assumptions, investor credit impairment, a below 85% appraisal amount to loaded cost ratio along with an extraordinarily high percentage of leases coming due in 5 years. If some or all of these attributes described above exist, plus there are a number of items of unsubordinated compensation to the sponsor, the deal will probably score close to 1 point on the ScoreCard.

So there you have it. An evaluation method that is really a due diligence check list; a quantifiable tool to evaluate direct participation program offerings. Of course this method is not perfect. In using it over 1,400 times since 1972, my experience with the ScoreCard due diligence analysis, reflects an overall 76% success ratio. In other words, over 75% of the time, when I have scored an investment offering below 52 points, it has not worked. The property has been foreclosed upon by the lender, the sponsor has been declared fraudulent, the loan is in default, it has been classified as a Ponzi scheme or it has stopped providing cash distributions with no hope of restoration. The same is true of offerings that have passed the check list. For the balance of the 24%, it is too early to tell in many cases. For example, something to really keep in mind at this time is that all those 10 year “due and payable” loans will now be maturing in 2015 – 2017. This necessarily will place a great deal of refinancing pressure on lenders in the real estate marketplace as well as finalizing many outstanding real estate deals.

Some of the programs have come back somewhat, but may be wavering a bit with the final results still undetermined. I only count in the 76%, the program’s whereby a resolution has been finalized. Since a PPM or prospectus is hundreds of pages in length, the ScoreCard breaks the deal down into 5 or 6 pages in a logical format that the trier of fact can understand and appreciate. It makes it much easier for an arbitrator or mediator to verify the deal points of the program by hearing the ScoreCard presentation and then referencing the Table of Contents in the offering document. As Victor Hugo once wrote, “Nothing is more powerful than an idea whose time has come”. The ScoreCard as a reasonable due diligence method is one such idea.

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RESPONDENT'S COUNSEL IN FINRA ARBITRATION CLAIMS: DOS AND DONT'S

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I. Introduction

As FINRA hearing locations shuttered, and in person arbitration hearings became impossible, practitioners were faced with the dilemma of how to best bring resolution to a case when presenting a case to the arbitration panel in person became increasingly difficult or impossible. As a result, FINRA arbitrations moved to virtual platforms and practitioners quickly adjusted to presenting their cases and defenses in the new virtual era. In 2020, requests for virtual hearings were granted nearly 300 times and since the postponement of in-person hearings through July 2021, over 400 arbitration cases have conducted one or more hearings via Zoom. Despite the radical shift in the presentation of FINRA arbitration claims in 2020 and 2021, the fundamentals of practically dealing with the defense bar remain the same and will be discussed in this article.

II. Defenses to Anticipate

Counsel for brokerage firms have a basic lawyer “playbook” of defenses utilized in virtually every case. The most common defenses in this playbook include (1) the sophisticated-investor defense; (2) the blame-the-market defense; (3) the prospectus-defense; (4) the net-out-of-pocket-defense; (5) the failure-to-mitigate-damages defense; and, most frequently seen, (6) the blame-the-victim defense. To facilitate these defenses, the brokerage firm seeks broad “discovery” from the aggrieved investor, requesting all kinds of financial records. Well-known Claimant’s attorney Seth Lipner (and many others) have described this process as a “financial colonoscopy.”

The financial documents the brokerage firms seek from the Claimant typically include all customer and customer party owned business (including partnership and corporate) federal income tax returns, including Schedules A, B, D, and E, and the IRS worksheets related to these schedules, or the equivalent for any other type of return for the three years prior to the first transactions at issue in the Statement of Claim through the date the Statement of Claim was filed. Defense lawyers also typically demand financial statements, including statements made in connection with a loan application, or similar statements of the customer parties’ assets, liabilities, and/or net worth. Most enterprising defense lawyers will attempt to reach far beyond this list and ask for banking statements, credit card statements, and any other tangentially related financial document going back years.

A. Sophisticated Investor Defense

The goal of Respondent’s fishing expedition is to characterize the investor as a gambler or speculator who was seeking to secure outsized returns from his or her brokerage account, and therefore was willing to accept substantial risks and/or attempt to label the Claimant as “financially sophisticated”. In other words, Claimant is a sophisticated investor who knew and accepted the risk of loss. Many times, the breadth of the information sought is grossly disproportionate to the size of the case and facts at issue. This is often an attempt to burden an investor with a long list of discovery demands.

B. Blame the Market Defense

Another common defense is related to the market's performance. This "blame-the-market" defense is more commonly used in a bear market like in 2000 and 2008 but it is still utilized even with cases filed in 2016 and 2017. The defense lawyer claims the decline in the investor's account was caused by the decline in the overall market and was completely unanticipated (unforeseeable). This defense can often be overcome with an analysis of how the client's portfolio performed when compared to the actual market during the same exact time-period. Most expert witnesses can provide this market adjusted information after completing a profit and loss analysis.

C. Disclosure Defense

The disclosure or prospectus defense has long been a brokerage firm favorite. It is argued primarily in mutual fund, structured product and other product related cases. The basic premise is that the brokerage firm provided the investor with a prospectus which the investor was required to read. The defense will assert that the investor can't now complain about the investment because they didn't read the prospectus or that the investor, knowing of the risks related to the investments, accepted the risks and knowingly invested in the product, thus accepted the disclosed risk factors.

D. Net-Out-Of-Pocket Defense

The net-out-of-pocket defense is common where the account was open for a long time, or where the investments paid interest or dividends. It is a way to attack the damage issue in a case. The firm using the defense wants credit for any and all interest or dividends received from the investment. They use these positive cash flows to set-off capital losses. The other variation of the net-out-of-pocket defense is the "you-have-to-look-at-the-whole-account" defense. That defense is used to try to convince the arbitrators to ignore an egregious loss on an unsuitable security by setting off that loss against gains made on other (suitable) securities.

E. Failure to Mitigate Defense

A final common defense is the failure-to-mitigate defense. The argument is that some of the loss could have been avoided if the investor had discovered the scheme sooner and acted quicker to liquidate the losing investment. That "you should have caught me sooner" or "you shouldn't have trusted me" defense can be turned around against the firm and the broker in many circumstances.

Over the years, these defenses have proved useful to brokerage firms, and they have been the cause of hundreds of middle-ground, compromise awards and losses for Claimants. For example, if the arbitrators in a case think that something probably went wrong in the sale process, but they aren't certain, these defenses have been used by arbitrators to rationalize lowering the award (even though many state securities acts don't allow these common law related defenses to be used against statutory claims). Arbitrators looking for a middle-ground result have adopted the blame-the-market defense, the netting defense, or the mitigation defense. Be mindful that arbitrators in the past have compromised the award, yet do not explain their reasoning and are not usually subject to a motion to vacate absent some limited circumstances.

The lesson to be learned is that we must be aware of these defenses and attempt to include in your pleadings facts you will need to argue that these defenses do not support findings against your client or the reduction of damages. Anticipating these commonly utilized defense tactics remains key whether your case proceeds to hearing in person or virtually.

III. Pre-Filing Demands

Pre-filing demands are rarely successful and shouldn't be made absent extraordinary circumstances. Most in-house attorneys are extremely busy handling both FINRA and non-FINRA related work for the firm, and pre-filing customer complaints do not garner the immediate attention of busy in-house lawyers and often go ignored. In addition, most pre-filing demands result in de minimis, low-ball offers. If a Claimant is nonetheless inclined to make a pre-filing demand, my practice is to prepare a detailed draft Statement of Claim rather than a standard demand letter. This demonstrates Claimant's seriousness and readiness to file an arbitration claim if the pre-filing negotiations are unsuccessful. A well-crafted statement of claim is more likely to command the firm's attention than a routine letter to in-house counsel. It is also helpful to have some core supporting documents ready to produce to the other side in support of Claimant's position. The downside is that these documents, or at least the information in them, are almost certain to be used in the Answer if the case does not settle early.

IV. Regulatory Inquiries/Investigations

If there exists a pending regulatory inquiry or investigation related to your client's complaint, or to the broker about whom your client is complaining, this can have an important impact upon the evaluation of the case by the defense lawyer. A brokerage firm may believe that settling a case could have a negative impact upon the pending regulatory matter. If that is the circumstance, the brokerage firm may believe it is necessary to fight the claim. On the other hand, a regulator may be exerting pressure on a firm to settle a particular case or group of cases, and yours may be included in that discussion. The reality is that regulatory inquiries and investigations usually move at a pace slower than federal practice and FINRA arbitrations. While regulatory investigators often indicate they desire to promptly investigate claims at the onset of their involvement, the regulator often ends up sitting on statements for years before deciding whether to pursue the matter. Brokerage firm lawyers often believe that a regulatory investigation has ended when in fact it is only inactive. The average FINRA investigator has a caseload even larger than the typical brokerage firm in-house attorney. They are also paid substantially less. As a result, regulatory investigations simply tend to move at a glacial-like pace.

V. Will the Broker Have to Pay Part of the Settlement?

Will the broker be forced to contribute to the settlement or award? This may become an issue when a brokerage firm will only pay a certain amount to resolve a claim, and more is needed to reach a final settlement acceptable to the client(s) so that the case can be resolved. Where the individual broker has not been named as a Respondent, and the broker remains employed by the Respondent firm, the broker may still be forced to contribute to a settlement by the firm. This argues for naming the broker individually as a Respondent in the Statement of Claim. Moreover, when suing a small firm where collection may ultimately be an issue, naming brokers, supervisors and others as parties becomes a more relevant consideration. Naming the broker poses the inherent risk that the arbitrator may find the broker liable and not the brokerage firm, which has the potential for collection issues, and must also be taken into consideration when ultimately deciding who to name as a Respondent in the Statement of Claim.

VI. Claimant May Place the Respondent's Counsel in a Conflicted Position, Further Enhancing Settlement Pressure

If the same defense counsel represents the firm and the broker, there always exists the possibility that a conflict exists or will develop for the defense attorney. Whether the conflict can be waived depends upon the facts of the individual case. Claimant's lawyers can attempt to create conflicts in a number of ways. For example, Claimant's lawyers may request an on-the-record interview of the broker in exchange for the broker's dismissal. This may be in the broker's best interest, but not in the firm's interest. If the defense lawyer believes that a conflict has been created it may become necessary to obtain separate counsel for the broker. Whether this strategy can be productive is questionable. Furthermore, if a second defense lawyer is involved, other issues come into play, such as the Respondents getting greater weight on the ranking of the arbitrators.

VII. Conclusion

In conclusion, the strategies to be considered by investor's counsel and the defenses employed by the industry have been well developed by counsel over the years and most defenses can be adequately anticipated. The forum of FINRA arbitration may have undergone a radical transformation as a result of the Covid pandemic, but the fundamentals of effectively and practically dealing with defense counsel remain unchanged.

ETHICAL PROBLEMS IN USING SOCIAL MEDIA

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Advanced Mediation Training-Family Law, A.A. White Resolution Institute
Mediation training, A. A. White Dispute Resolution Institute

RECOGNITIONS

Listed in Texas Super Lawyers, Texas Monthly Magazine 2003, 2004, 2006, 2007-2012
Listed H-Texas Magazine, Houston Top Lawyer, 2004 - 2011
Listed H-Texas Magazine, Houston Top Family Lawyers, 2006 – 2011
Martindale-Hubbe, AV Peer Review Rated

PROFESSIONAL ACTIVITIES AND ASSOCIATIONS

State Bar District Director, District 4, Place 7 (2014-2017)
Member, State Bar of Texas Family Law Council, Legislative Committee; Section Report Board of Editors; Website and Technology Committee
Director, Texas Family Law Foundation
Past President, Texas Academy of Family Law Specialists (officer since 2008); (director 2002 – 2005); (member since 1994)
Editor, Texas Academy of Family Law Specialists – Newsletter “Family Law Forum” (2005-2008)
Fellow, American Academy of Matrimonial Lawyers
Fellow, International Academy of Matrimonial Lawyers
Fellow, Texas Chapter of American Academy of Matrimonial Lawyers
2012 President, Houston Chapter, Burta Raborn Family Inns of Court
Course Director, Ultimate Trial Notebook Family Law, 2009
Member of the College of the State Bar of Texas
Past President, Gulf Coast Family Law Specialist
Past Director, Houston Bar Association - Family Law Section
Former Investigator/Litigator, The Supreme Court of Texas, Unauthorized Practice of Law Committee
Past Chairperson, State Bar Grievance Committee 4A-1
Member, Family Law Section, State Bar of Texas
Member, Family Law Section, Houston Bar Association
Member, Gulf Coast Family Law Specialist
Member, Texas Family Law Foundation
Life Fellow, Houston Bar Foundation
Life Fellow, Texas Bar Foundation

LEGAL SEMINARS & PUBLICATIONS

Speaker/Author, Defending & Excluding Evidence Based on Discovery, 2016 Marriage Dissolution
Speaker/Author, Discovery on a Budget, 2015 Advanced Family Law Drafting
Speaker/Author, Child Support Outside the Box “When the Guidelines Don’t Fit.”, 2015 Advanced Family Law Seminar
Speaker/Author, Informal and Mediated Settlement Agreements, 2015 Marriage Dissolution 101
Speaker/Author, Show Me the Money, Using Technology to Create and Present Inventories and Other Financial Documents, 2014 Family Law Technology

Speaker/Author, To Bundle or Not to Unbundle, 2014 Advanced Family Law Course
 Speaker/Co-Author, Phase Three-Pretrial and Trial; Family Law 101 Course, 2014 Advanced Family Law Course
 Speaker/Co-Author, To Object or Not to Object That is the Question, 2013 Advanced Family Law Course
 Speaker/Co-Author, Social Media: How to Get It, Where to Get It, and How to Admit it, 2014 Marriage Dissolution
 Speaker/Co-Author, To Object or Not to Object That is the Question, 2013 Advanced Family Law Course
 Speaker/Co-Author, Social Media and Your Clients, Marriage Dissolution Institute, April 2013
 Speaker/Co-Author, Criminal and Ethical Considerations in the Age of Technology, 2012 Advanced Family Law Course
 Speaker/Co-Author, Parentage, State Bar College 14th Annual Summer School, July 2012
 Speaker/Co-Author, Ethical Pitfalls of Social Media, Marriage Dissolution Institute, 2012
 Speaker/Co-Author, Social Networking and Getting e-Evidence, 2011 Advanced Family Law Drafting Course
 Speaker/Co-Author, Hearsay, 2011 Texas Advanced Family Law Seminar
 Speaker/Co-Author, Top Ten Tips in a Custody Case, State Bar College 13th Annual Summer School, July 2011
 Speaker/Author, Things Clients Do on Social Media That Get Them in Trouble, Marriage Dissolution Institute, 2011
 Speaker/Co-Author, Trial Tactics & Evidence, 2011 Parent Child Relationships: Critical Thinking for Critical Issues, January 2011
 Speaker/Co-Author, Discovery & Drafting in the Computer Age, Advanced Family Law Drafting Course, 2010
 Speaker/Author, Electronic Evidence, Marriage Dissolution, 2010
 Speaker/Author, Witness Preparation and Assessment, The Ultimate Trial Notebook; Family Law 2009
 Speaker/Moderator, Electronic Evidence Workshop, Advanced Family Law Course 2009
 Speaker/Author, Getting Information from 3rd Parties about Kids, Parent-Child Relationships, Critical thinking for Critical Issues, University of Texas, Austin
 Speaker/Author, The Amicus Attorney, State Bar of Texas Annual Meeting, Family Law Section, Continuing Education Program, 2008
 Speaker, Harris County Youth and Family Services 5th Annual Conference on Youth and Families, Testimonial Two-Step: What Works in the Courtroom, 2008
 Speaker, Galveston County Bar Foundation, Child Custody Evaluations, Ethics and Investigating Allegations of Sexual Abuse, 2008 – Direct & Cross Examination of a Custody Evaluator
 Speaker, South Texas College of Law, Annual Family Law Conference 2008 – *Appealing Your Family Law Case*
 Speaker/Author, The University of Texas School of Law: Effective Family Law Practice, The Definitive Short Course on Parent-Child Relationships 2007, *The World of Court Appointees: Amicus Attorneys, Attorney Ad Litem, Guardian Ad Litem and Social Studies*
 Speaker/Author, Advanced Family Law Practice for Paralegals: Handling Financial Issues at a Higher Level 2007 – *Effective Presentation of Financial Matters – Financial Information Statements, Inventory & Appraisements, and Proposed Property Divisions*
 Speaker/Author, Advanced Family Law Course 2006 – *Who Represents the Child? Not Me, I am the Amicus Attorney!*
 Speaker, Texas Academy of Family Law Specialists Trial Institute 2006 – *Litigating the Case – The Trial*
 Speaker/Author, Advanced Family Law Drafting Course 2005 – *"It Don't Mean a Thing if it Ain't Got that Swing" - Tips from the Bench*
 Speaker/Author/Course Director, Advanced Family Law Course 2004 – Law Office Management Boot Camp
 Speaker/Author, Houston Bar Association Continuing Legal Education Seminar, 2004 – *Family Law for the General Practitioner*
 Speaker, 309th Judicial District Court of Harris County, Texas 2003, *Ad Litem's Interaction with Mental Health Professional*
 Co-Course Director, 309th Judicial District Court of Harris County, Texas, 2003, *Ad Litem Course*
 Speaker/Author, 309th Judicial District Court of Harris County, Texas 2003, *Ad Litem's Role in Trial*
 Speaker, South Texas College of Law, Family Law Conference, 2003 - *Working with Ad Litem*
 Speaker/Author, Advanced Family Law Course, 2002 - *ANALYZE THIS! The Use of Mental Health Professionals in Ways Other Than Custody Evaluations*
 Speaker/Author, South Texas College of Law, 2002 - *Ad Litem Appointments in Publication Divorce*
 Speaker, State Bar of Texas, Pro Bono Seminar, 2001 - *Terminations and Adoptions*
 Speaker, HBA Pro se Drafting Clinic, 2001 - *Pro Se Pleadings*
 Speaker, Texas Family Law Practice for Paralegals, 2001 - *Handling Custody Disputes*
 Speaker/Author, South Texas College of Law, Family Law Conference, 2001 - *Depositions and Other Forms of Discovery "What you Don't Know Can Hurt You"*
 Moderator, South Texas College of Law, Family Law Conference, 2001
 Speaker, State Bar of Texas, Telephone Seminar, 2000 - *Value of Real Property*
 Co-Course Director, 309th Judicial District Court of Harris County, Texas 2000, *Nuts and Bolts of Being an Ad Litem*
 Speaker/Author, 309th Judicial District Court of Harris County, Texas, 2000 - *Ad Litem's Role in Trial; Ad Litem's Interaction with Mental Health Professionals*

Speaker, South Texas College of Law, 10th Annual Family Law Conference, 2000 - *Local Rules, Associates Judges, Scheduling Orders and Discovery*

Speaker/Author, Advanced Family Law Drafting Course, 1999 - *Ethics, Grievances, Malpractice and Professionalism*

Speaker/Author, Houston Bar Association, Second Annual Family Law Institute, 1999 - *The Family Lawyer's Top Ten Ethical Issues*

Speaker/Author, South Texas College of Law, 9th Annual Family Law Conference, 1999 - *Top Ten Ethical Issues in Family Law Cases*

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ETHICAL PROBLEMS IN USING SOCIAL MEDIA

I. INTRODUCTION

The use of advanced technology has transformed the practice of law, with social media revolutionizing the way clients and lawyers communicate. Because of these advances, lawyers need to be aware of the dangers that can arise, which will only become more complex as technology evolves. In addition to the risk of giving legal advice without adequate information or inadvertently establishing inappropriate attorney-client relationships on social websites, there are other ethical implications in online communications that attorneys should consider, particularly regarding attorney advertising and solicitation of clients. Another key area that has become more complicated with the proliferation of social media is the protection of attorney-client privilege.

Until recently, there were relatively few cases addressing social media. Guidance can now be found with more frequency in case law as these issues are being tested in court. This article will discuss social media issues that courts have addressed as well as review ethics opinions from bar associations across the country. Based on these rulings, the paper will offer some tips to help avoid the pitfalls that can arise.

The article is also intended to remind us all to practice professionalism when using social media. Professionalism should guide how we conduct ourselves in our emails, texts, tweets, posts, and other online interactions with opposing counsel, the court, and our clients. In Texas, the Disciplinary Rules of Professional Conduct govern the conduct of lawyers, and the paper will review the disciplinary rules that impact online communications.

Finally, the paper provides a serious reminder that in addition to ethical violations, misuse of social media can sometimes result in civil and criminal penalties. Major state and federal statutes imposing such penalties are highlighted.

As usual, many thanks are extended to those authors of previous papers related to this topic, including Kristal Thomson, Kenneth Raggio, John G. Browning, and Judge Emily Miskel. The assistance provided by these authors' excellent work is greatly appreciated.

II. SOCIAL MEDIA AND ATTORNEY ADVERTISING, MARKETING, AND SOLICITATION

Instead of traditional networking for client development, lawyers now are venturing into social media to expand the scope of their audience. Thousands of legal professionals use social media sites like LinkedIn, Facebook, Twitter, Instagram and more to extend their contacts. These sites can be like a free business brochure to publish work experience, education, specialties or interests. The ability to participate in specialized groups, such as "divorce lawyers," on these sites is another marketing tool. Users can post questions to the group, make announcements about their practice, and share information with the group. Therefore, social media profiles and posts can constitute legal advertisements.

Most states, including Texas, have special requirements for lawyer advertising and strictly limit solicitation. Novel issues arising from the use of online marketing must be considered.

A. Texas Rules Governing Solicitation and Advertising

In Texas, Part VII of the Texas Disciplinary Rules of Professional Conduct governs how lawyers may provide information about their services. An advertisement or solicitation remains subject to the Texas Disciplinary Rules regardless of the media used. Thus, Part VII applies to information disseminated over the internet. A review of these rules is essential to avoid unanticipated hazards. *See, e.g., Izen v. Comm'n on Lawyer Discipline*, 322 S.W.3d 308 (Tex. App.—Houston [1st Dist.] 2010, pet. denied) (affirming jury findings of numerous disciplinary rule violations regarding website advertisements resulting in probated suspension of law license).

The State Bar Advertising Review Committee has adopted Interpretive Comments to assist lawyers who advertise or solicit clients in public media. (available at <https://www.texasbar.com>). Interpretive Comment 17 addresses the "Internet and Similar Services Including Home Pages" and offers some clarification about the application of the Texas ethics rules to websites and other social media sites. The Comment confirms that Part VII only applies to commercial speech intended to secure professional employment. Thus, if an attorney's statements are not designed to market the lawyer's services, then Part VII's advertising restrictions do not apply.

Texas Disciplinary Rule of Professional Conduct 7.01 prohibits lawyers from advertising or practicing under a trade name or a name that is false and misleading. Therefore, an Internet domain name or URL may not be used as the name under which a lawyer or firm does business. Interpretive Comment 17(D). A domain name that is a reasonable variation of the law firm name as provided in Rule 7.01 may be used if it does not violate Rule 7.02. *Id.*

Texas Disciplinary Rule of Professional Conduct 7.02 addresses communications concerning a lawyer's services. The rule prohibits communications that contain material misrepresentations of fact or law or omit a fact necessary to

make a statement not materially misleading. In addition, the rule requires advertising lawyers to include specific information when referring to past successes or results. The rule provides:

- (a) A lawyer shall not make or sponsor a false or misleading communication about the qualifications or the services of any lawyer or firm. A communication is false or misleading if it:
 - (1) contains a material misrepresentation of fact or law, or omits a fact necessary to make the statement considered as a whole not materially misleading;
 - (2) contains any reference in a public media advertisement to past successes or results obtained unless:
 - (i) the communicating lawyer or member of the law firm served as lead counsel in the matter giving rise to the recovery, or was primarily responsible for the settlement or verdict;
 - (ii) the amount involved was actually received by the client;
 - (iii) the reference is accompanied by adequate information regarding the nature of the case or matter and the damages or injuries sustained by the client; and
 - (iv) if the gross amount received is stated, the attorney's fees and litigation expenses withheld from the amount are stated as well;
 - (3) is likely to create an unjustified expectation about results the lawyer can achieve, or states or implies that the lawyer can achieve results by means that violate these rules or other law;
 - (4) compares the lawyer's services with other lawyers' services, unless the comparison can be substantiated by reference to verifiable, objective data;
 - (5) states or implies that the lawyer is able to influence improperly or upon irrelevant grounds any tribunal, legislative body, or public official;
 - (6) designates one or more specific areas of practice in an advertisement in the public media or in a solicitation communication unless the advertising or soliciting lawyer is competent to handle legal matters in each such area of practice; or
 - (7) uses an actor or model to portray a client of the lawyer or law firm.

Comment 2 to Rule 7.02 provides that "Whatever means are used to make known a lawyer's services, statements about them must be truthful and nondeceptive." Be alert to exaggerations. In addition, remember that Rule 4.1 contains general restrictions on attorneys making false statements or providing false information.

Rule 7.03 of the Texas Disciplinary Rules of Professional Conduct deals with in-person telephone, and other prohibited electronic contact between a lawyer and a prospective client where the lawyer seeks professional employment. Rule 7.03 forbids using "electronic contact" to solicit business directly from a potential client. The prohibited contact is defined as, "any electronic communication initiated by a lawyer or by any person acting on behalf of a lawyer or law firm that will result in the person contacted communicating in a live, interactive manner with any other person by telephone or other electronic means." Tex. Disc. R. Prof. Conduct 7.03(f). Attorney websites are expressly excluded. *Id.* Comment 1 explains that forms of electronic communications are prohibited that pose a danger of overbearing a prospective client's will or that may lead to a hasty and ill-advised decision, just as with face-to-face solicitations. These include soliciting business in chat rooms, or sending "an unsolicited, interactive communication to a prospective client that, when accessed, puts the recipient in direct contact with another person." Tex. Disc. R. Prof. Conduct 7.03 cmt. 1.

Texas Disciplinary Rule of Professional Conduct 7.04 deals with advertisements in the public media by a lawyer seeking professional employment. A lawyer who advertises on the internet must display the statements and disclosures required for traditional print advertising. *See* Tex. Disc. Rule Prof. Conduct 7.04(r). Rule 7.04(f) requires lawyers to keep a copy or recording of each advertisement in the public media, the approval of the ad, and a record of when and where the ad was used for four years after its last dissemination. Even though social media pages and blogs are subject to constant, sometimes daily revision, Interpretive Comment 17 states that a printed copy of electronic communication, including profile pages, are subject to the retention requirements under Rule 7.04(f).

Rule 7.04(a)(3) permits lawyers to publicize their availability in legal directories and legal publications. Thus, lawyers have more latitude on sites like Texas Bar Connect, the social networking site restricted to members of the State Bar of Texas, than on other social media sites.

Texas Disciplinary Rule of Professional Conduct 7.05 expressly includes digital and electronic communications to prospective clients for the purpose of obtaining professional employment. The rule provides that the communication "shall, in the case of an electronic mail message, be plainly marked "ADVERTISEMENT" in the subject portion of

the electronic mail and at the beginning of the message's text." Tex. Disc. R. Prof. Conduct 7.05(b)(2). A copy of each solicitation communication and a record of the date, the name, and electronic address to which each such communication was sent must be kept by the lawyer or firm for four years. Tex. Disc. Rule Prof. Conduct 7.05(e).

Rule 7.07 sets out the requirements for public advertisements and written, recorded, electronic, or other digital solicitations to be filed with the Advertising Review Committee of the State Bar of Texas. Tex. Disc. R. Prof. Conduct 7.07. All the forms of communication addressed in the Interpretive Comment 17 are subject to the filing requirements under Rule 7.07, unless otherwise exempted under 7.07(e). Interpretative Comment 17 provides: "A digitally transmitted message that addresses the availability of a Texas lawyer's services is a communication subject to Rule 7.02, and when published to the Internet, constitutes an advertisement in the public media."

Summary of Rule 7.07:

- General rule: Attorneys must file each "advertisement in the public media" with the State Bar Advertising Review Committee. Rule 7.07(b).
- "Advertisement in the public media" generally includes a profile available to the public on the Internet.
- A specific sub-section applies to websites. Rule 7.07(c).
- The filing requirement is not the same as "pre-approval" available under Rule 7.07(d).
- Rule 7.07(e) has a list of information that is exempt from the filing requirement.
- The Advertising Review Committee has adopted Internal Interpretive Comments to be used by staff, and if the advertisements comply with the Interpretive Comments, staff is authorized to approve them.

B. Attorney Websites

Websites have become an increasingly necessary means by which lawyers communicate with the public. In addition to providing information about the law and the value of legal services, websites also offer lawyers a twenty-four-hour marketing tool. Lawyers can disclose their qualifications and explain the scope of legal services provided, but they must be mindful of the expectations created by the website. In addition, lawyers must be careful not to include any misleading information on websites and should review all current and future law firm website content for violations. Ensure that the website has a statement identifying who wrote the content and who is responsible for it.

Texas Disciplinary Rule of Professional Conduct 7.07(c) requires a lawyer's website to be filed with the Advertising Review Committee of the State Bar of Texas, unless it is limited to certain exempt information enumerated in Rule 7.07(e). These exemptions include contact information, dates of admission to the bar, areas of practice, acceptance of credit cards, languages spoken and other specified information. Because of this limited information, an exempt ad is sometimes called a "tombstone" ad.

An attorney website's initial, or home, page must include:

1. The name of the lawyer or law firm responsible for the content;
2. A conspicuously displayed disclaimer regarding special competence or board certification; and
3. The geographic location of the lawyer or firm's principal office.

The State Bar of Texas Advertising Review Committee Interpretive Comment 17(A). A link to a separate page does not satisfy the requirement.

Interpretative Comment 17 states that social networking sites with "landing pages" generally available to the public, such as those on Facebook, Twitter, and LinkedIn, are advertisements. (A landing page is a website page that allows you to capture a visitor's information through a lead form, instead of merely directing the visitor to your homepage.) Where access is limited to existing clients and personal friends, however, filing with the Advertising Review Department is not required. The Comment clarifies that "blogs or status updates considered to be educational or informational in nature are not required to be filed with the Advertising Review Department." It is the responsibility of the attorney to demonstrate that any communication does not need to be filed with the Committee. State Bar of Texas Advertising Review Committee Interpretive Comment 17(G).

Lawyers who use website marketing must be alert to the risks associated with website visitors relying on information on the site or seeking legal advice. The American Bar Association issued a formal opinion with guidelines for lawyer websites. See Formal Opinion 10-457, August 5, 2010 (available at <http://www.americanbar.org>). The ABA rules allow a lawyer to include accurate information that is not misleading about the lawyer and the lawyer's law firm, including contact information and information about the lawyer's practice. To avoid misleading readers, this information should be updated on a regular basis. Lawyers should make sure that legal information is accurate and current. A lawyer who poses answers to a hypothetical question generally is not characterized as offering legal advice.

Lawyers should include statements that the information is general in nature and that it should not be a substitute for personal legal advice.

Websites should also include a user agreement that spells out the terms that the user must agree to when using the website. Attorneys who have websites should include a disclaimer to negate the intent to form an attorney-client relationship. Law firm websites should also include a disclaimer that legal information contained on the website is not the same as actual legal advice. A simple disclaimer or legal notice at the bottom of a home page probably does not create an enforceable agreement. Courts have held that terms may not be hidden or on another screen; they should be affirmatively “clicked” and agreed to by a website user (referred to as “click wrap” agreements). *See Specht v. Netscape Comm. Corp.*, 306 F.3d 17, 33-35 (2d Cir. 2002); *see also Barnett v. Network Solutions, Inc.*, 38 S.W.3d 200, 204 (Tex. App.—Eastland 2001, pet. denied) (upholding a forum selection clause in an online contract for registering Internet domain names that required users to scroll through terms before accepting or rejecting them).

The California Bar has addressed the required disclaimer. *See* St. B. of Cal. Standing Comm. On Prof. Resp. & Conduct Formal Op. No. 2005-168. A lawyer who provides to website visitors seeking legal services and advice a means for communicating with him, whether by e-mail or some other form of electronic communication on his website, may effectively disclaim owing a duty of confidentiality *only if* the disclaimer is in sufficiently plain terms to defeat the visitors’ reasonable belief that the lawyer is consulting confidentially with the visitor. Simply having a visitor agree that an “attorney-client relationship” or “confidential relationship” is not formed would not defeat a visitor’s reasonable understanding that the information submitted to the lawyer on the lawyer’s website is subject to confidentiality. *Id.* If the lawyer has received confidential information from the visitor that is relevant to a matter in which the lawyer represents a person with interests adverse to the visitor, acquisition of confidential information may result in the lawyer being disqualified from representing either party. *Id.*

Residents outside of Texas may view a Texas lawyer’s website or other internet advertisement. Because many states have their own disciplinary rules related to online advertising, it is a good idea to include a disclaimer that the page or advertisement is intended solely for residents of Texas or persons seeking representation in Texas.

C. YouTube Videos

If a lawyer’s YouTube video goes beyond strictly educational, informational or entertainment content, it constitutes advertising, subject to same rules that apply to television ads. In Texas, an attorney must file video postings seeking clients with the Advertising Review Committee. Merely including an attorney’s contact information on a purely educational video, without soliciting contact, does not constitute advertising in Texas.

D. Profiles on Social Media

Although State Bar of Texas Advertising Review Committee Interpretive Comment 17 states that Facebook pages are advertisements and, therefore, subject to the filing requirements under Rule 7.07, the basic information that may be included on the firm profile would fall within the exceptions to the filing requirement. The Advertising Review Department of the State Bar of Texas takes the position that LinkedIn and Facebook profiles do not need to be filed for advertising review. The Director of the State Bar Advertising Review Department, Gene Major, has stated that attorneys may include their true and factual educational background in their social media profiles without triggering a filing requirement. *See* Debra Bruce, *Ethically Navigating the Social Media Landscape*, Tex. Bar J. March 2010 at 197. Comment 7 to Rule 7.02 of the Texas Disciplinary Rules of Professional Conduct states that the prohibition against false or misleading communications does not prohibit communications about “other truthful information that might invite the attention of those seeking legal assistance.”

In Texas, Comment 6 to Rule 7.07 reminds us that “communications need not be filed at all if they were not prepared to secure paid professional employment.” Using social media to build and enhance relationships and to engage in discussions about topics of interest can be distinguished from advertisement or solicitation. If the lawyer’s profile said “Call me if you have been injured,” and set out prior successes, a different conclusion would be reached, however. Solicitations offering to provide legal services are restricted under Rule 7.03 of the Texas Rules of Disciplinary Procedure. The rule expressly governs solicitation about a particular occurrence by “electronic contact.”

Be aware that when an attorney lists areas of “expertise” or “specialties,” the social media platform will label the lawyer to the public as an “expert.” For example, a LinkedIn profile has a field for “specialties.” You should leave the specialties field blank unless you are board certified by the Texas Board of Legal Specialization. Rule 7.04(b)(2) prohibits a statement in an advertisement that a lawyer has been designated by an organization as possessing special competence, unless the organization meets the requirements of the rule.

Be extremely careful in participating in websites where lawyers answer legal questions. Websites often describe the answering attorneys as “experts.” The “Answers” section on the LinkedIn toolbar can also pose problems in this area. When you respond to questions there, the readers vote on the best responses posted. If you accrue several best

response votes, LinkedIn automatically designates you an “Expert” in that category. That designation would probably violate the specialization rules. Alternatively, you can demonstrate your knowledge and build relationships by answering questions in LinkedIn discussion groups that you join. Discussion groups do not have an “Expert” designation or “best answer” feature.

Although state bars usually categorize attorney websites as advertisements, they often treat legal blogs differently. In Texas, the Advertising Review Department does not consider blogs to be advertising if they consist of commentary or educational information. Comment 1 to Texas Rule 7.02 clarifies that the advertising rules “are not intended to affect other forms of speech by lawyers, such as political advertisements or political commentary.”

LinkedIn permits your connections to write testimonials about you in the Recommendations section of your profile. You can prescreen these recommendations before they are posted for public view, so make sure they comply with the disciplinary rules. In Texas, Rule 7.02(4) prohibits comparisons to other lawyers’ services, unless substantiated by verifiable objective data. Therefore, if your client enthusiastically reports that you are “the best trial lawyer in Houston,” unfortunately, you need to ask that it be changed before the review is published.

E. Email Advertising

Advertising sent by email is permissible, but it must meet the specific requirements of Rule 7.05, which states that all solicitation emails must state “ADVERTISEMENT” in the subject line and at the beginning of the email’s content. In addition, the email must not reveal the nature of the prospective client’s legal problem in the subject line, must not resemble legal pleadings or other legal documents, must explain how the lawyer obtained the prospective client’s email address, and must address whether the contact was prompted by a specific occurrence. A lawyer must keep all email solicitations he or she sends for four years.

There are some notable exceptions contained in Rule 7.05(e), such as email solicitations directed to past or present clients, the lawyer’s immediate family, email information requested from a prospective client, and email communication not related to a particular event or existing legal problem. Attorneys must also be aware that there are numerous state and federal laws that prohibit email spamming and phishing.

F. Twitter and Chat Rooms

Under Rule 7.03, a lawyer is prohibited from initiating contact with a prospective client who has not sought the lawyer’s legal advice through any live interactive manner online. This Rule applies to conversations in public chat rooms or bulletin board forums.

Rule 7.03(a) forbids using “regulated telephone or other electronic contact” to solicit business arising out of a particular occurrence or event from someone who has not sought the lawyer’s advice. Rule 7.03(f) defines “regulated electronic contact” to include electronic communication initiated in a “live, interactive manner.” Comment 1 to Rule 7.03 specifically references chat rooms, and communications on Facebook and Twitter can sometimes resemble a chat room conversation.

III. SOCIAL MEDIA’S IMPACT ON REPRESENTING A CLIENT

Attorneys always should be mindful of the obligations to clients, prohibited conduct, and precautions that are delineated in the Texas Disciplinary Rules of Professional Conduct. The most frequently encountered issues and the relationship to social media are outlined below.

A. The Duty to Keep Clients Informed

Rule 1.03 of the Texas Rules of Disciplinary Conduct provides that the lawyer must keep the client reasonably informed of the status of a matter and promptly reply to reasonable requests for information, and shall explain the matter to the extent necessary to permit the client to make informed decisions about the representation.

Comment 4 to Rule 1.03 provides that in some circumstances, a lawyer may be justified in delaying transmission of information to a client “when the lawyer reasonably believes the client would be likely to react imprudently to an immediate communication.” For example, a lawyer might withhold a psychiatric diagnosis of a client when the examining psychiatrist indicates that disclosure would harm the client. However, such circumstances appear infrequently.

It should come as no surprise that the single most common grievance against lawyers involves the failure to keep the client reasonably informed of the status of their case. Often, complaints arise about unreturned phone calls; unanswered emails, which often come at all hours of the day or night, pose the same risks.

B. Duty to Provide Competent Representation

Recently, the American Bar Association expanded Rule 1.1 of its Model Rules of Professional Conduct to make it clear that competent representation includes staying abreast of “the benefits and risks associated with relevant technology,” including the impact on conducting investigations, engaging in legal research, advising clients, and conducting discovery. ABA Model Rule 1.1. Some jurisdictions have already concluded that lawyers should be held to a higher standard in making use of online resources. Therefore, because most divorce lawyers review the Facebook pages of both their client and the adverse spouse, arguably a lawyer who does not do so may fail to render competent representation.

The way an attorney acts to safeguard confidential client information is governed by the duty of competence, and determining whether a third party can access and use that confidential client information is a subject that must be considered in conjunction with that duty. A recent article advises that an attorney’s duty to keep attorney-client communications private now includes knowing how to prevent hackers from gaining unauthorized access to a client’s confidential information. *See* David Sarif and Natalie Tyler, *The Dangers of Free Wi-Fi*, Family Lawyer, Fall/Winter 2016. The article warns that hackers can steal information from your private or office secure network by using a rogue Wi-Fi access point installed without your knowledge. *Id.* at 6-7. An attack is not limited to sophisticated users; websites and online videos are readily available to show how to install these rogue Wi-Fi access points and hack someone’s data. The article cautions attorneys to enable the “Ask to Join Network” function on all devices to prevent automatically joining Wi-Fi networks. In addition, attorneys should use tools like wireless intrusion prevention systems to safeguard against hacking.

The California Bar has addressed the duty of competence related to the use of technology in transmitting or storing confidential client information. In an advisory ethics opinion, the bar addressed a query about an associate attorney who regularly took his firm laptop computer to the local coffee shop and accessed a public wireless Internet connection to conduct legal research on a client matter and then emailed the client. He also took the laptop computer home to conduct the research and emailed the client from his personal wireless system. The Bar concluded that due to the lack of security features provided in most public wireless access locations, an attorney risks violating his duties of confidentiality and competence in using the wireless connection at the coffee shop to work on a client’s matter unless he takes appropriate precautions, such as using a combination of file encryption, encryption of wireless transmissions and a personal firewall. Depending on the sensitivity of the matter, attorneys may need to avoid using public wireless connections entirely. In addition, if an attorney’s personal wireless system has been configured with appropriate security features, he would not violate his duties of confidentiality and competence by working on a client’s matter at home. St. B. of Cal. Standing Comm. On Prof. Resp. & Conduct Formal Op. No. 2010-179.

In summary, the Bar wrote that the duties of confidentiality and competence that attorneys owe to their clients require a basic understanding of the electronic protections afforded by the technology they use in their practice. Before using a particular technology in the course of representing a client, an attorney must take appropriate steps to evaluate: (1) the level of security attendant to the use of that technology, including whether reasonable precautions may be taken when using the technology to increase the level of security; (2) the legal ramifications to a third party who intercepts, accesses or exceeds authorized use of the electronic information; (3) the degree of sensitivity of the information; (4) the possible impact on the client of an inadvertent disclosure of privileged or confidential information or work product; (5) the urgency of the situation; and (6) the client’s instructions and circumstances, such as access by others to the client’s devices and communications. *Id.*

When an attorney employs encryption while using public wireless connections and enables his or her personal firewall, the risks of unauthorized access may be significantly reduced. Both of these tools are readily available and relatively inexpensive, and may already be built into your device’s operating system. Likewise, activating password protection features on mobile devices, such as laptops and PDAs, helps protect against access to confidential client information by a third party if the device is lost, stolen or left unattended.

C. Truthfulness in Statements to Others

Texas Disciplinary Rule of Professional Conduct 4.01 provides as follows:

In the course of representing a client, a lawyer shall not knowingly:

- (a) make a false statement of material fact or law to a third person; or
- (b) fail to disclose a material fact to a third person when disclosure is necessary to avoid making the lawyer a party to a criminal act or knowingly assisting a fraudulent act perpetrated by a client.

The Comment to ABA Rule 4.1, on which the Texas rule is modeled, states that a lawyer “generally has no affirmative duty to inform an opposing party of relevant facts.” Model Rules of Prof’l Conduct R. 4.1 cmt. 1.

If a lawyer discovers that a client has committed, or intends to commit, a criminal or fraudulent act, the lawyer is required to urge the client to take appropriate action. *See* Tex. Disc. R. Prof. Conduct 1.02(d), (e), (f); 3.03(b). If the client has not complied, the lawyer then has a duty to disclose to others. *See* cmt. 4.

Be sure to keep your obligations under Rule 4.01 when using social media.

D. Communication with Someone Represented by Counsel

Another rule to remember when emailing or using other forms of social media is Texas Disciplinary Rule of Professional Conduct 4.02, which provides:

- (a) In representing a client, a lawyer shall not communicate or cause or encourage another to communicate about the subject of the representation with a person, organization or entity of government the lawyer knows to be represented by another lawyer regarding that subject, unless the lawyer has the consent of the other lawyer or is authorized by law to do so.
- (b) In representing a client a lawyer shall not communicate or cause another to communicate about the subject of representation with a person or organization a lawyer knows to be employed or retained for the purpose of conferring with or advising another lawyer about the subject of the representation, unless the lawyer has the consent of the other lawyer or is authorized by law to do so.

E. Disobedience of Court Rulings

Texas Disciplinary Rule of Professional Conduct 3.04(d) states that a lawyer may not:

- (d) knowingly disobey, or advise the client to disobey, an obligation under the standing rules of or a ruling by a tribunal except for an open refusal based either on an assertion that no valid obligation exists or on the client’s willingness to accept any sanctions arising from such disobedience.

A recent story reported in the news offers a cautionary tale about a client’s disobedience of a court order. An Ohio man, Mark Byron, was found guilty of civil domestic violence against his wife. The court entered a temporary protective order prohibiting him from causing his wife “physical or mental abuse, harassment or annoyance.” Five months after the entry of the protective order, Byron posted on his Facebook wall: “If you are an evil, vindictive woman who wants to ruin your husband’s life and take your son’s father away from him completely – all you need to do is say you’re scared of your husband or domestic partner and they’ll take him away!” Byron was threatened with 60 days in jail as a contempt sanction for this comment posted on his Facebook page in violation of the court’s order. The court ruled that Byron could avoid jail and a \$500 fine by posting daily apologies, written by the judge, for a month, and paying his wife’s attorney’s fees. *See Court’s offer: Apologize on Facebook or go to jail*, Houston Chronicle, Feb. 25, 2012, A2.

F. Breaching Client Confidentiality

Texas Disciplinary Rule of Professional Conduct 1.05 prohibits lawyers from “knowingly” revealing a client’s confidential information, with limited exceptions. Because social media can be used casually, it may lead a lawyer to unintentionally breach client confidentiality. For example, a lawyer might Tweet, “Just talked to a client who totally lied to me.” Because the date and time of the Tweet is posted, it could reveal information to someone who knew who the lawyer was meeting with that day.

Confidentiality of client information and disqualification of the lawyer due to conflicts of interest may be implicated by website communications. When a website visitor submits information about his case or legal issue, the exchange may create a “prospective client” relationship. Whether the attorney invited submission of specific details about the case may govern whether such a relationship has been created. If a prospective client relationship is created, the lawyer may have a duty to treat the specific details provided by the potential client as confidential. The law firm may also face a conflict of interest that could prohibit representation of other parties.

Attorneys should employ precautions to protect confidential information when in public, such as ensuring that the person sitting in the adjacent seat on an airplane cannot see the computer screen or moving to a private location before discussing confidential information on a mobile phone. St. B. of Cal. Standing Comm. On Prof. Resp. & Conduct Formal Op. No. 2010-179.

Most bar associations have taken the position that the risks of a third party’s unauthorized review of email (whether by interception or delivery to an unintended recipient) are similar to the risks that confidential client information

transmitted by standard mail service will be opened by any of the many hands it passes through on the way to its recipient or will be misdirected. *See, e.g.*, ABA Formal Op. No. 99-4138 (concluding that attorneys have a reasonable expectation of privacy in email communications, even if unencrypted, “despite some risk of interception and disclosure”).

In 2011, the ABA updated its position. In ABA Formal Opinion 11-459 the Committee concluded that lawyers must warn clients about the risks of sending confidential communications when using email:

Whenever a lawyer communicates with a client by e-mail, the lawyer must first consider whether, given the client’s situation, there is a significant risk that third parties will have access to the communications. If so, the lawyer must take reasonable care to protect the confidentiality of the communications by giving appropriately tailored advice to the client.

The rationale behind this holding is because email is inherently insecure. Practitioners are now advocating the use of communication tools like client portals and law practice management software platforms, like MyCase, that incorporate some form of encrypted client communication into their platforms, as a solution to the problem of unencrypted, insecure email.

Lawyers routinely include a confidentiality notice in emails. A typical confidentiality notice seen on emails reads as follows:

Confidentiality Notice: The information contained in this email and any attachments is intended only for the recipient(s) listed above and may be privileged and confidential. Any dissemination, copying, or use of or reliance upon such information by or to anyone other than the recipient(s) listed above is prohibited. If you have received this message in error, please notify the sender immediately at the email address above and destroy any and all copies of this message.

If this notice is included on every email, however, no matter how routine (e.g., “How about lunch today?”), the notice loses its effectiveness. It could be argued that an important email is no more confidential than these trivial communications.

The question of attorney-client confidentiality may arise if a disgruntled client posts a negative comment about an attorney on social media such as Facebook or on an internet site such as AVVO. An attorney may only respond in a general manner, making a statement such as, “This firm strives to provide its clients with excellent legal service and regrets that any client is less than satisfied. Please contact the firm, and we will be happy to discuss your concerns with you.”

G. Attorney-Client Privilege

The attorney-client privilege provides the client the right to prevent certain confidential communications from being revealed. Several exceptions to confidentiality have been developed in evidentiary law where the services of the lawyer were sought or used by a client in planning or committing a crime or fraud as well as where issues have arisen as to breach of a duty by the lawyer.

For the attorney-client privilege to apply, the communication must be confidential. Therefore, it is important to determine what is confidential. What is posted on the Internet has a lower “expectation of privacy” than a private telephone conversation. Once something is posted on Facebook or a blog, the information is available to the public. Therefore, viewing it does not constitute an invasion of privacy.

Courts have determined that an employee should have no expectation of privacy on a computer at work. All email coming in through a system operated by an employer can be subject to the employer’s viewing. In California, a plaintiff who discussed his suit with her lawyer on work email was not permitted to claim privilege. *See Holmes v. Petrovich Dev. Co.*, 191 Cal. Rptr. 4th 1047 (Cal. App. 3d Dist. 2011). The court reasoned that the emails sent on a company computer were like consulting the lawyer in her employer’s conference room, in a loud voice, with the door open, so that any reasonable person would expect that their discussion would be overheard by the employer. *Id.* The lesson that lawyers should take from *Holmes* is that failure to immediately recognize that a potential client is corresponding through an employer’s email account could result in candid communications being displayed before a jury.

H. Conflicts of Interest

In Texas, Comment 1 to Texas Disciplinary Rule of Professional Conduct 1.06 addresses conflicts of interest, as follows:

Loyalty is an essential element in the lawyer's relationship to a client. An impermissible conflict of interest may exist before representation is undertaken, in which event the representation should be declined.

Disqualification of the lawyer due to conflicts of interest may be implicated by website communications and email inquiries. In California, a divorce law firm believed its online disclaimer concerning client inquiries and the non-existence of client-lawyer relationships created by email inquiries was sufficient. The law firm attempted to avoid taking on a duty of confidentiality by requiring each online inquirer to agree that (1) by submitting a question, the inquirer was not forming an attorney-client or a confidential relationship; and (2) whatever response the law firm provided would not constitute legal advice but, rather, "general information." A potential client emailed the firm, revealing her marital circumstances, including her adultery. A conflict check revealed that the firm already represented her husband. Although the firm was clearly conflicted out from representing the wife, the California State Bar Association ruled that the firm could no longer represent the husband either because of its inadequately worded online disclaimer. The opinion concluded a web site should contain a statement in sufficiently plain language that any information submitted at the web site will not be confidential. St. B. of Cal. Standing Comm. On Prof. Resp. & Conduct Formal Op. No. 2005-168.

The California rules are substantially the same as those in Texas. Therefore, a similar outcome would be likely in Texas.

I. Unsolicited Email and Tweets

A webpage listing attorney email addresses allows a putative client to send an email to a lawyer disclosing important confidential information that could lead to disqualification of the firm. A lawyer who receives an unsolicited telephone call can simply stop the prospective client from disclosing additional information as soon as the lawyer recognizes that a conflict exists. An email, however, is sent instantaneously and opened in full at once.

The Arizona Bar Association concluded that a lawyer who did not have a website, but only had an email address, did not implicitly invite prospective clients to submit information. Therefore, the lawyer did not owe a duty of confidentiality to prospective clients because there was no indication of a willingness to accept clients by email. On the other hand, the Arizona ethics opinion reasoned that if the attorney maintains a website without any express limitations on the formation of an attorney-client relationship or disclaimers explaining that information will not be held confidential, then the lawyer has implicitly agreed to consider forming an attorney-client relationship with the sender of an email. See St. B. of Ariz. Eth. Op. No. 02-04 (Sept. 2002) (available at <http://www.azbar.org/ethics/ethicsopinions>).

Beware of the temptation to offer legal services in response to a tweet. For example, it would be improper if someone tweeted on Twitter that she just got a DWI, and a lawyer responded to her, "If you are looking for a DWI lawyer, I can give you a break on fees. Email me." Unless the lawyer already had a prior relationship with the tweeter, that contact would violate ethical rules. On the other hand, consider a tweet stating, "Just got out of jail. Anyone know a good inexpensive DWI lawyer?" A response from a lawyer to that tweet would likely be permitted because the tweeter asked for a lawyer.

In addition, beware of online scams. One common scam involves a lawyer receipt of what appears to be a legitimate email from a prospective client, often based in another country. The terms of an attorney-client relationship and a fee agreement may be negotiated. The lawyer then receives what appears to be a valid domestic cashier's check, purporting to be a settlement check from a debtor drawn on a reputable bank. After the check is deposited in the lawyer's client trust account, the new "client" asks that the funds be wired to a foreign bank. The cashier's check is fraudulent, leaving the lawyer holding the bag, with his trust fund overdrawn. The California State Bar's Committee on Professional Responsibility and Conduct has issued an ethics alert describing how these scams work and how lawyers can protect themselves. (available at <http://ethics.calbar.ca.gov>, Jan. 2011).

IV. SOCIAL MEDIA AND LITIGATION

Most leading U.S. divorce lawyers surveyed report seeing an increase in the use of evidence from social networking sites in U.S. divorce cases, per survey results released in 2010 by the American Academy of Matrimonial Lawyers (AAML). An overwhelming 81% of the nation's top divorce attorneys say they have seen an increase in the number of cases using social networking evidence during the past five years. Facebook is the primary source for online divorce evidence; 66% of the members surveyed named Facebook as the source of compromising information used in litigation. See <http://tinyurl.com/AAML-Study>.

Attorney competence related to litigation generally requires, among other things, and at a minimum, a basic understanding of, and facility with, issues relating to e-discovery, including the discovery of electronically stored information (ESI). On a case-by-case basis, the duty of competence may require a higher level of technical knowledge and ability, depending on the e-discovery issues involved in a matter, and the nature of the ESI. Competency may

require even a highly experienced attorney to seek assistance in some litigation matters involving ESI. An attorney lacking the required competence for e-discovery issues has three options: (1) acquire sufficient learning and skill before performance is required; (2) associate with or consult technical consultants or competent counsel; or (3) decline the client representation. Lack of competence in e-discovery issues also may lead to an ethical violation of an attorney's duty of confidentiality. St. B. of Cal. Standing Comm. On Prof. Resp. & Conduct Formal Op. No. 2015-193.

Obtaining and admitting social media evidence is beyond the scope of this paper. However, some ethical implications of social media on litigation are addressed.

A. Ethical Hazards in Obtaining Information From Social Networking Websites

Many lawyers find useful information about a party or witness in their postings on social media. To what extent may an attorney ethically use social media during case investigation and discovery? As a general rule, attorneys may access and review the public portions of a party's social-networking pages without facing ethical repercussions.

The New York State Bar Association Committee on Professional Ethics addressed whether a lawyer may view and access data that is publicly available on another party's social networking websites. The committee determined that a lawyer may obtain information that is publicly available on a social networking site so long as he does not use deception. "[T]he lawyer may ethically view and access the Facebook and MySpace profiles of a party other than the lawyer's client in litigation as long as the party's profile is available to all members in the network and the lawyer neither 'friends' the other party nor directs someone else to do so." NYSBA Ethics Op. 843 (2010) (available at <http://www.nysba.org>).

Due to privacy settings, sometimes valuable information would not be visible to the public in general, but would be visible to hundreds of "friends" of the target on Facebook or other media. Lawyers may be tempted to disguise their identity in order to friend the target, or to ask someone else to friend the target and share what they see. This kind of deception is a violation of ethics rules.

In March 2009, the Philadelphia Bar Association issued an opinion that such pretexting would involve dishonesty, fraud, deceit or misrepresentation on behalf of the lawyer, or the encouragement of such behavior, in violation of the Pennsylvania ethics rules. Phila. Bar Ass'n Prof'l Guidance Comm. Op. 2009-02.

B. Discovery

Several recent cases highlight the perils of electronic discovery gone wrong and illustrate the risks of failing to have in place document preservation procedures and litigation hold policies. While these cases address corporations, some of the principles also can apply to individuals.

A federal judge in Texas ordered Microsoft to pay damages of \$25 million plus almost \$2 million in attorney's fees for, among other matters, failing to produce a key email on a timely basis during discovery and failing to disclose the existence of a database. See *i4i LP v. Microsoft Corp.*, No. 07-CV-113, U.S. Dist. Ct. E. Dist. Tex. (Tyler Division).

Oracle America, Inc. sued Google alleging patent infringement related to Google's Android. *Oracle America, Inc. v. Google, Inc.*, No. 3:10-cv-03561-WHA, U.S. Dist. Ct. N. Dist. Ca. (San Francisco Div.). Google fought to protect as privileged an email from its engineer to a vice president at Oracle, including a draft of the email that Google had inadvertently produced. The federal court denied Google's attempts to claim attorney-client privilege of the potentially devastating email. See Henry Kelston, *Google's EDD Search Blunder in Oracle Case: the \$1 Billion Mistake?* (Feb. 17, 2012) (available at <http://www.law.com>).

C. Spoliation

Spoliation is the intentional destruction of evidence relevant to a case by the producing party. *Trevino v. Ortega*, 969 S.W.2d 950, 955 (Tex. 1998). To constitute spoliation, it must be established that the nonproducing party had a duty to preserve the evidence. Parties have a duty to preserve evidence that is "relevant to litigation, or potential litigation." *Id.* This duty arises when a party knows or reasonably should know that there is a substantial chance that a claim will be filed and that evidence in its possession or control will be material or relevant to the claim. *Wal-Mart Stores v. Johnson*, 106 S.W.3d 718, 722 (Tex. 2003).

To determine whether spoliation of evidence was intentional, the court will look at the regular practice of the user. If the court determines that the producing party intentionally destroyed evidence, the court may impose sanctions or find the requesting party is entitled to a spoliation instruction in which the jury is instructed to presume that the destroyed evidence was unfavorable to the spoliating party. *Trevino*, 969 S.W.2d at 954, 960. The courts are given broad discretion regarding sanctions, and depending on the facts, can impose death penalty sanctions. In *Rimkus Consulting Group, Inc. v. Cammarata*, Judge Lee Rosenthal of the Southern District of Texas required a showing of bad faith before imposing severe sanctions for failure to preserve electronic information. 688 F. Supp. 2d 598, 612-13 (S. Dist. Tex. 2010).

The Texas Supreme Court set out to clarify the common law rules that govern spoliation of evidence in Texas and held that spoliation analysis involves a two-step judicial process:

- (1) The trial court—rather than the jury—must determine, as a question of law, whether the party spoliated evidence.
- (2) If spoliation occurred, the court must then assess an appropriate remedy.

Brookshire Brothers, Ltd. v. Aldridge, 438 S.W.3d 9, 20-21 (Tex. 2014). The court reasoned that spoliation is an evidentiary issue and not a separate cause of action, and because evidentiary issues are resolved by the trial court and not the jury, it is inappropriate to present spoliation issues to the jury for resolution. *Id.* at 20. The court also noted that while a trial court may hold an evidentiary hearing to assist the court in resolving spoliation issues, such a hearing may not take place in the presence of the jury. *Id.*

Upon a finding of spoliation, the trial court has broad discretion to impose a remedy. *Id.* In addition to the remedies available in the Texas Rules of Civil Procedure, the trial court also has discretion to craft other remedies, including the submission of a spoliation instruction to the jury. *Id.* at 22-23. The court noted that the imposition of a spoliation instruction as a remedy, “among the harshest sanctions a trial court may utilize to remedy an act of spoliation,” should be taken cautiously. *Id.* at 23. An improper spoliation instruction presents a substantial likelihood of harm. *Id.* at 28-29 (reversing for improper spoliation instruction).

In addition to penalties against the party, a lawyer could be subject to discipline. Texas Disciplinary Rule of Professional Conduct 3.04(a) provides that an attorney shall not obstruct access to evidence; alter, destroy, or conceal a document or other material; or counsel or assist another to do so, if a competent attorney would believe the document or other material has evidentiary value.

The ethical duty to preserve information is a concern in the age of Facebook and Twitter. In the context of social networking sites, the user is invited to regularly update their profile to reflect changes in their day to day life, which can complicate matters. If a user simply deletes or removes information from media sites, it can still be retrieved from their computer’s hard drive. The risk always exists that a client could delete or destroy outdated social media data as a regular course of activity without intending to have an impact on litigation. It is important to educate clients regarding the duty to preserve evidence. Attorneys should consider a written admonishment about spoliation to clients, including a requirement that the client consult with the attorney’s office prior to destroying any social media evidence, altering social media, or making a social media page unavailable on the internet.

It is recommended that attorneys advise clients that they may not destroy any evidence, including evidence (prior posts and pictures) found on their social networking sites. For example, to the extent there is information on a party or witnesses’ Facebook page which reveals facts or information relevant to custody, then the deletion of that information could be characterized a spoliation.

In 2011, a Virginia court sanctioned one lawyer \$542,000.00 because his legal assistant advised their client to remove Facebook pictures that were detrimental to his case. See John Patzakis, *Facebook Spoliation Costs Lawyer \$522,000; Ends His Legal Career*, (Nov. 15, 2011) (available at <https://blog.x1discovery.com>). When the defendant’s lawyers learned this had happened, they filed a motion for sanctions based on spoliation of evidence. The motion was granted, and both the lawyer and client were fined. The lawyer’s license was suspended for five years.

It is a good practice to include in temporary restraining orders and injunctions a prohibition against deleting any information from any social media site. The Texas Family Practice Manual provides for the following injunction: “Destroying, disposing of, or altering any e-mail or other electronic data relevant to the subject matters of this case, whether stored on a hard drive or on a diskette or other electronic storage device.” This injunction should cover social media, but the better practice would be to include a separate injunction which specifically targets and social media accounts of the parties.

D. Trial Publicity

Texas Disciplinary Rule of Professional Conduct 3.07 provides:

In the course of representing a client, a lawyer shall not make an extrajudicial statement that a reasonable person would expect to be disseminated by means of public communication if the lawyer knows or reasonably should know that it will have a substantial likelihood of materially prejudicing an adjudicatory proceeding.

Many consider the rule vague and imprecise. Some commentators suggest that it has a chilling effect on free speech by silencing lawyers and denying the public accurate and truthful information.

The United States Supreme Court interpreted a similar rule in *Gentile v. State Bar of Nevada*, 501 U.S. 1030 (1991). Justice Kennedy wrote that the rule, as interpreted by the Nevada Supreme Court, was void for vagueness, failed to provide fair notice to those to whom it was directed, and was so imprecise that discriminatory enforcement was a real probability.

E. Juror Misconduct

Lawyers are not permitted to communicate, or cause another to communicate, with a juror during trial. Tex. Disc. Rule Prof. Conduct 3.06(c). Likewise, jurors are not supposed to discuss with anyone the cases they hear before deliberation or outside the jury deliberation room to avoid improper influences and to ensure that a jury's verdict will be just and fair. While there have certainly been instances of jurors improperly commenting on cases in the past, social media has made it quicker and easier for jurors to engage in misconduct. Courts have recognized that the widespread availability of the Internet and the extensive use of social networking sites, such as Twitter and Facebook, have increased the risk of prejudicial communications among jurors. *See, e.g., United States v. Fumo*, 655 F.3d 288, 305 (3d Cir. 2011).

Juror misconduct by unauthorized use of e-mails during deliberations has been addressed by some courts. In a recent federal criminal trial, a juror who had been dismissed disobeyed the court's orders and discussed via email with other jurors her opinion on the defendant's guilt. The federal court found the juror guilty of criminal contempt for juror misconduct and fined her \$1,000. *U.S. v. Juror No. One*, Criminal Action No. 10-703, 2011 WL 6412039, (E.D.Pa. Dec. 21, 2011).

In an Arkansas state court, a defendant, Stoam Holdings, attempted to overturn a \$12.6 million verdict because a juror used Twitter to send updates during the trial. One post stated "Oh, and nobody buy Stoam. It's bad mojo and they'll probably cease to exist now that their wallet is 12m lighter." *See* Renee Loth, *Mistrial by Google*, Boston Globe, Nov. 6, 2009, at A15 (available at http://www.boston.com/bostonglobe/editorial_opinion/oped/articles).

In Maryland, Baltimore Mayor Sheila Dixon sought a mistrial in her embezzlement trial because, while the trial was going on, five of the jurors became Facebook friends and chatted on the social networking site, despite the judge's instructions not to communicate with each other outside of the jury room. Brendan Kearny, *Despite Judge's Warning, Dixon Jurors Went on Facebook*, The Daily Record, Dec. 2, 2009 (available at <http://mddailyrecord.com>).

The Arkansas Supreme Court recently reversed a defendant's conviction and death sentence due to juror misconduct which occurred during a trial and the failure of the trial judge to declare a mistrial or replace the juror with an alternate. *Dimas-Martinez v. Arkansas*, No. CR 2007-94-2-A, 2011 Ark. 515, 2011 WL 6091330, at *11-15 (Ark. Dec. 8, 2011). During the trial, the juror tweeted about the proceedings. Even after the juror was questioned, admitted to the misconduct, and was again admonished not to discuss the case in Internet forums, he continued to tweet, specifically during jury deliberations. *Id.* at *14-15.

In Texas, rules have been adopted to address jurors and social networking. Rule 226a of the Texas Rules of Civil Procedure was amended, changing the mandatory instructions that trial judges give to potential jurors on a panel, and to the jury once selected. The amended rule includes the following instructions:

Do not discuss this case with anyone, even your spouse or a friend, either in person or by any other means [including by phone, text message, email message, chat room, blog, or social networking websites such as Facebook, Twitter, or MySpace]. Do not allow anyone to discuss the case with you or in your hearing. If anyone tries to discuss the case with you or in your hearing, tell me immediately. We do not want you to be influenced by something other than the evidence admitted in court. * * *

Do not investigate this case on your own. For example:

- a. Do not try to get information about the case, lawyers, witnesses, or issues from outside this courtroom.
- b. Do not go to places mentioned in the case to inspect the places.
- c. Do not inspect items mentioned in this case unless they are presented as evidence in court.
- d. Do not look up anything in a law book, dictionary, or public record to try to learn more about the case.
- e. Do not look anything up on the Internet to try to learn more about the case.
- f. And do not let anyone else do any of these things for you.

V. LAWYERS INTERACTING WITH THE JUDICIARY

The Texas Rules of Professional Conduct govern attorneys' interactions with the judiciary. These rules have implications for interactions on social media.

A. Disparaging the Judiciary

Beware of ethical rules prohibiting attorneys from making false or reckless statements about the judiciary or taking actions that prejudice the administration of justice. Refrain from disparaging judges, which is a frequent theme in online posts. A Florida attorney was sanctioned \$1250 for posting comments calling a judge “unfit” “evil,” and an “unfair witch.” Stephanie Adams, *Sanctions for Lawyers who Blog, Tweet and Facebook*, May 2, 2011 (available at <http://thedefensiveline.wordpress.com>). Florida’s rules prohibiting attorneys from making false or reckless statements about the judiciary are similar to Texas Disciplinary Rule of Professional Conduct 8.02, which provides that “a lawyer shall not make a statement that the lawyer knows to be false or with reckless disregard as to its truth or falsity concerning the qualifications or integrity of a judge.”

B. Honesty

Lying to a tribunal is prohibited in all jurisdictions. Texas Rule 3.03 prohibits attorneys from making a false statement of fact to a tribunal. The ABA Journal reported about an attorney who sought a continuance because of the death of her father. Judge Susan Criss of Galveston’s 212th District Court, checked the attorney’s Facebook page and learned that during that time the attorney had a busy social schedule to attend to—not a funeral. Molly McDonald, *Facebooking Judge Catches Lawyer in Lie*, July 21, 2009 (available at www.abajournal.com).

C. Maintaining Impartiality of the Tribunal; Ex parte Communications

Rule 3.05 of the Texas Disciplinary Rules of Professional Conduct prohibits ex parte communications, providing that a lawyer shall not:

- (a) seek to influence a tribunal concerning a pending matter by means prohibited by law or applicable rules of practice or procedure;
- (b) except as otherwise permitted by law and not prohibited by applicable rules of practice or procedure, communicate or cause another to communicate ex parte with a tribunal for the purpose of influencing that entity or person concerning a pending matter other than:
 - (1) in the course of official proceedings in the cause;
 - (2) in writing if he promptly delivers a copy of the writing to opposing counsel or the adverse party if he is not represented by a lawyer;
 - (3) orally upon adequate notice to opposing counsel or to the adverse party if he is not represented by a lawyer.

Canon 3A(4) of the Texas Code of Judicial Conduct prohibits many ex parte contacts with judicial officials. A lawyer in turn violates Rule 8.04(a)(6) by communicating with a judicial official in a manner that causes the official to violate Canon 3A(4), which provides.

A judge shall not allow any relationship to influence judicial conduct or judgment. A judge shall not lend the prestige of judicial office to advance the private interests of the judge or others; nor shall a judge convey or permit others to convey the impression that they are in a special position to influence the judge. A judge shall not testify voluntarily as a character witness.

Some states strictly apply rules against ex parte communications. According to a public reprimand, a North Carolina judge engaged in unethical Facebook activity relating to a case being tried before him. During a child custody case, District Judge B. Carlton Terry Jr. “friended” one of the lawyers on the case, and each of them discussed aspects of the case on Facebook, constituting ex parte communications. The lawyer asked how he could prove the negative that his client did not have an affair. The lawyer noted that he had a wise judge, and the judge responded that he had two very good parents to choose between in the case. The judge also conducted ex parte online research about the wife by googling her and visiting her website. See Debra Cassens Weiss, *Judge Reprimanded for Friending Lawyer and Googling Litigant*, June 1, 2009 (available at <http://www.abajournal.com>).

The role of an amicus attorney is “to provide legal services necessary to assist the court in protecting a child’s best interests rather than to provide legal services to the child.” Tex. Fam. Code § 107.001(1). Therefore, some courts have decided that an amicus attorney “represents neither an appellant nor an appellee,” and “the trial court, is, in effect, the amicus attorney’s client for a limited purpose.” *O’Connor v. O’Connor*, 245 S.W.3d 511, 515 (Tex. App.—Houston [1st Dist.] 2007, no pet.); see also *In re Collins*, 242 S.W.3d 837, 842 (Tex. App.—Houston [14th Dist.] 2007, no pet.).

Section 107.005(b)(4) requires an amicus attorney to become familiar with the American Bar Association's standards of practice for attorneys who represent children in child custody cases. Tex. Fam. Code § 107.005(b)(4). In discussing the advocacy of the child's best interests, the ABA commentary recommends, although in the context of settlement negotiation, that ex parte communication with the judge should be avoided. Based on the ABA commentary, the Texarkana Court of Appeals found that the trial court erred in allowing ex parte communications with the amicus attorney, although it determined the error was not harmful. *In re S.A.G.*, 403 S.W.3d 907, 916-17 (Tex. App.—Texarkana 2013, pet. denied).

D. Judges on Facebook

In some states, it is clear that a judge and an attorney who appears before the judge can be “friends” on Facebook. See N.Y. Op. 08-176 (2009); S.C. Op. 17-2009 (2009); KY. Op. JE-119 (2010); and Ohio Op. 2010-7 (2010). Florida is an exception. See Florida JEAC Op. 2009-20. The Florida Judicial Ethics Advisory Opinion determined that a judge who friends a lawyer appearing before him violates the judicial canon prohibit a judge from conveying, or permitting others to convey, the impression that someone is able to influence the judge.

South Carolina judges are free to participate in online social networking. In response to a question about whether a judge can “friend” law enforcement officers and employees of the court, the South Carolina Advisory Committee on Standards of Judicial Conduct issued the following conclusion in October 2009:

A judge may be a member of Facebook and be friends with law enforcement officers and employees of the Magistrate as long as they do not discuss anything related to the judge's position as magistrate.

Opinion 17-2009.

Although the technology is new, social networking sites simply provide other means of communication and social interaction. Judges must contend with the ethical risks, such as the appearance of impropriety, posed by other forms of social interaction. Therefore, the judicial conduct rules already in place should govern social media use. “Existing rules of judicial conduct are more than sufficient to provide guidance when it comes to judges’ use of social media, once one recognizes that communications and interaction via social media are no different in their implications than more traditional forms of communication.” John G. Browning, *Why Can't We Be Friends? Judges' Use of Social Media*, 68 U. Miami L. Rev. 487, 490 (2014); see also *Youkers v. State*, 400 S.W.3d 200, 206 (Tex. App.—Dallas 2013, pet. ref'd) (“while the internet and social media websites create new venues for communications, our analysis should not change because an ex parte communication occurs online or offline.”).

The Texas Judicial Canons do not, on their face, prohibit Texas judges from participating in online social networking. Nonetheless, social media activity can cause problems for judges, including providing a basis to recuse a judge. In *Youkers*, the Dallas Court of Appeals considered an allegation that a trial judge's designation as a “friend” of a victim's father on Facebook constituted a basis for recusal. *Youkers*, 400 S.W.3d at 205. In reaching its decision that recusal was not required, the court found that no rule, canon of ethics, or judicial ethics opinion in Texas prohibits Texas judges from using social media outlets like Facebook. *Id.* Merely designating someone as a “friend” on Facebook “does not show the degree or intensity of a judge's relationship with a person.” *Id.* (citing ABA Op. 462). The judge testified at the hearing regarding the nature of the relationship with the victim's father. He stated they were running for office at the same time—that was “the extent of [their] relationship.” *Id.* at 206. Additionally, the judge stated that he ceased reading the father's message once he realized it was an ex parte communication; he emphasized, “I have not considered any of the information in your e-mail as it would be improper for me to do so.” The Court of Appeals found the judge acted in full compliance with the Texas Committee on Judicial Ethics' recommended procedure for treatment of ex parte communications. *Id.* at 206-07 (citing Comm. on Jud. Ethics, State Bar of Tex., Op. 154 (1993), which provides that a judge receiving an ex parte communication from a litigant may comply with canon 3B(8) by placing the communication in clerk's file, providing the communication to all parties, determining if the communication is proper, and, if it is not, advising the communicant that all ex parte communications must cease).

Another recent Texas opinion addresses a judge's posts on Facebook. See *In re Slaughter*, 480 S.W.3d 842, 846 (Tex. Spec. Ct. Rev. 2015). A Special Court of Review appointed by the Texas Supreme Court addressed complaints against a judge who was very active in posting comments about matters that were occurring in her court and in utilizing her Facebook page to educate the public about her court. The judge maintained a public Facebook page which displayed: (1) a photograph of the judge wearing her judicial robe; (2) featured a photograph of the Galveston County Courthouse; and (3) described the judge as a “public figure” and as “Judge of the 405th Judicial District Court.” She posted about a high profile, criminal jury trial concerning a man charged with unlawful restraint of a child for allegedly keeping a nine-year-old boy in a 6 x 8-foot wooden enclosure inside the family home. The case became known in the media as “the Boy in the Box” case.

A couple of days before the trial was set to begin, the judge posted the following on her Facebook page:

We have a big criminal trial starting Monday! Jury selection Monday and opening statements Tues. morning.

The following day, in response to the above-described post, a person posted the following comment on the judge's Facebook page:

One of my favorite Clint Eastwood movies is "Hang 'Em High," jus sayin your honor.

When trial began, the judge posted the following comments on her Facebook page:

Opening statements this morning at 9:30 am in the trial called by the press "the boy in a box" case.

After we finished Day 1 of the case called the "Boy in the Box" case, trustees from the jail came in and assembled the actual 6' x 8' "box" inside the courtroom!

This is the case currently in the 405th!

The judge also included a link to a Reuters article entitled "Texas father on trial for putting son in box as punishment." *Id.* at 847.

On the third day of trial, defense counsel in the criminal case filed a motion to recuse the judge and a motion for mistrial based on the judge's Facebook activities. A visiting judge assigned to hear the motion to recuse granted the motion and removed the judge from the case. The case was transferred to another court and that judge granted the defendant's motion for mistrial, causing the case to be retried. In the subsequent trial, the defendant was acquitted of the charges. *Id.* 480 S.W.3d 847.

The Special Court of Review ultimately concluded the judge did not violate Canons 3(B)(10) and 4(A) of the Code of Judicial Conduct or Article V, Section 1-a(6)(A) of the Texas Constitution. There was no evidence presented that the judge's extrajudicial statements would suggest to a reasonable person the judge's probable decision on any particular case or that would cause reasonable doubt on the judge's capacity to act impartially as a judge. The posts "amounted to an error in judgment by posting facts from a pending case in her court." The reviewing court found the judge's actions "troublesome," however, because the comments went "beyond mere factual statements of events occurring in the courtroom and add the judge's subjective interpretation of these events at or near the time of their occurrence." *Id.* at 852. The opinion noted "extrajudicial comments made by a judge about a pending proceeding will likely invite scrutiny" and can "create the very real possibility of a recusal (or even a mistrial)." *Id.*

VI. CRIMINAL AND CIVIL LIABILITY

State and Federal laws impose civil and criminal liability for wiretapping, improper access of stored communications, and invasion of privacy. Thus, lawyers should advise clients of potential criminal violations or civil liability that could result from improper use of social networking sites and emails.

A. Federal Statutes

Unless a federal statute grants exclusive jurisdiction to the federal courts, claims arising under federal law may be brought and adjudicated in state courts. Claims under the Federal Wiretap Act and the Stored Communications Act have been adjudicated in Texas state courts. *See, e.g., Boehringer v. Konkel*, 404 S.W.3d 18, 32 (Tex. App.—Houston [1st Dist.] 2013, no pet.).

1. Federal Wiretap Act

The Federal Wiretap Act is found at 18 U.S.C. § 2510-22. In 1986, the Electronic Communications Privacy Act (ECPA) was added as an amendment to the federal wiretap law. The act makes it illegal to intercept stored or transmitted electronic communication without authorization and imposes criminal penalties and civil damages. In 1994 the Wiretap Act was amended again to expressly provide protection for wireless and cellular communications. *See Communications Assistance for Law Enforcement Act*, Pub. L. No. 103-414, 108 Stat. 4279 (1994); *see also Bartnicki v. Vopper*, 532 U.S. 514, 524 (2001) (confirming the protections to wireless and cellular communications under the Federal Wiretap Act).

Use or disclosure of intercepted communications is prohibited under the Federal Wiretap Act. Courts have found that the act may be violated by simply revealing or suggesting the general nature of an intercepted communication. *See Godspeed v. Harman*, 39 F. Supp.2d 787, 790 (N.D. Tex. 1999). Liability is not limited to the person who intercepted

the communication. If a third person is given an illegally intercepted communication, the third person violates the Wiretap Act if he intentionally discloses the contents of an intercepted communication that he knew or should have known was obtained through interception. 18 U.S.C. § 2511(1)(c).

The Federal Wiretap Act applies to interceptions that are contemporaneous with the communication. Therefore, the Act does not apply to stored electronic communications. *See Steve Jackson Games, Inc. v. U.S. Secret Serv.*, 36 F.3d 457, 461-62 (5th Cir. 1994).

There is no exception in the act for the interception of communications by spouses in the marital home. Therefore, many courts have applied the law to spouses. Not all intercepted communications between spouses will be actionable, however. The interception must be intentional, the intercepting spouse must have knowledge that information was obtained through interception in violation of the act, and the other party must not have consented. *See Thompson v. Dulaney*, 970 F.2d 744, 788 (10th Cir.) 1992.

There is also no immunity under the Federal Wiretap Act for attorneys. An attorney may be held criminally or civilly liable for using or disclosing communications that were illegally obtained in violation of the act. Civil damages for violating the Federal Wire Tap Act are assessed as the greater of \$100 a day for each day of violation or \$10,000. 18 U.S.C. § 2520(c)(2)(B).

The Federal Wiretap Act contains a specific exception for an interception by a *party to the communication*. 18 U.S.C. § 2511(2)(d). Second, an interception is permissible if *one party to the communication has given prior consent* to the interception. *Id.* Generally, a parent may vicariously consent to the recording on behalf of his or her child if the parent has a good faith reasonable basis to believe that consent was necessary for the protection of the welfare of the child. *Pollock v. Pollock*, 154 F.2d 601 (6th Cir. 1998); *Allen v. Mancini*, 170 S.W.3d 167, 173 (Tex. App.—Eastland 2005, pet. denied) (stating father was entitled to consent to a tape recording both for himself and for his child as her joint managing conservator).

There is a strict exclusionary rule for all illegally intercepted wire or oral communications. 18 U.S.C. § 2525. The exclusion applies to the contents of the illegally obtained communication and any evidence derived from it.

2. Stored Communications Act

The Stored Communications Act (SCA) protects the privacy of Internet users by prohibiting Internet service providers from generally disclosing the contents of electronic communications while in storage by that service. 18 U.S.C. § 2701-12. The penalty under the federal law is imprisonment for one to ten years and a fine. 18 U.S.C. § 2701(b). In addition, the act provides for a civil cause of action and damages. 18 U.S.C. § 2707.

The Stored Communications Act requires that, when the government seeks such records from a service provider, it must obtain a court order after submitting an application identifying “specific and articulable facts showing that there are reasonable grounds to believe that the contents of a wire or electronic communication, or the records or other information sought, are relevant and material to an ongoing criminal investigation.” 18 U.S.C. § 2703(d).

Courts have been inconsistent regarding the applicability of the SCA to social networks and the discoverability of information contained on social media. Some courts have ignored the SCA and permitted broad production of a party’s entire social network site on the theory that the information is public because it is disclosed to third parties. Other courts have attempted to apply the SCA, but ordered portions of the social network site to be produced. *See Miguel Helft and Claire Cain Miller. News Analysis: 1986 Privacy Law is Outrun by the Web*, The New York Times, Jan. 9, 2011.

3. The Computer Fraud and Abuse Act

The Computer Fraud and Abuse Act (CFAA), Title 18 U.S.C. § 1030, criminalizes unauthorized access to computers to obtain financial information or commit fraud, among other actions. Hacking and malicious viruses are also criminalized.

The statute contains a wide variety of penalties for violations, including fines and maximum imprisonment ranging from one to ten years, depending on the circumstances. 18 U.S.C. § 1030 (c)(2)(A-C). *See, e.g., U.S. v. Phillips*, 477 F.3d 215 (5th Cir. 2007) (affirming a conviction for intentionally accessing a protected computer without authorization and recklessly causing damage, including the assessment of over \$170,000 in restitution).

B. State Laws

There are state law counterparts to the Federal Wiretap Act and the Stored Communications Act. In addition, there are statutes imposing criminal penalties and civil liability for other specific internet related actions. In particular, the Texas Penal Code makes unauthorized access to a computer a crime and includes several Internet crimes, including online impersonation.

1. The Texas Wiretap Acts

The Texas criminal wiretap statute is found in Texas Penal Code Section 16.02 and is substantially similar to the Federal Wiretap Act. The statute criminalizes the interception of a wire, oral, or electronic communication, and an offense is a second-degree felony. *See* Tex. Penal Code § 16.02(f). In essence, a person violates the wiretap statute by intentionally recording, or intentionally disclosing the contents of, a “wire, oral, or electronic communication.” Tex. Penal Code Ann. § 16.02(b)(1), (b)(2). For purposes of the wiretap statute, an “oral communication” is one “uttered by a person exhibiting an expectation that the communication is not subject to interception under circumstances justifying that expectation.” Tex. Penal Code Ann. § 16.02(a).

The Texas statute prohibiting the unlawful interception of electronic communications applies to interspousal telephone wiretaps. *See Duffy v. State*, 33 S.W.2d 17, 23 (Tex. App.—El Paso 2000, no pet.) (Texas wiretap statute prohibits a spouse from intercepting the other spouse’s telephone calls). Texas follows the vicarious consent doctrine, allowing a parent to vicariously consent to a recording on behalf of his or her child. *See Alameda v. State*, 235 S.W.3d 218, 233 (Tex. Crim. App. 2007); *see also Allen v. Mancini*, 170 S.W.3d 167, 172 (Tex. App.—Eastland 2005, pet. denied) (in a modification action, father who was JMC could consent on behalf of his daughter to a recording between the daughter and her mother).

The civil wiretap act is found in Chapter 123 of the Texas Civil Practice and Remedies Code and mirrors the civil penalties in the federal statute in several respects. Tex. Civ. Prac. & Rem. Code § 123.002. The Act provides that an aggrieved party may sue a person who intercepts communications and provides for damages of \$10,000 *for each occurrence*.

2. Texas Penal Code Section 16.04; Unlawful Access to Stored Communication

The Texas counterpart to the Stored Communication Act is found in Texas Penal Code Section 16.04, which provides: “A person commits an offense if the person obtains, alters, or prevents authorized access to a wire or electronic communication while the communication is in electronic storage.”

The Texas act provides that “[a] court shall issue an order authorizing disclosure of contents, records, or other information of a wire or electronic communication held in electronic storage if the court determines that there is reasonable belief that the information sought is relevant to a legitimate law enforcement inquiry.” Tex. Code Crim. Proc. art. 18.21, sec. 5(a).

The State must comply with both Texas law and the Stored Communications Act to obtain stored records. The information required for a court order under the Stored Communications Act is less stringent than the standard for probable cause to obtain a search warrant. The State’s warrantless acquisition of four days’ worth of historical cell-site-location information (CSLI) recorded by the cell-phone service provider did not violate the Fourth Amendment’s protections from unreasonable search and seizure because a third-party (AT&T) gathered and maintained the information as business records of the service provided to the customer and there was no reasonable expectation of privacy in the data. *Ford v. State*, 477 S.W.3d 321, 330 (Tex. Crim. App. 2015).

3. Texas Penal Code Section 32.51; Fraudulent Use or Possession of Identifying Information

Section 32.51 of the Texas Penal Code makes it a crime to obtain, possess, transfer or use another person’s identifying information without consent with the intent to harm or defraud. The relevant statutory language states: “A person commits an offense if the person, with the intent to harm or defraud another, obtains, possesses, transfers, or uses an item of: (1) identifying information of another person without the other person’s consent.” Tex. Penal Code § 32.51(b)(1). The Texas Court of Criminal Appeals has determined that the statutory language is ambiguous because the word “item” is statutorily undefined and it is reasonably susceptible to more than one understanding in this context. *Cortez v. State*, 469 S.W.3d 593, 598 (Tex. Crim. App. 2015)

Although the law was designed to criminalize identity theft, it has also penalized the creation of, and posting to, a social media site in another person’s identity. *See Ex Parte Harrington*, ___ S.W.3d ___, No. 14-16-00059-CR, 2016 WL 3902228, at *4 (Tex. App.—Houston [14th Dist.] July 14, 2016, no. pet. h.) (concluding that section 32.51 was not constitutionally overbroad and rejecting argument that it was a “thought crime”); *see also Roller v. State*, No. 13-09-00175-CR, 2010 WL 2783764 (Tex. App.—Corpus Christi July 15, 2010, pet. ref’d) (mem. op.) (affirming conviction for setting up false MySpace page and posting explicit photos of complainant).

4. Breach of Computer Security

Texas Penal Code Section 33.02 covers breach of computer security and states that it is a crime to knowingly access a computer or computer network without the effective consent of the owner. A violation of this section ranges from a Class A misdemeanor to a felony of the first degree, depending on the dollar amount involved in the case. Tex. Penal Code § 33.02(b).

No violation of Texas Penal Code section 33.02 was found where the defendant's unmarked and unlocked flash drive was left in a common-use computer facility. *Kane v. State*, 458 S.W.3d 180, 187-88 (Tex. App.—San Antonio 2015, pet. ref'd). Therefore, the evidence obtained from the flash drive was legally obtained and the denial of the defendant's motions to suppress was affirmed. *Id.*

Unauthorized viewing of emails is not expressly included in the Texas statute. Criminal prosecutions may nonetheless result, however. For example, a Michigan man was tried for reading his wife's emails under a felony statute. The 1980 Michigan statute at issue also does not mention that reading another person's emails is a crime. The statute merely states as follows:

A person shall not intentionally access or cause access to be made to a computer program, computer, computer system, or computer network to devise or execute a scheme or artifice with the intent to defraud or to obtain money, property, or a service by a false or fraudulent pretense, representation, or promise.

Because the Michigan law is similar to the Texas law, an aggressive prosecutor could seek to apply the law to viewing a spouse's email.

5. Online Impersonation

Texas Penal Code Section 33.07 makes it a crime to:

- (a) use the name or persona of another person to create a web page on a commercial social networking site or to post one or more messages on a commercial social networking site without obtaining the other person's consent and with the intent to harm, defraud, intimidate, or threaten any person.
- (b) send an electronic mail, instant message, text message, or similar communication that references a name, domain address, phone number, or other item of identifying information belonging to any person without obtaining the other person's consent, with the intent to cause a recipient of the communication to reasonably believe that the other person authorized or transmitted the communication, and with the intent to harm or defraud any person.

To establish an offense under section 33.07, an intent to harm must be established. The harm need not be physical. *See Hudspeth v. State*, 31 S.W.3d 409, 411 (Tex. App.—Amarillo 2000, pet. ref'd). Emotional distress can be sufficient. *White v. State*, No. 14-05-00454-CR, 2006 WL 2771855 (Tex. App.—Houston [14th Dist.] Sept. 28, 2006, pet. ref'd) (mem. op.); *see also Ex parte Dupuy*, ___ S.W.3d ___, No. 14-15-00677-CR, 2016 WL 3268442, at *8 (Tex. App.—Houston [14th Dist.] June 14, 2016, no pet. h.) (reviewing bail and considering seriousness of third degree felony charges against defendant who allegedly posted advertisements in escort section of adult website with true names, photos, and phone numbers of complainants).

The statute has survived recent constitutional challenges. *State v. Stubbs*, No. 14-15-00510-CR (Tex. App.—Houston [14th Dist.] Aug. 9, 2016, no pet. h.) (reversing finding that section 37.07 was unconstitutional); *Ex parte Bradshaw*, No. 05-16-00570-CR (Tex. App.—Dallas Aug. 23, 2016, no pet. h.) (rejecting constitutionality challenge).

6. Civil Action for Harmful Access by Computer

Section 143.001 of the Texas Civil Practice and Remedies Code creates a cause of action to "a person who is injured or whose property has been injured as a result of a violation under Chapter 33" of the Texas Penal Code. A prevailing party is entitled to actual damages and reasonable attorney's fees.

A recent opinion from Dallas, *Pickens v. Cordia*, 433 S.W.3d 179 (Tex. App.—Dallas 2014, no pet.) discusses this cause of action. The defendant, the son of T. Boone Pickens Jr., is a recovering drug addict who, as an "interventionist," helps addicts "to get and stay clean." He also writes a blog that he says has as its "primary theme" his own "history of, and then recovery from, substance addiction." His family members sued him for harmful access by computer, invasion of privacy, defamation, and other causes of action based on remarks he published about them on his blog. *Id.* at 182.

In seeking dismissal of the suit, the defendant was required to show that the plaintiffs' allegations related to a matter of public concern as defined by the TCPA, the Texas Citizens' Participation Act. *See* Tex. Civ. Prac. & Rem. Code §§ 27.001(3), (7); 27.005(b). The TCPA provides an expedited means for dismissing actions involving the exercise of certain constitutional rights, including free speech. *See* Tex. Civ. Prac. & Rem. Code § 27.001–.011

Although the evidence showed some previous coverage regarding T. Boone Pickens outside the business world, the appellate court found the defendant had not made the necessary statutory showing to establish the kind of

prominence associated with general-purpose public figures. *Pickens*, 433 S.W.3d at 186. The Court of Appeals reversed the dismissal of the harmful access by computer cause of action. *Id.* at 187.

VII. DEFAMATION

Defamation is a broad term covering slander and libel. Slander is a false statement made to injure the reputation of a person. Libel is a similar statement that is published, usually in writing. The Internet, because of the freedoms it provides, is a potential source of defamatory issues. The *Pickens* case discussed above also addressed defamation. 433 S.W.3d at 187. The family alleged the blog contained false and defamatory statements about them, and the appellate court noted, “free speech is not absolute and does not insulate defamation.” *Id.* at 187. Therefore, the Court of Appeals affirmed the trial court’s denial of the motion to dismiss on this claim.

Lawyers face huge difficulties when trying to address unfavorable online comments. In addition to client confidentiality issues addressed above, lawyers should be cautious in responding to a disgruntled client to avoid exacerbating the problem. As recently reported in *Texas Lawyer*, a Dallas firm has sued an anonymous “Ben Doe” who allegedly wrote a negative Google Review about the firm. See Angela Morris, *Dallas Firm Sues Doe Defendant Over Online Review*, *Texas Lawyer*, Jan. 16, 2012, p. 5. As alleged in the petition, the review stated, “Bad experience with this firm. Don’t trust the fake reviews here.” In the petition, filed December 22, 2011, in Travis County’s 98th District Court, the firm alleges the review is defamatory because it “implies professional incompetence” and “alleges dishonesty and fraudulent conduct.” The firm felt there was no other option than to sue “Ben,” so that it could subpoena Google to learn the reviewer’s identity.

Debra Bruce, president of Lawyer-Coach in Houston, a legal consulting firm, believes it is a “big mistake” for firms to sue the authors of negative reviews. “I think they’ll draw more attention to it. They’ll hurt themselves more than help themselves,” says Bruce. Jay Pinkert, a principal at Tenacious Marketing and Communications in Austin, which offers legal marketing services, says it “boggles the mind” that firms would sue online reviewers. By filing suit, the firm “created a story where there was none: Now it will show up in search, now it will attract attention.” Bruce and Pinkert give the same advice about the best way for firms to react to negative reviews: Post responses to express concern about the reviewers’ experiences with the firm, and invite the reviewers to discuss their issues offline to resolve them. See Morris, *supra*.

By posting on YouTube a video in which he solicited plaintiffs for a class action, the California 1st District Court of Appeal ruled that a lawyer had opened himself up to a defamation suit and could not use the state’s anti-Slapp law, designed to protect free speech and public participation, to ward it off. See Kate Mosier, *Lawyer Sued Over YouTube Video Can’t Fight Back With Anti-Slapp Law*, Feb. 1, 2012 (available at <http://www.law.com>).

The Texas anti-Slapp law, the TCPA, is set forth in Chapter 27 of the Texas Civil Practice and Remedies Code. The Legislature explained its purpose in enacting the TCPA was “to encourage and safeguard the constitutional rights of persons to petition, speak freely, associate freely, and otherwise participate in government to the maximum extent permitted by law and, at the same time, protect the rights of a person to file meritorious lawsuits for demonstrable injury.” Tex. Civ. Prac. & Rem. Code § 27.002. The Act contains a “commercial speech exception” and does not apply to a suit against “a person primarily engaged in the business of selling or leasing goods or services, if the statement or conduct arises out of the sale or lease of goods, services, or an insurance product, insurance services, or a commercial transaction in which the intended audience is an actual or potential buyer or customer.” Tex. Civ. Prac. & Rem. Code § 27.010(b).

Lawyer advertising is commercial speech. See *Neely v. Comm’n for Lawyer Discipline*, 196 S.W.3d 174, 181 (Tex. App.—Houston [1st Dist.] 2006, pet. denied). In a recent case, the Court of Appeals found the lawyers’ television advertisement was created primarily to attract clients; therefore, it was commercial speech and exempt from the protection of TCPA pursuant to Section 27.010(b). *Miller Weisbrod, L.L.P. v. Llamas-Soforo, M.D.*, No. 08-12-00278-CV (Tex. App.—El Paso Nov. 25, 2014, no pet.) (mem. op.).

VIII. EMPLOYEE USE OF SOCIAL MEDIA

Because the use of social media allows someone to immediately communicate with exponential numbers of people, employers have increased concerns regarding employee communications. Due to perceived anonymity, an employee may engage in conduct online that the employee might refrain from in person, without understanding that online communications may be traced to a particular user. The employee may not be fully aware of the ethical implications of social media given the relative newness of these online activities.

A partner or supervising lawyer is in a position of authority over the work of other lawyers and may be disciplined for permitting another lawyer to violate the disciplinary rules. In addition to governing a lawyer’s own conduct, Texas Disciplinary Rule of Professional Conduct 8.04 provides that a lawyer may not “violate these rules, knowingly assist or induce another to do so, or do so through the acts of another.” While Rule 5.01 of the Texas

Disciplinary Rules of Professional Conduct follows the general principle that a lawyer is not vicariously subjected to discipline for the misconduct of another person, under Rule 8.04, a lawyer is subject to discipline if the lawyer knowingly assists, induces, orders or encourages another to violate these rules. Comment 4 to Rule 5.01 also suggests that a supervising lawyer who knows that a supervised lawyer misrepresented a matter to an opposing party in negotiation, may be required by Rule 5.01(b) to correct the resulting misunderstanding.

Lawyers also have ethical responsibilities regarding non-lawyer assistants, including secretaries, paralegals, and law student interns. These assistants act for the lawyer in rendition of the lawyer's professional services. A lawyer should give these assistants appropriate instruction and supervision concerning the ethical aspects of their employment, particularly regarding the obligation not to disclose information relating to representation of the client, and should be responsible for their work product. Rule 5.03 provides that a lawyer will be subject to discipline for the violation of these rules by an assistant if the lawyer "orders, encourages, or permits the conduct involved," and "knowingly fails to take reasonable remedial action to avoid or mitigate the consequences" of the misconduct. Tex. Disc. R. Prof. Conduct 5.03(b).

The Philadelphia Bar Association's Professional Guidance Committee has issued an ethics opinion that a lawyer may not ask a non-lawyer assistant to "friend" an unrepresented witness on Facebook without revealing that she is affiliated with the lawyer or the true purpose of the friend request. Opinion 2009-02 (March 2009). The Pennsylvania ethical rules discussed in the opinion are substantially the same as those in Texas. In the opinion, the Committee found that the deception in concealing the purpose of the access would violate Rule 4.1's prohibition against making false statements of fact.

There are many risks to employers from employee misuse of social media. Some of these dangers are that employees may engage in:

- copyright infringement: posting content without permission from the owner;
- trademark infringement: showing third party logos or trademarks without permission;
- invasion of right of privacy: showing a person's image or likeness without permission;
- defamation, libel and slander: making false claims about a person;
- false advertising or unfair competition: making false claims about a service; and
- disclosure of proprietary or confidential information.

IX. TIPS FOR LAWYERS USING ONLINE SOCIAL NETWORKING

Lawyers should follow some of the same advice they give to clients: treat social media as any other form of communication, subject to the same ethical rules. The following tips can help avoid problems for attorneys who use online social networking:

- Be very clear who you are online. When an attorney networks, he should identify his profession as a lawyer but never engage in offering any legal advice.
- Look very carefully before joining a site. Evaluate whether the site is appropriate for lawyers.
- Make sure all entries, posted anywhere online, are updated and correct.
- Be wary of posting anything specific about clients and the firm.
- Be careful not to solicit clients.
- With the tendency to quickly send electronic communications, it is easy to write before thinking and to lose track of what is written.
- Think long-term. View anything written through the eyes of a client or prospective client. Once something is posted, it might live forever in the world of Google, even if you think the offending passage has been deleted.

X. CONCLUSION

Social media is a huge part of our personal and professional lives. These sites provide exceptional marketing opportunities and are used frequently as litigation tools. Lawyers are now beginning to identify the ethical issues encountered with social networking, and the rules governing our professional conduct will continue to evolve and adapt at a rapid pace. All lawyers should stay abreast of these changes and the effects on their clients and their practices.

HOW TO SAVE YOUR CASE FROM DISMISSAL - MOTIONS TO DISMISS BASED ON ELIGIBILITY (RULES 12504 AND 12206) AND STATUTES OF LIMITATION

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I. Introduction.

Prior to 2009, Motions to Dismiss were a scourge in FINRA arbitrations. Respondents' counsel would routinely file a Motion to Dismiss prior to the final hearing in most cases, typically making legal arguments that Claimants could not carry their burden of proof for various causes of action. Although this did allow Claimants to begin presenting the strengths of their case to the panel before hearing, it created a significant amount of additional work and wasted time, turning the allegedly streamlined arbitration into time-consuming litigation.

In part in response to concerns from PIABA and the Claimants' bar, FINRA enacted Rule 12504 which discouraged Motions to Dismiss prior to the conclusion of Claimants' case in chief, and further limited those Motions to certain subject matter. Under the current Rules, Motions to Dismiss are scarcer, and largely limited to Motions under the FINRA Eligibility Rule. This seminar will address how to save your case from dismissal by responding to and arguing Eligibility Motions and Motions to Dismiss after the conclusion of your case in chief.

II. Specific requirements under the Rules for Motions to Dismiss in general, and specifically the Eligibility Rule.

FINRA Rule 12504, enacted in 2009, contains multiple significant limitations on Motions to Dismiss that should limit their abuse and effectiveness:

"Motions to dismiss a claim prior to the conclusion of a party's case in chief are **discouraged** in arbitration." Emphasis added. 12504(a)(1).

1. Motions must be in writing and filed at least 60 days before the final hearing, unless the parties agree otherwise, or the panel determines otherwise.
2. The Motion must be heard at a recorded prehearing conference, and any decision to grant the Motion must be unanimous.
3. If denied, the panel must assess the fees against the filing party, and the panel can award attorneys' fees for frivolous Motions.
4. Motions to Dismiss prior to the conclusion of a Claimants' case in chief are limited to the following subject matter:
 - a. A prior release or settlement agreement.
 - b. The moving party was not associated with the account, securities, or conduct at issue.
 - c. The claim was previously adjudicated on the merits.

- d. The claim is not eligible for arbitration under Rule 12206.
- e. The claim should be dismissed for failure to comply with a Panel's Order or for Discovery Abuse.

Motions to Dismiss under the FINRA Eligibility Rule 12206 must follow additional requirements under that Rule. The standard for that Rule is as follows: "No claim shall be eligible for submission to arbitration under the Code where six years have elapsed from the occurrence or event giving rise to the claim. The panel will resolve any questions regarding the eligibility of a claim under this rule."

Rule 12206 also contains the following requirements and restrictions for such a Motion in addition to the requirements of Rule 12504:

1. Motions must be served at least 90 days before the final hearing with Claimants having 30 days to respond.
2. In addition to the requirement that granting such a Motion must be unanimous, the panel must provide a written explanation of the decision to grant the Motion.
3. If the Motion is granted for some or all claims, Claimants may pursue their claims in Court.
4. Eligibility Motions to Dismiss must be addressed before other Motions to Dismiss.

III. Caselaw typically cited by Respondents in support of dismissal, and how to counter it.

Invariably, when filing a Motion to Dismiss based on the FINRA Eligibility Rule 12206, Respondents will argue that the six-year eligibility rule time period begins on the "purchase date" of the securities at issues, despite the fact that the Rule makes no mention of the "purchase date."

Respondents typically rely on caselaw prior to the 2002 U.S. Supreme Court *Howsam* decision for their arguments that the purchase date triggers the eligibility rule time period and that it is not subject to tolling. The cases cited by Respondents typically start with the assumption that FINRA Rule 12206 is a substantive rule, serving as an absolute bar for claims that are not filed within 6 years from the purchase of the investment.

However, in 2002, in *Howsam v. Dean Witter Reynolds*, 537 U.S. 79 (2002), the Supreme Court of the United States ("SCOTUS") settled the question of whether eligibility of a claim within the meaning of NASD Rule 10304, (the predecessor to FINRA Rule 12206(a)), was a substantive question or a procedural question to be decided by the arbitration panel. The SCOTUS held that the determination of a claim's eligibility was a gateway procedural question to be decided by the arbitration panel and was not a question of substantive arbitrability which would be decided by the court:

"... we find that the applicability of the NASD time limit rule is a matter presumptively for the arbitrator, not for the judge... Moreover, the NASD

arbitrators, comparatively more expert about the meaning of their own rule, are comparatively better able to interpret and to apply it... And for the law to assume an expectation that aligns (1) decisionmaker with (2) comparative expertise **will help better to secure a fair and expeditious resolution of the underlying controversy**—a goal of arbitration systems and judicial systems alike.”

(Emphasis added).

Respondents typically rely exclusively on court decisions that were made prior to *Howsam*, when some lower courts had held that eligibility was a substantive arbitrability issue and starting the clock at the date of purchase.

Some examples of arguments made by Respondents are that Rule 12206 “serves as an absolute bar to claims” more than six years old. *PaineWebber, Inc. v. Farnam*, 870 F.2d 1286, 1292 (7th Cir. **1989**).” (Emphasis added). Also: “if the customer’s ‘claim is clearly no more than a tolling or discovery argument, the court must enjoin its arbitration.” *PaineWebber v. Hofman*, 984 F.2d 1372, 1382 (3rd Cir. **1993**). These arguments completely ignore SCOTUS’s more recent decision on this issue, which overturned all of these pre-*Howsam* decisions. In other words, all of the cases cited by Respondents for the proposition that there is no equitable tolling or accrual arguments available to claimants are old law that have been overturned. A federal district court in Nevada summarized the fallacy of these arguments well in *Mid-Ohio Secs. Corp. v. Estate of Burns*, explaining that the SCOTUS’ decision in *Howsam*:

[U]ndermined the basic premise upon which courts relied upon to determine eligibility rules like Rule 12206 were not subject to tolling. Those courts relied on the premise that the eligibility rule was a substantive limit on the agreement to arbitrate, not a statute of limitations. Thus, the time period was not subject to tolling. However, *Howsam* eviscerated that premise, finding that the eligibility time limit was not a question of arbitrability, but a gateway procedural matter for the arbitrator. Thus, the entire line of cases that suggest Rule 12206 is not subject to tolling is undermined.

Mid-Ohio Secs. Corp. v. Estate of Burns, 790 F. Supp. 2d 1263, 1271–72 (2011).

When reviewing the interpretations of the rule post-*Howsam*, the date that the investment was sold does not serve as the trigger date for the six-year eligibility window. Instead, the caselaw is clear that the Panel must decide which is the last “occurrence or event” that gave rise to the claims against Respondent and that tolling does apply. See *Oshidary v. Purpura-Andriola*, No. C 12-2092 SI, 2012 WL 2135375, at *5 (N.D. Cal. 2012) *aff’d*, 564 F. App’x 325 (9th Cir. 2014) (“The Panel was free to interpret Rule 12206 as it saw fit, in particular with respect to the triggering date. ... There is no ‘well defined, explicit, and clearly applicable’ law regarding whether the trigger date must be the date of investment.”); *Mid-Ohio Sec. Corp. v. Estate of Burns*, 790 F. Supp. 2d 1263, 1271-72 (D. Nev. 2011) (“Because Rule 12206 is not a strict rule of eligibility, but a question for the arbitrators more akin to a statute of limitations, the arbitrators were free to interpret the rule as they saw fit, including adding in tolling provisions or a discovery rule.”).

Subsequent to the *Howsam* ruling, FINRA arbitration panels can interpret the rule as written (not referencing a “purchase date”), apply equity as discussed below when deciding 12206 Motions, and further may follow FINRA guidance providing for delay of the beginning of the running of the time period in cases of ongoing fraud.

IV. How to define and address the “occurrence or event giving rise to the claim” standard and argue when it occurs and how tolling applies (particularly after *Howsam*).

Contrary to the typical claims of Respondents, the relevant triggering “occurrences or events” under the 6-year Eligibility Rule are not the “purchase dates.” Section 12206 of the FINRA Code of Arbitration Procedure provides, in relevant part:

(a) No claim shall be eligible for submission to arbitration under the Code where six years have elapsed ***from the occurrence or event giving rise to the claim.*** The panel will resolve any questions regarding the eligibility of a claim under this rule.

Emphasis added. The dates of the transactions and/or purchases by Claimants are not definitive. Rather, the definitive consideration is whether Claimants filed the Statement of Claim within six years ***“from the occurrence or event giving rise to the claim.”*** The words “purchase date” are simply not in the Rule.

A. FINRA Has Rejected Claims That the Purchase Date Is Automatically the Start Date.

The eligibility rule is *not* a statute of limitation. No hard and fast event, such as the date of purchase, automatically triggers the rule’s application. Indeed, in interpreting its own eligibility rule, the NASD—FINRA’s predecessor—stated repeatedly that the eligibility rule does not refer specifically to the purchase date as the time that the six-year limitation begins to run. See, e.g., NASD DIRECTOR LETTER RULINGS dated July 26, 1991; Sept. 17, 1991; Oct. 28, 1991; Oct. 20, 1992; Jan. 16, 1993. In each instance, the NASD stated that “the purchase date is **not** the event or occurrence that gave rise to this dispute.” *Id.* (emphasis added). Rather, the NASD Director explained it is “appropriate that the **discovery by the claimant** [of the misconduct] be treated as the ‘occurrence or event’ giving rise to the dispute.” See NASD DIRECTOR LETTER RULINGS dated July 26, 1991; Sept. 17, 1991; Oct. 28, 1991 (emphasis added.)¹

FINRA’s position that the “purchase date” is not what always gives rise to a dispute is consistent with the use of the words “occurrence or event” in the eligibility rule. When enacting the FINRA Code, the drafters chose not to use “purchase date,” “date the account was opened,” or some other more objective and definite term. And FINRA chose not to change the “occurrence or event” language when the new FINRA Code was implemented in April 2007, despite knowing that many brokerage firms wanted “purchase date” to be the trigger. By the plain language used in the new FINRA Code, FINRA did not intend to simply count six years from the purchase date of securities to determine eligibility.

¹ See also *Goldberg v. Parker*, 1995 WL 396568 (N.Y. Sup. Ct. Apr. 12, 1995) aff’d, 634 N.Y.S.2d 81 (N.Y. App. Div. 1995) (courts regularly rely upon the guidance which FINRA has given). The *Goldberg* court recited and adopted FINRA’s rationale that discovery can be the occurrence or event giving rise to a dispute. In that case, the New York court observed that the NASD [FINRA] Director of Arbitration had determined “that, at least in fraud cases, the ‘occurrence or event’ language in [former Rule 15, now Rule 12206] is not automatically interpreted as the investment purchase date.” *Goldberg*, 1995 WL 396568, at *3. The court then quoted the Director of Arbitration for the proposition that rather than focus on purchase date, “it is equally appropriate that the discovery by the claimant be treated as the occurrence or event giving rise to the dispute.” *Id.* at *4.

Furthermore, the FINRA Arbitrator's Guide and Training Manual explicitly state that investors may bring arbitration claims for wrongful conduct that occurred within the six-year eligibility period, in connection with securities that were purchased well beyond the six-year eligibility period. Specifically, the FINRA Arbitrator's Guide states:

The panel determines whether a claim meets the six-year eligibility requirement by reviewing the submissions, pleadings and arguments of the parties. When appropriate, the panel may give the parties a reasonable opportunity to conduct discovery. As with any discovery request, arbitrators have discretion to grant, deny or modify the request. If the arbitrators have additional questions about the eligibility of the claim, they should ask the parties to brief the issue. The arbitrators may find that there is a continuing occurrence or event giving rise to the dispute. For example, although a customer purchased stock 10 years ago, there are allegations of ongoing fraud starting with the purchase, but continuing to a date within six years of the date the claim was filed.

Respondents' typical interpretation of the six-year rule would also provide a safe-harbor for crooked brokers and Broker-Dealers. Under the "date of purchase" theory, a broker need only string clients along for six years from the initial investment date to immunize the broker and the firm from any liability in FINRA arbitration. To apply the inflexible six-year measure from date of purchase to bar a claim, notwithstanding subsequent after-purchase misconduct or fraudulent behavior by the broker and firm, would serve only to encourage a continuous course of misconduct by the industry. This is why FINRA's own Arbitrator Guide explains that a claim related to securities purchased ten years ago is eligible if there are allegations of ongoing misconduct.

B. Federal Courts Also Reject the Argument that the Date of Purchase is Necessarily the Start Date for Calculating the Six Year Eligibility Period

Many federal courts have followed FINRA's interpretation of its own rule, interpreting the occurrence or event not to be simply the date of purchase. In particular, in *Painewebber, Inc. v. Hofmann*, 984 F.2d 1372 (3d Cir. Pa. 1993), the claimants alleged various types of "occurrences or events" that did not violate the Eligibility Rule: (1) respondent's advice to "hold" certain securities – claiming each time the "hold" advice was given there was a new actionable occurrence; (2) respondent's active concealment of its wrongdoing -- the concealment was also an independent, actionable wrong; (3) claimant's discovery of respondent's wrongdoing -- the date of discovery was the first date on which claimant could prevent further injury; (4) the continuation of an integrated pattern of wrongdoing -- the fraudulent inducement to buy and hold the stock over the period of nine years constituted a single, ongoing wrong; and (5) the continuation of a wrongful brokerage relationship -- the entire brokerage relationship was so tainted with fraud and mismanagement that the relationship itself constitutes a single, actionable wrong. *Id.*, at 1380.

Consistent with FINRA's own interpretation of its eligibility rule, courts have ruled that an eligibility determination looks well beyond the point of a claimant's initial investment with a broker. In *Osler v. Ware* 114 F.3d 91 (6th Cir. 1997), the Court explained:

Although counsel for [broker-dealer] contended at oral argument that the only relevant date for determining whether a claim is time-barred is when the initial investment was made, this theory does not comport with either the "occurrence or

event” language contained in [the Arbitration Code] or the case law that is developed thereunder. ... Accepting [broker-dealer's] proposed approach would create situations in which certain claims would be barred before they even arose. Needless to say, we refuse to interpret the "occurrence or event" language, which does not otherwise suggest that the purchase date always triggers the running of the six-year period, in this matter.

Id. at 93.

Federal courts have routinely interpreted the “occurrence or event” not to be simply the “date of purchase.” See, e.g., *Smith Barney, Inc. v. Harvey*, 260 F.3d 1302 (11th Cir. 2001) citing *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cohen*, 62 F.3d 381 (11th Cir.1995) (events subsequent to purchase such as failure to diversify and advice not to sell can constitute an “occurrence or event” under the eligibility rule); *J.E. Liss & Co. v. Levin*, 201 F.3d 848 (7th Cir. 2000) (subsequent actions of broker to lull claimant into holding securities was the occurrence or event for eligibility rule purposes); *Kidder, Peabody & Co. v. Brandt*, 131 F.3d 1001 (11th Cir. 1997) (explaining that nothing in the NASD Code provides that the purchase date is the relevant occurrence or event giving rise to claims); *PaineWebber, Inc. v. Elahi*, 87 F.3d 589 (1st Cir. 1996); *Smith Barney Shearson, Inc. v. Boone*, 47 F.3d 750, 754 (5th Cir. 1995); *Painewebber v. Hoffman*, 984 F.2d 1372 (3d Cir. 1993) (numerous claims arise after initial purchase of investment); *John Hancock Distrib., Inc. v. Saponaro*, 901 F. Supp. 194, 197 (E.D. Pa. 1995) (broker’s subsequent advice to “hold all stock” purchased outside six-year period, or active concealment within the six-year period of wrongdoing outside of the period, may be “events or occurrences” for purposes of eligibility rule); *FSC Secs. Corp. v. Freel*, 811 F. Supp. 439 (D. Minn. 1993) (“occurrence or event” can be something other than the date of purchase), *aff’d* 14 F.3d 1310 (8th Cir. 1994); *EQ Financial Consultants, Inc. v. Blackward*, 1998 WL 1989710 (Mich. App. 1998) (“We reject petitioners’ argument that the six-year eligibility period imposed by this rule can accrue only on the date that the relevant securities are purchased.”); *Equity Securities Trading Co., Inc. v. Gillan*, 1997 WL391794 (M.D. Fla. 1997) (“‘events or occurrences’ are not limited to the purchase date of the stock in dispute”); *Mid-Ohio Securities Corp. v. Estate of Burns*, 790 F.Supp.2d 1263 at 1271 (D. Nev. 2011) (“[c]ourts have recognized that the relevant event or occurrence from which the time period begins to run is not necessarily the purchase or sale of securities.”); *Owens v. Andover Securities, Inc.*, 1998 WL 52058 (N.D.N.Y. 1998); *Smith Barney Inc. v. Vogele*, 967 F. Supp. 165 (E.D. Va. 1997) (“Clearly, the drafters of the NASD Code could have provided that claims shall be brought for arbitration within six years of the purchase of the disputed investment. Their quite different choice of language is telling, and belies any conclusion that an ‘occurrence or event’ is necessarily the date of purchase.”).

C. Federal Courts Interpret the Eligibility Rule’s Trigger as the Date the Damages Occur.

Significantly, Federal courts have also held that to ensure due process, the “occurrence or event” under the eligibility rule should not be construed to have run before all of the elements of a claim have arisen. In particular, in *Brandt, infra*, the court held the eligibility period did not start to run until the claimants suffered damages because that was an element of the claim. *Kidder, Peabody & Co. v. Brandt*, 131 F.3d 1001, 1004-1005 (11th Cir.1997). This interpretation is fully consistent with FINRA’s own interpretation of Rule 12206.

In *Brandt*, a group of investors filed an arbitration claim against their brokerage firm for the brokerage firm’s wrongful conduct in connection with the sale of shares in a limited partnership. *Id.* at 1002. The investments at issue were purchased more than six years prior to the date the

investors filed their arbitration claim. *Id.* The brokerage firm filed a motion for summary judgment contending that the “occurrence or event” giving rise to the investors’ claims, including the purchase of the limited partnerships, did not occur within six years as required by Section 15 of the NASD code [now FINRA Rule 12206]. *Id.* The trial court rejected the brokerage firm’s argument that the investors’ claims were ineligible, and the brokerage firm appealed. *Id.* at 1002-1003. On appeal, the brokerage firm argued that in order for the investors’ claims to be eligible for arbitration, all of the predicate acts for the claim (including the purchase of the limited partnerships) must occur within six years of the filing of the claim for the matter to be eligible for arbitration. *Id.* at 1003. The appellate court expressly **rejected** the brokerage firm’s position and held:

Therefore, **we reject [the brokerage firm’s] interpretation** of the “occurrence or event giving rise to the... claim” language of § 15. **Instead, we hold that under § 15 the “occurrence or event” which “gives rise to the... claim” is the last occurrence or event necessary to make the claim viable.** A claim is viable when all the elements of that claim can be established such that it could withstand a motion to dismiss for failure to state a claim for relief pursuant to Federal Rule of Civil Procedure 12(b)(6).

Id. at 1004. (Emphasis added.). The appellate court further explained the reasons why the brokerage firm’s reasoning is fatally flawed:

In other instances, separate “occurrences or events” establish the various elements of a claim. **For example, an action for negligence based on the defective design of a product is not viable until an injury is caused** by that product. Although the duty and breach elements of such a claim are established by the company’s act of marketing the product, that act does not establish the causation and injury elements of the claim. **The incident in which the product causes injury, not the company’s act of marketing a defective product, is the “occurrence or event which gives rise to the ... claim” within the meaning of §15.** Hypothesizing some dates for the occurrences or events in this example reveals the flaw in Kidder’s position. Suppose that the company marketed the defectively designed product in year one and that, as a result of that defective design, the product caused injury in year eight. **Under Kidder’s theory, even if a claimant filed an arbitration complaint the moment after his or her claim arose-the moment after he or she was injured-the claim would be ineligible for arbitration. We decline to adopt an interpretation of §15 that would render some claims ineligible for arbitration before they even come into existence.**

Id. at 1004. (Emphasis added.) *See also Oshidary v. Purpura-Andriola*, 2012 WL 2135375 (N.D. Cal. 2012) (“The Panel was free to interpret Rule 12206 as it saw fit, in particular with respect to the triggering date, i.e., the ‘occurrence or event giving rise to the claim.’... the Panel believed the triggering event was a 2006 board meeting ‘in which the claimants were informed that their loans and monetary investments into the company weren’t worth anything.’ ... It was not manifest disregard of the law to so find.”)

In many arbitration claims, the last element necessary to establish a viable cause of action for Claimants’ claims is the damage to Claimants. In other words, until Claimants suffered actionable losses and damages, Claimants had no viable cause of action against the Respondents. Any attempt by Claimants to bring such a claim prior to incurring any losses would invariably have

resulted in a Respondent request that the claims be summarily dismissed because Claimants had not suffered any damages; the cause of action had not accrued.

To aid in making these arguments, Claimants' counsel should closely examine the elements of the claims being made, as well as applicable statutes which may delay the accrual of claims. For example, in Virginia, similar to many states, the accrual of a cause of action for common law fraud and constructive fraud in Virginia does not occur until discovery. Specifically, Va. Code § 8.01-249 states:

The cause of action in the actions herein listed shall be **deemed to accrue** as follows:

1. In actions for fraud or mistake... when such fraud, mistake, misrepresentation, deception, or undue influence is discovered or by the exercise of due diligence reasonably should have been discovered...

(Emphasis added).

The language of the statute above meshes perfectly with the FINRA Eligibility Rule language to begin the eligibility period upon discovery. The FINRA Rule starts the six-year period upon the "event **giving rise** to the claim," and a fraud cause of action "**accrue(s)**" upon discovery. These bolded words carry the same meaning, thereby starting the FINRA eligibility period upon discovery of the fraud (or when it reasonably should have been discovered), not the purchase date.

V. How to address Respondents' citation to other arbitration awards in support of Eligibility Motions.

Respondents often will reference and/or attach other FINRA arbitration awards where dismissal under Rule 12206 was granted, some of which may reference a purchase as the applicable date for beginning the time period.

Unfortunately, the requirements of Rule 12206 create a situation where arbitrator opinions granting awards are required and are publicly available, but Orders and opinions denying awards are generally not. The Rule specifically requires at Section (5): "If the panel grants a motion under this rule (in whole or part), the decision ... must be accompanied by a written explanation." Denials are not required to have a written explanation. Furthermore, due to the fact that most cases settle prior to a final hearing, most cases where a 12206 Motion was denied will not even have a publicly available award referencing the denial.

Claimants can argue that other arbitration awards have no precedential value, and the panel should focus on the facts and equities of the present arbitration, not others. See *Peoples Sec. Life Ins. Co. v. Monumental Life Ins. Co.*, 991 F.2d 141, 147 (4th Cir.1993)("prior arbitral awards are not precedential authority for the Tribunal or this Court.").

However, because arbitration panels may give weight to other awards, the sharing of denial Orders among Claimants' counsel is an important means to respond to a claim by Respondents that the granting of these Motions is a common occurrence.

VI. How to plead facts in your Statement of Claim to survive a Motion to Dismiss.

Specific facts to plead in your Statement of Claim (and avoid) to survive a Motion to Dismiss will be addressed in the live session.

VII. The ability to file a case in Court if an Eligibility motion is granted, and associated strategies.

As noted above and in Rule 12206, perhaps the most Claimant-friendly aspect of Rule 12206 is that a granting of the Motion is not with prejudice. The Rule expressly allows Claimants to take claims that are dismissed (as well as any additional claims) and file them in Court. Notably, the rule addresses whether claims are “eligible” for arbitration, not whether they should or should not be extinguished.

The practical effect of this aspect of the Rule is that, assuming Claimant’s counsel is willing to pursue the claims in Court, Claimants are given two bites of the timing of the claim apple. Should an arbitration be dismissed under Rule 12206, Claimants may immediately file the same case in Court, often causing Respondents to have to hire local counsel and incur significantly more attorney’s fees. Although the Respondents/Defendants will then try to dismiss the Court case with similar arguments related to statutes of limitation, the Claimants/Plaintiffs may then fully utilize the various legal arguments in that jurisdiction that delay the running of statutes of limitation, and then utilize the more robust discovery in Court to strengthen the claim.

The threat of taking a case to Court may also be utilized to keep from ever getting there. Such a threat made by Claimants’ counsel early on in the arbitration may stop Respondents from even filing a 12206 Motion in FINRA arbitration, or cause Respondents to withdraw their Motion.

The alternative is to pre-emptively file the case in Court. While this bears the risk of subjecting your clients’ claims to an immediate motion to dismiss on statute of limitations grounds, if you believe you are strong there, you will often force the Respondent to move to compel arbitration which results in Respondent waiving the 12206 eligibility rule. It also gives further ammunition to the arguments in section IX below that if Respondent wanted a statute of limitations applied, they could have done so in Court. By compelling arbitration and waiving the eligibility rule, Respondent has also waived any other timing defenses.

VIII. How to prepare for expected Motions to Dismiss based on Statutes of Limitation after the conclusion of Claimant’s case at the final hearing.

If the timing of the filing of the arbitration is an issue, winning a denial of a 12206 Motion may not be the end of argument on the issue. The restrictions of FINRA Rule 12504 end upon the conclusion of the presentation of Claimants’ evidence in their case in chief at the final hearing. Upon conclusion, Respondents can and do make oral (and written) Motions to Dismiss. These Motions may be limited to statutes of limitation issues, or also may include arguments that Claimants’ have not presented evidence to support the elements of their claims.

FINRA clearly sets out the standard to be applied by its arbitrators hearing a Motion to Dismiss after the Claimants’ case: “When ruling on motions to dismiss after a claimant has concluded its case-in-chief, arbitrators should view the evidence in the light most favorable to the claimant. If

the claimant has presented credible evidence to support a recovery, the panel should deny the motion.” FINRA Arbitrator’s Guide, at p. 50 (February 2021).

Although Respondents may try to use the Motion to attack the allegations and causes of action in the Statement of Claim, FINRA makes clear in its Arbitrator’s Guide that any Motion to Dismiss made after Claimants’ case should address the **actual evidence presented**, not the allegations in the Statement of Claim. One can also cite the FINRA Rule regarding Statements of Claim that makes clear that allegations of causes of action and related elements of causes of action are not required therein: “To initiate an arbitration, a claimant must file the following with the Director: ... (2) A statement of claim specifying the relevant facts and remedies requested.” FINRA Rule 12302.

Addressed below are arguments which may be used in response to statute of limitation Motions to Dismiss in arbitration. To the extent that a Motion to Dismiss is made related to the substantive claims, Claimants’ counsel must be prepared to essentially make a mini-closing argument, explaining how the facts presented support the various claims being made, and require an award of damages against Respondent. If counsel is prepared for such a Motion, they can not only prevail on the Motion, but use the opportunity to further convince the panel of the strength of the evidence presented and the need for an award in Claimants’ favor.

IX. How to argue that Statutes of Limitation do not apply in arbitration.

Many courts have taken the position that statutes of limitation do not apply in arbitration. A thorough judicial treatment of this issue appears in *NCR Corp. v. CBS Liquor Control*, 874 F. Supp. 168, (S.D. Ohio 1993), in which an arbitrator’s refusal to apply a statute of limitations was found not to be manifest disregard of the law.

During the arbitration underlying the NCR case, NCR Corp. made the argument that the claims against it were barred by a number of potentially applicable statutes of limitation. The arbitrator refused to apply those statutes of limitation and awarded damages to CBS Liquor Control. NCR Corp. then petitioned to vacate the award, claiming that the arbitrator’s refusal to apply a statute of limitations was manifest disregard of the law. The U.S. District Court disagreed, stating that: “the effect of a statute of limitations is to bar an action at law, not arbitration.” *Id.*, at 172. The court went on to point out that, if NCR had allowed the claims against it to remain in court, rather than forcing them into arbitration, it might well have defended successfully on statute of limitations grounds: “Had these claims remained pending in the New York Supreme Court, NCR would have had an excellent motion to dismiss the counterclaims as barred by the statute. It chose instead to demand the claims be arbitrated.” *Id.*

The NCR court recognized the critical difference between statutes of limitation that extinguish claims, on the one hand, and those which place time limits on the filing of actions: “If the statutes of limitations on which NCR relies were of the sort that purport to extinguish claims, rather than limit actions in court, they might be relevant, but they do not purport to be statutes of that sort. Rather, on their face they limit the bringing of actions.” *Id.* Thus, the statutes of limitation in NCR, like those that Respondent attempts to assert in its defense here, were limitations on actions in court rather than on the underlying claims. They are not a defense in an arbitration proceeding.

This position is also supported by *Son Shipping Co. v. De Fosse & Tanghe*, 199 F.2d 687 (2d Cir. 1952), cited favorably in NCR. The Son Shipping Court held that a claim made outside of the time limit provided by a statutory cause of action was not barred, and stated as follows:

Nor does the reservation to the carrier in the charter party of all rights it would have under the Carriage of Goods by Sea Act, 46 U.S.C.A. section 1300 et seq., make the demand for arbitration untimely. It is true that the demand was not made within the one year limitation upon suits, contained in section 1303(6) of the above Act, but there is, nevertheless, no time bar because arbitration is not within the term "suit" as used in that statute. Instead, it is the performance of a contract providing for the resolution of a controversy without suit.

Id. at 689.

Multiple other state court opinions have found that statutes of limitation limiting "actions" do not apply to arbitrations: *Carpenter v. Pomerantz*, 634 N.E.2d 587, 599 (Mass.App.Ct. 1994) ("As used in statutes of limitation, the word "action" has been consistently construed to pertain to court proceedings."); *Skidmore, Owings & Merrill v. Conn. Gen. Life Ins. Co.*, 197 A.2d 83, 90 (Conn. Super. Ct. 1963) ("An arbitration proceeding is not the bringing of an action within the meaning of the phrase as used in the Statute of Limitations cited above."); *Lewiston Firefighters Ass'n v. City of Lewiston*, 354 A.2d 154 (Me. 1976); *Har-Mar, Inc. v. Thorsen & Thorshov, Inc.*, 218 N.W. 2d 751, 755 (Minn. 1974) ("Based upon the special nature of arbitration proceedings and both the statutory and common-law meaning of the term 'action,' we feel compelled to hold that § 541.05(1) was not intended to bar arbitration of Thorsen's fee dispute solely because such claim would be barred if asserted in an action in court.); *Cameron v. Griffith*, 370 S.E. 2d 704 (N.C. Ct. App. 1988) ("...by its terms the limitations period stated in G.S. 25-2-725 applies only to an "action," which is a "judicial proceeding," G.S. 25-1-201(1); and an arbitration is neither an "action" nor a "judicial proceeding," but a non-judicial, out-of-court proceeding which makes an action or judicial proceeding unnecessary.") Similarly, the Maine Supreme Court overruled a determination that a statute of limitations must be applied to claims asserted in arbitration. *Lewiston Firefighters Ass'n v. Lewiston*, 354 A. 2d 154, 166 (Me. 1976) ("[a]rbitration is not an action at law and the statute [of limitation] is not, therefore an automatic bar to the firefighter's recovery").

Claimants' counsel should also closely examine the actual statutes of limitation relied upon by Respondents, and note the specific language used therein such as "action" or "civil suit," etc. Definitions of those terms can then be useful to demonstrate that the statutes of limitations were written to only apply to court cases. For example, in Virginia statutes of limitation generally reference the filing of "actions," and Virginia Rule of Supreme Court 3:2 states "A civil action is commenced by filing a complaint in the clerk's office." Thus, a FINRA arbitration, which is a product of a contract between the parties, is not an "action" because it was not initiated by a Complaint filed in the Clerk's office.

Although Respondents will point out that the FINRA Eligibility Rule (12206) states "The Rule does not extend applicable statutes of limitations...", the word "applicable" is referencing specific statutes that mandate application of statutes of limitation to arbitration in several states such as New York and Georgia. For example, under N.Y. C.P.L.R. 7502(b) the statute provides that a party may assert a statute of limitation as a bar to an arbitration. Assuming Claimants are not asserting a New York claim, Claimants can argue that statutes of limitation are not applicable in the case at bar.

Claimants may also argue that in FINRA arbitrations, one need not make a claim based on specific causes of action (with accompanying statutes of limitation), but instead Claimants may bring an equitable claim under FINRA rules.

The FINRA Arbitrators' Guide begins with a quote discussing the equitable nature of arbitration:

Equity is justice in that it goes beyond the written law. And it is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view, whereas the judge looks only to the law, and the reason why arbitrators were appointed was that equity might prevail.

In furtherance of this position by FINRA, Linda Feinberg, the former President of FINRA Dispute Resolution, has stated that FINRA arbitration is an equitable forum in which one does not have to submit claims under federal or state law. The following quotes from Ms. Feinberg are found in Lipner & Long, *Securities Arbitration Desk Reference* (Thomson/West 2012), Appendix N. In a July 20, 2004 statement made at a NASAA forum, she stated:

"... In arbitration, an SRO, an NASD [now known as FINRA] arbitration, unlike in court, you get an equitable result. You do not have to have a claim that is cognizable under state or federal law. It can be cognizable under NASD rules."

Ms. Feinberg then stated in 2012 in the Securities Regulation and Law Reports that "the arbitration forum is designed to do equity... You can also assert in your [arbitration] claim violation of FINRA Rules." BNA's Securities Regulation & Law Report Interview, 44 SRLR 1501, 2012 WL 3142073 (Aug. 6, 2012).

Because equitable claims for violation of FINRA Rules will not have specific statutes of limitation, Claimants' counsel may then argue that the 12206 six-year eligibility rule is the only timing restriction on such claims.

X. Strategies to argue for delay of the running of Statutes of Limitation based on discovery, estoppel, obstruction, tolling, and fraudulent conduct.

To the extent that the arbitration panel may consider applying statutes of limitation, Claimants should argue in the alternative that the running of any applicable statutes were tolled or delayed under the applicable state law. As an example, below are such arguments made under Virginia law.

Although fraud may be present in a case, conduct short of fraud can delay the running of statutes of limitation under Virginia law based on equitable estoppel. The Fourth Circuit in *Barry v. Donnelly*, 781 F.2d 1040, 1042 (4th Cir. 1986) discusses equitable estoppel in a statute of limitation context:

Under Virginia law, one may be estopped to plead the bar of a statute of limitations by conduct short of fraud, under the general doctrine of equitable estoppel. [citation omitted]. Under that doctrine, estoppel occurs where "the aggrieved party reasonably relied on the words and conduct of the person to be estopped in allowing the limitations period to expire."

...While equitable estoppel in both its general applications as well as in its special application to statutes of limitations pleas frequently involves fraud or deceit and is "most clearly applicable" when it does, "deceit is not an essential element of estoppel" in either its general or special applications under Virginia law.

The Virginia Supreme Court defined the elements of equitable estoppel in the absence of fraud in the case of *Lataif v. Commercial Indus. Const., Inc.*, 286 S.E.2d 159, 161, 223 Va. 59 (1982): “Elements necessary to establish equitable estoppel, absent a showing of fraud and deception, are a representation, reliance, a change of position, and detriment.” citing *T... v. T...*, 216 Va. 867, 873, 224 S.E.2d 148, 152 (1976).

The Virginia Code also contains a provision regarding situations where wrongdoers directly or indirectly obstruct the filing of an action. Va. Code § 8.01-229(D) states:

“When the filing of an action is obstructed by a defendant’s ... (ii) using any other direct or indirect means to obstruct the filing of an action, then the time that such obstruction has continued shall not be counted as any part of the period within which the action must be brought.”

Notably, the obstruction under the Code does not need to be direct, and includes “indirect” means to do so. To “obstruct” by direct or indirect means under this section includes taking affirmative acts to conceal a cause of action. *Newman v. Walker*, 618 S.E.2d 336, 338-340, 270 Va. 291 (2005).

The accrual of causes of action related to fraud in Virginia do not occur until discovery or when they should have been discovered. Specifically, Va. Code § 8.01-249 states:

The cause of action in the actions herein listed shall be deemed to accrue as follows:

1. In actions for fraud or mistake... when such fraud, mistake, misrepresentation, deception, or undue influence is discovered or by the exercise of due diligence reasonably should have been discovered...

Many state securities acts contain their own discovery rule delaying the beginning of their statute of limitation, but if they do not, a Claimant may argue that general fraud discovery delay provisions such as the above apply.

XI. Conclusion.

The current iteration of the FINRA Rules provide many protections for Claimants regarding Motions to Dismiss. When faced with a potential Motion to Dismiss in FINRA arbitration, practitioners should read and understand Rules 12504 and 12206 and related FINRA guidance thoroughly to defend and defeat such Motions, and utilize the non-prejudicial nature of the eligibility Rule to prevent such Motions from even being made, or in a worst-case scenario, to continue to pursue claims in Court should a 12206 Motion be granted.