31ST ANNUAL MEETING

Public Investors Advocate Bar Association
1225 W. Main St., Ste. 126
Norman, Oklahoma 73069
Office: 405.360.8776
Fax: 405.360.2063
E-Mail: piaba@piaba.org

2022 © PIABA

The information provided in this publication is for the convenience of the members of PIABA and is designed to provide practical and useful information on the subject matter being discussed. Although this information has been obtained from sources which we believe to be reliable, it does not constitute the rendering of legal advice and should not be used and/or otherwise relied on without independent verification. The information and opinions expressed herein do not necessarily reflect the views, policies and/or opinions of PIABA and/or its Board of Directors.

PIABA 31st Annual Meeting

Table of Contents

PAGE

2022 PIABA Annual Meeting Speaker Biographies xi
2022 PIABA Board of Director Biographies xxiv

§ 0 Post-COVID-How AI and Other Technologies Can Help Every Arbitrator and Arbitration Practitioner Resolve Disputes in a Digital Setting
Ian Hardy, Lindsay Walsh

Thinking Outside the Banker's Box: Managing Arbitration Exhibits Electronically,
David Jackson 1
Remote Work Depends on Managing Exhibits Electronically 3
Agenda 5
Four Challenges of Remote Hearings 6
Managing the Move to Electronic Exhibits – Key Questions to Consider 7
All These Issues are Now Manageable as the Following Slides Will Illustrate 8
With a Move to Electronic Exhibits Good Organization Upfront is Critical 9
In a Remote Hearing you Need to Get Everyone on the Same Page Quickly so You Do Not Lose Momentum 10
Enhanced Search Also Becomes More Useful, Especially in Arbitration Where the Arbitrator May Want to Review Material Prior to Award 11
Multimedia Use is Growing, but to Manage it in a Remote Hearing There Are Additional Issues to Consider 12
Software That Lets You Embed Video Will be Invaluable for All Parties 13
Cybersecurity is Becoming a Critical Risk in Dispute Resolution 14
The Latest Technologies also Empower Litigators in New Ways to do Remotely What You Can Do Today in a Physical Hearing 15
Witness Presentation and Markup is More Difficult Remotely but Technology Can Help 16
Automatic Transcription, Using AI is a Powerful New Tool that Aids Review Both Pre- and Post-Hearing 18
Another Booming Use of AI is in Citation Tools 19
Citation Analysis Tools Can Help Level the Playing Field 21
Remote Arbitration is Now Well Established, Prompting Market Responses to Support Electronic Exhibit Management 22
Managing Evidence Electronically Need Not be Difficult and Service Providers ("SP") are Responding to Support Litigators 23
What Technologies do You Need for a Remote Appearance? 25

§ 1 Review of FINRA DR Activities and Developments in 2022
Michael Edmiston, Moderator; Rick Berry, Carolann Gemski, Laura McNamire

The Financial Industry Regulatory Authority's Dispute Resolution Activities, Revised August 4, 2022 28
I. Background 28
II. Statistics and Trends 29
Case Filing Statistics for June 2022 29
Customer Award Statistics 30
Case Processing Statistics 31
III. FINRA's Response to COVID-19 33
Impact on Arbitration and Mediation Hearings 33
Vaccination Requirement for In-Person Participants 33
Testing Requirement for In-Person Participants (Florida Hearing Locations Only) 34
FINRA Dispute Resolution Services Arbitrator Resource Guide for Virtual Hearings 34

IV. Recent Significant Rule Changes 35
Regulatory Notice 22-15: FINRA Amends the Code of Arbitration Procedure for Industry Disputes to Align the Code with the Ending Forced Arbitration of Sexual Assault and Sexual Harassment Act of 2021 35
V. Proposed Rule Changes 35
Regulatory Notice 22-09: FINRA Requests Comment on a Proposed Rule to Accelerate Arbitration Proceedings for Seriously Ill or Elderly Parties 35
Proposed Rule Change to Amend the Codes of Arbitration Procedure to Modify the Current Process Relating to the Expungement of Customer Dispute Information 35
Proposal to Prohibit Compensated Non-Attorney Representatives (NARs) in Arbitration and Mediation 36
VI. Regulatory Notices 36
FINRA Reminds Members About Requirements When Using Predispute Arbitration Agreements for Customer Accounts 36
Forum Selection Provisions Involving Customers, Associated Persons and Member Firms 37
VII. Significant Initiatives 37
List of Member Firms and Associated Persons with Unpaid Customer Arbitration Awards 37
Expanded Expungement Guidance for Arbitrators and Parties 37
Short List Option to Reduce Extended List Appointments 41
VIII. FINRA Neutrals 42
Arbitrator Disclosure 42
Arbitrator Recruitment 43
Arbitrator Application and Approval 44
Arbitrator Training 45
IX. FINRA Dispute Resolution Services Technology Initiatives 45
Online Portals 45
FINRA Dispute Resolution Services Website 46
Arbitration Awards Online 46
Videoconferencing 47
X. Mediation 47
Mediation Program for Small Arbitration Claims 48
XI. Arbitrator Selection News 49
Recent Court of Appeals of Georgia Decision 49
Independent Review of Arbitrator Selection Process 49

§ 2 Overview of Increased Focus on Cryptocurrency Enforcement and Guidance

Jorge Riera, Moderator; Eric Werner, Kavita Kumar Puri, Micah Hauptman

Overview of Increased Focus on Cryptocurrency Enforcement and Guidance, Jorge L. Riera 50
I. 2022 SEC Enforcement Actions 50
1. SEC v. Okhotnikov, et al., No. 1:22-cv-03978 (N.D. Ill. Aug. 1, 2022) 50
2. SEC v. Wahi, et al., No. 2:22-cv-01009 (W.D. Wash. July 21, 2022) 51
3. SEC v. MCC International Corp. et al., No. 2:22-cv-13129 (S.D. Fla. Apr. 1, 2022) 51
4. In the Matter of NVIDIA Corporation, Securities Act Release No. 33-11060 (May 6, 2022) 52
5. SEC v. Barksdale, et al., No. 1:22-cv-01933 (Mar. 8, 2022) 53
6. In the Matter of BlockFi Lending LLC, Securities Act Release No. 33-11029 (Feb. 14, 2022) 53
II. SEC Crypto Resources 54
1. Initial Exchange Offerings (IEOs) – Investor Alert (January 14, 2020) 54
2. Funds Trading in Bitcoin Futures – Investor Bulletin (June 10, 2021) 54
3. Digital Asset and “Crypto” Investment Scams – Investor Alert (September 1, 2021) 55
4. Crypto Asset Interest-bearing Accounts – Investor Bulletin (February 14, 2022) 55
III. 2022 CFTC Enforcement Actions 55
1. CFTC v. McAfee et al., No. 21-cv-1919 (S.D.N.Y. July 14, 2022) 55
2. CFTC v. Mirror Trading International Proprietary Limited et al., No. 1:22-cv-00635 (W.D. Tex. June 30, 2022) 56
3. CFTC v. Ikkurty et al., No. 1:22-cv-02465 (N.D. Ill. May 10, 2022) 56
4. CFTC v. HDR Global Trading Limited et al., No. 1:20-cv-08132 (S.D.N.Y. May 5, 2022) 57
5. CFTC v. Fintech Investment Group, Inc. et al., No. 6:20-cv-00652 (M.D. Fla. Mar. 24, 2022) 58
6. CFTC v. Tinoco et al., No. 3:21-cv-00237 (W.D. Tex. Mar. 25, 2022) 58
7. CFTC v. Golden et al., No. 22-cv-01252 (E.D.N.Y. Mar. 8, 2022) 59
IV. CFTC Digital Assets Resources 60

1. What is a Bitcoin Futures EFT? – Article (February 1, 2022) 60
2. Funds Trading in Bitcoin Futures – CFTC/SEC Investor Alert (June 10, 2021) 60
3. Understand the Risks of Virtual Currency Trading – Advisory (December 15, 2017) 61
4. Use Caution When Buying Digital Coins or Tokens – Advisory (July 16, 2018) 61
5. Beware Virtual Currency Pump-and-Dump Schemes – Advisory (February 14, 2018) 61
6. Beware "IRS Approved" Virtual Currency IRAs – Advisory (February 2, 2018) 62
V. 2022 FINRA Disciplinary Action – Outside Business Activities 62
1. FINRA Department of Enforcement v. Minich, No. 2020066999801 (Aug. 16, 2022) 62
VI. FINRA Crypto Resources 63
1. Don't Fall for Cryptocurrency-Related Stock Scams – Alert (December 21, 2017) 63
2. Bitcoin: More than a Bit Risky – Alert (May 07, 2014) 63
3. Digital Assets: Getting a Handle on Virtual Currencies – Insights (May 31, 2018) 63
4. Scams: Here's How to Avoid Crypto Stock Scams – Insights (September 6, 2018) 63
5. Digital Assets: Bitcoin Basics-9 Things You Should Know About the Digital Currency – Insights (May 24, 2017) 63

§ 3 What To Do When Securities Fraudsters Do You a Favor and File for Bankruptcy?
Jamie Falgout, Moderator; Randy Pulman, Kathy Phelps

When Securities Claims Collide With the Bankruptcy Code, Randall A. Pulman 65
Fact Pattern 65
1) Is the SPS Bankruptcy Filing a Chapter 7 Liquidation or a Chapter 11 Reorganization? 66
2) Should Lilly File a Proof of Claim? 66
3) Don't Vote for That Chapter 11 Plan – You May Be Releasing Claims Against Third Parties 67
4) Can Lilly Pursue Claims Against Burt Blackheart and Oakmont? 68
A) We Don't Need to Fight Any More After the Panel Has Ruled. Debts Arising From Securities Violations (Even the Unsuitable Ones) Are Not Dischargeable 68
B) Burt, Hand Over Your Homestead, Or At Least All Value Above $170,350.00 71
Appendix I: Requirements for Approval of a Chapter 11 Plan of Reorganization 73

Detecting Ponzi Schemes, Pursuing Litigation Claims, and Defending Fraudulent Transfer Claims, Kathy Bazoian Phelps 75
I. Ponzi Schemes 76
A. Definition 76
B. Common Characteristics and Red Flag Warning Signs 76
II. Types of Due Diligence 77
A. Investigate Company's Auditor 77
B. Financial Statements 77
C. Public Information About the Company 77
D. The Business Model 78
E. Complicated Corporate Structure 78
F. Operational Issues 78
G. Red Flags From Financial Transactions 78
III. Potential Tort Theories 79
A. Malpractice and Professional Negligence 79
B. Negligent Misrepresentation 80
C. Deepening Insolvency 80
D. Fraud 81
E. Aiding and Abetting Fraud and Breach of Fiduciary Obligations 82
1. The Knowledge Requirement 82
2. The Substantial Assistance Requirement 82
IV. Fraudulent Transfer Claims 83
A. Actual Fraudulent Intent 83
B. Constructive Fraudulent Transfer 84
1. Issues Pertaining to Investors 85
2. Issues Pertaining to Salespeople 85
3. Issues Pertaining to Charitable Organizations 86
C. Good Faith Value Defense 86

§ 4 Don't Call it Selling Away – Negligent Supervision and Agency-Based Claims for Ponzi Schemes and Scams Against Broker/Dealers by Non-Client Plaintiffs

Joe Wojciechowski, Moderator; Sander Ressler, Gary Saretsky, Jeff Erez

Don't Call it Selling Away – Negligent Supervision and Agency-Based Claims for Ponzi Schemes and Scams Against Broker/Dealers by Non-Client Plaintiffs,
Joseph R. Wojciechowski 89
I. Introduction 89
II. Jurisdictional Issues Confronting "Non-Clients' in Selling-Away Claims 89
III. Use the FINRA Rules for What They Are – Evidence of the Standard of Care 93
1. FINRA and the SEC Regularly Fine, Suspend, and Bar Firms for Failing to Reasonably Supervise Outside Business Activities and Private Securities Transactions 95
IV. Discovery Is Where You Win Your Case 95
1. Electronic Communications 95
2. Broker's Personal Finances 97
3. Regulatory Investigations 97
V. Trying the Case – Conclusion 98

Attachments:
Exhibit A 99
Exhibit B 126
Exhibit C 150
Exhibit D 176
Exhibit E 200

§ 5 An Ethical Review of Representing Estates, Trusts, or Beneficiaries After the Account Holder's Death

Debra Speyer, Moderator; David Miller

My Client Just Died – Now What?, Debra G. Speyer 214
Introduction 214
The Rules of Professional Responsibility 214
Rule 1.0(e) Terminology 214
Practical Ramification 214
The Rule 214
Rule 1.2: Scope of Representation & Allocation of Authority Between Client & Lawyer 215
Practical Ramification 215
The Rule 215
Rule 1.4 Communications 215
Practical Ramification 215
The Rule 215
Rule 1.6 Confidentiality of Information 217
Practical Ramification 217
The Rule 217
Rule 1.9 Duties to Former Clients 221
Practical Ramification 221
The Rule 221
Rule 3.3: Candor Toward the Tribunal Share 221
Practical Ramifications 221
The Rule 221
Rule 4.1 Truthfulness in Statement to Others 222
Practical Ramification 222
The Rule 223
The Estate Process 223
Joint Account With Rights of Survivorship 223
Payable On Death Accounts 223
IRA With Beneficiary 223
Trusts 223
Decreased Individual Account 224
Conclusion 224

§ 6 What is This Thing Worth and How Do I Sell It?

Patricia Vannoy, Moderator; Adam Weinstein, Gordon Yale, Mike Yan, Greg Kyle

Introduction: Regulation D Offerings & Customer Complaints, Mike Yan 225
No. of Offering 226
No. of Offerings, All Industries, 2009-2021 226
Kalos Capital, Inc., # Offerings vs # Brokers with IP Complaints 227
Concorde Investment Services, LLC, # Offerings vs # Brokers with IP Complaints 227

Valuation of Distressed Securities, Gordon Yale 228
Fair Market Value 230
Premise of Value 231
Generally Accepted Valuation Theory 232
So Why Not Value at Net Asset Value? 236
So Why Not Value Griffin at NAV? 239
So Why is NAV Not a Fair Measure of Fair Market Value? 240
Primary Methodologies 244
Discounting Economic Income 245
Income Method Requires 246
Estimate of Future Cash Flows 247
Estimate of Sales Proceeds From the Entity at Some Terminal Point 248
Estimate Proper Discount for Lack of Control 249
Estimate of Proper Discount for Lack of Marketability 250
Estimate of Discount Rates 251

Attachment:
Information Sources and Potential Secondary Markets or Brokers for Illiquid Private Placements 255

§ 7 Securities Arbitration Boot Camp

Adam Gana, Moderator; Jonathan Kurta

The Anatomy of a FINRA Arbitration, Adam Gana 256
Suitability 256
    Reasonable-Basis Suitability 256
    Customer-Specific Suitability 256
    Quantitative Suitability 256
Institutional-Investor Exemption 257
Fiduciary Duties – Brokers 257
Churning (Excessive Trading) 258
    a. Excessive Trading 258
    b. Broker Control 258
Failure to Supervise 259
An Underlying Securities Violation 259
Association With a Brokerage Firm 259
Supervisory Jurisdiction 259
Failure to Supervise 260

§ 8 Wisdom of the Crowd

Sean Sweeney, Moderator; Courtney Werning, Adam Gana

FINRA Neutral Corner Volume 2 – 2016, "The 20-Day Exchange: Identification of Expert Witnesses" 261
"Expert Witness Cross Examination: The Ultimate Guide" – Joseph B. Evans, J.D. – The Expert Institute 277
ABA Model Rule 1.8 and Comments 289
"Five Tips for an Effective Mediation Statement" – Mark A. Romance – American Bar 299

Strategy-Proof and Efficient Mediation: An Ordinal Market Design Approach,
Onur Kesten, Selcuk Ozyurt 302
Abstract 302
I. Introduction 302
1.1 Online Dispute Resolution and E-Negotiation Systems 307
2. An Example 309
3. The Main Setup: Multi-Issue Mediation 311
3.1 Preliminaries 312
3.2 Discussion 315
4. Main Results 317
4.1 Strategy-Proof Mediation 317
4.2 Full Characterization and Quid Pro Quo 322
4.3 A Visual Characterization of the Class of Logrolling Mechanisms 327
4.4 A Practical Formulation of Logrolling Mechanisms 329
5. Special Members of the Logrolling Family 330
6. Discussion and Extensions 333
6.1 Modeling Conflicting Preferences 333
6.2 Symmetric Treatment of the Outside Options 334
6.3 More Than Two Issues or Negotiators 334
6.4 Issue-Wise Voting in the Direct Mechanism with Veto Rights 334
6.5 Reconciliation with the Negative Results in Bayesian Settings 335
7. Related Literature 336
8. Conclusion 340
9. Appendix 341

FINRA Neutral Corner Volume 3 – 2017, "Subpoenas and Orders of Appearance and Production" 354

§ 9 Insurance Coverage Issues for Securities Arbitration

Jeffrey Sonn, Moderator; Patti Vannoy

Insurance Coverage Basics for the Securities Arbitration Attorney, Jeff Sonn 371
I. Timely Notices to Carriers 371
II. Insurance Disclosure Laws 373
III. Claims Made Policies vs. Occurrence Policies 377
IV. Reservation of Rights Letters 377
V. Related Acts Exclusions 379
VI. Pleadings 386
VII. Policy Limits 389
VIII. Policy Limit Demands 390
IX. Assignment of Bad Faith Rights 392

Attachments:
Appendix A, ACE Advantage Securities Broker-Dealer Professional Liability Insurance Policy 395
Appendix B, Securities Shield for Broker-Dealers, Securities Broker-Dealer Professional Liability 408
Appendix C, Professional First – Life Agent Broker-Dealer Professional Liability Policy 425

§10 Avoiding Ethical Pitfalls

Nicole Iannarone

What Every Attorney Should Know About Technology in Practice, Nicole Iannarone 444
Introduction 444
I. The Ethical Duty of Technological Competence Beyond the ABA 445
II. Cloud Computing 446
III. Using Social Media in Practice 449
IV. Protecting Against Cybersecurity Threats 451
A. Cybercriminals Target Law Firm 451
B. Lawyers' Networks are Vulnerable to Virtual Kidnappers 452
C. Protect Yourself and Your Clients by Learning About the Threats 453
V. Understanding Capabilities of New Technologies 455
VI. Preventing Client Harm From Technology 456

VII. Level of Technological Competence Required 458
Conclusion 460

§11 Imbedded Losses in Covered Calls, Options in a Volatile Market – Finding the Invisible Case

Jenice Malecki, Moderator; Fred Rosenberg, Sean Coughlin, Melinda Steuer

Imbedded Losses in Covered-Calls – Finding the Invisible Case 461
Introduction 462
Facts 463
Covered Calls 464
Speed of the Market and Risk 465
Benchmarks-Baseline Standards 466
Index Data Comparison 467
The VIX 468
Covered Calls Basics 469
Three Exit Strategies for Covered Calls 470
Expirations 471
Assignments 472
Assignment Impact 473
The Data Needed to Assess Outcome 474
The Underlying Stock Price Matters 475
Options Trading Analysis-Summary 476
Impact of Assignments on Underlying Equities 477
Analyzing Underlying Equity Performance 478
30-Day Calls vs. Longer Expirations 479
Covered Call LEAPS 480
Assigned Puts 481
Conclusions 482
FINRA Rules: Rule 2111.05 Components of Suitability Obligations 483
FINRA Rules 3120. Supervisory Control System 484
FINRA Rule 3260. Discretionary Accounts 485
FINRA Rules 2360. Options: (18) Discretionary Accounts 486
2360. Options/FINRA 487
2360. Options/FINRA.org 488

§12 Winning Private Placement, Non-Traded and Other Alternative Investment Cases

Samuel Edwards, Moderator; Michael Hill, Meghan McElligott

Winning Strategies for Prosecuting Alternative Investment Cases 490
1. The Problem With Alternative Investments 490
2. Pleading the Alternative Investment Case 494
3. Suitability in Alternative Investment Cases 495
4. Fighting FINRA Rule 12206 Motions 503
5. Damage Analysis 506
6. Conclusion 508

§13 The Ethics of Attorney Well-being in the Post-Covid World

Angela Hayden, Moderator; Beverly Davidek, Andrew Borrego

The Ethics of Attorney Well-Being in a Post-Covid World, Angela Hayden 509
1) Why is Attorney Well-Being Even Matter for Lawyers in Particular? 509
The Important Ethical Rules Impacted by a Lack of Well-Being 510
Rule 1.1. Competence 511
Rule 1.3 Client-Lawyer Relationship 511
Rule 1.4 Communications Client-Lawyer Relationship 511
Rule 1.16 Declining or Terminating Representation 512
Rule 3.2 Expediting Litigation – Advocate 512
Rule 5.1 Supervisory Lawyers Law Firms and Associations 512

Rule 8.3 Reporting Professional Misconduct Maintaining The Integrity of The Profession....512
The Legal Profession Has a Drinking Problem....513
2) What is the Significance of Well-Being in a Post-Covid World?....514
3) What is Well-Being?....515
Category Definitions....516
Work....516
Physical....516
Emotional....516
Money....516
Community....516
Love....517
Purpose....517
Fun....517
Environment....517
Learning....517
4) How Can Greater Well-Being Be Achieved?....517
Conclusion....520

§14 Synergies Between Class Actions, Individual Cases, and FINRA Arbitrations
Birgitta Siegel, Moderator; Adam Polk, Elizabeth Kramer, Carol Villegas

Blue Apron and the Facial Validity of Federal Forum Selection Clauses,
Carol Villegas and Lisa Strejlau....521
Salzberg v. Siabacucchi, No. 346, 2019 (Del. March 18, 2020)("Blue Apron")....521
Background....521
SCOTUS Confirms Viability of State Courts' Jurisdiction Over Section 11 Claims in *Cyan*....521
Delaware General Corporation Law (DGCL) Permits Forum Provisions....521
Blue Apron & Federal Forum Provisions....521
Delaware Court of Chancery Invalidates FFPS....522
In Re Brightview Holdings, Inc. Sec. Litig.....523
BrightView's FFP....523
BrightView's Registration Statement....523
Delaware Supreme Court Reverses....523
1. The Plain Language of DGCL Section 102(b)(1) Permits FFPs....523
2. FFPs Do Not Conflict With Delaware Public Policy....523
3. FFPs Relate to Intra-Corporate Claims....523
Practical Implications....524
Post-Blue Apron Enforceability of Federal Forum Selection Clauses....524
Wong v. Restoration Robotics, Inc., et al., No. 18-CIV-02609 (Sept. 1, 2020)....524
In re Dropbox, Inc. Securities Litigation, No. 19-CIV-05089....524
Blue Apron & Federal Forum Provisions....524
Wong v. Restoration Robotics, Inc. 524
In Re Dropbox, Inc. Securities Litigation....526

Attachments:
Salzberg v. Sciabacucchi, 227 A.3d 102 (2020)....527
Wong v. Restoration Robotics, Inc., 2020 WL 6050540 (2020)....564
In re Dropbox Securities Litigation, Slip Copy (2020)....568

Looking Classy While Vetting New Cases, Elizabeth Kramer and Adam Polk....579
Identifying Class Actions....579
Threshold Questions....579
Elements of Rule 23....579

§15 RIA Supervisory Duties: Claims and Resources for RIA Cases

Darlene Pasieczny, Moderator; Jorge Riera, William Nelson, Ron Heakins

RIA Supervisory Duties: Claims and Resources for RIA Cases, Jorge Riera 581
What You Should Know About Supervision of RIAs 582
What Is An IRA? 583
What Is an Investment Adviser? 584
Growth of RIAs 585
Did you know? 586
RIA Conduct Standards 587
What Is the Standard of Conduct for Investment Advisers? 588
RIA Prohibited Transactions 590
Section 206 of the Advisers Act 591
RIA Compliance Obligations 592
Chief Compliance Officer (CCO) 593
Failure to Supervise Defense 594
The Compliance Rule, Rule 206(4)-7 595
Florida Compliance Rule, F.A.C. Rule 69W-600.0131 596
The Compliance Rule – Written Supervisory Procedure 597
The Compliance Rule – Annual Reviews 598
The Compliance Rule – Oversight of Key Areas 599
The Compliance Rule – Exam Deficiencies 600
RIA Ethics Code 601
Code of Ethics, Advisers Act Rule 204A-1 602
Enforcing Code of Ethics 603
RIA Supervisory Duties 604
Supervision of RIAs 605
Supervised Person, Section 202(a)(25) of the Advisers Act 606
Supervision of RIA, Portfolio Management 607
Supervision of RIA, Trading Practices 609
Supervision of RIA, Proprietary Trading & Personal Trading 611
Supervision of RIA, Disclosure Obligations – Form ADV, Part II 613
Supervision of RIA, Disclosure Obligations – Enforcement Actions 617
Supervision of RIA, Florida Disclosure Obligations 618
Supervision of RIA, Safeguarding Client Assets 619
Supervision of RIA, Books & Records 620
Supervision of RIA, Marketing Advisory Services 621
Supervision of RIA, Valuation & Fees 622
Supervision of RIA, Protect Privacy of Client Records 623
Supervision of RIA, Business Continuity 624
Resources, SEC – RIA Risk Alerts 625
Resources, SEC – RIA Compliance, Conduct & Ethics 626

§16 Settling Securities Dsputes

Courtney Werning, Moderator; Melanie Cherdack, Michael Bixby, Jeffrey Grubman, Gregg Breitbart

Is Virtual Mediation Here to Stay?, Courtney Werning, Michael Bixby, Melanie Cherdack, Jeffrey Grubman 628
I. Introduction 628
II. Benefits of Virtual Mediation 628
III. Challenges of Virtual Mediation 629
IV. Best Practices for Effective Virtual Mediations 630
V. Conclusion 631

§17 How to Bring Reg BI Cases

Christine Lazaro, Moderator; Jim Wrona, Dave Neuman

Pleading and Advocating a Negligence Claim Through the Regulation Best Interest Lens, Christine Lazaro and Michael S. Edmiston 632

I. When Does Regulation Best Interest Apply? 632

II. What are the Broker's Specific Obligations? 633

- a. Disclosure Obligation 633
  - i. Duties Under Regulation Best Interest 633
  - ii. FINRA's Perspective on Inadequate Procedures 635
  - iii. Important Considerations and Documents 636
- b. Care Obligation 637
  - i. Duties Under Regulation Best Interest 637
  - ii. FINRA's Perspective on Inadequate Procedures and Best Practices 639
  - iii. Important Considerations and Documents 640
    1. Reasonable Basis Component Considerations 640
    2. Customer-Specific Component Considerations 640
    3. Quantitative Component Considerations 641
    4. Final Considerations for the Care Obligation 641
- c. Conflict of Interest Obligation 642
  - i. Duties Under Regulation Best Interest 642
  - ii. FINRA's Perspective on Inadequate Procedures and Best Practices 644
  - iii. Important Considerations and Documents 644
- d. Compliance Obligation 645
  - i. Duties Under Regulation Best Interest 645
  - ii. FINRA's Perspective on Inadequate Procedures and Best Practices 645
  - iii. Important Considerations and Documents 646

III. Conclusion 646

PIABA 31st Annual Meeting Speaker Biographies

Richard W. Berry, Esq.
Executive Vice President and Director of FNRA Dispute Resolution
New York, New York

Richard W. Berry is Executive Vice President and Director, FINRA Dispute Resolution Services.

Prior to serving in this capacity, Mr. Berry was Senior Vice President, Dispute Resolution. In that role, he oversaw the four regional offices—New York, Boca Raton, Chicago and Los Angeles—and the New York Case Administration unit.

Mr. Berry joined FINRA, then NASD, in 1995 as head of Dispute Resolution's Los Angeles satellite office. In 2001, he was named Director of Case Administration in the New York City office. Mr. Berry serves as Executive Champion of FINRA's Toastmasters Clubs. Mr. Berry earned his Certified Regulatory and Compliance Professional™ designation through the FINRA Institute.

Prior to joining FINRA, he taught American law for one year in Budapest. Mr. Berry began his career practicing law in San Francisco. He is a graduate of the University of California at Santa Barbara and Hastings College of the Law. Mr. Berry is a member of the California Bar.

Michael Bixby, Esq.
Levin Papantonio et al
Pensacola, Florida

Michael Bixby is an attorney and shareholder of Levin Papantonio Rafferty in Pensacola, Florida. He concentrates his practice on securities and investment fraud litigation and has represented over 1,000 clients in FINRA Arbitration and state and federal court. Mr. Bixby is an active member of PIABA where he serves as a Director and Co-Chair of the Arbitration Committee. He regularly lectures to attorneys, paralegals, and investors around the country, and he has been quoted in various national and local publications such as Reuters, Bloomberg, and Investment News. Mr. Bixby has obtained numerous verdicts, judgments, and arbitration awards in excess of $1 million, including a $19 million plus FINRA arbitration award obtained for an investor involving Puerto Rico Closed End Funds against UBS Financial Services (through 2021 this remains the largest Puerto Rico CEF arbitration award against UBS), and a $1.16 million plus arbitration award involving alternative investments against Berthel Fisher (through 2021 this remains the largest FINRA Arbitration customer verdict ever obtained against Berthel Fisher).

Andrew Borrego, Esq.
Moreno & Borrego Law
San Antonio, Texas

Andrew Borrego is a native of San Antonio, Texas. He is licensed to practice law in Texas and New York. Andrew has a broad practice emphasizing on Business and Corporate Transactions and Entertainment and Sports Law.

Andrew has served as principal legal advisor on numerous transactions in various industries (e.g. mergers and acquisitions, health care, advertising, banking, food and beverage, marketing and public relations, health and wellness, oil and gas, technology, etc.) and has represented clients in various civil litigation matters (e.g., business and real estate disputes, invasion of privacy, intellectual property, oil and gas, revenge porn, personal injury, etc.).

In the area of entertainment and sports, Andrew has negotiated music related agreements on behalf of national and international recording artists and producers with major record labels (e.g. Atlantic Records, Warner Music Group/Asylum Records, Interscope, Universal Music Group/Fontana Music/Ingrooves, and Universal Music Group/Fonovisa, Crescent Moon Records, Inc., Estefan Music Publishing) and numerous music industry related agreements. In addition to his work in the music industry, he has negotiated numerous film and television production agreements with major television networks and streaming media companies (e.g. CMT) and production companies (e.g. MiTu/Netflix, Bunnim & Murray).

Andrew has also represented professional boxers, professional wrestlers, a former NBA first round draft pick, sports agents, on-air television personalities, and various entertainment related business entities. In addition, Andrew

advises entertainment and sports clients in all aspects of their entertainment and business related careers (e.g. business and endorsement opportunities).

Andrew has also served as an expert witness in the music industry, having served as an expert witness in a copyright ownership and valuation case relating to the popular 70's funk band "Ohio Players" music catalog; In Re: Lisa Ann Galaz, Debtor, Lisa Galaz v. Segundo Suenos, LLC, et.al., Cause No. 07-53287 rbk, in the United States Bankruptcy Court in the Western District of Texas, San Antonio Division.

In addition to the practice of law, Andrew served as an adjunct professor at Trinity University (2007-2012) where he taught Sport Finance, Sports Law, and Ethics in Sports and assisted the university in establishing a Sport Management minor program. He also served as an adjunct professor in the business school at Our Lady of the Lake University (2008-2013) where he taught Business Law, Health Law and Non-Profit Law.

Andrew is passionate about serving the community and served on the board of trustees at Our Lady of The Lake University where he was Chair of the Academic Affairs Committee. In addition to his community involvement, he also enjoys public speaking on a variety of matters and has been a featured speaker at various functions for a variety of organizations.

A self described boxing and fitness enthusiast, Andrew has a passion for boxing and enjoys sparring amateur and professional boxers and incorporating plyometrics into his training regiment. In 2019, Andrew was featured in the Texas Bar Journal, "Boxing Is Life", https://www.texasbar.com/AM/Template.cfm?Section=articles&ContentID=43957&Template=/CM/HTMLDisplay.cfm

---

Gregg Breitbart, Esq.
Kaufman Dolowich & Voluck LLP
Ft. Lauderdale, Florida

Gregg Breitbart serves as the Co-Managing Partner of Kaufman Dolowich & Voluck, LLP's Florida office and as the Co-Chair of the Firm's Financial Services & Institutions Practice Group. Mr. Breitbart's practice focuses on securities arbitration and litigation; securities regulatory and enforcement matters before the Securities and Exchange Commission, FINRA and state regulatory authorities; employment litigation; directors & officers (D&O) litigation; corporate governance matters; and related commercial litigation and counseling.

Prior to joining Kaufman Dolowich & Voluck, LLP, Mr. Breitbart served as a partner at a Wall Street-based law firm focusing on representation of corporate and individual clients in securities-related matters, including arbitration, litigation and regulatory proceedings.

Preceding that position, Mr. Breitbart served for ten years as the General Counsel of a regional broker-dealer and investment bank with more than 300 associated persons. In that role, he handled a wide range of matters, including securities regulatory and enforcement issues with the Securities and Exchange Commission, FINRA and various state regulatory authorities; securities arbitration and litigation on behalf of the firm and its representatives; employment-related disputes, litigation and arbitration; and related commercial litigation and counseling. Prior to serving as General Counsel, Mr. Breitbart was a partner with the international law firm of K&L Gates, in its Miami, Florida office. His practice focused on representing clients in securities litigation and arbitrations, regulatory investigations and proceedings, and commercial litigation.

Mr. Breitbart began his legal career in New York with one of the oldest law firms in the country, Cadwalader, Wickersham & Taft, where he participated in a variety of commercial matters, including litigation (securities/broker-dealer, corporate governance, employment) and corporate finance (CMO's, sale-leaseback transactions and other securitized finance transactions).

Melanie S. Cherdack, Esq.
Genovese, Joblove & Battista, PA
Miami, Florida

Melanie Cherdack is the Acting Associate Director of the Investor Rights Clinic at the University of Miami School of Law. She is also of counsel in the Miami, Florida office of Genovese Joblove & Battista, P.A. Earlier in her career, she served as Assistant General Counsel in the litigation department of PaineWebber Inc. (now UBS). Melanie graduated with honors from the University of Florida College of Law where she was a Senior Editor on the Florida Law Review. She has published numerous articles and has lectured before many legal and professional organizations on issues

related to securities arbitration. She is an editor of the PIABA Bar Journal and co-authors the Recent Awards section of that publication.

Cherdack has been a FINRA arbitrator since 1994, as well as a National Futures Association arbitrator, and has served as a panel member or chair on dozens of arbitration actions. Ms. Cherdack primarily represents individual and institutional investors in securities arbitrations.

She also represents securities brokers in employment disputes against their firms. Additional information can be found on her website www.investorfraudlaw.com . She can be contacted at mcherdack@GJB-law.com.

Sean J. Coughlin, Esq.
Bressler, Amery & Ross, P.C.
New York City, New York

Sean Coughlin specializes in the representation of Financial Institutions and their employees, including individual registered representatives in FINRA arbitrations and before regulatory agencies. He has appeared on behalf of corporate clients in New York state court, the Commodities Futures Trading Commission, and in more than 100 arbitrations before self-regulatory organizations. Mr. Coughlin also represents individuals in regulatory enforcement actions.

In addition to representing Financial Institutions in customer initiated cases, Mr. Coughlin has also represented broker dealers in employments matters ranging from defamation disputes, wrongful termination cases, and cases challenging Citigroup's practice of paying executives and brokers restricted stock ("CAP') as part of its discretionary annual compensation. He has also defended claims relating to employer's rights to products created by employees within the scope of their employment.

Before joining Bressler, Amery, & Ross, Mr. Coughlin was an Executive Director and Supervising Attorney at Morgan Stanley Smith Barney from 2009 until 2011. Between 1994 and 2009, he was in-house counsel at Citigroup Global Markets Inc./Smith Barney where he tried arbitrations and managed outside counsel. In 2008, he was promoted to Managing Director.

Between 1988 and 1994, Mr. Coughlin was an Assistant District Attorney in the Kings County District Attorney's Office, where he prosecuted multiple homicides and other felonies. In addition, he argued appellate matters before the Second Department Appellate Division.

He graduated from Rutgers Law in Newark NJ in 1988 and Rutgers University in 1985.

Beverly Davidek, Esq.
Davidek Law Firm PLLC
New Braunfels, Texas

Beverly R. Davidek has been a licensed attorney since 1994 and has been in full-time practice for most of those years. She and her husband Dirk are the co-authors of the best-selling book *Happy Lawyer: The Art of Having It All Without Losing Your Mind*. Beverly took a break from practicing law when she and Dirk owned a health and wellness center in San Antonio, Texas, and then again when they embarked upon a 14-month around the world trip. In 2017, Beverly opened her own estate planning practice in New Braunfels, Texas; and she boasts that her firm feels part wellness center/part law firm. In addition to her law license, Beverly is a former school teacher (pre-law school); and she also holds certifications as an ICF Life Coach, a nutrition coach, a blood microscopist, and a raw food chef. Her passion is educating lawyers and non-lawyers on life and legacy planning, as well as on various health and wellness topics.

Michael S. Edmiston, Esq.
Jonathan W. Evans & Associates
Studio City, California

Michael S. Edmiston is an attorney at Jonathan W. Evans & Associates in Studio City, California. He has practiced with the firm since 2006. Prior to entering private practice, Michael served as a Senior Staff Attorney with NASD Dispute Resolution (now FINRA) in Los Angeles, California (1997-2001), and as a Business Manager with JAMS in Dallas, Texas and Orange, California (2001-2005).

His practice focuses on representing investors in FINRA arbitration, private commercial arbitration forums, and in state and federal court. His work continues to result in successful recoveries for clients by way direct negotiation, mediation, arbitration, and litigation. Michael volunteers his time to Community Legal Aid SoCal working with senior citizens in a variety of civil and administrative matters. Michael is published in the PIABA Bar Journal, Practising Law Institute, Los Angeles Lawyer, the San Fernando Valley Bar Association, the New York City Bar, and various financial services industry publications.

Michael currently serves as PIABA's President (2021-2022). He joined PIABA in 2007 and was elected to the Board of Directors in 2015. He has served as the organization's Executive Vice-President/President-Elect (2020-2021), Treasurer (2017-2018), Secretary (2016), and as chair and co-chair of various committees. Michael has served and continues to serve on the PIABA Bar Journal, including as its Editor-in-Chief (2014-2015).

Michael is a 1994 graduate of Whittier College, with B.A.s in both Business Administration and Economics. In 1997, he obtained his J.D. from Pepperdine University School of Law, and was admitted to the California Bar later that same year. He received his Master's Degree in Dispute Resolution from Pepperdine in 2001.

Samuel B. Edwards, Esq.
Shepherd, Smith, Edwards & Kantas, LLP
Houston, Texas

Sam Edwards is a Houston based Securities Litigation and Arbitration attorney with a national practice. Sam and his firm – Shepherd, Smith, Edwards & Kantas – focus primarily on representing investors who have been injured. That has included the representation of individual investors, small hedge funds, community banks, pension plans and municipalities, some as large as entire state governments. Sam received his BA from the University of Texas at Austin and his law degree from the University of Houston Law Center. He began working on investment disputes while still in law school and joined his current firm shortly after graduation. Wanting to become even more specialized in this area of law, Sam made the seemingly insane decision to continue his education while also maintaining a full docket of cases, earning an LL.M. from Georgetown University Law Center in 2015 in Securities Law and Financial Regulation. He received the Thomas Bradbury Chetwood Prize at Georgetown, an award given to the student with the highest grade point average in the LL.M. program.

Sam was previously a member of FINRA's National Arbitration and Mediation Committee (NAMC), where he worked with other attorneys, both claimants counsel and respondents counsel, to help make better rules and procedures for FINRA arbitration participants. He is currently a member of FINRA's Zoom Task force where Sam is again working with both claimants counsel and respondents counsel to help FINRA develop better rules and procedures for arbitrations now that many are going forward via Zoom, rather than in person. In addition, Sam has been a member of PIABA for 20 years. Sam was previously elected as the President of PIABA and before that served on numerous PIABA committees and was the editor-in-chief of the PIABA Bar Journal. Sam has been on the PIABA Board of Directors since 2013 and remains active in the organization.

Jeffrey Erez, Esq.
Erez Law, PLLC
Miami, Florida

The founder of Erez Law, Jeffrey Erez focuses exclusively on securities arbitration and litigation. Mr. Erez passionately believes in representing aggrieved investors and obtaining justice for his clients through litigation. Mr. Erez has worked on thousands of FINRA arbitrations and other securities cases as a lead attorney or in collaboration with other lawyers, obtaining over $175 million in recoveries for investors.

Mr. Erez has tried in excess of 44 FINRA arbitration proceedings through final hearing or to award. Mr. Erez is regarded as a preeminent trial lawyer is known to dedicate the time, resources and effort to prevail at trial. In 2022, Mr. Erez and his firm obtained four consecutive awards against UBS involving the YES strategy including an award for punitive damages. In 2019, Mr. Erez obtained a $3 million sanctions award against Morgan Stanley for failing to produce records. This is believed to be the largest sanctions award ever in FINRA Arbitration. Mr. Erez has also obtained an award for clients against UBS for $4.3 million for losses in Puerto Rico closed-end funds and bonds in 2018. Mr. Erez obtained an award for a client against UBS for $2.5 million for losses in Puerto Rico closed-end funds in 2015. Mr. Erez obtained an award against Morgan Stanley for $4.5 million in 2014 in a complex international securities case. Mr. Erez obtained an award for $3.1 million against Citigroup in 2013 in a selling away case where a Citigroup broker sold an unapproved real estate investment that failed. In 2013, Mr. Erez recovered $831,000 for investors against RBC Capital related to losses in Lehman Bros. preferred stock. The award included $250,000 in

punitive damages and was the fourth time Mr. Erez recovered punitive damages for his clients. Mr. Erez obtained two $1 million dollar verdicts in 2010.

Representing a retired Air Force General, Mr. Erez obtained a verdict of over $1.1 million against Morgan Keegan for fraud involving several closed-end funds. In the same year, Mr. Erez obtained another $1 million dollar verdict for a family business, also against Morgan Keegan for fraud in the sale of mutual funds that were largely comprised of complex subprime structured financial products, which were touted as stable fixed income funds.

Mr. Erez graduated from McGill University in 1993 cum laude and received his law degree cum laude in 1996 from The University of Miami Law School. Mr. Erez is admitted to practice law in State of Florida and the U.S. District Court for the Southern District of Florida. Mr. Erez is frequently quoted in press articles regarding securities-related matters. Mr. Erez is fluent in French and Hebrew.

Jamie Falgout, Esq.
Peiffer Wolf Carr Kane & Conway & Wise
New Orleans, Louisiana

Jamie Falgout is an attorney at Peiffer Wolf Carr Kane Conway & Wise. Based in the New Orleans office, Jamie has a wide-ranging practice. While she primarily focuses her practice in the firm's products liability and pharmaceutical and medical device section, she actively assists in the representation of investors against their investment advisors and brokerage firms. Jamie is currently litigating multiple ERISA actions involving breaches of fiduciary duties on behalf of retirement plan participants and beneficiaries.

Jamie earned her Juris Doctor (JD) and Master of Business Administration (MBA) from Tulane University. She is admitted to practice in Louisiana.

Adam Gana, Esq.
Gana Weinstein LLP
Chicago, Illinois

Adam Gana is the managing partner of Gana Weinstein LLP. His practice focuses on all aspects of securities arbitration, complex commercial and business litigation. As a seasoned trial lawyer, Mr. Gana's experience includes litigation in both State and Federal Courts as well as in various alternative dispute resolution venues. As lead counsel, he has tried more than fifty cases to verdict before the state and federal trial and appellate courts, AAA, JAMS, NFA and FINRA and has served as lead counsel in hundreds more cases through mediation and direct negotiation.

Mr. Gana was named in the New York *Super Lawyers Rising Stars*® for eight straight years (an honor given to the top 5% of attorneys), ranked AV® Preeminent™ by Martindale - Hubbell™ (the highest honor offered), and ranked by the National Trial Lawyers as one of the Top 100 attorneys in the state of New York.

Carolann Gemski, Esq.
Regional Director, Midwest FINRA Office of DR Services
Chicago, Illinois

Carolann Gemski is the Midwest Regional Director for FINRA's Office of Dispute Resolution. Carolann has 30 years of experience as a litigator, compliance professional and business leader. In her current role, Carolann oversees administration of FINRA's arbitration program in 17 states.

Carolann has spent the majority of her career working in public service, including 10 years as an SEC enforcement attorney in Chicago. Prior to that, Carolann held the positions of Assistant Corporation Counsel in the General Litigation Division of the District of Columbia Office of Corporation Counsel, Special Counsel for Child Support Enforcement in Rockville, MD, and Associate in private practice in Annapolis, MD. Prior to joining FINRA, Carolann held leadership positions in Compliance at BMO Financial Group and Kaplan Higher Education.

Carolann is a graduate of the University of Chicago Booth School of Business (MBA), the American University Washington College of Law (JD, cum laude), and Louisiana State University, (BA, Journalism), and she is a member of the Bar in the District of Columbia, Maryland, and Illinois.

W. Scott Greco, Esq.
Greco & Greco, P.C.
McLean, Virginia

W. Scott Greco is the managing partner of Greco & Greco, P.C. in McLean, Virginia where he has worked his entire career. He has represented investor Claimants from Virginia and around the country in FINRA securities arbitrations and courts for over twenty years. After graduating from the University of Virginia in 1991, he received his J.D. from the College of William and Mary, Marshall-Wythe School of Law in 1994, and subsequently has been admitted to practice in Virginia, Maryland, and Washington, D.C., as well as numerous federal District and Appeals Courts. Mr. Greco has appeared as a guest lecturer at Georgetown Law School on the topic of FINRA securities arbitrations as well as lectured fellow attorneys in continuing legal education classes.

Jeffrey S. Grubman
JAMS
Boca Raton, Florida

Jeffrey Grubman, Esq. is a veteran ADR professional who has served as a mediator in over 2,000 cases in 36 states, the District of Columbia, and Puerto Rico in a wide variety of complex cases, including class actions and high impact, multi-party matters. Mr. Grubman works tirelessly to settle every case he mediates, employing a variety of creative settlement techniques. Before becoming a neutral, a significant portion of Mr. Grubman's legal practice involved securities litigation and arbitration. He had a particular expertise in FINRA arbitration matters. He worked at Morgan, Lewis & Bockius for several years during which time he represented some of the largest brokerage firms in the world. Subsequently, he was a partner at two boutique South Florida law firms and represented claimants in FINRA matters. Mr. Grubman's one and one-half decades of experience handling cases for and against brokerage firms, registered investment advisors, and other financial services companies uniquely qualifies him to evaluate securities disputes and to assist all parties in reaching a fair resolution. He understands the concerns and issues facing the investor, the broker, the brokerage firm, and their respective attorneys, and he interacts with all concerned in a respectful and professional manner. Mr. Grubman is certified by the Financial Industry Regulatory Authority (FINRA) and is a qualified arbitrator under Florida law. He is also certified by the Supreme Court of Florida as a certified Circuit and County Court mediator and by the Federal District Court for the Southern District of Florida.

Ian Hardy
President, Optima Juris

Ian Hardy is the internationally-recognized Global Deposition Expert and President of Optima Juris. An active member of the international legal community, Ian regularly consults for law firms, domestic reporting agencies, and in-house legal departments on court reporting, interpreting, and exhibit management and presentation solutions for international depositions and arbitrations. Through his work at Optima Juris, Ian proudly serves over 70% of the world's leading law firms. He is also a technology consultant for several major arbitral institutions.

A graduate of UC Berkeley and the University of Pennsylvania, Ian started out in the legal industry by working as a technical consultant and videographer at depositions and hearings taking place in Paris, France, where he lived for many years.

In 2000, Ian launched Optima Juris, a California based technology and litigation support firm offering services to leading US litigators and across Europe, quickly growing to provide services in multiple regions. Today, Optima Juris provides litigation and arbitration support services worldwide.

Ian's self-stated mission is twofold: to help the legal community by facilitating international arbitrations and depositions; and to bridge the gap between technology and legal processes to simplify attorneys' lives. After the changes wrought by Covid, Ian has been a major proponent of the possibilities emerging from remote and hybrid hearings and depositions. Specifically, the opportunity to go paperless and to present evidence electronically, across multiple screens in courtrooms as well as remotely, has been a major area of focus for Ian and for Optima Juris. Ian is excited to share the possibilities inherent in these new technologies with his colleagues in the legal industry.

Micah Hauptman
Director of Investor Protection of the
Consumer Federation of America

Micah Hauptman is the director of investor protection at the Consumer Federation of America (CFA), a nonprofit association of nearly 300 national, state, and local pro-consumer organizations. Hauptman leads CFA's investor protection work through conducting research and engaging in advocacy on investor protection issues, focusing primarily on the regulation of investment advisers, investment companies, and broker-dealers, particularly as they relate to the provision of retail investment products and services. He is also focused on restoring an appropriate balance between public and private securities markets in order to promote investor protection, market integrity, and efficiency. Prior to re-joining CFA, Hauptman served as counsel to Securities and Exchange Commission (SEC) Commissioner Caroline A. Crenshaw, where he focused on investment management issues, examinations of investment advisers, investment companies, broker-dealers, and regulatory implementation of Regulation Best Interest. Previously, Hauptman served as CFA's Financial Services Counsel for nearly seven years. Hauptman also worked at Public Citizen on a broad range of banking and tax issues and started his career as a prosecutor for the Los Angeles City Attorney's office.

Micah graduated from the University of California at Los Angeles in 2005, magna cum laude, and graduated from the University of the Pacific McGeorge School of Law in 2009, with distinction.

Angela D. Hayden, Esq.
Sage Legal, LLC
Newmarket, New Hampshire

Angela Hayden is a longtime member of PIABA and the founder of Sage Legal, LLC, a law practice located in Newmarket, NH, as well as Big LIfe Leaps Coaching (www.biglifeleaps.com) where she works with legal, financial services, and other professionals with demanding careers who are looking for more meaning in work and life. Angela addresses wellness issues in her coaching practice, helping professionals identify easy solutions to problems they are facing in their lives. She is a past PIABA board member and has served on multiple PIABA committees over the years. She started the PIABA Wellness Group in 2020, which meets online monthly. All PIABANs are welcome to join the monthly calls at any time - no work required!

Ronald Heakins, Esq.
RE Heakins Expert Services, Inc.
Pittsburgh, Pennsylvania

Ronald E. Heakins started his career in the financial service industry in May 1981 working for Paine Webber in Pittsburgh, Pennsylvania. During his time at Paine Webber he held positions as a Securities Broker and an Insurance and Tax Advantage Coordinator, training and assisting brokers on insurance and tax shelter products to assure proper suitability was undertaken during the sells process. Mr. Heakins additionally served as Account Vice President and the branch office manager for Paine Webber in Pittsburgh until August of 2000, when Mr. Heakins founded his own registered investment advisory firm, Oaktree Investment Advisors, Inc. Mr. Heakins continues to work at Oaktree Investment Advisors as founding principal and President.

Mr. Heakins has always placed extraordinary value on industry and ethical standards by pursuing a client' s best interests, adhering to FINRA standards, and ensuring proper suitability is applied to portfolio management; however, securities arbitration and mismanaged assets have become prolific industry problems. As such, Mr. Heakins has used his knowledge, expertise, and industry background to serve as a securities arbitration expert and has founded his own firm, R.E. Heakins Expert Services, Inc. wherein he assists in securities arbitration, consulting services, and trust litigation. He has consulted on 433 securities dispute/arbitration cases, and testified as expert witness in 92 of the cases.

Mr. Heakins is authorized by the Pennsylvania State Board of Accountancy to teach CPE credit courses relevant to compliance issues in the securities industry and is a graduate of the "Wharton Private Wealth Management Professional Track Program" offered through The Wharton School at the University of Pennsylvania and has also been designated as a Certified Regulatory Compliance Professional (CRCP) through the NASD Institute at Wharton. Mr. Heakins has also been certified to perform fiduciary audits by the University of Pittsburgh Katz Graduate School of Business Center for Fiduciary Studies earning the professional designation Accredited Investment Fiduciary Analyst TM (AIFA) and is a member of the National Ethics Association.

Michael Hill, Esq.
Menzer & Hill, P.A.
Boca Raton, Florida

Michael Hill's securities industry expertise is rooted from his experience as a licensed stock broker and insurance agent and later as a brokerage executive. As a brokerage executive, Michael served as a Chief Compliance Officer for two publicly-traded broker-dealers for a total of ten years. For seven years prior to his compliance roles, Michael worked as a financial advisor then later managed a trading desk.

Michael received a bachelor's degree in Mechanical Engineering with a concentration on Aerospace Systems from the United States Military Academy, West Point, NY and received his Juris Doctor sixteen years later from Nova Southeastern University, Shepard Broad Law Center. He is admitted in Florida and the U.S. District Court, Southern District of Florida and U.S. District Court, Middle District of Florida. Michael has also been an NASD/FINRA industry arbitrator since 1998 and selected for over 50 cases. He received a letter of appreciation from FINRA Dispute Resolution for having served on five full hearings in 2005, one of which as a panel chair (all while still attending law school).

Michael is an annual guest speaker on securities arbitration at Nova Southeastern University, Shepard Broad Law Center's Alternative Dispute Resolution Clinic and has served on several compliance and regulatory conference panels with FINRA and industry trade conventions when he worked on the industry side. Michael has held the series 3, 4, 7, 9, 10, 14, 24, 53, 55 and 63 registrations. He was formerly a Certified Financial Planner (CFP) and a Certified Anti-Money Laundering Specialist (CAMS). After 21 years of service, Michael received an honorable discharge from the US Army and US Army Reserves at the attained rank of Lieutenant Colonel. Michael's Army roles included company commander, platoon leader and battalion operations officer.

Nicole Iannarone, Esq.
Assistant Professor of Law
Drexel University Thomas R. Kline School of Law
Philadelphia, Pennsylvania

Nicole Iannarone teaches courses including Business Organizations, Civil Procedure, Complex Litigation, Business Arbitration, and Professional Responsibility. Her scholarship focuses on consumer disputes with professional services providers, exploring the intersection between professional regulation, dispute resolution systems, transparency, and technology. She examines average consumers' experiences in dispute resolution to identify barriers they face in entrenched mandatory arbitration forums and recommends interventions to increase consumers' access to justice. Professor Iannarone's scholarship has appeared in or is forthcoming in the *Washington Law Review, Cardozo Law Review, Stetson Law Review, Tennessee Journal of Business Law, Chicago Kent Law Review, and the University of Toledo Law Review*. She frequently is asked to share her expertise with regulatory and policy making bodies and has been invited to testify before the U.S. Securities & Exchange Commission and International Association of Securities Commissioners (IOSCO) on issues relating to consumer investor protection.

Professor Iannarone is involved in national-level engagement in communities related to her scholarly focus. She was appointed Chair of the Financial Industry Regulatory Authority (FINRA) National Arbitration and Mediation Committee (NAMC), the advisory group responsible for studying the FINRA mandatory securities dispute resolution forum and recommending changes to FINRA's board of governors, in 2021. She also serves as a public member of the Certified Financial Planner (CFP) Board of Standards Public Policy Council.

Before joining the faculty in 2019, Professor Iannarone founded the Investor Advocacy Clinic at Georgia State University College of Law where she oversaw students' representation of consumer investors with small claims in FINRA arbitration. Previously, Professor Iannarone taught at Mercer Law School and at Vanderbilt Law School. Before entering academia, Professor Iannarone was an equity partner and deputy general counsel in a litigation boutique firm where she represented plaintiffs and defendants in litigation at all levels of state and federal trial and appellate courts. Beginning with her time in law practice and throughout her academic career, Professor Iannarone has been heavily involved in service to the practicing bar, including by serving as President of the Atlanta Bar Association, President of the Atlanta Council of Younger Lawyers, Chair of the State Bar of Georgia's Professionalism Committee, Chair of the Atlanta Bar Association Reputation and Public Trust Committee and liaison to the Georgia Chief Justice's Commission on Professionalism. She is also a former chair of the AALS Section on Employee Benefits and Executive Compensation and a fellow of the American Bar Foundation. Professor Iannarone

received her JD from Yale Law School, where she served on the *Yale Journal on Regulation*, and graduated *summa cum laude* and with high honors in liberal studies from Brenau Women's College.

Scott C. Ilgenfritz, Esq.
Johnson, Pope, Bokor, Ruppel & Burns, LLP
Tampa, Florida

Scott C. Ilgenfritz is a partner in the law firm of Johnson, Pope, Bokor, Ruppel & Burns, LLP, and practices in the firm's Tampa, Florida, office. Scott has spent his entire thirty-eight year legal career with Johnson, Pope. Over the years, Scott has had a varied commercial and business litigation practice, which has included securities arbitration and litigation, commercial tort litigation, professional malpractice litigation, corporate litigation, real estate-related litigation, and contract litigation. Since 1997, Scott has been Board certified by The Florida Bar as a Business Litigation Specialist. In 1992, Scott began representing investors in claims against broker/dealers, stockbrokers, investment advisors, and other financial professionals. Since the late 1990's, a primary focus of Scott's practice has been representing investors in securities arbitration and litigation matters. Scott has been a member of the Public Investors Arbitration Bar Association ("PIABA") since 1997. He served on PIABA's Board of Directors from 2008 until 2017. Scott served as President of PIABA from November, 2012, through October, 2013. During his term as President, he authored PIABA's second expungement study. In 2017, PIABA recognized Scott as a Director Emeritus, and in 2019, PIABA recognized Scott with its Distinguished Service Award. Scott has been regularly recognized by his peers through inclusion in such publications as Florida's Super Lawyers (2007-2014) and Best Lawyers in America (2012-2022).

Elizabeth A. Kramer, Esq.
Erickson Kramer Osbourne LLP
San Francisco, California

Elizabeth Kramer is a founding partner and trial attorney at EKO. She works at the cutting edge of class action litigation. In the last 3 years, she has been a central figure in some of the largest sexual abuse class actions ever, including serving as lead counsel in litigation against USC ($215 million settlement) and against UCLA ($73 million settlement). The Daily Journal described her role as "a very active and important voice in the settlement process." Jason Ingber's Outside the Courtroom podcast referred to her as "the Queen of Class Actions." She is also a leader in the field of FinTech litigation, as the primary attorney in cases against Robinhood and Coinbase and has been interviewed by the Wall Street Journal regarding the rise of cryptocurrency litigation.

Jonathan Kurta, Esq.
Kurta Law
New York, New York

Jonathan Kurta is a Founding Partner of Kurta Law, a national law firm representing investors who have suffered financial losses as a result of stockbroker fraud. Mr. Kurta has extensive experience litigating investor disputes before Financial Industry Regulatory Authority (FINRA) arbitration panels. He has handled hundreds of cases for clients all over the U.S. and overseas. These cases often involve stocks, bonds, options, mutual funds, private placements, real estate investment trusts (REITS), structured products, and exchange-traded funds (ETFs).

Before founding Kurta Law, Jonathan Kurta worked at a large national law firm where he worked on high-profile disputes. Mr. Kurta spent his early career representing large and medium-sized brokerage firms throughout the country—an experience that makes him particularly effective when he represents investors who have been defrauded by those very same companies.

Mr. Kurta understands that for most investors, their investment portfolios represent years of hard work and sacrifice. Kurta Law works with every type of investor—empty-nesters, experienced investors, farmers, doctors, and entrepreneurs. He started his law firm to protect hardworking individuals from fraudulent brokers and greedy brokerage firms.

Jonathan Kurta has devoted himself to improving the securities industry for investors. To support this mission, he became a member of the Public Investors Arbitration Bar Association (PIABA). PIABA promotes investor education and the enforcement of securities industry rules and regulations. Throughout his career, Mr. Kurta has lectured on various issues involving securities arbitration and violations of securities laws. He is an Associate Professor at New York Law School where he teaches a class on securities litigation. When he is not fighting to recover money that has

fallen into the wrong hands, Mr. Kurta enjoys spending time with his wife and three children at home on Long Island. Mr. Kurta is, unfortunately, an avid Jets fan.

Greg A. Kyle
The Bates Group
Brooklyn, New York

Greg Kyle is a director with The Bates Group's New York office. He uses his extensive background in the securities industry, specifically investment research and fund management, to consult and provide expert witness testimony on investment management and capital market matters, including equities, fixed income, alternative investments, private placements, valuation, volatility, market manipulation and due diligence issues. As a capital markets expert, Mr. Kyle has provided analysis, written numerous expert reports, and testified in various forums including in U.S. District Courts, federal criminal cases and arbitrations.

Prior to Bates, Mr. Kyle was the founder and chief analyst for Pegasus Research, an internationally recognized investment research firm. With his firm he provided capital market analysis, as well as industry and company-specific research on public and private companies. He has also produced a number of topical studies including comprehensive financial risk analyses in conjunction with Dow Jones and Barron's, the Pegasus Strategy Insights, the Pegasus IPO Monitor, the Pegasus Credit Watch, and others. Mr. Kyle also wrote a weekly column for the Wall Street Journal Interactive edition and other financial newspapers throughout the world.

Before founding Pegasus Research, Mr. Kyle worked for Union Bank of Switzerland in Zurich, serving as the head of the North American research team where he was responsible for formulating U.S. investment policy for UBS in Switzerland. During the time with UBS in Switzerland, he also successfully managed several U.S. tranches of a global asset allocation fund. Mr. Kyle began his professional career in the investment industry with Credit Suisse Holding as a research editorial associate.

Mr. Kyle's 30 years of experience in the investment management and research sector continue today. He still actively analyzes the economy and the financial markets and publishes studies on economic and market cycles, volatility, and other capital markets topics.

Christine Lazaro, Esq.
St. John's University School of Law
Brooklyn, New York

Christine Lazaro is Director of the Law School's Securities Arbitration Clinic and a Professor of Clinical Legal Education. She came to St. John's in 2007 as the Clinic's Supervising Attorney. She is also a faculty advisor for the Corporate and Securities Law Society and the Moot Court Honor Society. Professor Lazaro holds a B.A. from New York University and a J.D. from Fordham Law School.

After graduating from law school and prior to joining St. John's, she was an associate at Davidson & Grannum, LLP, representing broker-dealers and individual brokers in disputes with clients in both arbitration and mediation, and handling employment law cases and debt collection cases. She also advised broker-dealers regarding investment contracts they had with various municipalities and government entities. Professor Lazaro is also of Counsel to the Law Offices of Brent A. Burns, LLC, where she consults on securities arbitration and regulatory matters.

Professor Lazaro is admitted to the United States Court of Appeals for the Second Circuit, the United States District Courts for the Southern District of New York, the Eastern District of New York, and the District of New Jersey and the New York and New Jersey State Bars. She is a member of the New York State and the American Bar Associations, and the Public Investors Advocate Bar Association (PIABA). Professor Lazaro is a past President of PIABA, a member of the Board of Directors, and chair of PIABA'S Fiduciary Standards Committee. Professor Lazaro is the co-chair of the Securities Disputes Committee in the Dispute Resolution Section of the New York State Bar Association. Professor Lazaro serves on the SEC Investor Advisory Committee, the FINRA Investor Issues Advisory Committee, and the CFP Board's Standards Resource Commission. She is also a member of the Editorial Advisory Board of the Securities Arbitration Alert, and occasionally contributes to its newsletter.

Professor Lazaro speaks and writes regularly on the standards of conduct governing brokerage firms and investment advisers.

Robert W. Lowry
RL Consulting Services, Inc.
Leesburg, Virginia

RL Consulting Services Inc. (RLCS) is a leading provider of expert witness and consulting services related to the regulation of broker dealers and investment advisers. RLCS, which is located outside of Washington DC in Leesburg, VA, was founded in 1996 by Robert W. Lowry.

Mr. Lowry has nearly 50 years of experience in the securities industry including 23 years with the SEC in the Division of Market Regulation and one year as a Director in the Corporate Compliance Department of Prudential Insurance. He has published articles for the Practicing Law Institute and the Public Investors Arbitration Bar Association. He is a recognized expert in the field of federal securities laws and regulations, accounting practices, capital formation and the customs and practices of the securities industry. His many clients retain him to provide expert witness services because of his unique regulatory qualifications and experience.

- Since 1996 Mr. Lowry has been retained in over 700 matters ranging from securities arbitrations, state and federal regulatory proceedings, federal criminal and civil proceedings and compliance related audits;
- He has had more than 60 engagements with federal and state government agencies including the SEC and the Department of Justice;
- He was qualified as an expert and testified in federal and state courts (civil and criminal), SEC, Finra and state disciplinary hearings, and more than 300 arbitration proceedings;
- He was qualified in matters involving suitability, best execution, market manipulation, clearing firm liability, supervision of broker dealers and investment advisers, churning, and selling away.
- He has provided consulting services to broker dealers and investment advisers; and on two occasions, he provided services as an independent compliance consultant.

Jenice L. Malecki, Esq.
Malecki Law
New York, New York

Jenice Malecki, Esq. is a well-known New York securities attorney, adjunct professor at NY Law School and has been a FINRA arbitrator and Chairperson. She represents individual and institutional investors in arbitration and litigation, as well as licensed industry participants in regulatory hearings, employment disputes and whistleblower matters. Clients include private and public companies around the world, as well as individuals, from blue-collar workers to athletes, musicians, and billionaire founders of well-known international companies. Malecki Law has represented clients in the United States, many Western European countries, India, China, Hong Kong, Singapore, Israel, Puerto Rico and in several South American countries.

Ms. Malecki is also the Co-Chair of the NYS Bar Association Commercial and Federal Litigation Section's Securities Arbitration Committee. She has been a member of FINRA's National Arbitration and Mediation Committee, on the Board of Directors (and an Officer of) of both the Public Investors Arbitration Bar Association (PIABA) and the PIABA Foundation, as well as has been a member of the Securities and Exchanges Committee at the New York City Bar Association, as well as has been a member of the American and New York State Bar Associations. She has spoken at the Practicing Law Institute (PLI), the New York City Bar Association and the New York County Lawyers Association on several panels, and at Fordham Law School, St. John's Law School, Brooklyn Law School and New York Law School, in addition to speaking at PIABA's annual conferences. Ms. Malecki has also participated in mock trials at Yale, Columbia, Albany, Fordham and FINRA.

Jenice L. Malecki's experience as a New York securities attorney began in class action litigation, In re Crazy Eddie, counsel's office of the lead plaintiffs. Throughout the 1990s she represented numerous broker dealers and was instrumental in regulatory matters against well-known "boiler room" stock fraud of the era, including working with people and firms associated with the notorious "Wolf of Wall Street." In 1999 Ms. Malecki founded her own practice, MALECKI LAW, in Manhattan.

Ms. Malecki has been a "Top Attorney" according to Super Lawyers and the National Law Journal, featured in the New York Times Magazine, New York Magazine, National Law Journal and other publications, as well as being named as one of "New York's Women Leaders in the Law 2014." Ms. Malecki is Martindale- Hubbell's highest legal ability rating of "AV Preeminent." She appears regularly on TV, in the news and on the radio. She is a frequent bar association and law school speaker, as well as a seasoned authority on New York law, who frequently files official

comments for consideration on new rules and laws. In 2014, 2015 and 2019, she visited Senators and House of Representatives members' offices to gain support for investor related laws.

Meghan L. McElligott, Esq.
Peiffer Wolf Carr Kane & Conway & Wise
Rochester, New York

Meghan McElligott is an associate at the firm's New York office. Her area of focus is representing clients in Financial Industry Regulatory Authority (FINRA) arbitrations.

She received her Juris Doctorate from the University at Buffalo School of Law in 2020. While there, she was the Editor-in-Chief of the Buffalo Environmental Law Journal. She also had the opportunity to attend the 2018 United Nations Climate Change Conference in Katowice, Poland as a student observer. The article she wrote as a student, A Framework for Responsible Solar Panel Waste Management in the United States, was published in the January 2020 edition of the Oil and Gas, Natural Resources, and Energy Journal. She remains passionate about environmental justice.

Before joining Peiffer Wolf, Meghan spent her time as a Staff Attorney at Legal Assistance of Western New York where she practiced elder law, unemployment insurance benefits law, and family law.

Prior to law school, Meghan attended the State University of New York College at Geneseo. She graduated with a degree in Geography and a minor in History. While at Geneseo, she had the opportunity to study abroad at Trinity College in Dublin, Ireland.

Meghan is a member of the New York State Bar and is a member of the Public Investors Arbitration Bar Association (PIABA). In her free time, she enjoys crafting and hiking with her dog, Linus.

Laura McNamire, Esq.
Regional Director, FINRA Dispute Resolution
Los Angeles, California

Laura D. McNamire is the Western Regional Director for FINRA Dispute Resolution Services.

Ms. McNamire joined the Los Angeles office of FINRA, then NASD, in 2002 as a Staff Attorney. In 2009, she was promoted to Regional Director. Ms. McNamire also serves as a member of FINRA's Diversity Leadership Council, supporting a culture of inclusion and diversity awareness.

Ms. McNamire was a member of the Pepperdine/Straus American Inn of Court from 2018 to 2019, and taught arbitration courses at Pepperdine University's Straus Institute for Dispute Resolution in 2016. She was also an adjunct professor at Woodbury University from 2007 to 2012, where she taught masters level courses in business ethics and conflict resolution.

Prior to joining FINRA, Ms. McNamire specialized in general litigation and worked with a sole practitioner in Los Angeles. She is a graduate of Pepperdine University School of Law (J.D.), Southern Methodist University (M.A., Applied Economics), and The University of Texas (B.A., Economics). She is a member of the California Bar.

David W. Miller, Esq.
Shepherd, Smith, Edwards & Kantas, LLP
Houston, Texas

David Miller is an associate attorney at Shepherd, Smith, Edwards, and Kantas, LLP, one of the top securities law firm in the U.S. focused exclusively on the protecting investor's rights and recovering investment losses. For more than five years, Mr. Miller has successfully represented individual and institutional investors, corporate executives, business owners, regional banks, and municipal issuers in securities-related misconduct and investment fraud matters committed by financial institutions and brokers.

Mr. Miller's career began in the financial services industry, where he served as an officer in various corporate trust and investment banking groups at major financial institutions. In these roles, he gained extensive expertise and experience with exotic financial products while acting as an indenture trustee for collateralized debt obligations (CDOs) and mortgage backed securities. Mr. Miller also gained exposure to complex derivative contracts while working with a major oil and gas corporation. In those roles, Mr. Miller gained a unique and highly valuable

perspective on dealing with complex products, which has been invaluable to Mr. Miller's clients, tilting the scales in their favor time and time again to maximize their case values and to secure successful outcomes to their claims.

In his free time, he enjoys spending time with his wife and two young children.

William Nelson, Esq.
Investment Adviser Association
Associate General Counsel
Washington, DC

William currently serves as Associate General Counsel at the Investment Adviser Association. He also currently serves as Vice Chair for the DC Bar's Corporation, Finance and Securities Law Community.

Prior to joining IAA, William served as Assistant General Counsel at CFP Board, where he was responsible for assisting with the development of CFP Board's Code of Ethics and Standards of Conduct, Sanction Guidelines, Fitness Standards, and Procedural Rules. William also developed guidance materials concerning CFP Board's standards and assisted with corporate governance matters.

Prior to joining CFP Board, William served as Chief Compliance Officer for Mercer Advisors, one of the largest independent SEC-registered Investment Advisers. In this role, William redesigned the firm's entire compliance program, including the creation of a comprehensive compliance program to assist the firm in preventing, detecting, and correcting violations of securities laws. William served as Legal Advisor to Mercer Advisors' Investment Committee and ERISA Committee and served as a subject matter expert for the organization on questions concerning legal and regulatory compliance.

William previously served as the Public Policy Counsel for CFP Board, where he drafted Amicus briefs in the Department of Labor (DOL) fiduciary cases in the Northern District of Texas and the Fifth Circuit Court of Appeals and drafted several regulatory comment letters submitted to the DOL and Securities Exchange Commission (SEC) in support of investor protection issues. He has also held multiple roles as an attorney with both the U.S. Department of Justice and the U.S. Department of Veterans Affairs.

William has served as an Adjunct Professor at the University of Denver Sturm College of Law where he taught Securities Law and an Adjunct Professor at the George Washington University Law School where he taught Legal Research and Writing. William has been published in several scholarly law journals across the country and his work has been cited in legal treatises and state and federal court decisions.

William received his undergraduate degree from the University of Tulsa, his Juris Doctorate (J.D.) degree, with Honors, from the University of Tulsa College of Law and his Master of Laws (LL.M.) degree from the George Washington University Law School.

David P. Neuman, Esq.
Israels & Neuman, PLC
Seattle, Washington

David Neuman is an attorney who has been representing the interests of investors and consumers for over a decade. Before co-founding Israels & Neuman in the Summer of 2014, Mr. Neuman worked for over seven years at a law firm in Chicago which focused its practice on representing aggrieved and defrauded investors, mostly in FINRA arbitration. Throughout his years of experience, Mr. Neuman has recovered millions of dollars in hundreds of FINRA and court cases, on behalf of clients from over 40 states, as well as investors from the international community. In addition to representing investors in FINRA Arbitration, Mr. Neuman has represented investors in numerous courts throughout the U.S., as well as represented persons deceived by their insurance brokers and parties in shareholder disputes.

Mr. Neuman is currently on the Board of Directors of PIABA. He has also chaired several committees in PIABA. He is also an arbitrator with FINRA Dispute Resolution. David Neuman is admitted to practice law in Illinois, Washington, and Florida, as well as several federal courts.

Mr. Neuman graduated with Honors from the University of Illinois in December 2001 with a B.S. in Finance. He attended the Northern Illinois University College of Law and graduated Magna Cum Laude in May 2005. While at the NIU College of Law, Mr. Neuman was on Law Review and was an Associate Justice for the Moot Court Society. In addition, during his time at the NIU College of Law, he also was a research assistant for Professor David Gaebler and researched various areas of contract, commercial, and consumer law.

Darlene Pasieczny, Esq.
Samuels Yoelin Kantor LLP
Portland, Oregon

Darlene Pasieczny ("Pah-shetch-nee") is a securities and fiduciary litigator and appellate attorney, and leads the Investor Defenders practice group at Samuels Yoelin Kantor LLP, based in Portland, Oregon. She works on all stages of securities litigation and FINRA arbitration, as well as fiduciary litigation in trust and estate disputes, elder financial abuse cases, complex civil litigation, and related appeals.

Darlene serves on the Board of Directors and Executive Committee of the Public Investors Advocate Bar Association (PIABA), and currently co-chairs PIABA's RIA Committee. She is a public member of FINRA's National Arbitration and Mediation Committee (NAMC), and active participant on NAMC's Zoom Task Force, Discovery, and Mediation subcommittees. Darlene was the 2021 Chair of the Oregon State Bar's Securities Regulation Section and selected to the 2021 and 2022 Oregon Rising Stars list for securities litigation. Her professional affiliations include admission to the Oregon State Bar, Washington State Bar, U.S. District Court for the State of Oregon, and Multnomah Bar Association.

Darlene earned a B.A. from Reed College, *Phi Beta Kappa*, M.A. from Columbia University, and J.D. from Lewis & Clark Law School, *magna cum laude*. She is a frequent speaker on FINRA arbitration, broker-dealer and RIA issues in customer disputes, trust and estate litigation, and elder financial abuse prevention, recognition, and recovery.

Kathy Phelps, Esq.
Raines Feldman LLP
Los Angeles, California

Kathy Bazoian Phelps has been a lawyer since 1991 and is currently a partner at Raines Feldman LLP in the Los Angeles office. In addition to individually serving as a fiduciary in certain matters, Kathy practices in the area of insolvency law, fiduciary representation, and fraud litigation, where she represents federal equity and state court receivers and bankruptcy trustees. Kathy frequently serves as special litigation counsel for fiduciaries and interested parties in fraud-related litigation, cases arising out of receivership and bankruptcy as well as parallel criminal and civil forfeiture proceedings. She is particularly knowledgeable about the administration of Ponzi scheme cases and has extensive litigation experience in claims arising in these types of cases.

Kathy Khas lectured widely and written on bankruptcy and receivership matters, with a focus on Ponzi schemes. Her book entitled *The Ponzi Book: A Legal Resource for Unraveling Ponzi Schemes*, co-authored with Hon. Steven Rhodes, has garnered national and international attention as the authoritative work on Ponzi scheme law.

In addition to her roles as lawyer, speaker and author, Kathy also serves as a mediator and is currently on the mediation and arbitration rosters for the Financial Industry Regulatory Authority, as well as the Bankruptcy Mediation Panel for the Central District of California and the Bankruptcy Mediation Panel for the District of Arizona.

Adam Polk, Esq.
Girard Sharp LLP
San Francisco, California

Adam Polk is a partner at Girard Sharp who concentrates his practice on complex consumer, securities, and antitrust class actions. Adam's experience covers all aspects of civil litigation, from initial case investigation and complaint preparation through settlement or trial.

Adam currently serves as co-lead counsel in *In re Subaru Battery Drain Litigation* (an ongoing consumer protection action concerning defective batteries in Subaru vehicles); and *In re Maxar Technologies Inc. Shareholder Litigation* (an action alleging violations of the Securities Act of 1933). He also serves as a court-appointed executive committee member in *In re Allergan Biocell Textured Breast Implant Products Liability Litigation* (a multidistrict litigation centering on allegedly defective breast implants pending in the District of New Jersey).

Recently, Adam served as part of the trial team in the first *In re Pacific Fertility Center Litigation* trial. In a landmark result, the jury awarded approximately $15 million for the loss of four families' eggs and embryos. Adam also served on the lead counsel teams in several recent cases that resolved favorably for his clients, including *Bentley v. LG Electronics U.S.A., Inc.* and *Sosenko v. LG Electronics U.S.A., Inc.* (class actions alleging that LG's refrigerators are defective and prone to premature failure); and *In re Nexus 6P Products Liability Litigation* and *Weeks v. Google LLC* (two consumer class actions against Google relating to defective mobile phones, which resolved for a combined

$17 million). Adam was also instrumental in achieving substantial settlements for his clients in *In re Sears Holdings Corporation Stockholder and Derivative Litigation* ($40 million settlement) and *Daccache v. Raymond James Financial, Inc.* ($150 million partial settlement).

Adam is the chair of the American Bar Association's Class Action and Derivative Suits committee, where he is a frequent contributor of written and verbal content regarding emerging issues in class action litigation.

Randall A. Pulman, Esq.
Pulman, Cappuccio & Pullen, LLP
San Antonio, Texas

Mr. Pulman has been a member of the State Bar of Texas since November of 1986. In addition to being licensed in all Texas state courts, Mr. Pulman is licensed to practice in the United States District Courts for the Northern, Southern, Eastern and Western Districts of Texas, the United States Court of Federal Claims, the United States Fifth Circuit Court of Appeals, and the United States Supreme Court.

Mr. Pulman began practicing in Houston, Texas with Stumpf & Falgout, P.C., became a shareholder in 1992, and opened the firm's branch office in San Antonio, Texas in 1994. The firm changed its name to Stumpf, Craddock, Massey & Pulman, P.C. in 2000. Pulman, Cappuccio & Pullen, LLP was founded in 2004. Sixteen years later, the law firm has gained prominence in the Texas legal market.

Mr. Pulman has represented a wide range of commercial clients in the fields of banking and creditor rights, bankruptcy, telecommunications, broker/dealer, and insurance coverage disputes. Mr. Pulman has extensive courtroom and arbitration experience, including numerous jury trials, and has argued two cases before the Texas Supreme Court and three cases before the United States Fifth Circuit Court of Appeals.

Kavita Kumar Puri, Esq.
Administrative Judge
Office of Proceedings, Commodity Futures Trading Commission

Kavita Kumar Puri serves as the administrative judge in the Office of Proceedings at the Commodity Futures Trading Commission, adjudicating cases brought by futures and forex customers against certain CFTC registered persons for alleged violations of the Commodity Exchange Act. Before becoming the administrative judge for the CFTC, she served as an appellate litigator there, defending the CFTC against rule challenges and in enforcement appeals in federal courts. Prior to joining the CFTC in 2013, Judge Puri was in private practice at Arnold & Porter in Washington, DC and Davis Pole & Wardwell in New York, focusing on financial services litigation. She graduated from Columbia Law School in 2002, after which she clerked for federal judges in the Southern District of New York and Third Circuit Court of Appeals.

Sander Ressler
Ressler Consulting Services a.k.a. Your Securities Consultants, LLC
Delray Beach, Florida

Sander Ressler, Managing Director of Essential Edge Compliance Outsourcing Services, LLC, has broad and deep expertise in financial services compliance and operations – including more than 20 years of hands-on, frontline experience with broker-dealers and registered investment advisers. Sander began his career working for a regulator and subsequently served in senior compliance positions for financial services firms including American Express, American General Life Insurance, AIG, ING, and Société Générale S.A. He has led more than 20 regulatory examinations conducted by the SEC, FINRA and various state departments governing banking, securities, and insurance.

Since launching his own consulting company, Sander has assisted financial institutions with a wide range of outsourced compliance-related services, such as written supervisory procedures, branch office inspections, review and approval of advertising, and electronic correspondence.

Sander previously held the Series 3, 4, 7, 8, 9, 14, 24, 53, 63 and 65 licenses.

Jorge L. Riera, Esq.
Riera Law
Coral Gables, Florida

Jorge L. Riera, as former Senior Counsel for the Southeast Region of the U.S. Securities and Exchange Commission (SEC), focuses his nationwide practice on investor claims against their brokers, investment advisers, advisory firms, and brokerage firms. Jorge also draws on his years of experience at the SEC to assist clients in navigating difficult SEC and FINRA regulatory examination and enforcement issues.

Before founding Riera Law, Jorge gained extensive knowledge with investment fraud and securities fraud when he served for a decade at the SEC's Division of Enforcement. In this role, Jorge led numerous investigations and enforcement actions of potential complex federal securities law violations involving financial fraud, violations by broker-dealers and investment advisers, fraudulent oil and gas offering, Ponzi schemes, unregistered offerings, market manipulation, insider trading, trading suspension, accounting fraud and disclosure fraud. As Senior Counsel at the SEC, Jorge led many high-profile enforcement actions, and received awards recognizing him for his exemplary work on investigations and his commitment to excellence.

Jorge is committed to protecting harmed investors who have misplaced their trust with brokers and investment advisers, and helping them recover their hard-earned life savings. While serving at the SEC, he demonstrated his commitment by vigorously pursuing bad actors who committed investment fraud and securities fraud on behalf of thousands of harmed investors and successfully brought enforcement actions against them to hold them accountable for their misconduct.

Jorge has also served as in-house counsel regional compliance director for HSBC Bank North America's global banking, market and corporate businesses. As part of his role, Jorge led the transformation of HSBC's compliance and risk management function and was heavily involved in critical regulatory projects involving regulatory expectations for enterprise, compliance, and conduct risk management, and helping establish conduct-risk functions. His prior experience as an SEC regulator and director of compliance provides a unique background and strategic perspectives on how to identify and satisfy regulatory expectations.

Before commencing his legal career, Jorge practiced as a CPA. With his experience as a CPA, he has the ability to analyze the damages and trying to attribute the damages to the alleged bad acts. In cases involving claims for monetary or lost profits damages, clients will generally be able to recover damages only if it can be demonstrated that the breach or other wrongful act committed by the bad actor was the reason for the loss.

He has a business degree in Finance and International Business, with honors, from Florida International University, a masters degree in accounting, with highest honors, from Nova Southeastern University, and a law degree, with honors, from Nova Southeastern University, where he served as a member and board member of the NSU Law Journal and NSU Trial Association (f/k/a Association of Trial Lawyers of America).

Frederick W. Rosenberg, Esq.
Frederick Rosenberg, JD
East Hampton, New York

Frederick Rosenberg JD is a long term Piaban. He is retired from active legal practice to focus on forensic consulting. He has over 45 years in the financial industry and legal profession, and has experience as a bank auditor, principal owner of a NASD broker/dealer and licensed as a series 24 general principal and series 4 Registered Options Principal. He has managed a 250 Million foreclosed asset portfolio for a major bank and served as a VP of private equity investing between $10 and $15 million.

Over the past 20 years he has been retained in over 300 securities disputes and has testified on damages, non-conventional investments, supervision, and reasonable basis and customer basis suitability. He has written articles published in the Piaba Bar Journal on Damages, oil and gas due diligence, Tenancies in Common, 72T and variable annuities. His most recent article "What I Learned from Covered Calls" is the latest in several articles on Options.

Gary M. Saretsky, Esq.
Saretsky Hart Michaels & Gould
Birmingham, Michigan

Gary has defended more than 1,000 securities, commercial, and employment lawsuits and arbitration claims, and he regularly advises and represents clients in matters before federal and state regulators. Gary is also a frequent presenter at industry conferences such as the Midwest Securities Law Institute and the Independent Broker Dealers Conference. He is a certified arbitrator and mediator for FINRA and the AAA, and privately mediates a wide range of business disputes, including FINRA arbitration claims and business break-ups.

Gary's "track record" of success as a litigator is outstanding. Results are an absolute priority for Gary, whether he is defending an alleged sales practice violation, handling a recruitment or restrictive covenant dispute, or working with (and if need be, against) regulators to help a client obtain or preserve their registration. The regulatory world has become increasingly threatening and contentious for financial and insurance professionals, and Gary's experience and relationships with regulators benefit his clients.

Gary has a national practice, with a concentration in the Midwest. Gary is admitted to practice law in 9 states: Michigan, Ohio, Indiana, Illinois, Minnesota, Wisconsin, Colorado, Texas and Arizona. He is also admitted to practice before numerous United States District Courts throughout the Midwest, the United States Courts of Appeals for the Sixth and Eleventh Circuits, and the United States Supreme Court.

As a founding shareholder of the firm, Gary is proud that Saretsky Hart Michaels + Gould offers something refreshing and unique to clients. The firm's office reflects a fresh and creative vision. The firm has a clear sense of purpose and laser focus. Instead of attempting to be "all things to all people," the firm embraces the idea that the modern practice of law demands the highest level of specialization to meet clients' needs. The firm's roster of representative clients is enviable, and the firm has grown organically. Knowing that every law firm's most precious resource is its human capital, the firm invests in the professional development of its lawyers through an extensive training and mentoring program. The end result is that Saretsky Hart Michaels + Gould is known for delivering outstanding, value-driven client services, as well as offering lawyers a collaborative, harmonious, supportive team work environment.

Gary graduated from the University of Michigan with a Bachelor of Arts degree (with high distinction) in 1977. While in Ann Arbor, he was the recipient of the William J. Branstrom Freshman Prize and he was a James B. Angell Scholar, and Gary is currently a Member of the Advisory Board to the University's "Michigan in Washington" Program. Gary graduated from the Wayne State University Law School in Detroit, Michigan in 1980. He was Vice Chancellor of the school's Moot Court Program. Prior to founding Saretsky Hart Michaels + Gould, Gary was a principal shareholder in Hertz, Schram & Saretsky, P.C.

Birgitta Siegel, Esq.
Law Offices of Birgitta Siegel
Cornell Law School
Poughkeepsie, New York

Birgitta Siegel advocates for investors both as Adjunct Professor of Law in the Cornell Securities Law Clinic and as counsel in private practice. At Cornell Law School, Prof. Siegel also teaches Advanced Writing on topics concerning evolving digital assets du jour. In private practice, she handles investor arbitrations on behalf of customers only. She also mediates disputes in the space of film/tv production and development.

Professor Siegel is a longstanding, active member of the Public Investors Advocate Bar Association ("PIABA"), where she has Chaired its Self-Regulatory Organization Committee, written and edited for its Bar Journal, served on its Amicus Committee, attended Hill Day events to promote investors' rights, and more.

Prior to joining PIABA, Ms. Siegel spent years on the 'other side of the street'. After graduating from University of Miami Law School, she joined a preeminent law firm at the forefront of broker-dealer representation. Thereafter, she was hired away by a broker/dealer client in NYC, where she managed class actions, complex litigations such as those involving securitized assets, and other mass actions/arbitrations.

Ms. Siegel has appeared on investor education television panels, and presented CLE instruction offered through PIABA, state bar groups and other sponsors.

Jeffrey R. Sonn, Esq.
Sonn Law Group, PA
Aventura, Florida

For the last 33 years, Jeffrey Sonn focuses his practice principally on securities litigation and arbitration, class actions and business litigation. Mr. Sonn is the managing partner of Sonn Law Group, and has handled over 1,000 of securities cases in his career. Mr. Sonn has been rated as a "Superlawyer" and is "AV" rated by Martindale Hubbell.

In class actions, Mr. Sonn currently serves as class counsel in the In re: Woodbridge Litigation ($1.2 billion Ponzi Scheme), as class counsel in the Equialt Inc. Ponzi ($180 million Ponzi Scheme), as class counsel in 1 Global Financial Ponzi ($280 million Ponzi), and as class counsel in the Yieldstreet private placement action ($90 million in losses).

Mr. Sonn serves as a Director of the Public Investor Arbitration Bar Association (PIABA). Mr. Sonn is the author of many securities related articles, including Top Ten Things to Do During a Final Hearing (PIABA), Top Ten Mistakes to Avoid in a Final Hearing (PIABA), Elder Abuse and the Securities Industry (PIABA), and Ponzi Schemes, Picking up the Pieces from a Fallen House of Cards ("Securities Arbitration in the Meltdown Era" Practicing Law Institute, 2009).

During his career, Mr. Sonn has litigated numerous cases to successful resolution, recovering hundreds of millions of dollars for victims of investment fraud. He won a $50 million final judgment in Katz v. MRT Holdings. Mr. Sonn also served on the Plaintiffs' Steering Committee that successfully negotiated a $151 million dollar settlement for hundreds of investors who were the victims of the Medical Capital/Provident Shale Royalties Ponzi Schemes.

Mr. Sonn has acted as trial counsel to verdict in a number of successful cases, including First Union vs. the FDIC and Hollywood Associates (a $16 million dollar verdict), Madhany v. Citgroup ($11.1 million verdict), Regas v. Painewebber (a $2.2 million dollar verdict), and Tartell v. Krieger Financial ($1.7 million dollar verdict). Mr. Sonn has also served as counsel to United States Bankruptcy Trustees, Liquidating Trustees, and Court appointed Receivers.

Mr. Sonn has served as a legal correspondent and commentator on securities fraud and Ponzi schemes for CNBC, CBS, BBC Radio, ABC and MSNBC. Mr. Sonn served as a CNBC legal contributor on the Bernard Madoff Ponzi Scheme for the CNBC shows "On the Money" and the documentary "Scam of the Century, Bernie Madoff and the $50 Billion Dollar Heist."

Mr. Sonn also appeared on the television show "American Greed" on CNBC, about the $1 Billion Dollar Ponzi Scheme by convicted Fort Lauderdale attorney Scott Rothstein. Mr. Sonn represented victims in the Rothstein case and pushed the Rothstein law firm into bankruptcy when the fraud was first discovered.

Mr. Sonn graduated from the University of Florida in 1984 and from University of Miami Law School in 1988, where he was an Associate Editor of the University of Miami InterAmerican Law Review. Mr. Sonn is admitted to practice in the State of Florida, the United States District Courts for the Southern and Middle Districts of Florida, and the 11th Circuit Court of Appeals.

Debra G. Speyer, Esq.
Debra Speyer Law Firm
Bala Cynwyd, Pennsylvania

Debra G. Speyer is principal of the Law Offices of Debra G. Speyer and handles arbitrations throughout the United States. When she is not at her law office, she can be found on her solar powered farm raising heritage Scottish long horned Highland cattle, Galloway cattle, Llamas, and Dorper and Kahadian sheep.

Before going into private practice in 1990, Debra was an attorney with the Enforcement Division of the National Association of Securities Dealers (now known as FINRA) prosecuting brokerage firms and stockbrokers for investment fraud and regulatory violations. Prior to that, she was an attorney and vice president with Thomson McKinnon Securities, Inc., an international brokerage firm which later merged with Prudential Securities. While at Thomson McKinnon, she passed every stockbroker and brokerage firm examination that the securities industry offered, including all options and commodities examinations.

Debra holds a law degree, a master's degree in finance with a thesis on program trading and stock markets, and a bachelor's degree in accounting. Prior to entering law school, she was an accountant. She has been listed in Philadelphia Magazine's Best Lawyers, SuperLawyers, Suburban Magazine and Mainline Magazine for her work handling securities fraud and elder law matters. She is also listed in Who's Who in American Law and Who's Who in

America. She was honored by the National Organization of Women Business Owners with their "Women Making History" award. Debra is a member of the Million Dollar Advocates Forum for her securities arbitration work. The Million Dollar Advocates Forum is limited to attorneys who have won million - and multi-million-dollar verdicts and settlements.

Debra is a frequently invited guest speaker for business, professional and non-profit organizations, and is a legal commentator for radio talk shows and television. She has appeared on Wall Street Journal Radio, NBC TV, CNN Financial News TV, CNBC TV's "Wake Up Call" and "Power Lunch Financial News," The Suzanne Show, Anderson Cooper 360, CN8 TV, Fox News, and WB17, as well as Comcast TV's "Legal View" with the Securities and Exchange Commission Director speaking on topics related to securities fraud. Debra has written extensively about investment fraud and elder fraud, and those articles have appeared in various newspapers and magazines. She is frequently quoted in periodicals such as Newsweek, Kiplinger's Magazine, USA Today, Crain's New York Business, American Banker, The Street.com, Securities Week, Investment News, Registered Representative Magazine, the Philadelphia Inquirer, and Long Island's Newsday.

Debra is a lecturer for the Pennsylvania Bar Institute, Philadelphia Bar Association, AAJ, NBI, Public Investors Arbitration Bar Association and other continuing legal education programs on the subject of investment fraud, elder fraud, and elder law. She has been a co-lecturer with the Pennsylvania Securities Commissioner on the subject of investment fraud. She is co-chair of the Pennsylvania Bar Institute's annual course "Legal Issues in an Age of Aging," and was chair of an elder fraud conference in conjunction with the Philadelphia Corporation for Aging, the purpose of which was to educate senior citizens on how not to become victims of fraud. She was on the Lawyer Advisory Board of the Pennsylvania Securities Commission until that Board dismantled. She has also been an adjunct professor at Drexel Law School.

Debra has been chair of the Elder Law Committee, and is a member of the Securities Regulations Committee of the Philadelphia Bar Association. She was co-chair of the American Trial Lawyers Association's (now known as AAJ) Investment Fraud Committee of the Business Tort's Section, and serves on various committees and subcommittees of the American Bar Association, International Bar Association, Pennsylvania Bar Association, Public Investors American Bar Association, AAJ, Connecticut Bar Association, Florida Bar Association, New York State Bar Association and DC Bar Association. She is also an arbitrator for FINRA.

Pro bono work is an integral part of her law practice. She is on the Farmer Advisory Council of Waterkeepers Chesapeake which addresses environmentally responsible farming practices. She is on numerous other non-profit boards including AMIT Children in which she received an award from the organization for her fundraising efforts on behalf of abused and disadvantaged children.

Melinda Steuer, Esq.
Law Offices of Melinda Jane Steuer
Sacramento, California

Melinda Jane Steuer has spent her legal career working on behalf of savers, investors and retirees from all backgrounds and financial situations. Since 2001, she has successfully litigated and resolved disputes between investors and their financial advisors. Ms. Steuer has handled all aspects of securities litigation and arbitration on a wide range of issues including fraud/misrepresentation, breach of fiduciary duty, unsuitable investment advice, excessive trading/churning, and failure to supervise. Ms. Steuer has litigated cases involving early retirement pension cash-outs, variable annuities, stocks, bonds, mutual funds, options, alternative investments, life insurance and annuity products, and real estate investments. Ms. Steuer also represents financial professionals in employment-related disputes. Ms. Steuer has been counsel in multiple cases yielding seven figure awards/settlements to represented investors.

Ms. Steuer received her law degree from McGeorge School of Law in May of 2001, (in the top 10 percent of her class) with honors of Order of the Coif, and graduation With Great Distinction. Ms. Steuer received her undergraduate degree from University of California, Davis with majors in Political Science and German.

Ms. Steuer has been admitted to practice before all California courts, the Ninth Circuit Court of Appeals, and the Federal District Courts for the Eastern District, Northern District, Central District and Southern District of California.

Ms. Steuer is a member of the Public Investors Advocate Bar Association ("PIABA").

Ms. Steuer opened her own practice in February of 2012 following more than a decade serving as the sole associate for Howard M. Hoffman [attorney for plaintiff in the landmark California securities case of Duffy v. Cavalier].

Sean M. Sweeney, Esq.
Halling & Cayo S.C.
Milwaukee, Wisconsin

Sean M. Sweeney's practice focuses on securities fraud, business litigation and civil litigation. He has been a member of PIABA since 2009 and is a current member of FINRA's National Arbitration and Mediation Committee (NAMC).

Sean earned his Juris Doctor (JD) and Masters of Business Administration (MBA) from Marquette University. He earned his Bachelor of Science Degree in Business Economics from Northern Arizona University.

Sean and his team offer Flat Fees on complex business litigation cases. You can learn more about flat fee business litigation at www.hallingcayo.com/flatfees. He also runs www.The-Securities-Lawyers.com, in which Halling & Cayo's Securities Litigation team discusses securities fraud, stockbroker employment disputes, and FINRA arbitration.

Patricia L. Vannoy, Esq.
Mattson Ricketts Law Firm
Lincoln, Nebraska

Patti Vannoy is a partner at Mattson Ricketts Law Firm, where she focuses her practice on investors' rights and related issues. She has represented more than 400 clients with claims involving private placements, real estate investment trusts, variable annuities, life insurance, and all manner of securities, including cases against broker-dealers, registered investment advisers, insurers, and clearing firms. She has also led work on bad faith claims related to the financial services industry, against both errors and omissions and directors and officers insurers, and has represented whistleblowers seeking protection under the Dodd-Frank Act and Sarbanes-Oxley. She also serves as a Commissioner on the Nebraska Commission of Industrial Relations. Before practicing law, Patti worked as a reporter and editor with major newspapers in the Midwest.

Carol C. Villegas, Esq.
Labaton Sucharow LLP
New York, New York

Carol C. Villegas is a Partner in the New York office of Labaton Sucharow LLP. Carol focuses on prosecuting complex securities fraud and consumer cases on behalf of institutional investors and individuals. Leading one of the Firm's litigation teams, she is actively overseeing litigation against AT&T, Nielsen Holdings, Mindbody, Danske Bank, Peabody Energy, Flo Health, Amazon, and Hain. In addition to her litigation responsibilities, Carol holds a variety of leadership positions within the Firm, including serving on the Firm's Executive Committee, as Chair of the Firm's Women's Networking and Mentoring Initiative, and as the Chief of Compliance. She also leads the Firm's ESG Taskforce, which provides clients with tailored advice regarding corporate responsibility and environmental, social, and corporate governance risks and opportunities.

Carol's development of innovative case theories in complex cases, her skillful handling of discovery work, and her adept ability during oral arguments has earned her accolades from *Chambers & Partners USA*, *The National Law Journal* as a Plaintiffs' Trailblazer, and the *New York Law Journal* as a Top Woman in Law and a New York Trailblazer. *The National Law Journal* "Elite Trial Lawyers" has repeatedly recognized Carol's superb ability to excel in high-stakes matters on behalf of plaintiffs and selected her to its class of Elite Women of the Plaintiffs Bar. She has also been recognized as a Future Star by *Benchmark Litigation* and a Next Generation Partner by *The Legal 500*, where clients praised her for helping them "better understand the process and how to value a case." *Lawdragon* has named her one of the 500 Leading Lawyers in America, one of the country's top Plaintiff Financial Lawyers, and Leading Plaintiff Consumer Lawyers and Crain's New York Business selected Carol to its list of Notable Women in Law. *Euromoney's* Women in Business Law Awards has also shortlisted Carol as Securities Litigator of the Year and *Chambers and Partners* named Carol a finalist for Diversity & Inclusion: Outstanding Contribution.

Carol has played a pivotal role in securing favorable settlements for investors, including DeVry, a for-profit university; AMD, a multi-national semiconductor company; Liquidity Services, an online auction marketplace; Aeropostale, a leader in the international retail apparel industry; Vocera, a healthcare communications provider; Prothena, a biopharmaceutical company; and World Wrestling Entertainment, a media and entertainment company, among others. Carol has also helped revive a securities class action against LifeLock after arguing an appeal before the Ninth Circuit. The case settled shortly thereafter.

Prior to joining Labaton Sucharow, Carol served as the Assistant District Attorney in the Supreme Court Bureau for the Richmond County District Attorney's office, where she took several cases to trial. She began her career as an Associate at King & Spalding LLP, where she worked as a federal litigator.

Lindsay Walsh
Securities Consultant
Thomson Reuters Case Center

Lindsay is a legal software professional who provides workflow analysis and subject matter expertise to legal professionals around the world.

Hailing from the United Kingdom, Lindsay had the opportunity early in his career to work with UK police forces, gaining insight into the file preparation and administration that underpins the successful prosecution of justice.

For the past 5 years Lindsay has represented the Thomson Reuters Case Center product, assisting clients to modernize and improve their justice offering by digitizing their evidence management and presentation process. Lindsay's dynamic and personal approach draws from a wide range of experience, working with clients from the UK and US to Dubai, South Africa and beyond.

Eric Werner, Esq.
Associate Director, Securities and Exchange Commission
Fort Worth, Texas

Eric Werner is the Associate Director of the Securities and Exchange Commission's Fort Worth Regional Office, where he heads the agency's enforcement activities in Texas, Oklahoma, Arkansas, and Kansas. Prior to his appointment as Associate Director, Mr. Werner worked in the SEC's Division of Enforcement as an investigative staff attorney, in the Office of Chief Counsel, and in supervisory positions as Branch Chief and Assistant Director where he was a member of the Complex Financial Instruments Unit and the Public Finance Abuse Unit. Mr. Werner has worked on matters involving virtually every aspect of the securities markets, including financial fraud, hedge funds, insider trading, market manipulation, municipal securities, offering fraud, broker-dealers, and investment advisers. Mr. Werner earned his law degree from the Washington University School of Law and his undergraduate degree from Occidental College.

Adam J. Weinstein, Esq.
Gana Weinstein LLP
New York, New York

Adam Weinstein is a partner with Gana Weinstein. Mr. Weinstein's practice focuses on all aspects of securities and commercial litigation. He has successfully represented hundreds of investors, business owners, and companies in litigation brought through arbitration, State, and Federal courts.

Mr. Weinstein brings a unique background and experience to the firm. Prior to practicing law, Mr. Weinstein worked for companies in the areas of business consulting, manufacturing and supply chain management, marketing, and insurance. Having studied the business methods and operations of companies large and small, Mr. Weinstein brings more than just an understanding of the legal issues presented to his work.

Mr. Weinstein was named in the New York *Super Lawyers Rising Stars*® in 2013 and has been published in the Westlaw Journal and PIABA Law Journal.

Courtney Werning, Esq.
Meyer Wilson Co., LPA
Columbia, Ohio

Courtney Werning leads the investor claims practice group at Meyer Wilson based in Columbus, Ohio. She devotes her practice to the representation of investors who have claims against their financial professionals, investment advisers, and brokerage firms. Her practice includes litigation in state and appellate courts and various alternative dispute resolution forums. She has tried arbitrations to verdict before the Financial Industry Regulatory Authority, the National Futures Association, and the American Arbitration Association.

Courtney excels at aggressively preparing from day one to take a case to trial, which strengthens the chance for a successful outcome for her clients. Courtney's recent civil cases and arbitrations have involved allegations related to

unsuitable investment strategies, fraud and misrepresentation, Ponzi schemes, legal malpractice, elder financial abuse, securities act claims, and securities class actions.

Joseph R. Wojciechowski, Esq.
Stoltmann Law Offices
Barrington, Illinois

Joe Wojciechowski is the managing partner at Stoltmann Law Offices and has been a licensed attorney since November 2009. He has been with Stoltmann Law Offices since March 2005. Prior to Stoltmann Law Offices, he had a short stint as a paralegal with a Chicago securities defense firm, Mallon & Johnson. He is responsible for the day to day operations of the firm, docket and case management. Personally, he handles all aspects of case management from potential client/case intake to trying the case. He has been named class counsel representing investors in class actions and has successfully briefed motions to vacate arbitration awards before the Central District of California, Northern District of Illinois, and participated in appeals before the Ninth Circuit Court of Appeals.

Joe has appeared before FINRA arbitration panels in close to a thousand cases and successfully mediated over two hundred investor cases. He also practices in the Circuit Court of Cook County, Circuit Court of DuPage County, Northern District of Illinois, American Arbitration Association ("AAA") both under the Commercial Rules and Consumer Rules, and the Judicial Arbitration/Mediation Services (JAMS). His legal practice experience is mostly in representation of investor interests, whatever the venue. He also represents students defrauded by for-profit colleges and universities.

Joe has been a member of PIABA since 2009 and has participated as a member of the SRO committee, annual meeting committee, and other subcommittees on discovery abuses and E-discovery. He is a former Editor-in-Chief and Managing Editor of the PIABA Bar Journal, previously authored the “Cases and Materials" article which appears in every journal, and has previously authored “Investors, Cornered.”

James S. Wrona
FINRA, Vice-President and Associate General Counsel
Washington, DC

James S. Wrona is Vice President and Associate General Counsel for the Financial Industry Regulatory Authority (FINRA) in Washington, DC. In this role, he is responsible for various policy initiatives, rule changes and litigation regarding the securities industry. Mr. Wrona formerly was associated with the law firm of K&L Gates LLP, where his practice focused on complex federal litigation. He also previously served as a federal law clerk for the Honorable A. Andrew Hauk of the United States District Court for the Central District of California (Los Angeles). Mr. Wrona is a frequent speaker at securities and litigation conferences and author of numerous law review articles, including *The Best of Both Worlds: A Fact-Based Analysis of the Legal Obligations of Investment Advisers and Broker-Dealers and a Framework for Enhanced Investor Protection*, 68 BUS. LAW. 1 (Nov. 2012); *The Securities Industry and the Internet: A Suitable Match?*, 2001 COLUM. BUS. L. REV. 601 (2001).

Gordon Yale
Yale Forensics
Denver, Colorado

Gordon Yale is the principal of Yale Forensics, a Denver-based forensic accounting and financial consulting firm specializing in securities fraud and professional negligence matters as well as the former CEO of Yale Group, Inc., a boutique investment bank. Mr. Yale has been engaged to conduct investigations or provide expert testimony by the Securities & Exchange Commission, the Colorado Board of Accountancy, the Florida Attorney General, the Hawaii Insurance Commission as well as institutional and retail investors.

Mr. Yale has extensive experience analyzing debt and equity securities, primarily focusing on the adequacy of disclosure and due diligence in private and public offerings. He has written on accounting and auditing issues for both business publications and professional journals, including *Financial Executives International Research Foundation, American Banker*, *Fraud Magazine, the Journal of Credit Risk Management* and the *American Bar Association Officer’s and Director’s Liability Law Journal*.

Mr. Yale has taught financial analysis to law enforcement agencies, lawyers and accountants and was an adjunct faculty member at the University of Denver from 2003 through 2008 where he taught forensic accounting. Mr. Yale received a Bachelor of Arts from the University of Colorado in 1970 and a Master of Accountancy from the University of Denver in 1977.

Mike Yan
Securities Litigation and Consulting Group, Inc.
McLean, Virginia

Dr. Yan is Principal at SLCG Economic Consulting, LLC. He received his B.S. in Applied Mathematics from Fudan University in Shanghai, P.R. China and his Ph.D. in Applied Mathematics from University of California, Davis.

At SLCG, Dr. Yan worked on litigation cases involving municipal bonds arbitrage strategy, interest rate swaps, credit default swap, structured notes, structured CD, equity index annuity, auction rate securities, leverage and inverse leveraged exchange traded funds, privately-held business valuation, security valuation, and bank proprietary Indexes. Dr. Yan also specialized in large data analysis and worked on projects involving Cryptocurrency tradings, future and option tradings, and opioid shipments and dispensing.

Dr. Yan has published various papers in finance and applied math journals. He specializes in the fields of data analysis, statistics, applied mathematics, optimization and modeling. His doctoral work focused on the stability and resolution analysis in the imaging science.

Philip M. Aidikoff, Esq., *Director Emeritus*
Aidikoff, Uhl & Bakhtiari
Beverly Hills, California

Philip M. Aidikoff is a partner in the law firm of Aidikoff, Uhl & Bakhtiari and exclusively represents clients in securities arbitration and litigation. Mr. Aidikoff graduated from the University of California at Berkeley in 1969 where he was on the Dean's List and obtained his Juris Doctor degree from Southwestern University School of Law in 1975 where he was a member of Law Review. He is a past President and Director Emeritus of the Public Investors Arbitration Bar Association (PIABA). He served a five-year term (with three years as chair) on the National Arbitration and Mediation Committee of FINRA (formerly the NASD) which provides recommendations on rules, regulations and procedures governing arbitrations, mediations and dispute resolution. He served as one of three public members of the Securities Industry Conference on Arbitration (SICA), which was created with the support of the Securities and Exchange Commission to help protect the interests of public investors in securities arbitration. He also served as one of two investor advocates on the Securities Investor Protection Corporation (SIPC) Modernization Task Force. He served as a member of the FINRA Arbitration Task Force (2014-2015) which provided recommendations aimed at improving the transparency, impartiality and efficiency of securities arbitration. Mr. Aidikoff was recognized as a 2005, 2006, 2007, 2008, 2009, 2010, 2011, 2012, 2013, 2014, 2015 and 2016 Southern California Super Lawyer and was profiled in the February 2012 issue of Southern California Super Lawyers Magazine. He was also named by the National Law Journal as one of the 50 Litigation Trailblazers & Pioneers (2014). His legal rating as an attorney is the highest available "AV".

Mr. Aidikoff has spoken before numerous professional and lay groups on the topic of stockbroker abuse and the handling of arbitration and litigation involving brokers and firms. He has authored or co-authored a number of articles including: *Broker Abuse: Recovering for your Client*, Los Angeles Trial Lawyers Advocate (1993); *Take it or Leave it: Case Evaluation and Retention*, Practicing Law Institute Securities Arbitration Handbook (1995); *Recognizing and Evaluating Stockbroker Liability*, Consumer Attorneys Association of Los Angeles Convention (1995); *The Brave New World of Banks Selling Securities: Offline and Online*, Practicing Law Institute Securities Arbitration Handbook (1996); *Stockbrokerage Firm Liability: A Pre-Litigation Analysis*, Consumer Attorneys Association of Los Angeles Advocate (1996), reprinted in the Arizona Trial Lawyer Association Advocate (January 1997); *Recognizing and Guarding Against Fiduciary Abuse*, National Guardianship Association Annual Convention (1996); *Control Person Liability in the Securities Industry: A Legal Overview and Practical Applications*, Practicing Law Institute Securities Arbitration Handbook (1997); *Liability of Control Persons at Second Tier Firms*, Public Investors Arbitration Bar Association (1997); *Clearing Firm Liability: A Forward Looking Analysis*, Practicing Law Institute Securities Arbitration Handbook (1998); *Why Shouldn't Clearing Firms be Liable*, Public Investors Arbitration Bar Association (1998); *Motion Practice in Securities Arbitration: A Claimants Point of View*, Public Investors Arbitration Bar Association (1999); *Selective Recession and the Offset Defense in Securities Cases: A Survey of the Law,* Public Investors Arbitration Bar Association (2000); *After the Correction: Are Your Losses Recoverable?*, American Pathology Foundation (2001); *2001: An Update On Best Execution and Suitability Standards For Online Trading*, Public Investors Arbitration Bar Association (2001); *Arbitration: Can It Be Waived?*, Practicing Law Institute Securities Arbitration Handbook (2002); *Comments on The Claimants Bar On Proposed Changes In The Expungement Process*, The Association of the Bar of the City of New York (2002); *Due Diligence or Dont: Pre-Filing Considerations and Claim Drafting*, Public Investors Arbitration Bar Association (2003); *Confidentiality and Compliance Manuals: The Fight for Unfettered Access*, Public Investors Arbitration Bar Association (2004), republished in the Practicing Law Institute (2005); *From Wall Street to Main Street: A Guide to Litigation Over Hedge Funds Sold by Brokerage Firms to Retail Investors,* Public Investors Arbitration Bar Association (2005); *I Didn't Say That / Oh Yes, You Did: The Use of Court Reporters in Securities Arbitration,* Public Investors Arbitration Bar Association (2005); *Third Party Money Managers: Brokerage Firms Duty to Monitor and Resulting Liability*, Practicing Law Institute (2005); *A Practical Guide To The New NASD Code of Arbitration Procedure For Customer Disputes,* Practicing Law Institute Securities Arbitration Handbook (2006); republished Public Investors Arbitration Bar Association (2006); *Trying Asset/Mortgage Backed Securities Cases: A Practical Guide*, Public Investors Arbitration Bar Association (2007); *Wall Street Does It Again: The Auction Rate Securities Fraud,* Public Investors Arbitration Bar Association (2008); *The Prospectus Defense: Defeating It As A Matter of Fact and Law,* PIABA Bar Journal, *Vol. 16, No. 4* (2009); *Discovery of Regulatory Documents: Debunking the Myth of the SEC Privilege in Securities Arbitration*, Public Investors Arbitration Bar Association (2010); *Arbitrators Misclassified: Looking Back to Move Forward,* PIABA Bar Journal *Vol. 18, No. 1* (2011); *Discoverability Of Wells Submissions: What They Are And How To Get Them,* PIABA Bar Journal *Vol. 19, No. 2* (2012); *FINRA Six–Year Eligibility Rule 12206: The Purchase Date is Often Not the Triggering "Occurrence or Event Giving Rise to a Claim",* PIABA Bar Journal *Vol. 20, No. 1* (2013); *Market Adjusted Damages in the FINRA Forum*, PIABA Bar Journal *Volume 21, No. 2* (2014), reprinted in the Consumer Attorneys Associations for Southern California Advocate (April 2016); and most recently published *The Use of Third Party Subpoenas to Determine a Brokerage Firm's Pre-Hiring Due Diligence and Post-Hiring Supervision*, Public Investors Arbitration Bar Association (2015).

Mr. Aidikoff has served on the faculty of the Practicing Law Institute (1996, 1997, 2002), NASD Fall Securities Conference (2002, 2004, 2005, 2006), NASAA Enforcement Conference (2002, 2004), NASAA Attorney/Investigator Training Conference

(2006), University of Cincinnati School of Law Symposium-Twenty Years after Shearson v. McMahon (2007), SCMA Conference (2005), NERA Securities Litigation Seminar (2004), New York City Bar Securities Arbitration program (2002), Los Angeles County Bar Association Securities Arbitration program (2006, 2011, 2013 and 2015), the NASD faculty for training of discovery arbitrators, and on the JAMS faculty for training of securities arbitrators. He was a member of the NASD Neutral Roster Task Force (2005-2006), the FINRA Arbitrator Training Task Force (2009- 2010), FINRA Discovery Guide Task Force (2010–2013) and National Roundtable on Consumer and Employment Dispute Resolution, Pepperdine University 2012. He has appeared on CNBC, CNN/fn, PBS Nightly Business Report, National Public Radio, CBS Radio, and the Business Channel addressing investor rights topics, and has been quoted on securities matters in the Wall Street Journal, the Dow Jones News Service, Newsweek, Reuters, Fortune Magazine, Business Week, Money Magazine, Bloomberg News Service, Forbes, Medical Economics, Registered Representative, The New York Times, USA Today, The Los Angeles Times, The Washington Post and other national and local press. For five years he wrote a weekly column in the Palm Springs Desert Sun on issues of interest to investors. (www.securitiesarbitration.com)

Robert S. Banks, Jr., Esq., *Director Emeritus*
Samuels Yoelin Kantor, LLP
Portland, Oregon

Bob Banks has been practicing law for 36 years. He represents individuals and businesses in disputes with financial advisors, legal malpractice cases, and in business tort and minority shareholder rights cases. Mr. Banks has been an adjunct professor at Lewis and Clark Law School in Portland, Oregon. He practices at Banks Law Office PC in Portland, Oregon.

Honors

- 2017 Investor Champion Award, given by the North American Securities Administrators Association (NASAA)
- Distinguished Service Award, Public Investor Arbitration Bar Association (PIABA), 2016
- Distinguished Service Award, Federal Bar Association, Oregon Chapter
- Director Emeritus, PIABA
- PIABA President's Award," For Leadership Efforts In Protecting Investors Throughout the Country"
- Oregon Super Lawyers, 2006 – 2019, every year that it has existed in Oregon
- Chambers Best Lawyers In America
- Best Lawyers in America – Securities Law
- Martindale Hubbell Law Directory, Highest Rating
- Multi-Million Dollar Advocates Forum

Bar Leadership Positions

- Past President and 10-year board member, PIABA
- Past Chair, Oregon State Bar Securities Regulation Section
- Past Chair, Oregon State Bar Alternative Dispute Resolution Section
- Past President, Federal Bar Association, Oregon Chapter
- Past Chair, FINRA Arbitrator Training Committee Task Force, 2008-2009

Selected Court Decisions

- Brown v. Price, WL 3207235 2017 (D. Or. 2017) Representing Aequitas Investors
- Amerivest v. Maloof, Oregon Court of Appeals, No. A144457 (Pending) Representing North American Securities Administrators Association as Amicus Curiae
- Boyer v. Salomon Smith Barney, Inc. 344 Ore. 583 (2008) Representing Public Investors Arbitration Bar Association as Amicus Curiae)
- Houston v. Seward & Kissel, LLP, 2008 U.S. Dist. LEXIS 23914 (March 27, 2008)
- Marshall, et al. v.McCown DeLeeuw, 391 F. Supp. 2d 880 (D. Idaho 2005)
- Estate of Aguirre v. Koruga (I) 2002 U.S. App. LEXIS 14632 (9th Cir. 2002)
- Koruga v. Fiserv Correspondent Services, Inc., 183 F. Supp.2d 1245 (D.Or. 2001), 2002 U.S. App. LEXIS 6439 (9th Cir. 2002)

Educational Background
Reed College, B.A. 1977
University of Wisconsin Law School, J.D. 1982

Bar Memberships
Oregon, Washington.

Other
Finra Arbitrator Since 1989

Arbitration Services of Portland Arbitrator

Personal
Bob was born in New Jersey and grew up in upstate New York. He moved to Portland to attend Reed College and has considered himself to be an Oregonian for 40 years. He has completed 10 marathons, (2:46 PR), backpacked throughout the NW, and is an avid fly fisherman. He is married to Valerie Banks (25 years) and they have two adult sons.

Hugh D. Berkson, Esq.
2022 Executive Vice President/President Elect
McCarthy, Lebit, Crystal & Liffman Co., LPA
Cleveland, Ohio

Hugh Berkson is a principal with the firm of McCarthy, Lebit, Crystal & Liffman, Co. LPA in Cleveland, Ohio. He is also of counsel with the firm of Rosca Scarlato, LLC. Hugh is rated AV® Preeminent™ by Martindale-Hubbell® and has been selected as a Super Lawyer from 2013 through 2022. He is rated 10.0 by Avvo. He obtained a business degree in Finance from the University of Texas at Austin in 1989, and is a 1994 graduate of Case Western Reserve University School of Law, where he was a member of the Order of the Barristers and received both the American Jurisprudence Award, (National Mock Trial) in 1993 and the Jonathan M. Ault Mock Trial Prize for 1993-1994. Hugh later served as an Adjunct Professor of Law at the CWRU School of Law, where he taught trial practice from 1995-2004.

After gaining extensive trial experience in both business and personal injury litigation, Hugh decided in 2000 to focus on the representation of injured investors. Hugh tries and arbitrates investment cases and also puts his finance background to good use by performing much of the technical analysis required for his cases. He is a past President of the Public Investors Advocate Bar Association, has been a member of PIABA's Board of Directors since 2011, and is currently serving as PIABA's Executive Vice President.

Michael Bixby, Esq.
Levin Papantonio et al.
Pensacola, Florida

Michael Bixby is a shareholder with Levin Papantonio Rafferty in Pensacola, FL. He has been a PIABA member for 7 years and is the co-chair of the Arbitration Committee. He has successfully represented hundreds of clients around the country in a variety of forums including arbitrations, state court, and federal court. He focuses his practice on representing retirees and public investors.

Mr. Bixby has obtained numerous million dollar plus verdicts and judgments for his clients, including a $19 million dollar verdict against UBS (the largest UBS Puerto Rico Closed-End Fund award to date) and a $1.16mn verdict against Berthel Fisher (the largest FINRA arbitration award ever obtained against Berthel Fisher), multiple full well-managed damages awards, and multiple million dollar plus civil theft judgments in state court. His broad experience in securities and investment fraud cases includes representing clients in claims involving suitability, overconcentration, failure to supervise, breach of fiduciary duty, lack of due diligence, fraud, selling away, sale of unregistered securities, and ERISA 401(k) and retirement plan litigation.

Scot D. Bernstein, Esq., *Director Emeritus*
Law Offices of Scot D. Bernstein
Folsom, California

Mr. Bernstein has practiced law in California since 1980. For more than a dozen years, he has concentrated his practice on representing plaintiffs in class actions. He has been named class counsel in more than 25 cases, including both employment (wage-and-hour) and privacy class actions. He has been co-counsel in successful appeals that resulted in published decisions as well. He also has served as counsel in cases involving securities and franchise law violations, unfair competition, unlawful business practices and false advertising. And he has handled numerous arbitration matters, including one that resulted in an unusual judgment that is viewable on his website.

Mr. Bernstein studied engineering and economics at UCLA, where he received his bachelor's degree Magna Cum Laude in 1977 and was an officer of the UCLA chapter of Tau Beta Pi, the engineering honors society. He was a member of Omicron Delta Epsilon (economics honors society) and Phi Beta Kappa as well. He received his Juris Doctor degree at Boalt Hall School of Law, University of California at Berkeley, in 1980.

Mr. Bernstein is a member of the board of directors of the California Employment Lawyers Association ("CELA"), an association of more than 1,200 attorneys dedicated to representing employees in employment disputes. He currently co-chairs CELA's Legislative Committee and serves on its Wage and Hour Committee as well.

Mr. Bernstein served for eleven years as a director of the Public Investors Arbitration Bar Association ("PIABA"), a national association of attorneys dedicated to representing investors in disputes with the securities industry. He has published numerous articles in the PIABA Bar Journal and its predecessor, The PIABA Quarterly. Since 2008, he has worked hard to help PIABA defeat multiple attempts to pass legislation that would have created a broad new exemption for securities sold through general solicitation and general advertising in California. More recently, he has negotiated with the sponsors of those prior bills to arrive at a bill, supported by PIABA, which would be beneficial to investor protection. Mr. Bernstein has given continuing legal education lectures to PIABA, the North American Securities Administrators Association, CELA and other professional groups on investors' rights and remedies and on employees' rights under the wage and hour laws. He is a member of the National Employment Lawyers Association ("NELA") as well.

Reported Cases. Mr. Bernstein has served as co-counsel in successful federal and state appeals:

Kirby v. Immoos Fire Protection, Inc. (2012) 53 Cal.4th 1244 (co-counsel for successful appellants);
Stop Youth Addiction v. Lucky Stores, 17 Cal.4th 553, 950 P.2d 1086, 71 Cal.Rptr.2d 731 (1998) (attorney for amicus curiae in support of successful appellant);

Lippitt v. Raymond James Financial Services, et al., 340 F.3d 1033 (9th Cir. 09/22/2003)
(co-counsel for successful appellant);

Lazarin et al. v. Total Western, Inc. (2010) 188 Cal.App.4th 1560, 116 Cal.Rptr.3d 596, review denied, Jan. 19, 2011, S188164 (co-counsel for successful appellant).

Mr. Bernstein has been recognized as a Northern California Super Lawyer® every year from 2010 through 2019.

Steven B. Caruso, Esq., *Director Emeritus*
Maddox, Hargett & Caruso P.C.
New York, New York

Steven B. Caruso, the resident partner in the New York City office of Maddox Hargett & Caruso, P.C. until his retirement from the firm in September 2021, concentrated his practice on the representation of public investors in securities arbitration and litigation proceedings since the firm was founded in 1991.

Mr. Caruso was the Chairman and a public member of the National Arbitration and Mediation Committee ("NAMC") of the Financial Industry Regulatory Authority ("FINRA") for two (2) separate and distinct terms; former Chairman of the Discovery Task Force Committee of FINRA; former member of the Nasdaq OMX BX Arbitration Committee; former member of the Securities Investor Protection Corporation (SIPC) Modernization Task Force; Director Emeritus and former President of the Public Investors Advocate Bar Association ("PIABA"); testified before the U.S. House of Representatives, Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, in March 2012 and September 2010; and has served as a judge for the Yale University Mock Trial Invitational Tournament and for Invest-Write, the national investment strategy writing competition sponsored by the Securities Industry & Financial Markets Association (SIFMA) Foundation.

Among the publications that Mr. Caruso has authored are *Understanding the Assertion of Legal Privileges in Arbitration Proceeding, The Neutral Corner, FINRA Dispute Resolution, Vol. No. 1 (2021); Arbitrators Beware: The Defense that the Delivery of a Prospectus Constitutes a "Get Out of Jail Free Card" for Financial Professionals is Fake News, Practising Law Institute, Securities Arbitration (2020); Arbitrator Withdrawals Undermine the Arbitration Process, The Neutral Corner, FINRA Dispute Resolution, Vol. No. 3 (2019);An Introduction to FINRA's National Arbitration and Mediation Committee*, The Neutral Corner, FINRA Dispute Resolution, Vol. No. 1 (2018); *Post-Settlement Expungements: An Investor Protection Problem that Continues to Wait for a FINRA Solution*, Practising Law Institute, Securities Arbitration (September 2017); *Non-Attorney Representatives – Do They Present a Clear & Present Danger to the Integrity of FINRA Arbitration*, Association of the Bar of the City of New York, New York, N.Y. (May 2017); *Arbitrator Disclosures: Requests for Additional Information*, The Neutral Corner, FINRA Dispute Resolution, Vol. No. 4 (December 2016); *Ethical Implications of the Phantom Designation of Expert Witnesses in FINRA Securities Arbitration Proceedings*, Practising Law Institute, Securities Arbitration (September 2016); *Definition of a FINRA Customer: To Be or Not To Be – That Is the Ultimate Question*, Practising Law Institute, Securities Arbitration (July 2015); *Discovery in FINRA Arbitration*, The Neutral Corner, FINRA Dispute Resolution, Vol. No. 2 (2015); *FINRA Six-Year Eligibility Rule 12206: The Purchase Date is Often Not the Triggering Occurrence or Event Giving Rise to the Claim*, PIABA Bar Journal, Volume 20, No. 1 (September 2013); *All Public Arbitrator Panels: A More Level Playing Field*, Practising Law Institute,

Securities Arbitration (August 2013); *Arbitrator Challenges Under the FINRA Code of Arbitration Procedure for Customer Disputes*, Practicing Law Institute, Securities Arbitration (August 2010); *The Mandatory Industry Arbitrator: An Endangered Species on the Precipice of Extinction*, Practising Law Institute, Securities Arbitration (August 2009); *Sunshine May be the Best Disinfectant for What Ails Securities Arbitration: A Discussion of the 2008 SICA Empirical Study of Fairness*, Practising Law Institute, Securities Arbitration (August 2008); *Effective Closing Statements From the Perspective of Counsel for the Customer-Claimant*, New York State Bar Association, Securities Arbitration 2007 (November 2007); *Essential Principles for Honorable Arbitrators*, Practising Law Institute, Securities Arbitration (August 2007); *Motions to Dismiss: A Predatory Tactic That Must be Extinguished*, Association of the Bar of the City of New York, New York, N.Y. (June 2007); *Ethical Standards for Securities Arbitrators: A Statistical Perspective of Potential Partiality (Bias)*, Practising Law Institute, Securities Arbitration (August 2006); *Arbitrator Training in the Securities Dispute Arena*, The Review of Securities & Commodities Regulation (January 2005); *Discovery Objections Which are Irrelevant, Unduly Burdensome and are Reasonably Calculated to Lead to the Concealment of Admissible Evidence*, New York State Bar Association, Securities Arbitration 2004 (October 2004); *Model Arbitrator Instructions: Luxury or Emerging Necessity*, Practising Law Institute, Securities Arbitration (August 2004); *Ethical Considerations in Settlement Agreements*, Association of the Bar of the City of New York, New York, N.Y. (June 2004); *Examination of the Adverse Broker: Unimpeachable Questions with an Internet Twist*, Practising Law Institute, Securities Arbitration (August 2001); *On-Line Trading: The New Frontier*, Practising Law Institute, Securities Arbitration (July 1999); and *NASD Arbitration Discovery Procedures : Knowing Your Customer From the Securities Professional Perspective*, American Bar Association, Section of Litigation, Committee on Securities Litigation (August 1995).

Jason Doss, Esq., *Director Emeritus*
The Doss Law Firm
Marietta, Georgia

Jason Doss has represented investors in NASD and FINRA arbitrations for approximately sixteen (16) years. The Doss Firm, LLC, established by Jason Doss in January 2009, is a successful law firm primarily devoted to representing aggrieved consumers across the United States against financial services companies for mismanaging investments and engaging in financial fraud. The attorneys of the firm have represented almost 1000 clients and have a combined 45 years of experience representing individual retail investors, institutional investors, and businesses in financial fraud litigation, securities arbitrations, and collective and class actions. Jason Doss has represented dozens of investor clients in disputes with broker-dealers involving the unsuitable recommendations of life insurance products including but not limited to fixed-indexed and variable annuities. Since its inception, The Doss Firm has recovered tens of millions of dollars for investors and consumers.

In 2018, Jason Doss was selected by a federal court to serve as one of twelve attorneys to lead the Equifax Data Breach case on behalf of all consumers and small businesses across the country. The case is currently pending in the United States District Court, Northern District of Georgia.

Jason Doss was primarily responsible for originating a nationwide consumer class action consisting of approximately 420,000 policyholders in equity-indexed annuities against Allianz Life Insurance Company, *Linda L. Mooney et. al. v. Allianz Life Insurance Company of North America*, 06-cv-545, United States District Court of Minnesota. His former law firm Page Perry, LLC was co-lead counsel with two other firms.

Jason Doss has co-authored two books, Doss, J. and Frankowski, R., *A Practitioner's Guide To Securities Arbitration* (2013), American Bar Association (225 pages) and Armstrong, F. and Doss, J., *The Retirement Challenge: Will You Sink or Swim?* (Jan. 2009), FT Press, Prentice Hall Publishing (266 pages). *A Practitioner's Guide To Securities Arbitration* is used by law schools and practitioners across the country as a resource to help navigate the FINRA arbitration process. *The Retirement Challenge: Will You Sink or Swim?* is in bookstores across the country and is designed to help consumers avoid the pitfalls of investing and avoid becoming a victim of financial fraud.

Jason Doss is a past-President of the Public Investor Arbitration Bar Association (PIABA), a bar association of attorneys that represent investors in FINRA arbitrations. He also founded The PIABA Foundation, a Foundation devoted to preventing investment abuse, and currently serves as its President. In addition, Jason Doss helped create the Investor Advocacy Clinic at Georgia State University College of Law, a law clinic that represents investors *pro bono* in FINRA arbitration with investment losses too small for them to hire a private attorney.

Over the last ten years, Jason Doss has been quoted many times by major publications and news organizations about topics involving financial fraud including USA Today, The Wall Street Journal, The New York Times, Reuters, The Associated Press, Bloomberg, AARP Magazine, The Street, and The Atlanta Journal Constitution.

Michael S. Edmiston, Esq.
2022 PIABA President
Jonathan W. Evans & Associates
Studio City, California

Michael S. Edmiston is an attorney at Jonathan W. Evans & Associates in Studio City, California. He has practiced with the firm since 2006. Prior to entering private practice, Michael served as a Senior Staff Attorney with NASD Dispute Resolution (now FINRA) in Los Angeles, California (1997-2001), and as a Business Manager with JAMS in Dallas, Texas and Orange, California (2001-2005).

His practice focuses on representing investors in FINRA arbitration, private commercial arbitration forums, and in state and federal court. His work continues to result in successful recoveries for clients by way direct negotiation, mediation, arbitration, and litigation. Michael volunteers his time to Community Legal Aid SoCal working with senior citizens in a variety of civil and administrative matters. Michael is published in the PIABA Bar Journal, Los Angeles Lawyer, the San Fernando Valley Bar Association, the New York City Bar, and various financial services industry publications.

Michael currently serves as PIABA's President. He joined PIABA in 2007 and was elected to the Board of Directors in 2015. He has served as the organization's Executive Vice-President/President-Elect (2020-2021), Treasurer (2017-2018), Secretary (2016), and as chair and co-chair of various committees. Michael has served and continues to serve on the PIABA Bar Journal, including as its Editor-in-Chief (2014-2015).

Michael is a 1994 graduate of Whittier College, with B.A.s in both Business Administration and Economics. In 1997, he obtained his J.D. from Pepperdine University School of Law, and was admitted to the California Bar later that same year. He received his Master's Degree in Dispute Resolution from Pepperdine in 2001.

Samuel B. Edwards, Esq.
Shepherd, Smith & Edwards, LLP
Houston, Texas

Sam Edwards is a Houston based Securities Litigation and Arbitration attorney with a national practice. Sam and his firm – Shepherd, Smith, Edwards & Kantas – focus primarily on representing investors who have been injured. That has included the representation of individual investors, small hedge funds, community banks, pension plans and municipalities, some as large as entire state governments. Sam received his BA from the University of Texas at Austin and his law degree from the University of Houston Law Center. He began working on investment disputes while still in law school and joined his current firm shortly after graduation. Wanting to become even more specialized in this area of law, Sam made the seemingly insane decision to continue his education while also maintaining a full docket of cases, earning an LL.M. from Georgetown University Law Center in 2015 in Securities Law and Financial Regulation. He received the Thomas Bradbury Chetwood Prize at Georgetown, an award given to the student with the highest grade point average in the LL.M. program.

Sam was previously a member of FINRA's National Arbitration and Mediation Committee (NAMC), where he worked with other attorneys, both claimants counsel and respondents counsel, to help make better rules and procedures for FINRA arbitration participants. He is currently a member of FINRA's Zoom Task force where Sam is again working with both claimants counsel and respondents counsel to help FINRA develop better rules and procedures for arbitrations now that many are going forward via Zoom, rather than in person. In addition, Sam has been a member of PIABA for 20 years. Sam was previously elected as the President of PIABA and before that served on numerous PIABA committees and was the editor-in-chief of the PIABA Bar Journal. Sam has been on the PIABA Board of Directors since 2013 and remains active in the organization.

Adam Gana, Esq.
Gana LLP
New York City, New York

Adam Gana is the managing partner of Gana Weinstein LLP. His practice focuses on all aspects of securities arbitration, complex commercial and business litigation. As a seasoned trial lawyer, Mr. Gana's experience includes litigation in both State and Federal Courts as well as in various alternative dispute resolution venues. As lead counsel, he has tried more than fifty cases to verdict before the state and federal trial and appellate courts, AAA, JAMS, NFA and FINRA and has served as lead counsel in hundreds more cases through mediation and direct negotiation.

Mr. Gana was named in the New York *Super Lawyers Rising Stars*® for eight straight years (an honor given to the top 5% of attorneys), ranked AV® Preeminent™ by Martindale - Hubbell™ (the highest honor offered), and ranked by the National Trial Lawyers as one of the Top 100 attorneys in the state of New York.

Robert J. Girard, II, Esq.
Girard Bengali, APC
Los Angeles, California

A founding partner of Girard Bengali, APC, Robert J. Girard II advocates for institutional and individual investors in arbitration and litigation against unscrupulous brokerage and advisory firms in both court and FINRA Dispute Resolution/Arbitration. For 20 years, he has built a reputation as an effective advocate for his clients and has recovered millions of dollars for investors from most of the major Wall Street brokerage firms. Through negotiated settlements, arbitrations and trials, Mr. Girard has a proven track record of successfully protecting his clients' interests with a results-oriented approach and a zealous commitment to meeting, and exceeding, his clients' expectations. Mr. Girard's representations include victims of financial elder abuse, securities fraud, breach of fiduciary duty, unsuitable investment strategies, misrepresentations, account mismanagement, among others. Mr. Girard also represents securities professionals in employment disputes against broker-dealers and advisory firms, including claims for wrongful discharge, unfair business practices, retaliation, discrimination and Form U5 defamation claims.

From 2015 through 2022, Mr. Girard was named to the Southern California *Super Lawyers* list, and for three consecutive years (2012-2014) he was selected to the Southern California *Rising Stars* list by Super Lawyers Magazine, a rating service of outstanding lawyers who have attained a high-degree of peer recognition and professional achievement. He currently serves as a Director in the Public Investors' Arbitration Bar Association (PIABA), a national organization of attorneys dedicated to the advancement of investors' rights in securities arbitration proceedings.

Scott Ilgenfritz, Esq., *Director Emeritus*
Johnson, Pope, Bokor, Ruppel & Burns, LLP
Tampa, Florida

Scott C. Ilgenfritz is a partner in the law firm of Johnson, Pope, Bokor, Ruppel & Burns, LLP, and practices in the firm's Tampa, Florida, office. Scott has spent his entire thirty-four year legal career with Johnson, Pope. Over the years, Scott has had a varied commercial and business litigation practice, which has included securities arbitration and litigation, commercial tort litigation, professional malpractice litigation, corporate litigation, real estate-related litigation, and contract litigation. Since 1997, Scott has been Board certified by The Florida Bar as a Business Litigation Lawyer. Since 1997, Scott has been Board certified by The Florida Bar as Business Litigation Lawyer. In 1992, Scott began representing investors in claims against broker/dealers, stockbrokers, investment advisors, and other financial professionals. Since the late 1990's, a primary focus of Scott's practice has been representing investors in securities arbitration and litigation matters. Scott has been a member of the Public Investors Arbitration Bar Association ("PIABA") since 1997. He served on PIABA's Board of Directors from 2008 until 2017. Scott served as President of PIABA from November, 2012, through October, 2013. During his term as President, he authored PIABA's expungement study. In 2017, Scott was recognized by PIABA as a Director Emeritus. Scott has been regularly recognized by his peers through inclusion in such publications as Florida's Super Lawyers (2007-2014) and Best Lawyers in America (2012-2017).

Marnie C. Lambert, Esq.
Lambert Law Firm, LLC
Columbus, Ohio

Marnie C. Lambert is a 1992 graduate of the Pepperdine University School of Law in Malibu, California. Since 2005, she has been representing investors across the country in securities disputes with firms and registered representatives licensed by FINRA, the SEC and various states' securities divisions. She has prevailed and negotiated settlements on behalf of many investors in arbitrations processed by FINRA, JAMS and AAA, as well as in state and federal court cases.

Ms. Lambert has been an active member of the Public Investors Advocate Bar Association ("PIABA") for over 15 years, serving on the Board of Directors since she was elected in 2012 (holding the positions of Treasurer, Executive VP/President Elect and President from 2014-2017). She has participated in multiple panels at PIABA Annual Meetings and at the Practising Law Institute's Securities Arbitration Programs in New York City. She has served on the Ohio State Bar Association ("OSBA") Annual LGBTQ (and Allies) Diversity and Inclusion Conference Planning Committee since she was appointed in 2011 (serving as Co-Chair in 2016) and she was also an appointee to the OSBA's Litigation Section Council from 2005-2012.

Ms. Lambert has a reputation for her no-nonsense approach to cases and she is well-respected by clients, co-counsel, opposing counsel, experts, arbitrators, mediators, and judges alike. She is licensed to practice law in the states of Ohio and California and in all United States District Courts in Ohio and California.

Christine Lazaro, Esq.
St. John's University School of Law
Queens, New York

Christine Lazaro is an Associate Professor of Clinical Legal Education and the Director of the Securities Arbitration Clinic at St. John's University School of Law. The students in the Clinic represent investors in arbitration claims against brokerage firms and brokers on a pro bono basis. Professor Lazaro also teaches Broker-Dealer Regulation and Business Basics at St. John's, and is a faculty advisor for the Moot Court Honor Society and the Corporate and Securities Law Society. She joined St. John's in 2007 as a Supervising Attorney for the Clinic. Professor Lazaro is also currently Of Counsel to the Law Offices of Brent A. Burns, LLC, where she consults on securities arbitration and regulatory matters.

Professor Lazaro has been a member of the Public Investors Advocate Bar Association (PIABA) since 2008. She currently serves on the Board of Directors, co-Chairs the Fiduciary Standard Committee, and is a member of the Legislation Committee, the SRO (Self Regulatory Organization) Committee and the Securities Law Seminar Committee. She also serves on the New York State Bar Association's Securities Litigation and Arbitration Committee.

Professor Lazaro holds a B.A. from New York University and a J.D. from Fordham Law School. After graduating from law school and prior to joining St. John's, she was an associate at Davidson & Grannum, LLP, representing broker-dealers and individual brokers in disputes with clients in both arbitration and mediation, and handling employment law cases and debt collection cases. She also advised broker-dealers regarding investment contracts they had with various municipalities and government entities.

She speaks and writes regularly on the topics of securities arbitration and the duties of brokers and brokerage firms.

Seth E. Lipner, Esq., *Director Emeritus*
Deutsch & Lipner
Garden City, New York

Seth E. Lipner is a Professor of Law at the Zicklin School of Business of Bernard M. Baruch College (CUNY) in New York City, and a member of the finn Deutsch & Lipner in Garden City, New York. Professor Lipner is the author of numerous scholarly articles and law books, including SECURITIES ARBITRATION DESK REFERENCE, co-authored with Professors Joe C. Long and William Jacobson, and published each year by West Publishing. As a member of Deutsch & Lipner, Mr. Lipner focuses his practice on representing investors and other individuals with grievances against providers of financial services.

Professor Lipner was a founder of PIABA when it was created in 1990. He served as President in 1994-1995, and again in 2000-200 I. He served as Secretary to the organization and on its Board of Directors since the organization's inception until 2006, and now holds the title "Director Emeritus." Professor Lipner has appeared on CNN, NPR, BBC and the Wall Street Journal Report, and is often quoted in publications such as Forbes, The New York Times, Reuters, Business Week, Newsweek, the Wall Street Journal, Newsday, the New York Law Journal and the National Law Journal. Professor Lipner speaks often to bar groups, and in continuing legal education programs, including the New York State Bar Association, Practicing Law Institute and PIABA. He served on the National Arbitration and Mediation Committee of the NASD from 1998 to 2002, and was at one time a member of the Board of Editors at Securities Arbitration Commentator. He is now on the Editorial Board of the PIABA Bar Journal, and is a regular contributor to the Journal.

Along with Lisa Catalano, he is the author of "The Tort of Giving Negligent Investment Advice," 39 University of Memphis Law Review 663 (2009). His most recent law review article, "The Expungement of Customer Complaint CRD Infonnation Following the Settlement of a FINRA Arbitration," is at 19 Fordham Journal of Corporate & Financial Law 57 (2013). Professor Lipner's numerous columns and other writings can be found at DeutschLipner.com. and Forbes.com.

Mark E. Maddox, Esq., *Director Emeritus*
Maddox Hargett & Caruso, P.C.
Fishers, Indiana

Mark E. Maddox is a founding partner of Maddox Hargett & Caruso, P.C., one of the nation's largest legal practices concentrating on the representation of securities investors. He has concentrated his career representing investors in disputes with stockbrokers and their firms.

From 1989 - 1991, Mr. Maddox served as the Securities Commissioner for the State of Indiana. During his tenure, he also served on the Indiana Governor's Initiative on Economic Development Policy Panel. Mr. Maddox also led the International Enforcement Committee of the North American Securities Administrators Association as its Chairperson. He served on the Board of Directors of the Public Investor Arbitration Bar Association from 1994 - 2002 and was its President from 1998 - 2000. Mr. Maddox was also a public representative on the NASD Regulation's National Arbitration and

Mediation Committee from 1996 - 1998 and 2003 – 2005 and was appointed its Chair for the 2004 – 2005 term. He was admitted to practice before the U.S. Supreme Court in February 1995.

In 1991, Mr. Maddox opened his current private practice that concentrates in the representation of investors in securities arbitration, litigation and regulation. He is a member of the Indianapolis Bar Association and the Indiana State Bar Association where he is a Past Chair of the Securities Sub-Committee. He is an adjunct professor at Butler University where he teaches Business Law to undergraduates.

Mr. Maddox is a graduate of Wabash College (magna cum laude), and earned his J.D. from Vanderbilt University in 1986. He has been a speaker and lecturer for various Continuing Legal Education and securities-related seminars and has been published extensively, most notably the book Investor Rights for the 21st Century (2001).

Thomas D. Mauriello, Esq.
2022 PIABA Treasurer
Mauriello Law Firm, APC
San Clemente, California

Tom Mauriello is the principal of the Mauriello Law Firm, APC in San Diego, which he founded after beginning his legal career at a large national plaintiffs' securities class action firm. The firm focuses on investment disputes representing investors in FINRA arbitrations and courts and also has represented registered representatives, broker dealers, institutional investors, and issuers in various contractual, operational, employment, and other matters. Tom is a member of the California, New Jersey and Pennsylvania bars. He received his BA from Brown University in 1983 and his JD from the University of San Diego School of Law in 1988. Prior to law school, he worked as a paralegal at a New York City law firm registering securities offerings with the SEC and state securities regulators. After law school, Tom served as a judicial clerk to Judge Robert E. Cowen of the U.S. Court of Appeals for the Third Circuit. He is in his second term on the Board of Directors of the Public Investors Advocate Bar Association ("PIABA"), where he has served as secretary and currently serves as treasurer.

David P. Meyer, Esq.
Meyer Wilson Co., LPA
Columbus, Ohio

Attorney David P. Meyer is the managing principal of Meyer Wilson, a national law firm with offices in Ohio, Michigan, California, and Louisiana.

David is a past president of the Public Investors Advocate Bar Association (PIABA). He is also the current president of the Ohio Association for Justice, Ohio's statewide bar of plaintiff trial lawyers.

David is the author of the #1 best-selling book titled "The Investor Protector." He wrote the book to help prevent hard-working retirement savers from becoming victims of investment fraud and to share his experiences of cases he has handled over the past 20 years. The book is available on Amazon.

Since starting the law firm in 1999, David has earned a national reputation for successfully representing investors who are victims of investment fraud. He has represented more than 1,000 individual investors from across the country in securities arbitration and litigation.

Meyer Wilson has also been appointed lead class counsel in numerous consumer class actions across the country. The firm also represents hundreds of clients who suffered serious injuries from dangerous drugs and defective medical devices. His firm has recovered more than $350,000,000 for its clients.

David can be reached through his firm's website at www.investorclaims.com or via email at dmeyer@meyerwilson.com.

David P. Neuman, Esq.
2022 PIABA Secretary
Israels & Neuman PLC
Seattle, Washington

David Neuman is an attorney who has been representing the interests of investors and consumers for over a decade. Before co-founding Israels & Neuman in the Summer of 2014, Mr. Neuman worked for over seven years at a law firm in Chicago which focused its practice on representing aggrieved and defrauded investors, mostly in FINRA arbitration. Throughout his years of experience, Mr. Neuman has recovered millions of dollars in hundreds of FINRA and court cases, on behalf of clients from over 40 states, as well as investors from the international community. In addition to representing investors in FINRA Arbitration, Mr.

Neuman has represented investors in numerous courts throughout the U.S., as well as represented persons deceived by their insurance brokers and parties in shareholder disputes.

Mr. Neuman is currently on the Board of Directors of PIABA. He has also chaired several committees in PIABA. He is also an arbitrator with FINRA Dispute Resolution. David Neuman is admitted to practice law in Illinois, Washington, and Florida, as well as several federal courts.

Mr. Neuman graduated with Honors from the University of Illinois in December 2001 with a B.S. in Finance. He attended the Northern Illinois University College of Law and graduated Magna Cum Laude in May 2005. While at the NIU College of Law, Mr. Neuman was on Law Review and was an Associate Justice for the Moot Court Society. In addition, during his time at the NIU College of Law, he also was a research assistant for Professor David Gaebler and researched various areas of contract, commercial, and consumer law.

Timothy J. O'Connor, Esq.
The Law Offices of Timothy J. O'Connor
Albany, New York

Timothy J. O'Connor maintains a private practice of law in Albany, New York and is licensed in New York and Florida. He has been representing investors in securities brokerage customer claims since 1985. Mr. O'Connor has been a solo practitioner since 2005, after having been affiliated with Ainsworth Sullivan for 21 years.

A graduate of Middlebury College (A.B. Economics, 1980) and the University of Denver College of Law (J.D. 1984), Mr. O'Connor was nominated in the Fall of 2003 as the Inaugural Visiting Clinical Instructor for the Investor Rights Project Securities Arbitration Clinic of Albany Law School of Union University in Albany, New York, funded through the efforts of New York State Attorney General, Eliot Spitzer, from the proceeds of a settlement obtained against several national securities brokerage firms involving allegations of analyst fraud and wrongdoing. Mr. O'Connor served in this adjunct position through 2005.

In addition to his private practice, he is currently an Adjunct Lecturer at State University of New York at Albany, teaching courses in Law in Financial Market Regulation and Technology in Financial Market Regulation.

He has also widely written on a number of topics relating to the topic of investors rights. Most recently, "Trends in Supervisory and Clearing Firm Liability"(New York State Bar Association Continuing Legal Education Department – "Securities Arbitration and Mediation 2017: The Courage to Simplify" – April 6, 2017).

Darlene Pasieczny, Esq.
Samuels Yoelin Kantor, LLP
Portland, Oregon

Darlene Pasieczny ("Pah-shetch-nee") is a securities and fiduciary litigator, and leads the Investor Defenders practice group at Samuels Yoelin Kantor LLP, based in Portland, Oregon. Darlene works on all stages of securities litigation and FINRA arbitration, fiduciary litigation in trust and estate disputes, elder financial abuse cases, complex civil litigation, and has a growing appellate practice. She is a frequent speaker on FINRA arbitration, trust and estate litigation matters, and elder financial abuse prevention, recognition, and recovery.

Darlene serves on the Board of Directors of the Public Investors Advocate Bar Association (PIABA) and was the 2021 Chair of the Oregon State Bar's Securities Regulation Section. In June 2021, Darlene was appointed to FINRA's National Adjudication and Mediation Committee (NAMC) for service as a public member. Selected to the 2021 Oregon Rising Stars list, her professional affiliations include the admission to the Oregon State Bar, Washington State Bar, U.S. District Court for the State of Oregon, and Multnomah Bar Association. Darlene earned a B.A. from Reed College, *Phi Beta Kappa*, an M.A. from Columbia University, and J.D. from Lewis & Clark Law School, *magna cum laude*.

Joseph C. Peiffer, Esq.
2022 PIABA Vice President
Peiffer Wolf Carr Kane & Conway, APLC
New Orleans, Louisiana

Mr. Peiffer is a partner at Peiffer Rosca Abdullah & Carr. His practices consists of representing individuals and institutions in FINRA arbitration, prosecuting ERISA class actions, representing victims of labor trafficking and those that have suffered catastrophic injury.

Mr. Peiffer has represented hundreds of individual retirees against their brokers in FINRA arbitration. The highlights of this practice include representing 32 Exxon retirees in a 90-day FINRA arbitration against Securities America that resulted in a $22 million verdict -- one of the largest ever awarded by a FINRA arbitration panel. He has also represented hundreds of Xerox and Kodak retirees against their broker resulting from the broker's fraudulent advice to retire and subsequent unsuitable investments. He currently represents clients against British Petroleum arising from the oil spill that occurred in the Gulf of Mexico. He was recently part of the legal team that filed a temporary restraining order to stop BP from paying dividends to its shareholders before it could show that it could pay to clean up the Gulf. Also, he currently represents the Louisiana Firefighters Retirement Fund in their case against Northern Trust concerning securities lending. Additionally, he represents the Baylor College of Medicine and about 25 other hospitals and municipalities in cases against their investment banks arising out of their issuance of auction rate securities. He also is on the plaintiffs' steering committee in a nationwide antitrust class action involving the illegal tying of cable set-top boxes to the provision of premium cable services and in the leadership of an ERISA class action arising out of securities lending.

Mr. Peiffer was one of three Louisiana lawyers ranked by Chambers USA for securities litigation. He has been quoted by *USA Today, Wall Street Journal*, the Associated Press, *New York Times, New York Daily News*, *The Los Angeles Times, Business Week, Investment News*, and many other publications. Mr. Peiffer has also appeared on CNN. He was named as one of the fifty Leaders in Law by *New Orleans City Business Magazine*.

He has also taught and lectured extensively. He is co-authored a book on Litigating Business Torts for West, a Thomson Reuters Business. He co-created and taught a class entitled Storytelling and Advocacy at Loyola Law School. Also, at Loyola Law School, he has taught a course entitled "The Basics of Arbitration" and he also serves as an adjunct professor teaching Trial Advocacy. He has guest lectured at Tulane Law School in its Securities Regulations class and Syracuse Law School on securities arbitration. He has spoken at many national conventions on a variety of topics including prosecuting large, multi-client claims, broker's deficient advice to retire and FINRA arbitration.

Mr. Peiffer graduated from Tulane School of Law, *cum laude*, in 1999. While at Tulane, he served on the Tulane Law Review and was involved with the Tulane Legal Assistance Program. Prior to attending Tulane, he graduated from Bowling Green State University in 1996 with a major in communications. While at Bowling Green, he worked as the General Manager of the campus radio station and City Editor of the daily newspaper.

Mr. Peiffer has also successfully represented criminal defendants on a pro bono basis. He is a member of the Louisiana State and American Bar Associations. He also is a member of the American Association for Justice where he served as past Chairman for the Business Torts section. He is also a member of the Public Investors Advocate Bar Association where he serves on the Board of Directors and was recently elected Executive Vice President.

Rosemary J. Shockman, Esq., *Director Emeritus*
Shockman Law Office, P.C.
Scottsdale, Arizona

Rosemary J. Shockman received her B.A. from the University of Minnesota and J.D., magna cum laude, from California Western University. She practices with the firm of Shockman Law Office, P.C. in Scottsdale, Arizona. The firm's practice is devoted primarily to the representation of public investors in actions with broker/dealers and others. The firm has represented hundreds of investors in claims against broker/dealers or stockbrokers.

Ms. Shockman is a past member of the Board of Directors, past President, and past chair of the Arbitrator Recruiting Committee for Public Investors Arbitration Bar Association ("PIABA").

She served two terms as a member of the FINRA (formerly NASD) National Arbitration and Mediation Committee.

Brian N. Smiley, Esq., *Director Emeritus*
Smiley Bishop & Porter LLP
Atlanta, Georgia

Brian Smiley is a partner in the firm of Smiley Bishop & Porter LLP. He was born in Augusta, Georgia, and grew up in Atlanta. He attended Emory College, where he was initiated into Phi Beta Kappa and from which he graduated with highest honors in 1975. Following graduation, he attended Emory University School of Law, where he served on the Board of Editors of the Emory Law Journal and was initiated into the Order of the Coif.

Upon graduation (with distinction) in 1978, Mr. Smiley received an appointment as a Trial Attorney in the United States Department of Justice. While at the Justice Department, Mr. Smiley acted as counsel for the Government in numerous cases that were deemed by the Attorney General to be of unusual importance to the United States, including Nixon v. United States, various constitutional cases and litigation involving the NATO treaty.

In 1981, Mr. Smiley returned to Atlanta from Washington, and entered into the private practice of law. As a litigator, Mr. Smiley has handled constitutional and civil rights suits, products liability claims, personal injury litigation, commercial controversies, shareholders' derivative suits, fidelity bond and RICO suits, and securities litigation and arbitration. For over 20 years, Mr. Smiley has concentrated in the securities field, primarily representing investors in FINRA arbitrations.

Mr. Smiley is the author of numerous articles including: "Stockbroker-Customer Disputes-Making a Case for Arbitration," (Georgia State Bar Journal, May 1987); "Spotting Common Forms of Stockbroker Misconduct" (The Verdict, Jan. - Feb. 1991); and, "The Law and Ethics of Witness Preparation" (Practicing Law Institute, 1998). He has spoken at numerous seminars sponsored by the Public Investors Arbitration Bar Association and has been quoted on securities matters in the national press.

Mr. Smiley is a frequent lecturer on the topics of stockbroker misconduct, the handling of litigation and arbitration involving stockbrokers, and legal ethics. He has testified as an expert at special hearings about the "penny stock" industry conducted by the Secretary of State of Georgia. Mr. Smiley testified before the United States Senate Committee on Banking, Housing and Urban Affairs, Securities Subcommittee, on the topics of "penny stock" fraud and securities industry arbitration.

In 2002, Mr. Smiley was appointed to the National Arbitration and Mediation Committee (NAMC). The 13 members of the NAMC advise the Board of Directors of FINRA, which is the world's largest forum for handling arbitration and mediation of disputes between clients and brokerage firms. The NAMC is actively involved in the drafting of arbitration rules and the recruitment, training and evaluation of arbitrators.

He has been elected to serve on the Board of Directors of PIABA for three terms and was honored to act as PIABA's President in 2008-2009.

Jeffrey R. Sonn, Esq.
Sonn Law Group, PA
Aventura, Florida

For the last 34 years, Jeffrey Sonn focuses his practice principally on securities litigation and arbitration, class actions and business litigation. Mr. Sonn is the managing partner of Sonn Law Group, and has handled over 1,000 securities cases in his career. Mr. Sonn has been rated as a "Superlawyer" and is "AV" rated by Martindale Hubbell.

In class actions, Mr. Sonn served as class counsel, executive committee, for In re: Woodbridge Litigation ($1.2 billion Ponzi Scheme), as class counsel in the EquiaIt Inc. Ponzi ($180 million Ponzi Scheme), as class counsel in 1 Global Financial Ponzi ($280 million Ponzi), as class counsel in the Yieldstreet private placement action ($90 million in losses), and as class counsel in the MJ Capital litigation ($200 million Ponzi Scheme).

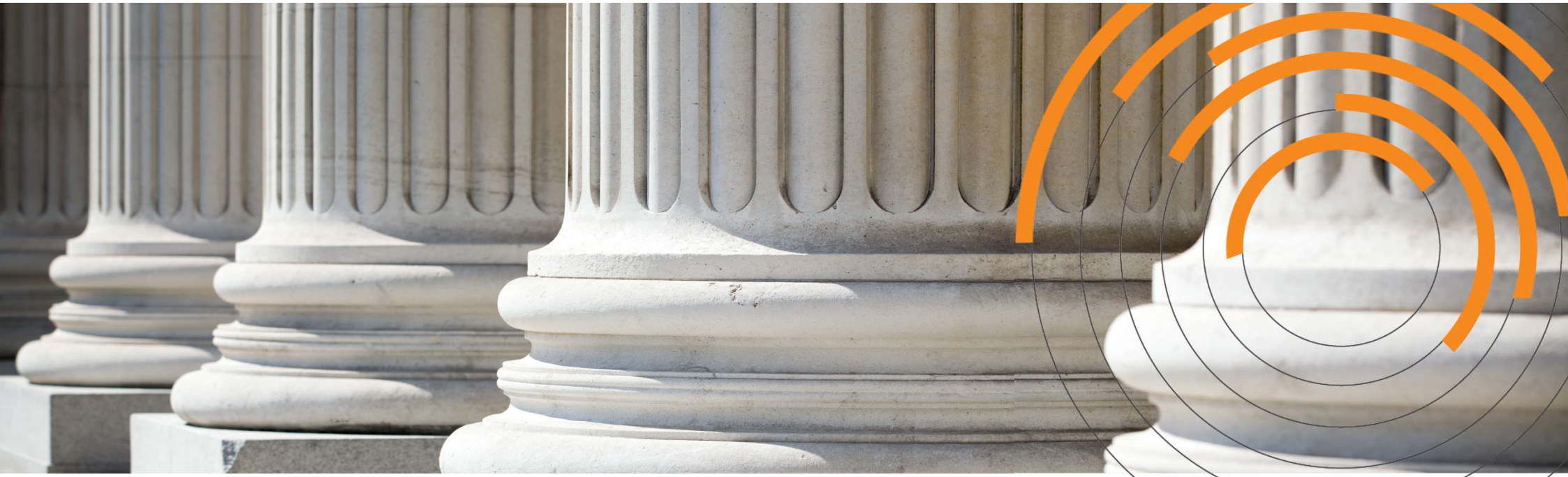
Mr. Sonn serves as a Director of the Public Investor Arbitration Bar Association (PIABA). Mr. Sonn is the author of many securities related articles, including Top Ten Things to Do During a Final Hearing (PIABA), Top Ten Mistakes to Avoid in a Final Hearing (PIABA), Elder Abuse and the Securities Industry (PIABA), and Ponzi Schemes, Picking up the Pieces from a Fallen House of Cards ("Securities Arbitration in the Meltdown Era" Practicing Law Institute).

During his career, Mr. Sonn has litigated numerous cases to successful resolution, recovering hundreds of millions of dollars for victims of investment fraud. He won a $50 million final judgment in Katz v. MRT Holdings. Mr. Sonn also served on the Plaintiffs' Steering Committee (with two other PIABA members) that successfully negotiated a $151 million dollar settlement for hundreds of investors who were the victims of the Medical Capital/Provident Shale Royalties Ponzi Schemes.

Mr. Sonn has acted as trial counsel to verdict in a number of successful cases, including Lacey Keath vs. JP Morgan ($4 million verdict); First Union vs. the FDIC and Hollywood Associates (a $16 million dollar verdict); Madhany v. Citgroup ($11.1 million verdict); Regas v. Painewebber (a $2.2 million dollar verdict), and Tartell v. Krieger Financial ($1.7 million dollar verdict). Mr. Sonn has also served as counsel to United States Bankruptcy Trustees, Liquidating Trustees, and Court appointed Receivers.

Mr. Sonn has served as a legal correspondent and commentator on securities fraud and Ponzi schemes for CNBC, CBS, BBC Radio, ABC and MSNBC. Mr. Sonn served as a CNBC legal contributor for the CNBC shows "On the Money" and the documentary "Scam of the Century, Bernie Madoff and the $50 Billion Dollar Heist."

Mr. Sonn also appeared on the television show "American Greed" on CNBC, covering the $1 Billion Dollar Ponzi Scheme by convicted Fort Lauderdale attorney Scott Rothstein. Mr. Sonn represented victims in the Rothstein case and pushed the Rothstein law firm into bankruptcy when the fraud was first discovered.



Thomson Reuters

Thinking Outside the Banker's Box: Managing Arbitration Exhibits Electronically

David Jackson, Senior Director, Thomson Reuters
Chair, IJIS Institute Courts Advisory Committee

October 2022

THOMSON REUTERS®

Meet the Speakers

David Jackson
Thomson Reuters



David co-founded Case Center, for evidence review and presentation. David also Chairs the IJIS Institute Courts Advisory Committee

Ian Hardy
Optima Juris

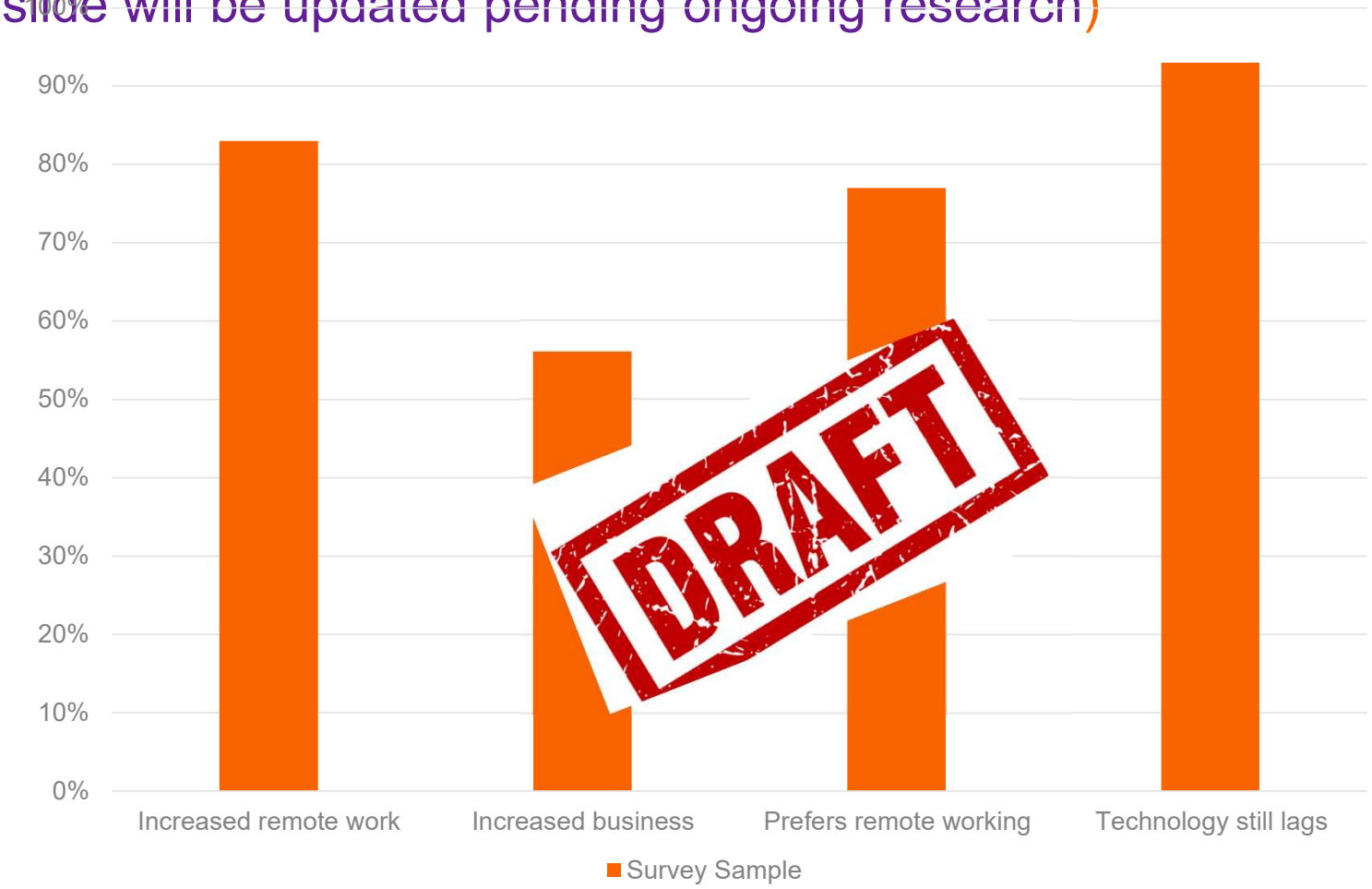


Ian is the founder of Optima Juris, which specialises in international depositions for arbitration and trial

Remote Work depends on managing exhibits electronically – Let's do a quick survey to see if that matters

- After the COVID crisis, who is still doing a significant amount of remote work?
- Who feels that they can attract more business by offering remote working?
- Who prefers remote working?
- Who believes that the technology still needs to catch up?

Thomson Reuters research indicates these are widespread issues (this slide will be updated pending ongoing research)



- Over 50% of arbitrators prefer virtual and online
- Over 60% are growing business outside their local area through virtual and online

THOMSON REUTERS®

Agenda

- Challenges attorneys and arbitrators face post-COVID
- New technologies
- New service offerings
- Ideas for the model office

Today's session will look at the technology and services landscape that can help you

We know that most litigator's have limited familiarity with the latest tools and service innovations

The right tools level the playing field – big firms can throw people at a problem, small firms leverage technology

THOMSON REUTERS®

Four Challenges of Remote Hearings

- Costs of creating and shipping paper evidence books for multiple parties
- Making sure everyone is in the right document and on the same page
- Increasing use of multimedia
- Managing security & confidentiality

3 things you need to do well in a remote hearing:

- Move everyone around seamlessly
- Manage multimedia
- Manage witness views and markup

Managing the move to electronic exhibits – key questions to consider

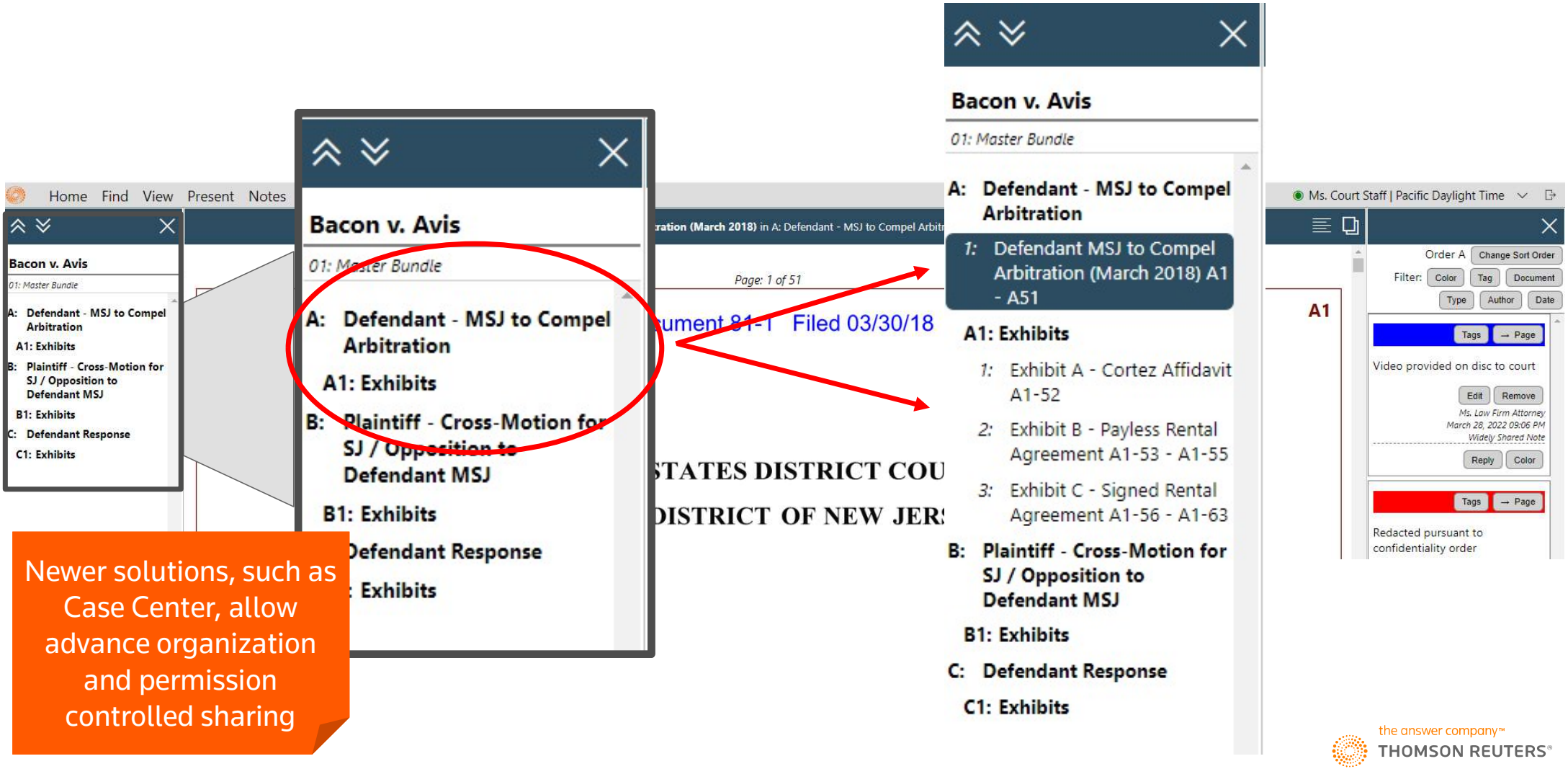
- Can you prevent inadvertent disclosures when sharing documents in a zoom screen share?
- Do the participants need their own software to view evidence?
- Can participants store and access documents before and after a hearing?
- Can participants quickly access evidence you want to show them?
- Can you and others search quickly for evidence others need to see?

All these issues are now manageable as the following slides will illustrate

- Can you prevent inadvertent disclosures when sharing documents in a zoom screen share?
- Do the participants need their own software to view evidence?
- Can participants store and access documents before and after a hearing?
- Can participants quickly access evidence you want to show them?
- Can you and others search quickly for evidence others need to see?

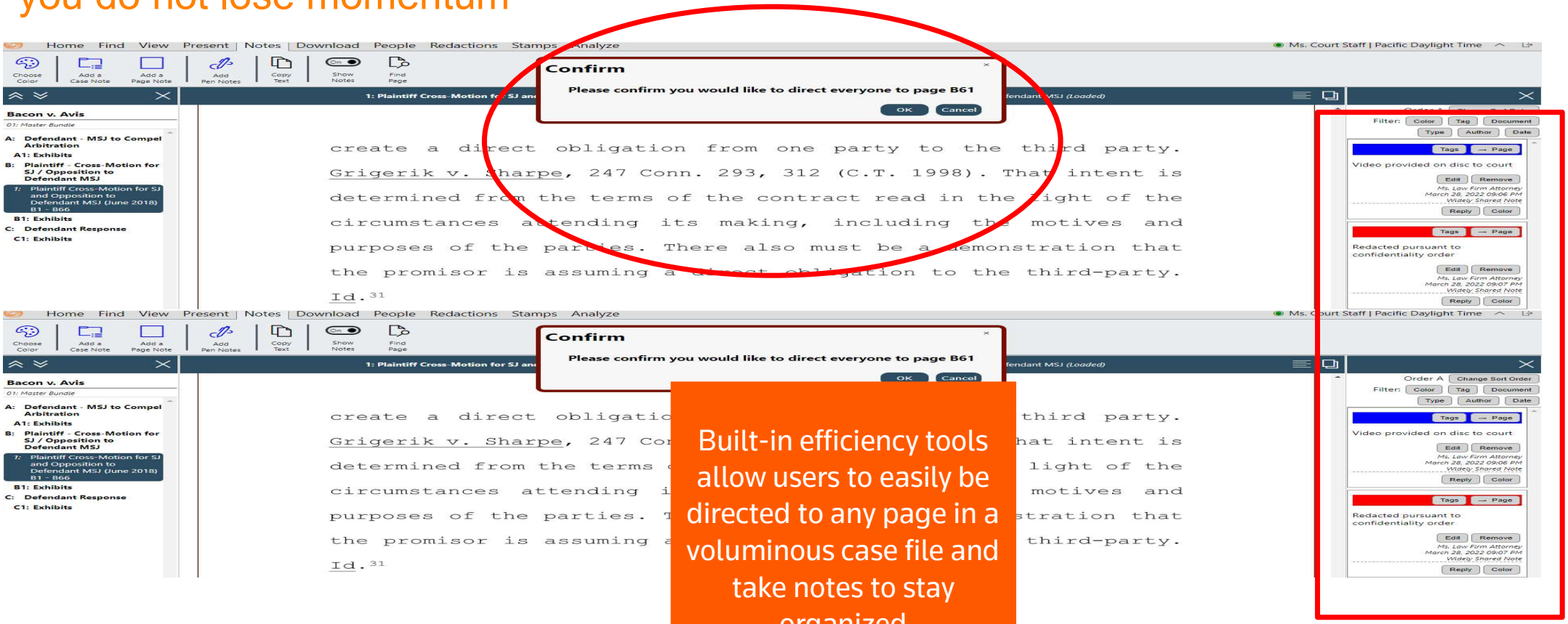
- Yes, use software where parties can access documents in a second browser window
- No, use cloud solutions so no-one need install software
- Yes, cloud solutions let you give time-limited access but control downloads
- Yes, make sure your software has good navigation tools that everyone can use
- Yes, cloud solutions use the latest AI for super fast searching without downloading files

With a move to electronic exhibits good organization upfront is critical

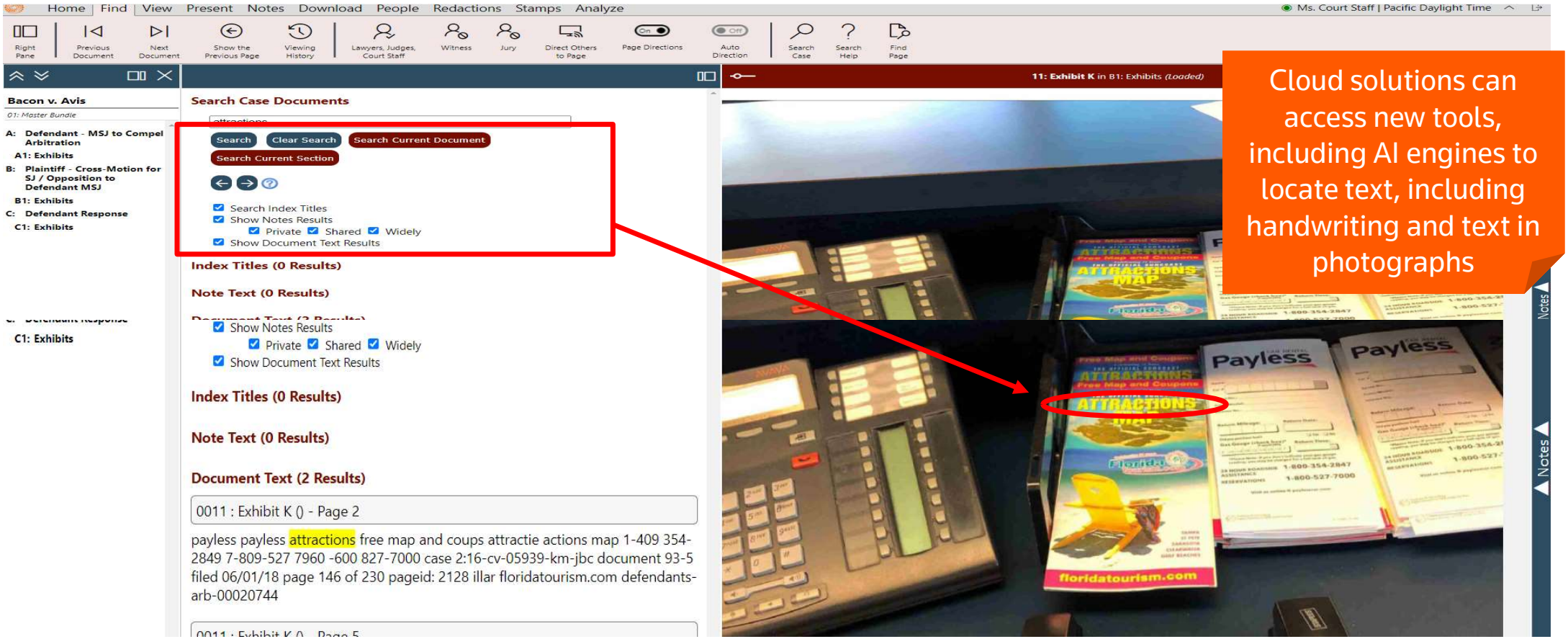


Newer solutions, such as Case Center, allow advance organization and permission controlled sharing

In a remote hearing you need to get everyone on the same page quickly so you do not lose momentum



Enhanced search also becomes more useful, especially in arbitration where the arbitrator may want to review material prior to award

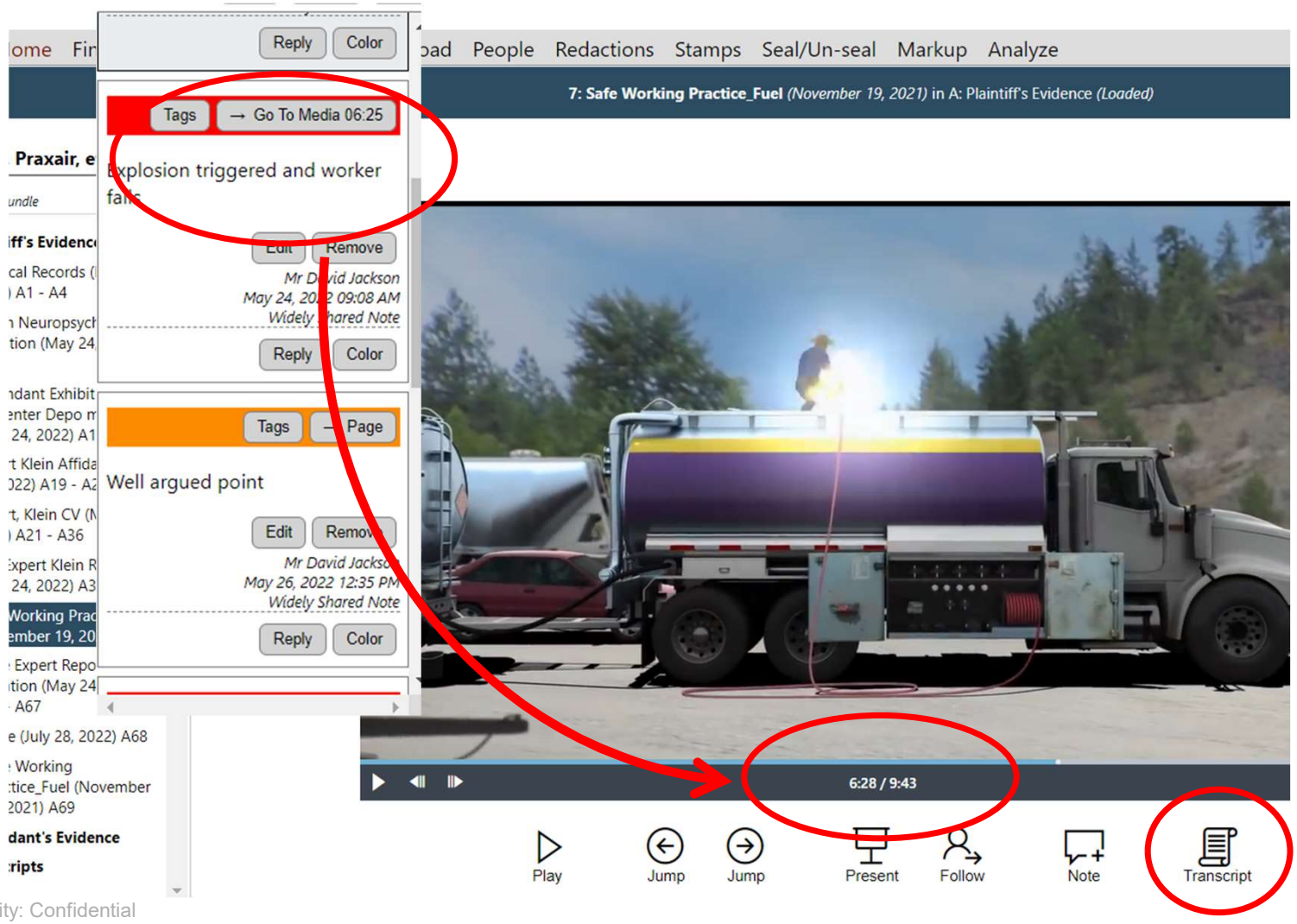


Multimedia use is growing, but to manage it in a remote hearing there are additional issues to consider

- Your software must accommodate a wide variety of file formats
- It has to be easy to get to the right point in the video or audio file
- You have to be able to get all participants copies of the multimedia files
- And … must display in a standard file format such as MPEG-4 so no-one else has issues
- And … everyone else has to get to the same point too!
- And … make sure others have sufficient bandwidth to download, or the software and hardware to read thumbdrives

THOMSON REUTERS®

Software that lets you embed video will be invaluable for all parties. Even better if it can cue up exactly what you want to show



Later we will look at automatic transcription

THOMSON REUTERS®

Cybersecurity is becoming a critical risk in dispute resolution– especially for PIABA members; client data is highly sensitive and not in the public domain

- Is your software properly certified?
- Is there an audit trail of all user access?
- Can you impose 2 factor authentication on users?
- Do you have redaction capability?
- Can you manage granular access to the electronic filings?

These are the standards to look for:

- ISO 27001 certification for info sec mgmt.
- SOC 2 independent audit
- Independent penetration testing
- FBI CJIS compliance
- FedRAMP approval

THOMSON REUTERS®

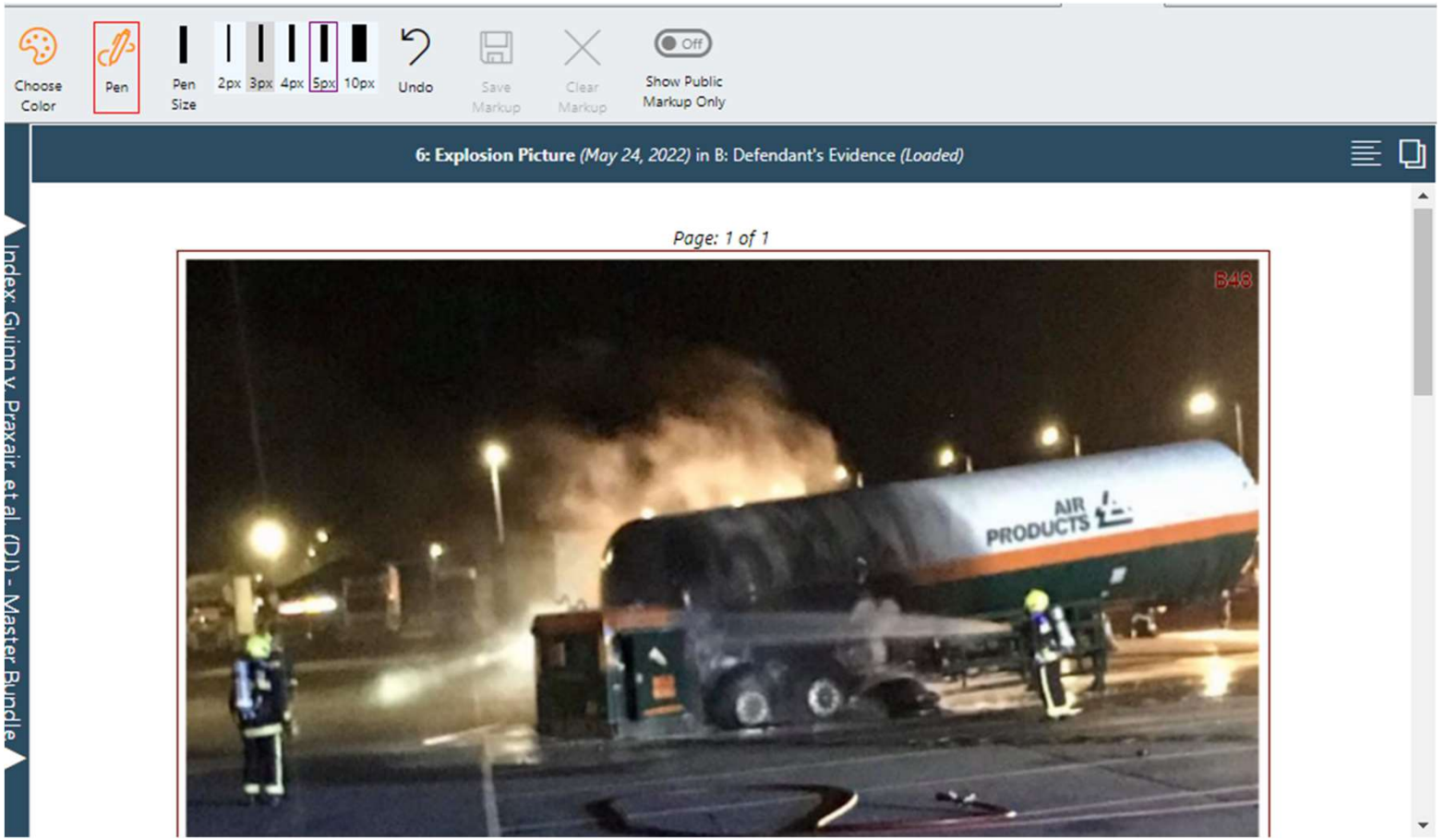
The latest technologies also empower litigators in new ways to do remotely what you can do today in a physical hearing – we will look at three

- Exhibit mark up
- Automatic transcription
- Citation analysis

THOMSON REUTERS®

Witness presentation and markup is more difficult remotely, but technology can help

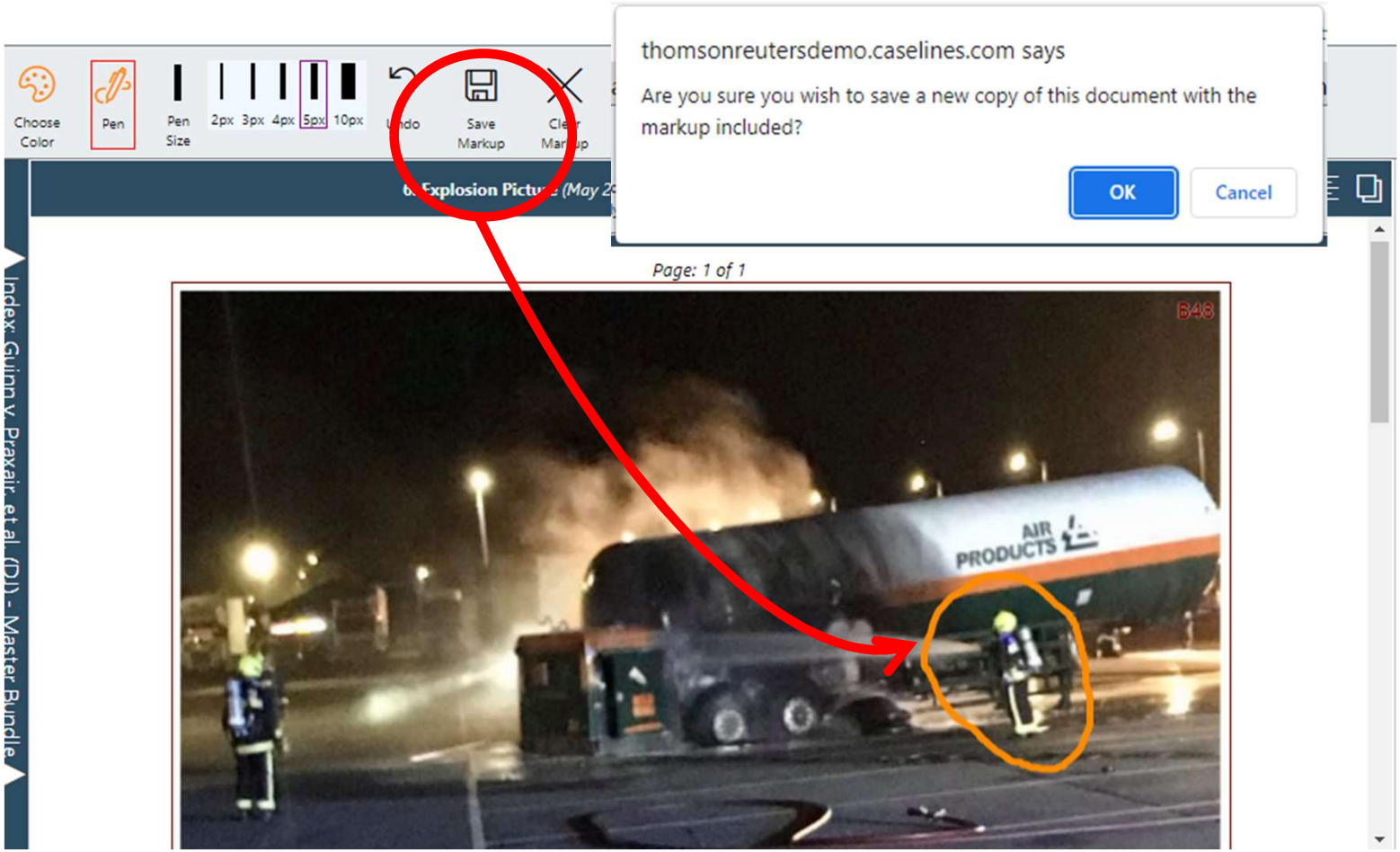
If the witness has a tablet or touch screen PC they can mark up themselves, otherwise make sure this option is available to counsel too



THOMSON REUTERS®

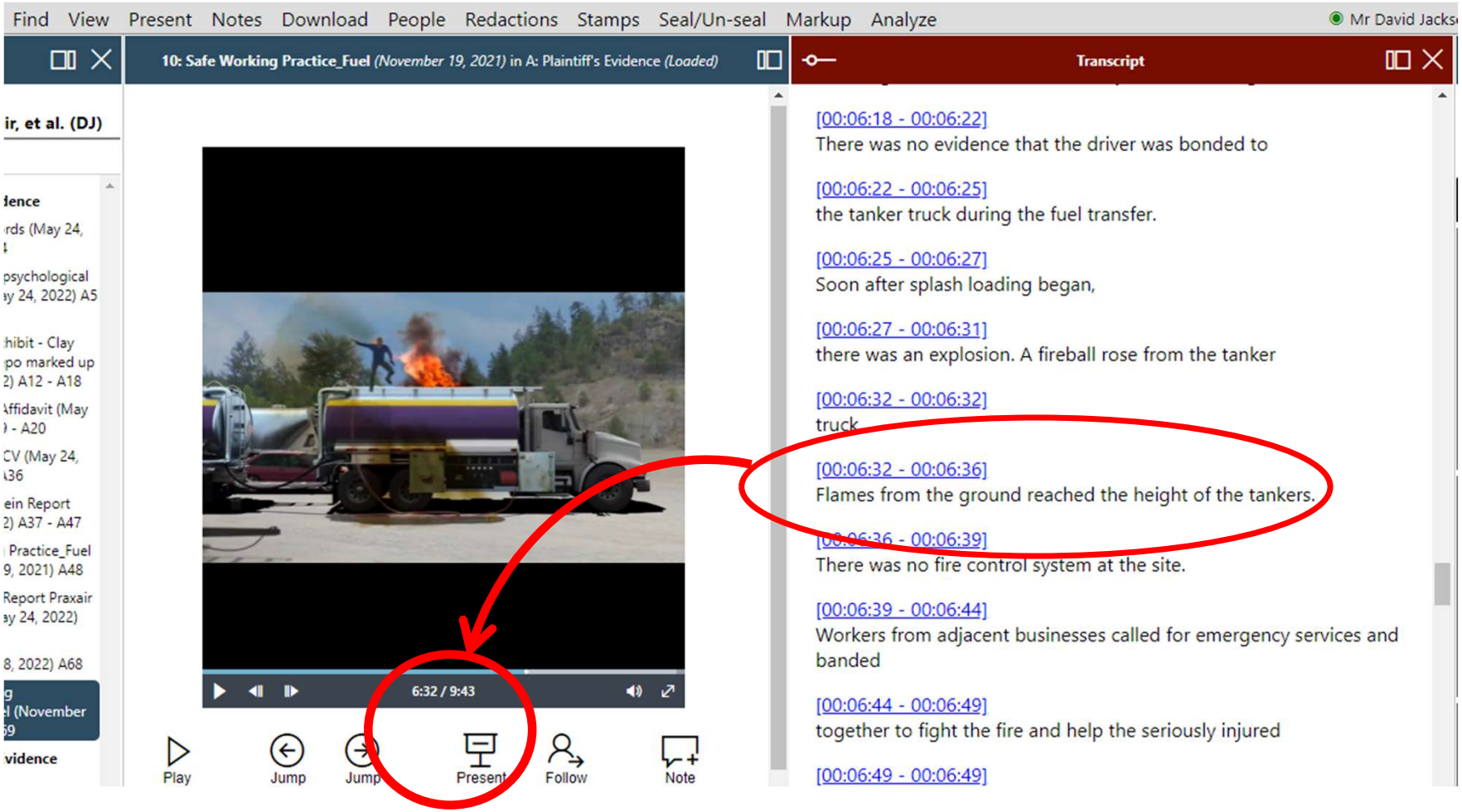
Witness presentation and markup is more difficult remotely, but technology can help

Make sure the software can store marked up documents as a complete record of the hearing



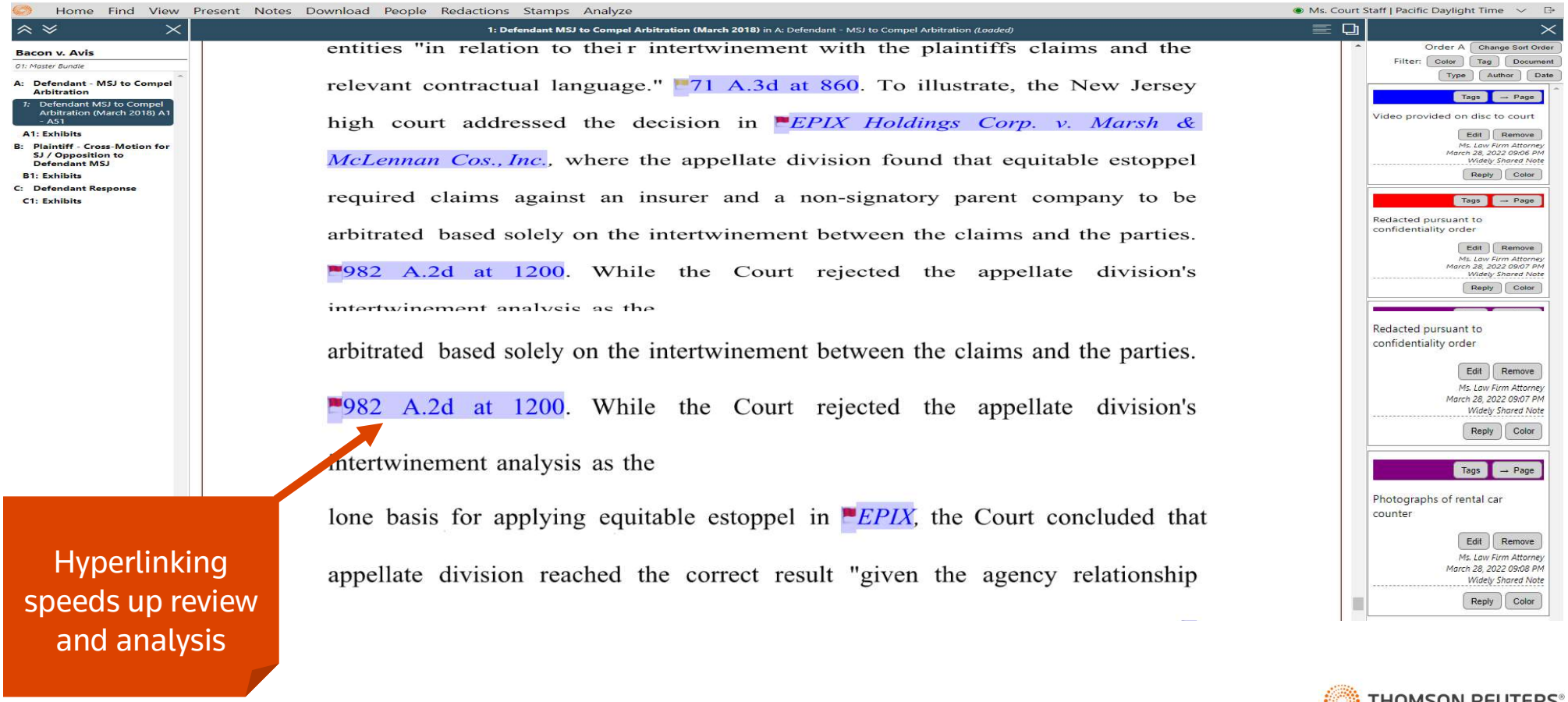
THOMSON REUTERS®

Automatic transcription, using AI, is a powerful new tool that aids review both pre- and post-hearing



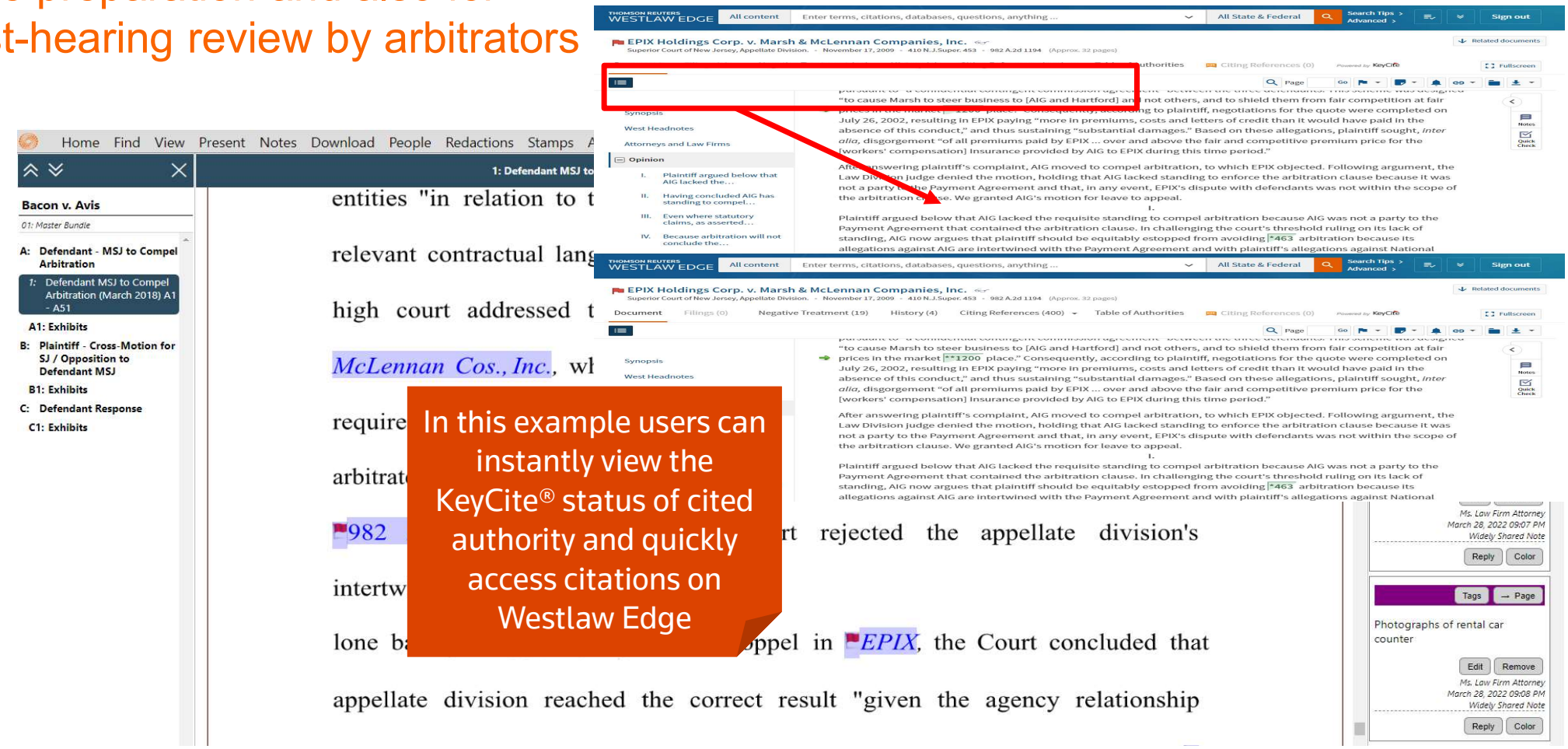
THOMSON REUTERS®

Another booming use of AI is in citation tools, both to assist in case preparation and also for post-hearing review by arbitrators

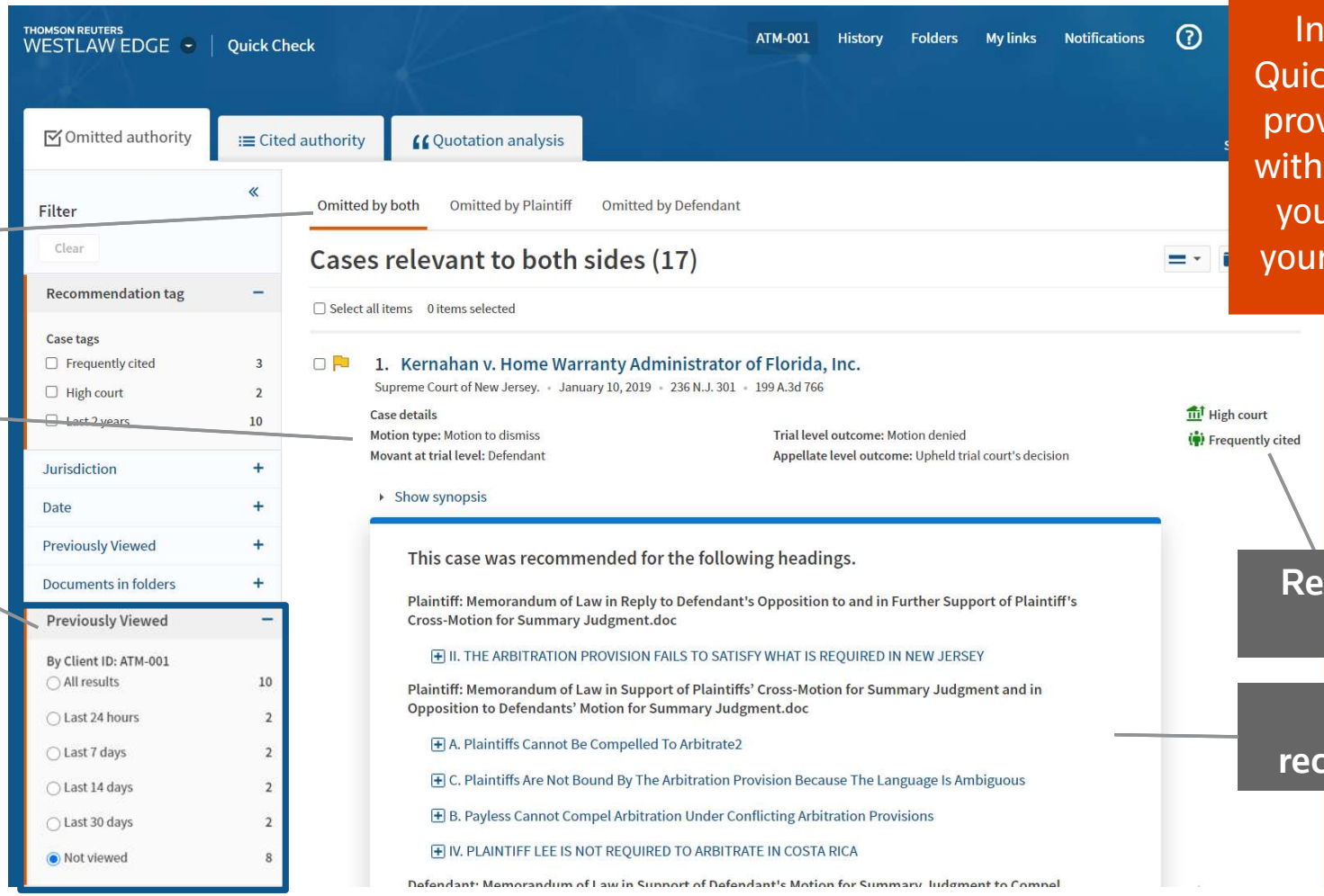


THOMSON REUTERS®

Another booming use of AI is in citation tools, both to assist in case preparation and also for post-hearing review by arbitrators



Citation analysis tools can help level the playing field for smaller law offices and make life easier for arbitrators



Organized by party

Relevant case details

Filter documents recently viewed

In this example Quick Check Judicial provides one report with the information you need to finish your research faster

Recommendation tags

Context for recommendations

THOMSON REUTERS®

Remote arbitration is now well established, prompting market responses to support electronic exhibit management, as Ian Hardy will explain (this slide will be updated prior to presentation to reflect latest market developments)

AAA

- Conducts 500+ hearings/month remotely
- Provides Zoom and a document storage repository
- Permits parties to use technical support

JAMS

- Uses HIPPA compliant version of Zoom
- Provides document repository for document sharing
- Exhibits presented via screenshare in Zoom

Optima Juris

- Provides court reporting and transcription services for deposition and hearings – platform agnostic, Optima Juris works with JAMS, AAA or neither
- Provides secure document repository for exhibits and other documents
- Offers technical support for exhibit presentation and management
- Optima Juris has recently introduced a fully managed service for electronic exhibit management and presentation, using the Case Center platform

THOMSON REUTERS®

Managing evidence electronically need not be difficult and service providers ("SP") are responding to support litigators

S I M P L E

Case Notification	Document loading	Depositions	Hearing presentation	Post-hearing
• SP sets up Case Center case • SP bills flat fee to parties • SP creates template for case structure, adds users & permissions	• Parties load hearing material into • Parties use Case Center for internal review and to "meet & confer" • SP provides remote support desk	• Parties use Case Center for witness deposition	• SP gives access to arbitrator(s) • Parties use Case Center for hearing presentation and witness examination • SP provides remote support desk	• Arbitrator uses Case Center for award preparation (transcript hyperlinked to exhibits, briefs hyperlinked to Westlaw etc)

THOMSON REUTERS®

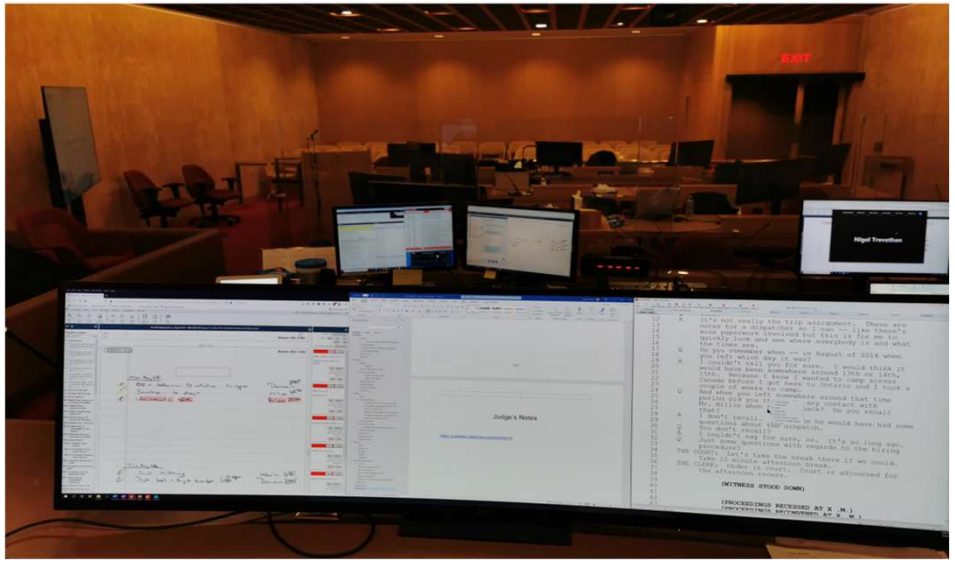
In more complex cases, especially with large document volumes, service providers can deliver “on the ground” support as well

Case Notification	Document loading	Depositions	Hearing presentation	Post-hearing
SIMPLE				
• SP sets up Case Center case • SP bills flat fee to parties • SP creates template for case structure, adds users & permissions	• Parties load hearing material into • Parties use Case Center for internal review and to “meet & confer” • SP provides remote support desk	• Parties use Case Center for witness deposition	• SP gives access to arbitrator(s) • Parties use Case Center for hearing presentation and witness examination • SP provides remote support desk	• Arbitrator uses Case Center for award preparation (transcript hyperlinked to exhibits, briefs hyperlinked to Westlaw etc)
COMPLEX				
	• SP manages case load and document organisation • SP provides advanced user training	• SP provides court reporting and document management service	• SP provides “doc tech” support and manages hearing presentation	

THOMSON REUTERS®

What technologies do you need for a remote appearance?





- Make sure you are agnostic regards Teams, Zoom, etc
- Use a touchscreen monitor for Case Center presentation so that you can mark up
- Have a back up internet option – learn to tether your cellphone
- Have a second screen for your Zoom call so that you can see the parties at all times
- Consider an external camera (Nexigo is cheap and good)

These technologies are worth getting to know, with most value coming from solutions that support your whole process

	Pre-trial preparation	Depositions	Hearing presentation	Post-hearing
	Thomson Reuters® Case Center	Thomson Reuters® Case Center	Thomson Reuters® Case Center	Thomson Reuters® Case Center
Presentation		oncue, AGILELAW, eDepoze	TRIALPAD	
Hybrid		OPUS 2, CourtCall		
Video		zoom, Microsoft Teams		
Storage		box		

Only Case Center has FedRAMP approval

y: Confidential

THOMSON REUTERS®

Thank You

Questions

THOMSON REUTERS®

THE FINANCIAL INDUSTRY REGULATORY AUTHORITY'S DISPUTE RESOLUTION ACTIVITIES

Revised August 4, 2022

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 8,400 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 Services (DRS) staff. A majority of the NAMC members and its chair are public. FINRA is regulated by the U.S. 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 Notices; Significant Initiatives; FINRA Neutrals; Technology Initiatives; Mediation; and Arbitrator Selection News.

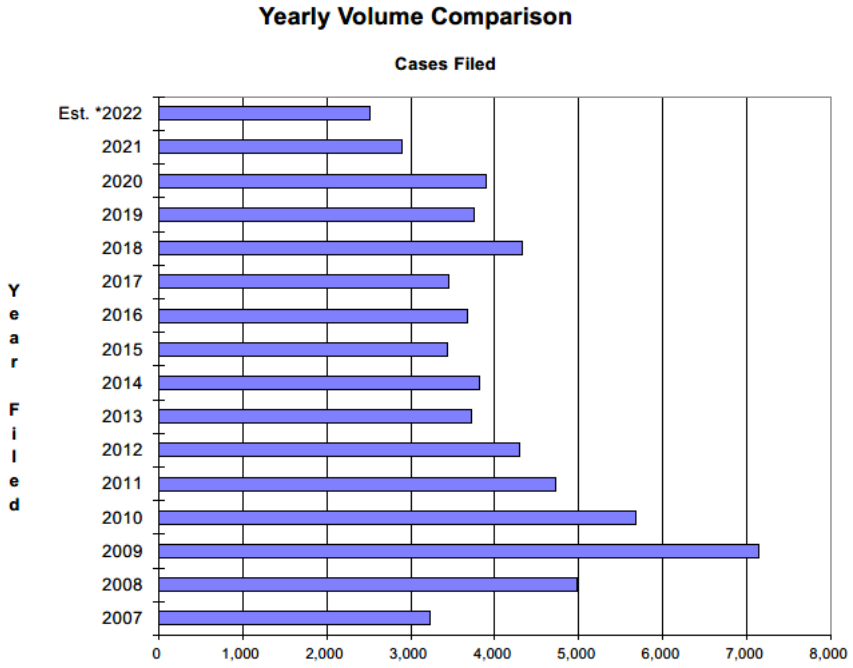
II. STATISTICS AND TRENDS

Arbitration case filings decreased through June 2022 compared to June 2021. Through June 2022, parties filed 1,260 cases – an 18% decrease from the 1,537 cases filed through June 2021. Customer claims decreased by 23% in June 2022 compared to June 2021. In June 2022, 38% of filed claims were intra-industry cases.

Mediation cases increased in June 2022 compared to June 2021. In June 2022, 465 mediation cases were filed compared to 223 in June 2021.

Case Filing Statistics for June 2022 - This section provides key filing data and trends.

Overall Arbitration Case Filings:
June 2022: 1,260 (18% decrease compared to June 2021).



Overall Mediation Case Filings:
June 2022: 465 (109% increase compared to June 2021).

© 2022 FINRA

Customer Award Statistics

Cases in which customers were awarded damages in June 2022:

- Overall: 37% (31% in 2021, 32% in 2020, and 45% in 2019).
- Regular Hearing cases (not including cases decided by Special Proceeding or review of documents only): 39% (37% in 2021, 34% in 2020 and 45% in 2019).[1]

Awards on the Merits of Customer Claimant Cases with One or More Zoom Evidentiary Hearings[2]

Year Decided	Cases Decided	Customer Awarded Damages	Customer Not Awarded Damages	Percentage of Cases Where Customer Awarded Damages
2022	66	32	34	48%
2021	136	60	76	44%
2020	30	12	18	40%

Awards on the Merits of Customer Claimant Cases with In-Person Evidentiary Hearings[3]

Year Decided	Cases Decided	Customer Awarded Damages	Customer Not Awarded Damages	Percentage of Cases Where Customer Awarded Damages
2022	34	16	18	47%
2021	46	22	24	48%
2020	34	17	17	50%

[1] In calculating this statistic, cases dismissed prior to the hearing on the merits are counted as cases in which the customer claimant was not awarded damages.
[2] The data in this chart excludes cases dismissed prior to the hearing on the merits.
[3] The data in this chart excludes cases dismissed prior to the hearing on the merits.

© 2022 FINRA

Case Processing Statistics

Processing times from service of the claim to close of the case in June 2022:

- Overall: 17.7 months (29% increase compared to June 2021).
- Hearing cases: 19.6 months (29% increase compared to June 2021).
- Special Proceeding cases: 7.9 months (2% decrease compared to June 2021).
- Paper cases (decided on the documents submitted without a hearing): 5.3 months (2% decrease compared to June 2021).

Percentage of all arbitration cases closed by award in June 2022:

- 19% (compared to 15% in 2021, 13% in 2020 and 16% in 2019).
- In June 2022, customer cases closed by settlement approximately 73% of the time.

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

Type of Controversy *		2022 Cases Served	2021	2020	2019	2018
Breach of Fiduciary Duty	Through June	594	786	842	981	1,183
	Year-End	--	1,445	1,714	2,053	2,290
Negligence	Through June	540	735	763	884	973
	Year-End	--	1,371	1,592	1,826	1,974
Failure to Supervise	Through June	472	627	713	818	959
	Year-End	--	1,218	1,433	1,731	1,935
Breach of Contract	Through June	444	597	623	722	830
	Year-End	--	1,110	1,292	1,563	1,711
Misrepresentation	Through June	436	644	679	742	984
	Year-End	--	1,181	1,384	1,688	1,775
Suitability	Through June	416	530	626	708	1,021
	Year-End	--	1,071	1,220	1,580	1,779
Omission of Facts	Through June	344	529	593	664	852
	Year-End	--	958	1,215	1,468	1,547
Fraud	Through June	310	390	506	695	864
	Year-End	--	744	918	1,499	1,707
Violation of Blue Sky Laws	Through June	155	192	153	291	397
	Year-End	--	355	338	657	810
Manipulation	Through June	109	165	170	166	128
	Year-End	--	285	316	384	302
Elder Abuse	Through June	77	80	91	101	117
	Year-End	--	162	172	207	216
Unauthorized Trading	Through June	75	90	91	106	128
	Year-End	--	160	190	197	245
Breach of Regulation BI**	Through June	54	--	--	--	--
	Year-End	--	--	--	--	--
Errors-charges	Through June	49	79	42	33	45
	Year-End	--	127	102	98	81
Execution Error	Through June	37	45	30	32	39
	Year-End	--	84	91	51	75

* 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.
**These categories were not tracked for the years in which no data appears.

© 2022 FINRA

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

Type of Security *		2022 Cases Served	2021	2020	2019	2018
Common Stock	**Through June**	160	244	196	243	324
	Year-End	--	433	385	436	579
Real Estate Investment Trust	**Through June**	111	228	136	112	91
	Year-End	--	429	421	236	205
Corporate Bonds	**Through June**	82	32	38	44	70
	Year-End	--	57	79	74	135
Private Equities	**Through June**	69	84	145	63	54
	Year-End	--	161	213	149	111
Mutual Funds	**Through June**	61	94	95	265	341
	Year-End	--	161	177	526	731
Options	**Through June**	59	87	97	118	103
	Year-End	--	157	180	204	150
Limited Partnerships	**Through June**	56	76	84	53	77
	Year-End	--	134	146	128	144
Business Development Company	**Through June**	50	115	24	13	6
	Year-End	--	177	218	26	20
Annuities	**Through June**	36	44	38	49	51
	Year-End	--	98	93	97	101
Variable Annuities	**Through June**	25	41	48	53	51
	Year-End	--	75	95	109	105
Exchange-Traded Funds	**Through June**	25	36	51	60	104
	Year-End	--	76	95	138	167
Municipal Bond Funds	**Through June**	24	33	81	338	446
	Year-End	--	57	136	717	959
401(k)	**Through June**	19	18	41	26	45
	Year-End	--	41	73	58	94
Preferred Stock	**Through June**	18	16	21	21	31
	Year-End	--	31	37	40	59
Municipal Bonds	**Through June**	16	30	98	331	462
	Year-End	--	51	148	702	971

* 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 Controversy *		2022 Cases Served	2021	2020	2019	2018
Breach of Contract	**Through June**	106	142	157	175	177
	Year-End	--	268	309	345	413
Compensation	**Through June**	44	46	72	71	79
	Year-End	--	84	135	135	168
Libel or Slander on Form U-5	**Through June**	43	46	73	60	77
	Year-End	--	89	148	119	135
Promissory Notes	**Through June**	42	72	127	120	135
	Year-End	--	126	229	240	261
Libel, Slander, or Defamation	**Through June**	37	24	73	74	90
	Year-End	--	59	152	135	166
Wrongful Termination	**Through June**	28	33	54	55	65
	Year-End	--	62	101	102	122
Commissions	**Through June**	23	27	38	40	42
	Year-End	--	55	72	82	95
Discrimination or Harassment**	**Through June**	14	18	20	26	24
	Year-End	--	36	38	46	38
Raiding Disputes	**Through June**	12	8	13	11	18
	Year-End	--	13	28	21	37
Breach of Fiduciary Duty	**Through June**	8	13	13	22	25
	Year-End	--	23	31	30	39
Fraud	**Through June**	6	3	11	9	13
	Year-End	--	8	16	11	24
Negligence	**Through June**	6	2	7	14	21
	Year-End	--	9	17	17	32
Misrepresentation	**Through June**	4	4	27	26	42
	Year-End	--	12	57	29	68
Suitability	**Through June**	4	3	41	15	53
	Year-End	--	5	82	17	63
Failure to Supervise	**Through June**	3	3	4	4	6
	Year-End	--	3	10	7	11

* 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.
** This category combines the following discrimination controversy types: disability, age, gender, race, sexual orientation, national origin, religion, employment discrimination, and sexual harassment. This number does not represent the number of cases served, as one case may have multiple discrimination claims.

© 2022 FINRA

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
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%
2021	139	54	39%	46	14	30%
YTD 2022	81	37	46%	29	5	17%

Through June 2022, investors prevailed 46% of the time (37 out of 81 cases) in cases decided by all-public panels and 17% of the time (5 out of 29 cases) in cases decided by majority-public panels. To find more information on case statistics and award outcomes please visit the **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

Effective August 2, 2021, all FINRA DRS hearing locations are open for in-person arbitration and mediation proceedings. More information about the impact on arbitration and mediation hearings is available on FINRA.org **here**.

Vaccination Requirement for In-Person Participants

Effective June 6, 2022 through December 31, 2022, all in-person participants, including arbitrators, mediators, counsel, parties, paralegals, witnesses, and others, must be fully vaccinated to attend FINRA Dispute Resolution Services arbitration hearings or

© 2022 FINRA

mediation sessions. An exception will be made for in-person participants who attest that there are circumstances preventing them from being vaccinated. All in-person participants must attest that they have taken a negative PCR or antigen test within 24 hours of the start of the hearing and every 24 hours during the course of the hearing. Arbitrators may request reimbursement for at-home COVID tests. For all other in-person participants, the costs associated with COVID testing are the responsibility of the parties or individuals that incurred them.

Testing Requirement for In-Person Participants (Florida Hearing Locations Only)

Effective June 6, 2022 through December 31, 2022, for cases with in-person arbitration hearings or mediation sessions in Florida, all in-person participants, including arbitrators, mediators, counsel, parties, paralegals, witnesses, and others, must attest that they have taken a negative PCR or antigen test within 24 hours of the start of the hearing and every 24 hours during the course of the hearing. Arbitrators may request reimbursement for at-home COVID tests. For all other in-person participants, the costs associated with COVID testing are the responsibility of the parties or individuals that incurred them.

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**. 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 on **FINRA.org**. 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 any additional questions about virtual hearings.

© 2022 FINRA

IV. RECENT SIGNIFICANT RULE CHANGES

Regulatory Notice 22-15: FINRA Amends the Code of Arbitration Procedure for Industry Disputes to Align the Code with the Ending Forced Arbitration of Sexual Assault and Sexual Harassment Act of 2021

On July 15, 2022, FINRA issued a regulatory notice announcing amendments to the Code of Arbitration Procedure for Industry Disputes to align the Code with the Ending Forced Arbitration of Sexual Assault and Sexual Harassment Act of 2021. The rule change also makes a conforming amendment to FINRA Rule 2263. FINRA designated this rule change as constituting a "non-controversial" rule change under the Securities Exchange Act, which rendered the proposal effective upon its filing.

V. PROPOSED RULE CHANGES

Regulatory Notice 22-09: FINRA Requests Comment on a Proposed Rule to Accelerate Arbitration Proceedings for Seriously Ill or Elderly Parties

On March 16, 2022, FINRA filed a regulatory notice seeking comment on a proposal to accelerate arbitration case processing when requested by parties who are seriously ill or are at least 75 years old. The proposal would help ensure that these parties are able to participate meaningfully in FINRA arbitration by shortening certain case processing deadlines for parties and arbitrators under the Codes. The comment period ended May 16, 2022.

Proposed Rule Change to Amend the Codes of Arbitration Procedure to Modify the Current Process relating to the Expungement of Customer Dispute Information

On July 29, 2022, FINRA filed with the SEC proposed amendments to the Codes to impose requirements on expungement requests (a) filed by an associated person during an investment-related, customer-initiated arbitration ("customer arbitration"), or filed by a party to the customer arbitration on behalf of an associated person ("on-behalf-of request"), or (b) filed by an associated person separate from a customer arbitration ("straight-in request"). Specifically, the proposed rule change would: (1) require that a straight-in request be decided by a three-person panel that is randomly selected from a roster of experienced public arbitrators with enhanced expungement training; (2) prohibit parties to a straight-in request from agreeing to fewer than three arbitrators to consider their expungement requests, striking any of the selected arbitrators, stipulating to an arbitrator's removal, or stipulating to the use of pre-selected arbitrators; (3) provide notification to state securities regulators of all

© 2022 FINRA

expungement requests and a mechanism for state securities regulators to attend and participate in expungement hearings in straight-in requests; (4) impose strict time limits on the filing of straight-in requests; (5) codify and update the best practices in the Notice to Arbitrators and Parties on Expanded Expungement Guidance applicable to all expungement hearings, including amendments to establish additional requirements for expungement hearings, to facilitate customer attendance and participation in expungement hearings and to codify the panel's ability to request any evidence relevant to the expungement request; (6) require the unanimous agreement of the panel to issue an award containing expungement relief; and (7) establish procedural requirements for filing expungement requests, including for on-behalf-of requests. The proposed rule change would also amend the Customer Code to specify procedures for requesting expungement of customer dispute information during simplified arbitrations.

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 NOTICES

FINRA Reminds Members About Requirements When Using Predispute Arbitration Agreements for Customer Accounts

In April 2021, FINRA published **Regulatory Notice 21-16** to remind member firms about requirements when using predispute arbitration agreements for customer accounts. Where member firms use mandatory arbitration clauses in their customer agreements, FINRA rules establish minimum disclosure requirements regarding the use of such clauses and prohibit predispute arbitration agreements from including conditions that, among other things, limit or contradict FINRA rules. In addition, FINRA rules do not allow class action claims in FINRA arbitration. Accordingly, FINRA rules prohibit member firms from incorporating provisions that would prevent customers from bringing or participating in judicial class actions by adding waiver language into

© 2022 FINRA

customer agreements (class action waivers) and prohibit member firms from enforcing arbitration agreements against members of a certified or putative class action. FINRA urges member firms to take prompt steps to ensure their customer agreements fully comply with FINRA rules. Member firms that fail to comply with FINRA rules related to customer agreements may be subject to disciplinary action.

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

© 2022 FINRA

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.

© 2022 FINRA

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.

The **Notice to Arbitrators and Parties on Expanded Expungement Guidance** can be found on 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 DRS quarterly newsletter for FINRA neutrals has provided expungement information and updates in numerous editions of *The Neutral Corner*.

December 2013 Edition (Volume 4, 2013)
This edition was devoted to expungement and included articles emphasizing the procedural requirements in recommending expungement and discussing the limitations on types of disclosures that may be expunged from CRD through arbitration.

September 2014 Edition (Volume 3, 2014)
This edition 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.

© 2022 FINRA

October 2015 Edition (Volume 3, 2015)
This edition included information on recent court decisions on expungement.

December 2015 Edition (Volume 4, 2015)
This edition included information on parties making second expungement requests after a previous denial.

March 2019 Edition (Volume 1, 2019)
This edition 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.

October 2019 Edition (Volume 3, 2019)
This edition included information on the Spring 2019 Neutral Workshop titled "Expungement of Customer Dispute Information."

March 2020 Edition (Volume 1, 2020)
This edition included information about FINRA's rule filing to apply minimum filing fees to requests for expungement of customer dispute information.

July 2020 Edition (Volume 2, 2020)
This edition included information about the SEC approval of the rule filing to apply minimum filing fees to requests for expungement of customer dispute information.

September 2020 Edition (Volume 3, 2020)
This edition 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.

September 2020 Edition (Volume 3, 2020); December 2020 Edition (Volume 4, 2020); March 2021 Edition (Volume 1, 2021); and June 2021 Edition (Volume 2, 2021)
These four editions included information about proposed amendments to the Codes relating to requests to expunge customer dispute information, including creating a special arbitrator roster to decide certain expungement requests.

June 2022 Edition (Volume 2, 2022)
This edition included information on the Discussion Paper issued by FINRA on April 22, 2022 providing background and data regarding expungement of customer dispute information and exploring potential alternatives to the current expungement process.

© 2022 FINRA

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 FINRA.org.

FINRA DR Portal User Guide: FINRA revised the **FINRA DR Portal User 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.

© 2022 FINRA

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 on 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.

© 2022 FINRA

- 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 our website 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.

We are continuously enhancing the diversity of our arbitrator roster. Since 2016, FINRA DRS has worked with a third-party consultant to survey annually—on an anonymous and voluntary basis—the demographics of newly added and existing neutrals and have made them available on FINRA's website. In sharing the findings, FINRA strives to

© 2022 FINRA

provide transparency about the current makeup of our arbitrator and mediator rosters.

Our 2021 demographic survey of the roster demonstrates our best results ever. The 2021 survey showed that we outperformed versus 2020 in key demographic groups. Of the new arbitrators added in 2021:

- 45% were female (40% in 2020)
- 23% were Black or African-American (14% in 2020)
- 7% were Hispanic or Latino (3% in 2020)
- 6% were Multi-Racial (3% in 2020)
- 5% were LGBTQ (2% in 2020)
- 4% were Asian (same as in 2020)

We are also enhancing the diversity of our mediator roster. Of mediators (who may also be arbitrators) polled in 2021, 25% were women, 8% African-American, 6% Hispanic or Latino, 4% Multi-Racial, 1% Asian, and 5% were LGBTQ.

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.

© 2022 FINRA

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 26, 2022, there were 4,069 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 2021, the average time to train arbitrators was 60 days (908 candidates trained). New arbitrators are invited to participate in voluntary 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;

© 2022 FINRA

- 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** section of our website 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 our website at FINRA.org. 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).

© 2022 FINRA

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 includes in customer awards information about the panel composition.

Videoconferencing

All four of FINRA's regional office locations have videoconferencing capabilities. We also offer videoconferencing in DRS' 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.

FINRA DRS' New York City and Jersey City hearing rooms offer the latest Zoom technology which is more user-friendly, has better sound and picture quality, and is easier to set up with remote locations. DRS' three other regional offices (Boca Raton, Chicago, and Los Angeles) will offer the same technology by the fourth quarter of 2022.

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**, which is accessible from the **Initiate a Mediation** page at FINRA.org. 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

© 2022 FINRA

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

FINRA expanded the Mediation Program for Small Arbitration Claims by increasing the maximum amount in controversy from $50,000 to $100,000 and making available all virtual platforms (telephonic and video) for these mediations. With these changes, the program is able to provide more parties the benefit of an expedient and cost-effective option for resolving small claims while also introducing parties to qualified, but underutilized diverse mediators on our roster.

The program offers virtual mediation at these costs:

- no cost for arbitration claims of $25,000 or less;
- $50 per hour for cases with claims between $25,000 and $50,000 to cover reduced mediator fees. (FINRA collects this fee and divides it equally between the parties); and
- $100 per hour for cases with claims between $50,000 and $100,000 to cover reduced mediator fees. (FINRA collects this fee and divides it equally between the parties).

Virtual mediation offers parties the option to participate in a mediation from their own homes. It also provides mediators with additional opportunities to mediate in hearing locations across the country, regardless of the mediator's home base. To help facilitate efficient virtual mediations, FINRA developed the **Guide for Using Breakout Rooms in Mediation**.

When parties mediate through this program, FINRA waives all mediation filing fees. Please contact FINRA's **Mediation Department** if you have any questions about this program.

© 2022 FINRA

For more information on FINRA's Mediation Program visit the **Learn About Mediation** page at FINRA.org.

XI. ARBITRATOR SELECTION NEWS

Recent Court of Appeals of Georgia Decision

On January 25, 2022, a Fulton County, Ga. Superior Court vacated an arbitration award in favor of respondent Wells Fargo. The court decision found, among other things, that Wells Fargo and its counsel manipulated the arbitrator selection process through an agreement with FINRA. In February 2022, the Audit Committee of the FINRA Board of Governors **engaged Lowenstein Sandler LLP** to conduct an independent review in connection with the Fulton County, Ga. Superior Court decision. Details on the outcome of this review are discussed below.

On August 2, 2022, the Court of Appeals of Georgia reversed the Fulton County, Ga. Superior Court decision finding no evidence of an agreement between Wells Fargo and FINRA. Furthermore, the Court of Appeals of Georgia found nothing that indicated Wells Fargo manipulated the arbitrator pool in the subject arbitration.

Independent Review of Arbitrator Selection Process

On June 29, 2022, FINRA **published the report** of the independent counsel, Lowenstein Sandler LLP, which found no evidence of an improper agreement to remove certain arbitrators from arbitration cases. **The report** also stated that FINRA personnel generally adhered to policies and procedures and that their actions were intended to be fair and reasonable at each step of the relevant arbitration.

The independent counsel's report did make some recommendations, which FINRA will promptly implement. More news on this progress will become available on FINRA.org in the coming months.

© 2022 FINRA

OVERVIEW OF INCREASED FOCUS ON CRYPTOCURRENCY ENFORCEMENT AND GUIDANCE

Jorge L. Riera, Esq., CPA, MAcc, CGMA

I. 2022 SEC ENFORCEMENT ACTIONS

The SEC continues to aggressively pursue potential federal securities laws violations in the crypto world. In May 2022, the SEC nearly doubled the number of attorneys in the Division of Enforcement's Crypto Assets and Cyber Unit, which, since its inception in 2017, has brought more than 80 enforcement actions in the crypto space. We expect the SEC's aggressive crypto enforcement to continue.

Press Release: SEC Nearly Doubles Size of Enforcement's Crypto Assets and Cyber Unit (May 3, 2022) https://www.sec.gov/news/press-release/2022-78

1. SEC v. Okhotnikov et al., No. 1:22-cv-03978 (N.D. Ill. Aug. 1, 2022) https://www.sec.gov/litigation/complaints/2022/comp-pr2022-134.pdf

The SEC filed a complaint against 11 crypto founders for their roles in creating and promoting Forsage. The SEC's complaint alleged that Forsage is a fraudulent crypto pyramid and Ponzi scheme that raised more than $300 million from millions of retail investors worldwide in connection with the crypto platform Forsage. According to the SEC's complaint, Forsage operated on the Ethereum and Tron, and later the Binance, blockchains, using smart contracts to direct funds to an investor as additional investors were recruited into the scheme. The smart contracts allocated payments automatically to investors' crypto-asset wallets.

According to the SEC's complaint, "Forsage is a textbook pyramid and Ponzi scheme. It did not sell or purport to sell any actual, consumable product to bona fide retail customers during the relevant time period and had no apparent source of revenue other than funds received from investors. The primary way for investors to make money from Forsage was to recruit others into the scheme. To participate, an investor created a crypto-asset wallet and then purchased "slots" in Forsage's smart contracts, which gave the investor the right to earn compensation from others whom the investor recruited into the scheme (the "downlines") and compensation from the larger Forsage community of investors in the form of profit sharing of payments known as "spillovers." When an investor purchased a slot, a portion of that investment was directed to the persons who recruited the investor (the "uplines") and the investor in turn became an upline to whomever the investor recruited. Thus, all payouts to earlier investors were made using funds received from later investors."

Key Takeaways:

- The SEC's Complaint makes clear that the SEC continues to make clear that "smart contracts" that operate on blockchain applications and allow for transactions of digital assets are securities.

- The SEC continues to pursue aggressively what it deems to be fraudulent crypto schemes, even where key defendants are foreign nationals, and the SEC will undoubtedly face

challenges in collecting civil penalties or other monetary relief. In the SEC's Complaint, those charged include the four founders of Forsage, who were last known to be living in Russia, the Republic of Georgia, and Indonesia.

- The SEC's heavy scrutiny of crypto markets and aggressive crypto enforcement is expected to continue.

Press Release: SEC Charges Eleven Individuals in $300 Million Crypto Pyramid Scheme (Aug. 1, 2022) https://www.sec.gov/news/press-release/2022-134

2. SEC v. Wahi et al., No. 2:22-cv-01009 (W.D. Wash. July 21, 2022) https://www.sec.gov/litigation/complaints/2022/comp-pr2022-127.pdf

The SEC filed a complaint against a former Coinbase product manager, his brother, and his friend for perpetrating a scheme to trade ahead of multiple announcements regarding certain crypto assets that would be made available for trading on the Coinbase platform.

According to the SEC's complaint, while Ishan Wahi was employed at Coinbase, he helped to coordinate the platform's public listing announcements that included what crypto assets or tokens would be made available for trading. Coinbase treated such information as confidential and warned its employees not to trade on the basis of, or tip others with, that information. The SEC's complaint alleges that Wahi repeatedly tipped the timing and content of upcoming listing announcements to his brother, and his friend. The SEC's complaint also alleges that ahead of those announcements, which usually resulted in an increase in the assets' prices, Wahi's brother and friend allegedly purchased at least 25 crypto assets, at least nine of which were securities, and then typically sold them shortly after the announcements for a profit. The long-running insider trading scheme generated illicit profits totaling more than $1.1 million.

Key Takeaways:

- The SEC determined that a number of the crypto assets at issue were securities, and, as alleged, the Wahi engaged in typical insider trading ahead of their listing on Coinbase.

- Carolyn M. Welshhans, Acting Chief of the Enforcement Division's Crypto Assets and Cyber Unit, stated "As today's case demonstrates, whether in equities, options, crypto assets, or other securities, we will vindicate our mission by identifying and combatting insider trading in securities wherever we see it."

Press Release: SEC Charges Former Coinbase Manager, Two Others in Crypto Asset Insider Trading Action (July 21, 2022) https://www.sec.gov/news/press-release/2022-127

3. SEC v. MCC International Corp. et al., No. 2:22-cv-14129 (S.D. Fla. Apr. 1, 2022) https://www.sec.gov/litigation/complaints/2022/comp-pr2022-81.pdf

The SEC filed a complaint against MCC International Corp. ("MCC"), d/b/a Mining Capital Coin Corp., and its founders in connection with the unregistered offerings and fraudulent sales of

investment plans called mining packages to thousands of investors. The complaint alleges that MCC and its founders netted at least $8.1 million from the sale of the mining packages and $3.2 million in initiation fees.

According to the SEC's complaint, MCC sold mining packages to 65,535 investors worldwide and promised daily returns of 1 percent, paid weekly, for a period of up to 52 weeks. The SEC alleged in its complaint that MCC represented that the weekly profits were a result of "profit sharing" and that MCC earned profits from its operations involving cryptocurrency mining, trading stocks and foreign exchange, and trading cryptocurrency on digital asset trading platforms through the use of arbitrage trading and semi-automatic robotic trading. The SEC's complaint also alleged that, in its early days, MCC investors were promised returns in Bitcoin, but later, MCC required investors to withdraw their investments in tokens called Capital Coin (CPTL), which was MCC's own token. The SEC's complaint further alleged that MCC investors were required to redeem their CPTL on Bitchain, a fake crypto asset trading platform. However, when investors tried to liquidate their CPTL on Bitchain before their one-year memberships expired, they encountered purported errors that thwarted their efforts and were required to either buy another mining package or forfeit their investments.

Press Release: SEC Halts Fraudulent Cryptomining and Trading Scheme (May 6, 2022)
Founders allegedly promised big returns, instead used investments to fund lavish lifestyles
https://www.sec.gov/news/press-release/2022-81

4. In the Matter of NVIDIA Corporation, Securities Act Release No. 33-11060 (May 6, 2022)
https://www.sec.gov/litigation/admin/2022/33-11060.pdf

The SEC settled charges against technology company NVIDIA Corporation for inadequate disclosures concerning the impact of cryptomining on the company's gaming business. According to the SEC's order, NVIDIA failed to disclose that cryptomining was a significant element of its material revenue growth from the sale of its graphics processing units (GPUs) designed and marketed for gaming. Cryptomining is the process of obtaining crypto rewards in exchange for verifying crypto transactions on distributed ledgers. NVIDIA's omissions of material information about the growth of its gaming business were misleading given that NVIDIA did make statements about how other parts of the company's business were driven by demand for crypto, creating the impression that the company's gaming business was not significantly affected by cryptomining.

Key Takeaways:

- NVIDIA's failure to disclosure critical information deprived investors the opportunity to evaluate the company's business in a key market.

- The SEC requires all issuers, "including those that pursue opportunities involving emerging technology, must ensure that their disclosures are timely, complete, and accurate."

Press Release: SEC Charges NVIDIA Corporation with Inadequate Disclosures about Impact of Cryptomining (May 6, 2022) https://www.sec.gov/news/press-release/2022-79

5. SEC v. Barksdale, et al., No. 1:22-cv-01933 (Mar. 8, 2022)
https://www.sec.gov/litigation/complaints/2022/comp-pr2022-37.pdf

The SEC filed a complaint against the Barksdales in connection with the offered and sale of Ormeus Coin to investors on crypto trading platforms. According to the SEC's complaint, the Barksdales offered and sold subscription packages through a multi-level marketing business called Ormeus Global that included Ormeus Coin and an investment in a crypto trading program. The SEC's complaint alleged that to promote the offerings, Barksdale held roadshows around the world while he and his sister led the production of social media posts, YouTube videos, press releases, and other promotional materials. The SEC's complaint also alleged that at the events, in the produced materials, and currently on Ormeus Coin's website, the Barksdales falsely claimed that Ormeus Coin was supported by one of the largest crypto mining operations in the world, even though they abandoned their mining operations in 2019 after generating less than $3 million in total mining revenue. The SEC further alleged, the Barksdales falsely stated in many of these investor communications that Ormeus Coin had a $250 million crypto mining operation and was producing $5.4 million to $8 million per month in mining revenues.

Key Takeaways:

- Melissa Hodgman, Associate Director in the SEC's Division of Enforcement, stated "We allege that the Barksdales acted as modern-day snake-oil salesmen, using social media, promotional websites, and in-person roadshows to mislead retail investors for their own personal benefit…. We will continue to vigorously pursue persons who sell securities in schemes to defraud the investing public no matter what label the promoters apply to their products."

Press Release: SEC Charges Siblings in $124 Million Crypto Fraud Operation that included Misleading Roadshows, YouTube Videos (March 8, 2022)
https://www.sec.gov/news/press-release/2022-37

6. In the Matter of BlockFi Lending LLC, Securities Act Release No. 33-11029 (Feb. 14, 2022)
https://www.sec.gov/litigation/admin/2022/33-11029.pdf

The SEC charged BlockFi Lending LLC (BlockFi) with failing to register the offers and sales of its retail crypto lending product, BlockFi Interest Account (BIA). According to the SEC's order, investors lent crypto assets to BlockFi through the BIAs; BlockFi used investors' crypto assets to make investments, including loans to institutional investors; and investors received interest paid monthly in crypto assets. In the first case of its kind, the SEC also charged BlockFi with violating the registration provisions of the Investment Company Act of 1940. To settle the SEC's charges, BlockFi agreed to pay a $50 million penalty, cease its unregistered offers and sales of the lending product, BIA.

Key Takeaways:

- The SEC's order found that the BIAs were securities and BlockFi did not register its offering of the BIAs.

- According to the order, BlockFi made a materially false and misleading statement on its website concerning its collateral practices, thus understating the degree of risk in its lending program.

- The SEC found that BlockFi operated as an unregistered investment company due to the amount of investment securities it held.

Press Release: BlockFi Agrees to Pay $100 Million in Penalties and Pursue Registration of its Crypto Lending Product (February 14, 2022) https://www.sec.gov/news/press-release/2022-26

II. SEC CRYPTO RESOURCES

1. Initial Exchange Offerings (IEOs) **–** Investor Alert (January 14, 2020)
https://www.investor.gov/additional-resources/news-alerts/investor-alerts/initial-exchange-offerings-ieos-investor-alert

The SEC issued this alert to urge investors to be cautious if they are considering making an investment in so-called "initial exchange offerings" through online trading platforms.

"Initial exchange offerings (IEOs) are a recent development in the rapidly evolving digital asset space. IEOs are similar to initial coin offerings (ICOs) in that they are initial offerings of digital assets (e.g., coins or tokens) to raise capital. However, IEOs are being touted as an innovation on ICOs because they are offered directly by online trading platforms on behalf of companies—usually for a fee—to provide immediate trading opportunities for the digital assets. These online trading platforms, which are typically not registered with the SEC and which may improperly refer to themselves as "exchanges," may also claim to perform due diligence or other quality assessments of the IEOs."

2. Funds Trading in Bitcoin Futures – Investor Bulletin (June 10, 2021)
https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins/funds

The SEC and CFTC issued this bulletin to urge investors that are considering making an investment in a fund with exposure to the Bitcoin futures market to carefully consider the potential risks and benefits associated with the investment.

"Among other things, investors should understand that Bitcoin, including gaining exposure through the Bitcoin futures market, is a highly speculative investment. As such, investors should consider the volatility of Bitcoin and the Bitcoin futures market, as well as the lack of regulation and potential for fraud or manipulation in the underlying Bitcoin market."

3. Digital Asset and "Crypto" Investment Scams – Investor Alert (September 1, 2021)
https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-alerts/digital-asset

The SEC issued this alert to caution investors to be careful with fraudulent investment schemes involving digital assets and "Crypto."

"Fraudsters continue to exploit the rising popularity of digital assets to lure retail investors into scams, often leading to devastating losses. "Digital assets" include crypto-currencies, coins, and tokens such as those offered in so called initial coin offerings (ICOs). Investors may be less skeptical of investment opportunities that involve something new or "cutting-edge," or may get caught up in the fear of missing out (FOMO). For example, some investors may have FOMO, given the rise in price of some digital assets in recent years, that they will miss an opportunity to become very wealthy. If you are considering a digital asset-related investment, take the time to understand how the investment works and to evaluate its risks. Look for warning signs that it may be a scam."

4. Crypto Asset Interest-bearing Accounts – Investor Bulletin (February 14, 2022)
https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins-97

The SEC issued this bulletin to educate investors about risks with accounts that pay interest on crypto asset deposits.

"Crypto assets, including so-called cryptocurrencies, stablecoins, tokens, and other digital assets have been of increasing interest to retail investors over the last few years. This Investor Bulletin highlights the risks that may be involved in a recent financial product related to crypto assets—an interest-bearing account for crypto asset holdings."

III. 2022 CFTC ENFORCEMENT ACTIONS

The CFTC Chairman Rostin Behnam has indicated that the CFTC plans to add resources and increase efforts in response to increased number of enforcement actions related to fraud and manipulation in virtual currency markets.

1. CFTC v. McAfee et al., No. 21-cv-1919 (S.D.N.Y. July 14, 2022)
https://www.cftc.gov/media/7481/enfjimmywatsonconsentorder071422/download

The CFTC settled charges against McAfee and Watson for engaging in a digital asset "pump and dump" manipulative and deceptive scheme. According to the CFTC's order, Watson was employed by and acted in concert with McAfee and others while engaged in a digital asset "pump and dump" manipulative and deceptive scheme in which McAfee endorsed several digital assets through social media distributed nation- and worldwide, for the purpose of inducing investors into entering into contracts of sale of virtual currency, including Bitcoin, Verge, Dogecoin, and ReddCoin, among others, through electronic web-based virtual currency trading platforms based

in various states and countries, thereby increasing short-term demand and higher prices for the digital assets that Watson had secretly purchased shortly before.

According to the CFTC's order, Watson participated in the scheme by assisting in the strategic selection of suitable digital assets. As is typical of pump-and-dump schemes, Watson also secretly accumulated positions in digital assets in anticipation of price spikes following the misleading social media endorsements that touted the assets. McAfee's endorsements "pumped" the asset in order to increase demand, while deceptively concealing the previously accumulated position and the intent to promptly sell the position. Watson then "dumped" the digital asset by selling it into the inflated demand as price levels rose in response to the deceptive touting.

Key Takeaways:

- This case marks the first enforcement action by the CFTC alleging use of a traditional fraud scheme known as "pump-and-dump" in digital asset markets.

Press Release: Federal Court Orders Texas Man to Pay Over $290,000 for Manipulative and Deceptive Digital Asset Pump-and-Dump Scheme (July 18, 2022) https://www.cftc.gov/PressRoom/PressReleases/8558-22

2. CFTC v. Mirror Trading International Proprietary Limited et al., No. 1:22-cv-00635 (W.D. Tex. June 30, 2022)
   https://www.cftc.gov/media/7426/enfmirrortradingcomplaint063022/download

The CFTC filed a complaint charging Mirror Trading International Proprietary Limited ("MTI") with engaging in an international fraudulent multilevel marketing scheme, using websites and social media to solicit Bitcoin from members of the public for participation in a commodity pool operated by MTI. According to the CFTC's complaint, the commodity pool was controlled by MTI and Steynberg and purportedly traded off-exchange, retail foreign currency on a leveraged, margined and/or financed basis with participants who were not eligible contract participants (ECPs) through what MTI and Steynberg falsely claimed was a proprietary "bot" or software program. The CFTC's complaint alleges that Steynberg accepted at least 29,421 Bitcoin—with a value of over $1,733,838,372—from approximately 23,000 non-ECPs from the United States, and even more throughout the world, to participate in the commodity pool without being registered as a commodity pool operator as required. The CFTC's complaint also alleges that MTI and Steynberg misappropriated, either directly or indirectly, all of the Bitcoin they accepted from the pool participants.

Press Release: CFTC Charges South African Pool Operator and CEO with $1.7 Billion Fraud Involving Bitcoin (June 30, 2022) https://www.cftc.gov/PressRoom/PressReleases/8549-22

3. CFTC v. Ikkurty et al., No. 1:22-cv-02465 (N.D. Ill. May 10, 2022)
   https://www.cftc.gov/media/7266/enfsenecacomplaint051022/download

The CFTC filed a complaint charging Sam Ikkurty a/k/a Sreenivas I Rao (Ikkurty), Ravishankar Avadhanam, and Jafia LLC with fraudulently soliciting at least $44 million for participation interests in a so-called income fund invested in digital assets and other instruments. The CFTC's complaint

also charged the defendants with operating an illegal commodity pool and failing to register as a Commodity Pool Operator.

The CFTC's complaint alleged that the defendants used a website, YouTube videos, and other means to solicit money from at least 170 participants to purchase, hold and trade digital assets, commodities, derivatives, swaps and commodity futures contracts. The CFTC's complaint further alleged that instead of investing the pooled participant funds as represented, the defendants misappropriated participant funds by distributing them to other participants, in a manner akin to a Ponzi scheme.

The CFTC's complaint also alleged that the defendants transferred some participant funds to accounts under their control and for their benefit. According to the CFTC's complaint the defendants also transferred millions of dollars to an offshore entity that, in turn, appear to have been transferred to a foreign cryptocurrency exchange. None of these funds were returned to the pool.

Press Release: CFTC Charges Oregon and Illinois Residents and Florida Company in $44 Million Misappropriation in Ongoing Digital Asset and Commodity Futures Fraud (May 19, 2022) https://www.cftc.gov/PressRoom/PressReleases/8532-22

4. CFTC v. HDR Global Trading Limited et al., No. 1:20-cv-08132 (S.D.N.Y. May 5, 2022)
   https://www.cftc.gov/media/7211/enfarthurhayesconsentorder050522/download
   https://www.cftc.gov/media/7216/enfdeloconsentorder050522/download
   https://www.cftc.gov/media/7221/enfreedconsentorder050522/download

The CFTC settled charges against three co-founders of the BitMEX cryptocurrency derivatives trading platform: Arthur Hayes, Benjamin Delo, and Samuel Reed for operating the BitMEX platform while conducting significant aspects of BitMEX's business from the U.S., and unlawfully accepting orders and funds from U.S. customers to trade cryptocurrencies, including derivatives on Bitcoin, Ether, and Litecoin.

According to the CFTC's consent orders Hayes, Delo, and Reed each controlled BitMEX and are responsible for BitMEX's violations of the CEA and CFTC regulations, as charged, because the co-founders failed to implement and enforce effective controls to prevent or detect BitMEX's unlawful conduct. BitMEX's violations include the operation of a facility to trade or process swaps without having CFTC approval to operate as a Designated Contract Market (DCM) or a Swap Execution Facility (SEF). In addition, BitMEX operated as a futures commission merchant (FCM) without CFTC registration, failed to implement a Customer Information Program (CIP) and Know-Your-Customer (KYC) procedures, and failed to implement an adequate Anti-Money Laundering (AML) program.

Key Takeaways:

- The CFTC strongly urged investors to verify a company's registration with the CFTC before committing funds.

Press Release: Federal Court Orders BitMEX's Three Co-Founders to Pay a Total of $30 Million for Illegally Operating a Cryptocurrency Derivatives Trading Platform and Anti-Money Laundering Violations (May 05, 2022) https://www.cftc.gov/PressRoom/PressReleases/8522-22

5. CFTC v. Fintech Investment Group, Inc. et al., No. 6:20-cv-00652 (M.D. Fla. Mar. 24, 2022) https://www.cftc.gov/media/7121/enffintechorder032422/download

The CFTC settled charges against Alan Friedland and his Florida-based companies, Fintech Investment Group, Inc. (Fintech), and Compcoin LLC, for fraudulently soliciting customers to purchase a digital asset they falsely promised would allow customers to gain access to a proprietary foreign currency (forex) trading algorithm.

According to the CFTC's order, Friedland and his companies fraudulently solicited customers and prospective customers to purchase a digital asset known as Compcoin. The CFTC's order found that the defendants falsely promised that Compcoin would allow customers to gain access to what they described as Fintech's proprietary forex algorithmic trading program known as ART.

The CFTC's order also found that the defendants misrepresented in solicitation materials, that the ART trading algorithm was "complete in form and function," and "ready for release on the open market." The defendants also misrepresented that "ART's high success rate at predicting...forex trades, coupled with the high rate of return from these trades, will stimulate demand among investors and forex traders to purchase and use Compcoin—specifically to gain access to ART."

As reflected in the CFTC's order, the defendants knew that customers could not lawfully use ART until Fintech received approval of its disclosure documents from the National Futures Association (NFA). Nonetheless, the defendants offered Compcoin prior to Fintech seeking NFA approval of its disclosure documents. According to the CFTC's order, the defendants touted the successful performance of ART even they knew that its performance was based largely or entirely on hypothetical performance results and not real trading. The CFTC's order also found that the defendants also knew the Compcoin LLC website and solicitations did not contain the required disclaimer for simulated or hypothetical performance. According to the CFTC's order, the NFA did not approve Fintech's risk disclosure statements, and purchasers of Compcoin never gained access to the supposedly highly profitable forex trading algorithm as promised. Instead, purchasers of Compcoin were left with a worthless digital asset.

Press Release: Florida-Based Companies and Their Owner Settle Mid-Trial for $1.8 Million for Fraudulent Forex and Digital Asset Scheme (April 07, 2022)
https://www.cftc.gov/PressRoom/PressReleases/8510-22

6. CFTC v. Tinoco et al., No. 3:21-cv-00237 (W.D. Tex. Mar. 25, 2022) https://www.cftc.gov/media/7096/enftinococonsentorder032522/download

The CFTC settled charges against Abner Alejandro Tinoco, and his company, Kikit & Mess Investments, LLC ("Kikit"), for fraudulently soliciting at least $7.2 million from at least 322 investors, promising to use the funds to trade foreign exchange and cryptocurrency in individual managed accounts. According to the CFTC's order, Tinoco did not trade the investors' funds as represented, and instead he used the vast majority of the funds to pay for his personal expenses

that included travel costs for chartering a private jet, the purchase of a luxury mansion and other real estate, and leased luxury automobiles. Some of the funds were also used to pay bogus "investment profits" to investors in a manner similar to a Ponzi scheme.

A commodity trading advisor ("CTA") is any person who for compensation or profit, engages in the business of advising others, either directly or through publications, writings, or electronic media, as the value of or advisability of trading in commodity interests. *See* Section la(12) of the Commodity Exchange Act. A CTA for purposes of forex transactions, is "any person who exercises discretionary trading authority or obtains written authorization to exercise discretionary trading authority over any account for or on behalf of any person that is not an eligible contract participant [non-ECP"]..., in connection with retail forex transactions." See Regulation 5.1(e)(1).

The CFTC has jurisdiction over an account that is offered for the purpose of trading, or to any agreement, contract or transaction in foreign currency that is offered to, or entered into with, a person that is a non-ECP, unless the counterparty, or the person offering to be the counterparty, of the person that is not an ECP falls under one of the enumerated exceptions.

Tinoco and Kikit, through their offer of customized client account services in the cryptocurrency and foreign exchange markets for compensation or profit on Kikit's website, engaged in the business of advising others, either directly or through publications, writings, or electronic media, as to the value of or the advisability of trading in "any agreement, contract, or transaction described in section 2(c)(2)(C)(i)."

Press Release: Court Finds El Paso Man and His Firm Liable for Defrauding Forex and Cryptocurrency Clients of More Than $7.2 Million (March 29, 2022)
https://www.cftc.gov/PressRoom/PressReleases/8507-22

7. CFTC v. Golden et al., No. 22-cv-01252 (E.D.N.Y. Mar. 8, 2022)
   https://www.cftc.gov/media/7046/enfgoldencomplaint030822/download

The CFTC filed a complaint charging Dwayne Golden, Jatin Patel, Marquis Egerton, and Gregory Aggesen with fraud for operating Ponzi schemes involving Bitcoin. According to the CFTC's complaint, the defendants fraudulently solicited more than $44 million of investments, and misappropriating millions of dollars. The complaint alleges that the defendants misappropriated approximately $17.6 million worth of bitcoin received through the Empowercoin, Ecoinplus and JetCoin websites.

The CFTC's complaint alleged that the defendants operated the websites Empowercoin and Ecoinplus, through which they fraudulently solicited individuals of more than $23 million of bitcoin. The CFTC alleged that Empowercoin and Ecoinplus websites made false and misleading representations to potential customers that they "would double their Bitcoin investments in 50 to 90 days, depending on which investment package they chose" and would make "[d]aily Bitcoin payments of at least 2% of the invested amount would be deposited into customers' registered wallets automatically." According to the CFTC's complaint, these statements were false and misleading because the guaranteed returns and commission payments were entirely fictitious (any daily or commission payments made to customers by the Ecoinplus Defendants were the product not of trading done by Empowercoin/Ecoinplus but instead Ponzi payments reflecting

misappropriated Bitcoin from other customers). The CFTC also alleged that Empowercoin and Ecoinplus stated on their websites that they were made up of "a worldwide team of high volume Bitcoin trading professionals" that needed "a larger amount of Bitcoin to achieve maximum profitability." According to the CFTC's complaint, these statements were false and misleading because Empowercoin and Ecoinplus were not made up of trading professionals and the defendants did not trade Bitcoin. Instead, Empowercoin and Ecoinplus made Ponzi payments reflecting misappropriated Bitcoin from other customers.

According to the CFTC's complaint, the defendants operated another website JetCoin, through which they fraudulently solicited individuals of more than $21 million of bitcoin. According to the complaint, the JetCoin website modeled the content of the Empowercoin and Ecoinplus. The CFTC's complaint alleged that JetCoin website also made false and misleading representations to potential customers that they "would double their Bitcoin investments in 40 to 50 days" and customers would receive "daily payments of 4-5%, depending on which investment package they chose." websites all promised customers that professionals would trade their bitcoin and they guaranteed that the resulting profits would be paid daily. According to the CFTC's complaint, JetCoin stated on its website that it had "the most robust system on the market," "the top trading team in the industry," and "the sharpest minds in the industry." According to the CFTC's complaint, did not use the services of any traders and did not trade Bitcoin. Instead, JetCoin made Ponzi payments reflecting misappropriated Bitcoin from other customers.

Press Release: CFTC Charges Four Operators for $44 Million Bitcoin Ponzi and Misappropriation Schemes (March 08, 2022) https://www.cftc.gov/PressRoom/PressReleases/8498-22

IV. CFTC DIGITAL ASSETS RESOURCES

1. What is a Bitcoin Futures ETF? – Article (February 1, 2022)
https://www.cftc.gov/LearnAndProtect/AdvisoriesAndArticles/BitcoinFuturesETF.html

A bitcoin futures exchange-traded fund (ETF) are securities issued by an investment company that offer exposure to the price movements of bitcoin futures contracts.

"An investment company creates a subsidiary that acts as a commodity pool. The pool in turn trades bitcoin futures contracts typically in an effort to mimic the spot price of bitcoin. But there are costs involved like "roll premiums" and management fees, among others. Plus, futures contracts don't track spot prices exactly, so returns may never be as high as, or in sync with, spot market prices."

2. Funds Trading in Bitcoin Futures – CFTC/SEC Investor Alert (June 10, 2021)
https://www.cftc.gov/LearnAndProtect/AdvisoriesAndArticles/fraudadv_funds_trading_in_bitcoin_futures.html

The SEC and CFTC issued this bulletin to urge investors that are considering making an investment in a fund with exposure to the Bitcoin futures market to carefully consider the potential risks and benefits associated with the investment.

"Among other things, investors should understand that Bitcoin, including gaining exposure through the Bitcoin futures market, is a highly speculative investment. As such, investors should consider the volatility of Bitcoin and the Bitcoin futures market, as well as the lack of regulation and potential for fraud or manipulation in the underlying Bitcoin market."

3. Understand the Risks of Virtual Currency Trading – Advisory (December 15, 2017)
https://www.cftc.gov/sites/default/files/idc/groups/public/@customerprotection/documents/file/customeradvisory_urvct121517.pdf

The CFTC issued this advisory to make investors aware of possible risks associated with investing or speculating in virtual currencies or recently launched Bitcoin futures and options.

"Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, or a store of value, but it does not have legal tender status. Virtual currencies are sometimes exchanged for U.S. dollars or other currencies around the world, but they are not currently backed nor supported by any government or central bank. Their value is completely derived by market forces of supply and demand, and they are more volatile than traditional fiat currencies. Profits and losses related to this volatility are amplified in margined futures contracts."

4. Use Caution When Buying Digital Coins or Tokens – Advisory (July 16, 2018)
https://www.cftc.gov/sites/default/files/2018-07/customeradvisory_tokens0718.pdf

The CFTC issued this advisory to alert investors to exercise caution and conduct extensive research before purchasing digital coins or tokens, such as those self-described as "utility coins" or "consumption coins."

"Several studies and news reports indicate that a large number of Initial Coin Offerings (ICOs) are fraudulent, or the underlying products or services fail to live up to their promises. Estimates of fraud range from 5 percent to more than 80 percent of ICOs. One report also identified nearly 300 offers that contained plagiarized investment documents, promises of guaranteed returns or fake executive teams. Another report indicates that after one year from their ICO, nearly half of the projects or companies have failed or shut down."

5. Beware Virtual Currency Pump-and-Dump Schemes – Advisory (February 14, 2018)
https://www.cftc.gov/sites/default/files/idc/groups/public/%40customerprotection/documents/file/customeradvisory_pumpdump0218.pdf

The CFTC issued this advisory to warn investors to avoid pump-and-dump that may occur in thinly traded or new "alternative" virtual currencies and digital coins or tokens.

"Customers should not purchase virtual currencies, digital coins, or tokens based on social media tips or sudden price spikes. Thoroughly research virtual currencies, digital coins, tokens, and the companies or entities behind them in order to separate hype from facts."

6. Beware "IRS Approved" Virtual Currency IRAs – Advisory (February 2, 2018)
https://www.cftc.gov/sites/default/files/idc/groups/public/%40customerprotection/documents/file/customeradvisory_irs020218.pdf

The CFTC issued this advisory to warn investors to be cautious of sales pitches touting "IRS approved" or "IRA approved" virtual currency retirement accounts.

"The IRS does not approve or review investments for IRAs. Advertisements or solicitations that use this kind of deceptive language should be viewed with caution. Federal agencies, including the CFTC and IRS, do not: (i) [e]ndorse any investment, (ii) [a]dvise people on how to invest their money, or (iii) [i]ssue statements that an investment in an IRA is protected because a trustee or custodian has been approved by the IRS, or is regulated by federal or state agencies. In most cases, these advertisements are selling self-directed IRAs."

V. 2022 FINRA DISCIPLINARY ACTION – OUTSIDE BUSINESS ACTIVITIES

1. FINRA Department of Enforcement v. Minich, No. 2020066999801 (Aug. 16, 2022)

Minich, while associated with Ameriprise Financial Services, LLC ("Ameriprise"), participated in three private securities transactions totaling approximately $200,000 without providing prior written notice to Ameriprise. Minich personally invested $50,000 in a hedge fund that purported to invest in cryptocurrency, without providing prior written notice to the Firm. In return for his investment, he received a limited partnership interest in the hedge fund. Minich also facilitated and assisted two Firm customers with investing a combined total of $150,000 into the same hedge fund in return for limited partnership interests in the fund. Again, Minich did not provide Ameriprise with prior notice of these transactions. Minich also falsely certified to the Firm in an annual attestation that he had not engaged in any private securities transactions other than those he had received preclearance for from the Firm when, in fact, he had engaged in the three private securities transactions alleged herein without receiving preclearance from the Firm.

Minich violated FINRA Rule 3280 because he participated in a private securities transaction by purchasing limited partnership interests in the Fund for approximately $50,000 away from the Firm and outside of the regular course or scope of his employment with the Firm. Minich also failed to provide prior written notice of his purchase of the limited partnership interests in the Fund to Ameriprise.

Minich also violated FINRA Rule 3280 because he participated in private securities transactions by facilitating two customers in separate purchases of limited partnership interests in the Fund for $50,000 and $100,000, respectively, away from the Firm and outside of the regular course or scope of his employment with the Firm. Again, Minich failed to provide prior written notice of his facilitation of these purchases to Ameriprise.

Minich violated FINRA Rule 2010 when he provided false information on a Ameriprise's annual attestation because his conduct was inconsistent with high standards of commercial honor and just and equitable principles of trade.

VI. FINRA CRYPTO RESOURCES

1. Don't Fall for Cryptocurrency-Related Stock Scams – Alert (December 21, 2017) https://www.finra.org/investors/alerts/cryptocurrency-related-stock-scams

FINRA issued this alert to warn investors to be cautious when considering purchasing shares of companies that make claims of high returns associated with cryptocurrency-related activities. "Do your research before purchasing shares of any company offering investment opportunities in cryptocurrency. And don't be fooled by unrealistic predictions of returns and claims made through press releases, spam email, telemarketing calls or posted online or in social media threads. These actions may be signs of a classic "pump and dump" fraud."

2. Bitcoin: More than a Bit Risky – Alert (May 07, 2014) https://www.finra.org/investors/alerts/bitcoin-more-bit-risky

FINRA issued this alert to advise investors about government hearings and media reports concerning virtual currencies and the abuses and criminal activity associated with it. "Investors should know that buying and using digital currency such as Bitcoin carry risks. Speculative trading in bitcoins carries significant risk. There is also the risk of fraud related to companies claiming to offer Bitcoin payment platforms and other Bitcoin-related products and services."

3. Digital Assets: Getting a Handle on Virtual Currencies – Insights (May 31, 2018) https://www.finra.org/investors/insights/virtual-currencies

FINRA published this article to caution investors that are exploring investments in Initial Coin Offerings, digital tokens, the virtual currency regulatory landscape and to provide tips to avoid fraud and scams in crypto space. "Significant uncertainty currently surrounds virtual currencies in general and their potential value as investments in particular. Only time will tell whether, and if so which, virtual currencies become a mainstream component of our financial markets—and whether investments in this emerging sector make sense as part of a diversified portfolio. Before you make any investment decisions, it is critical to understand some of the concepts underlying this emerging world of virtual currencies."

4. Scams: Here's How to Avoid Crypto Stock Scams – Insights (September 6, 2018) https://www.finra.org/investors/insights/avoid-crypto-stock-scams

FINRA published this article to caution investors thinking about investing in the stock of companies associated with cryptocurrency. "Do your research, and only invest money you can afford to lose. Don't be fooled by unrealistic predictions of returns and claims made through press releases, spam email, telemarketing calls or those posted online or in social media threads."

5. Digital Assets: Bitcoin Basics—9 Things You Should Know About the Digital Currency – Insights (May 24, 2017) https://www.finra.org/investors/insights/bitcoin-basics-9-things-you-should-know-about-digital-currency

FINRA's article describes essential things about Bitcoin. "Here are nine things to make you a bit wiser about bitcoin: Unlike traditional currency, bitcoin is digital. You can use it to buy things or

as an investment. But, as Campbell R. Harvey, a finance professor at Duke University's Fuqua School of Business, notes, "there is no physical coin."

WHEN SECURITIES CLAIMS COLLIDE WITH THE BANKRUPTCY CODE

Randall A. Pulman

FACT PATTERN

You, PIABA Pete, have just finished a first meeting with Lilly White. She invested all of her money in Stanford's Ponzi Scheme, Inc. ("SPS"). She has papers from a bankruptcy court for SPS and doesn't know what to do. This is the story of Lilly and Pete.

Lilly is a terrified, elderly and a retired schoolteacher. Her husband, a blue-collar worker, died in a terrible workplace accident twelve years ago. The Whites had always lived a frugal life, and between their savings, life insurance, the retirement accounts, and the settlement from her husband's wrongful death case, Lilly White found herself with a $1,000,000.00 estate. Burt Blackheart, a financial advisor, was a member of Lilly's church and a long-lost friend who previously did great work for her cousin. Burt attended Lilly's husband's funeral and, after an appropriate amount of time, asked her to dinner "just to get her out of the house." At dinner, Lilly confided in Burt that she had no idea what to do with all the money deposited into her bank accounts. But as luck would have it, Burt graciously volunteered his services to Lilly.

Shortly after the dinner meeting, Lilly opened an account with Burt's firm, Oakmont Financial Planners, which is both a Registered Investment Advisor ("RIA") and holds a broker's insurance license. Burt is an Investment Advisor Representative (an "IAR") and an insurance agent. Oakmont Financial Planners was a one-stop shop. Burt could sell her insurance, stocks, and bonds or simply give her financial advice. For special, high-net-worth individuals such as Lilly, Burt could offer guaranteed high yield investments in selective hedge funds, real estate projects, and off-shore bank CDs that all paid a guaranteed eight percent each year. The best part was that Lilly would not have to pay a commission. Lilly, for the first time in her life, felt special.

Burt recommended that Lilly invest all of her money in SPS, and all she needed was $7,000.00 per month (together with Social Security and her teacher's pension) to live like a queen. A one-million-dollar investment would generate $80,000.00 per year so she would be set for the rest of her life. SPS was even paying a ten percent bonus to investors who put in more than $750,000.00, so her starting principal balance would actually be $1,100,000.00 and she would receive $88,000.00 per year. Burt shared with Lilly that he had been putting many of his clients in SPS and that all had received regular monthly payments.

Lilly invested all of her estate in SPS twelve years ago and had received monthly checks for all of that time, until just a few months ago.

When the monthly checks stopped, Lilly called Burt. Burt came by her home and explained that he had heard that there had been a problem with the accounting department at SPS. Burt assured Lilly that everything was fine, and the checks would start coming again on the first of the month. The first of the month came and went, but no check ever arrived as promised, and Lilly's daughter suggested that Lilly needed to see a lawyer. She resisted doing so until the bankruptcy papers came, and now she has come to you for help.

The only documents Lilly has brought you are the original papers documenting the investment. The documents are printed on glossy paper and seem to describe something between a limited partnership interest, a promissory note and a simple contract. She does have copies of the

checks she received, but no financial statements and no account statements showing the amount of her investment. It looks like she has received $1,056,000.00 over the years.

What do you do?

1) Is the SPS bankruptcy filing a chapter 7 liquidation or a chapter 11 reorganization?

There are several kinds of bankruptcy estates, depending on the type of debtor. A corporate bankruptcy filing will typically be either a chapter 7 liquidation or a chapter 11 reorganization. The rules are materially different for each. For your purposes, you need to know whether to file a proof of claim. In a chapter 7, in all circumstances your client must file a proof of claim in order to receive a dividend or distribution. In a chapter 11, your client need only file a proof of claim if they are not properly listed on the schedules as undisputed and liquidated. In all other circumstances a timely proof of claim must be filed. The notice to creditors will set a bar date for filing a proof of claim. Calendar that date and do not miss it.

SPS filed a chapter 11 petition and will have to propose a plan of reorganization. There are a number of different flavors of a chapter 11 plan which are not material here, but if the chapter 11 is filed and is not converted to a chapter 7 liquidation, you will need to review the plan of reorganization and understand how your client's claim will be treated and paid.

If SPS has a legitimate business to reorganize, even if it were a ponzi scheme or was at least ponzi-lite in nature, it is possible that a plan will be proposed and confirmed. If SPS was a classic ponzi scheme--use new investor money to pay prior investors--, the court will likely either appoint a chapter 11 trustee or convert the case to a chapter 7 liquidation and appoint a panel trustee. Panel trustees are called upon regularly by the United States Trustee to administer chapter 7 cases. Whatever the outcome, calendar the bar date to file a proof of claim.

2) Should Lilly file a proof of claim?

Believe it or not, Lilly is a net winner. Lilly received $1,056,000.00 on an investment of $1,000,000.00. Although Lilly thinks she is still owed $1,000,000 from her original investment, she is likely to be the target of a chapter 5 avoidance action by the Trustee. Chapter 5 avoidance claims are the federal bankruptcy equivalent of state law Uniform Fraudulent Transfer Act ("UFTA") claims.

If Lilly files a proof of claim, she will be subject to bankruptcy court jurisdiction and can be sued in the bankruptcy court which is an Article I court of limited jurisdiction without the right a to a jury trial. If Lilly does not file a proof of claim she will have the right to a jury before an Article III district judge. On a $56,000 avoidance claim, that distinction will matter to the chapter 7 trustee and his counsel.

Depending on the likelihood of a distribution, it may not be in Lilly's best interest to file a proof of claim in the bankruptcy case. Lilly may just be out of luck, except for a claim against Burt and Oakmont, as described below.

3) DON'T VOTE FOR THAT CHAPTER 11 PLAN—YOU MAY BE RELEASING CLAIMS AGAINST THIRD-PARTIES.

Assuming that SPS does have a legitimate business, it stays in a chapter 11 reorganization and proposes a plan to pay creditors. Read the plan. The plan proponent will probably be an insider and he or she will likely not be kind to Lilly.

For example, the Woodbridge estate reorganized. Within the trustee's plan of reorganization, all creditors voluntarily (but likely unknowingly) gave up claims against third parties. The Devil is always in the details. The following provisions were buried within the fifty-page Woodbridge plan:[1]

- Defined Terms
  - Contributed Claims
    - All Causes of Action . . . against any Person that is not a Released Party and that are related in any way to the Debtors . . . including . . (b) all Cause of Action for unlawful dividend, fraudulent conveyance, fraudulent transfer, voidable transaction, or other avoidance claims under state or federal law; (c) all Causes of Action based on, arising out of, or related to the misrepresentation of any of the Debtors' financial information, business operation, or related internal controls . . . .
- Liquidating Trust
  - Contribution of Contributed Claims
    - [A]ll Contributed Claims will be irrevocably contributed to the Liquidation Trust and shall thereafter be Liquidation Trust Actions for all purposes.
  - Pursuit and Resolution of Liquidation Trust Actions

    The Liquidating Trust . . . will have the exclusive right, power, and interest on behalf of itself, the Debtors, the Estates, and the Contributing Claimants to institute, commence, file, pursue, prosecute, enforce, abandon, settle, compromise, release, waive, dismiss or withdraw any and all Liquidation Trust Actions or Assets[.]

<u>If these or similar provisions are in the SPS plan, and Lilly votes for the plan so that she can at least receive the ten percent distribution proposed, she has likely given up her claims against Burt and Oakmont.</u>

So be very careful in making this decision to vote for the plan and take the distribution from the bankruptcy estate[2]. If there is a bar order in the SPS Plan, and you pursue a lawsuit, AAA or

[1] Provisions from the *Joint Chapter 11 Plan of Liquidation of Woodbridge Group of Companies, LLC and its affiliated Debtors*, Case No. 17-12560, filed in the United States Bankruptcy Court District of Delaware [ECF No. 2138].

[2] The requirements for a bankruptcy court to approve a chapter 11 plan are byzantine at best. Appendix I sets forth a summary of those requirements for the practitioner who needs a place to start looking for an understanding of how the process works. A note for the practitioner: bankruptcy courts typically protect a chapter 11 trustee that has been appointed by the Office of the United States Trustee. Pick your battles wisely.

FINRA arbitration against Burt or Oakmont, you are at risk for being held in contempt of what is called the discharge or plan injunction. That will be a bad day[3].

4) CAN LILLY PURSUE CLAIMS AGAINST BURT BLACKHEART AND OAKMONT?

As the bankruptcy case proceeds, you learn that Oakmont received a ten percent commission on every investment made by its clients in SPS. During some periods of time, there was even a bonus paid to Oakmont if the total investor money exceeded certain thresholds. Burt split those commissions with Oakmont, 50/50.

Oakmont itself files for bankruptcy and liquidates with no assets to distribute, which leaves Burt Blackheart as your last source of recovery outside of the SPS Estate.

Burt is sued by several of his clients represented by PIABA members for the SPS investment recommendation, You file a lawsuit or AAA arbitration against Burt under the appropriate state law securities fraud statute for an unsuitable recommendation by an RIA and IAR. You proceed to an award. The award comes down to $1,000.00 for unsuitable investment advice. There is no specific award for the Blue Sky, ’33 Act or ’34 Act claims.

Burt’s lawyer is not concerned because he thinks the award will be discharged by the bankruptcy court and a bankruptcy filing will stop all litigation against Burt. Mercifully, Burt takes the poor legal advice and files for a chapter 7 bankruptcy[4]. Burt has one asset—a single family dwelling in Florida valued at $5,000,000.00 and designated as his homestead. You have come to the end or the road, Lilly is out of luck.

Maybe, but not so fast. Lilly has at least two good remedies under the bankruptcy code—an exception to discharge under 11 U.S.C. Section 523(a)(19) and a right to bust the homestead exemption above $170,350.00 under 11 U.S.C. Section 522(q).

A) WE DON’T NEED TO FIGHT ANY MORE AFTER THE PANEL HAS RULED. DEBTS ARISING FROM SECURITIES VIOLATIONS (EVEN THE UNSUITABLE ONES) ARE NOT DISCHARGEABLE.

Lilly can file an objection to Burt’s discharge[5] but, she must do so by the deadline set forth in the original notice to creditors. So, calendar that date. The date can be extended by Motion and Order. The exception to discharge is brought by way of an adversary proceeding, not a contested matter. An adversary proceeding is a lawsuit filed in the bankruptcy court and is typically subject to the

[3] If you find yourself on the business end of a Motion for Contempt, you should certainly call a lawyer who regularly practices in bankruptcy courts. 210-892-0420.

[4] If Burt’s secured and unsecured debts are less than $2,750,000, he may qualify for a chapter 13 filing. See **11 U.S.C.A. § 109. “Who may be a debtor: (e)** Only an individual with regular income that owes, on the date of the filing of the petition, noncontingent, liquidated debts of less than $2,750,000 or an individual with regular income and such individual’s spouse, except a stockbroker or a commodity broker, that owe, on the date of the filing of the petition, noncontingent, liquidated debts that aggregate less than $2,750,000 may be a debtor under chapter 13 of this title.” **(Effective: June 21, 2022).** There may be little room to except to a discharge of a chapter 13 plan, but the nuance of the plan is another topic. The first question is whether the debtor qualifies for the chapter 13 filing in the first instance.

[5] This paper focuses on 11 U.S.C. § 523(a)(19), however two sections 523(a)(2)(fraud) and (a)(4)(fraud or defalcation while a fiduciary) can also be used as a basis for an exception to a debtor’s discharge.

Fed. R. Civ. P. 26, however do be aware this rule varies by district. This a procedural point that matters.

> Applicable statutory provision - 11 U.S.C. § 523(a)(19)
>
> (a)A discharge under section 717, 1141, 1192,[6] 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—
>
> …
>
> (19) that—
>
> (A) is for—
>
> (i) the violation of any of the Federal securities laws, … any of the State securities laws or any regulation or order issued under such Federal or State securities laws; or
>
> (ii) common law fraud, deceit, or manipulation in connection with the sale of any security; and
>
> (B) results, before, on or after the date on which the petition was filed, from—
>
> (i) any judgment, order, consent order, or decree entered in by any Federal or State judicial or administrative proceeding;
>
> (ii) any settlement agreement entered into by the debtor; or
>
> (iii) any court or administrative order for any damages, fine penalty, citation, restitutionary payment, disgorgement payment, attorney fee, cost, or other payment owed by the debtor.

The creditor carries the burden to show a debt is non-dischargeable under any discharge exception within 11 U.S.C. § 523. *Grogan v. Garner,* 498 U.S. 279, 283 (1991). It is in the bankruptcy court's authority to determine if a debt is non-dischargeable. *Dennis v. Dennis (In re Dennis)*, 25 F.3d 274, 278 (5th Cir. 1994) (citing *In re Shuler*, 722 F.2d 1253, 1265 (5th Cir. 1984), *cert. denied*, 469 U.S. 817 (1984). If a "'tribunal other than the bankruptcy court [determines]. . . whether a federal or state securities violation or some type of related fraud has occurred,' the [bankruptcy c]ourt should not disturb or attempt to relitigate those findings." *See Jenkins v. Jones (In re Jones)*, 600 B.R. 561, 569 (Bankr. W.D. Tex. 2019) (quoting *Wright v. Minardi (In re Minardi)*, 536 B.R. 171, 192 (Bankr. E.D. Tex. 2015). However, the bankruptcy court may inquire into the true nature of the underlying debt litigated in state court or in arbitration if necessary. *Dennis*, 25 F.3d at 277 (citing *Brown v. Felsen*, 442 U.S. 127, 138 (1979).

[6] Small Business Reorganization Act, Pub. L. 116-54 effective February 19, 2020.

For a debt to be excepted from discharge due to a violation of securities law under § 523(a)(19), a creditor must prove that "(1) the debt is for violation of securities law or for common law fraud in connection with the sale of a security; and (2) the debt must be memorialized in a judicial or administrative order, or in a settlement agreement." *Wright v. Minardi (In re Minardi)*, 536 B.R. 171, 191 (Bankr. E.D. Tex. 2015) (citing *McGraw & Pfeifer Sutter Fam. LLC v. Collier (In re Collier)*, 497 B.R. 877, 903 (Bankr. E.D. Ark. 2013).

A FINRA award memorialized by a judicial order provides a bankruptcy court sufficient evidence to except a debt from discharge. *Jones*, 600 B.R. at 569. Even if a FINRA award does not specifically issue findings of specific violations of securities laws, fraud, or breach of fiduciary duty, the award may be non-dischargeable if "the FINRA [a]ward arose, at least in part, in connection with [debtor's] violation of [state] securities laws." *Id.*

Some courts have addressed nuances in excepting a debt from discharge. For example, the Tenth Circuit Court of Appeals affirmed a ruling discharging judgments for unjust enrichment in connection with a Ponzi scheme. *Oklahoma Dept. of Securities, ex. Rel. Fought v. Wilcox*, 691 F.3d 1171, 1177 (10th Cir. 2012). In *Wilcox,* creditors sued debtors in state court for unjust enrichment but did not pursue any actions for securities law violations. *Id*. at 1176-77. Creditors successfully obtained judgments, and the bankruptcy court excepted the judgments from discharge. *Id*. at 1174. The Tenth Circuit reversed the bankruptcy court based on a strict interpretation of § 523(a)(19), stating that a judgment only for unjust enrichment was not a judgment "for a violation" of securities law. *Id.* at 1174-75. The appellate court clarified that the ruling may have been different if the creditor prosecuted debtors for securities law violations in state court. *Id.* at 1176-77[7].

The Eleventh Circuit Court of Appeals determined that liability arising from a third party's violation of securities laws may be excepted from discharge. *Lunsford v. Process Techs. Servs. (In re Lunsford)*, 848 F.3d 963 (11th Cir. 2017). Within *Lunsford*, a creditor sued the debtor and the company in which the debtor served as president and obtained an arbitration award. *Id.* at 965. The award detailed the securities law violations and explicitly stated that the award's findings would include the debtor unless only the company was referenced. *Id.* at 967. The state court confirmed the award and entered joint and several judgments against the company and debtor. *Id.* at 965. The debtor asserted that the debt was dischargeable because he was merely a third party to the violations of securities laws. *Id*. at 969. The bankruptcy court determined the debt was excepted from discharge because the debtor was a party to the legal action in which a judgment was entered for securities laws violations against the company. *Id.* The appellate court affirmed the bankruptcy court and acknowledged that the ruling may be inconsistent with *Wilcox*, and nevertheless stated "[t]he whole text establishes section 523(a)(19) precludes discharge regardless of whether the debtor violated securities laws as long as the securities violation caused the debt." *Id.* at 968. A critical difference between *Lunsford* and *Wilcox* is that in *Lunsford*, the debtor was jointly and severally liable for the securities law's violations, whereas in *Wilcox*, the debtor was not charged with any securities law violations.

The broad language used in Section (a)(19) probably leaves a debtor who was involved in a securities violation at risk for an exception to his or her discharge. At least two commentators have reconciled the apparent conflict in circuit opinions in the following manner:

[7] The Ninth Circuit has also addressed an exception to discharge under Section 523(a)(19). *See In re Sherman*, 658 F.3d, 1009 (9th Circuit 2011). Essentially, the court allowed the debtor a discharge because the underlying conduct was a breach of fiduciary duty for which the statute of limitations had already passed, and the debt was not securities related.

> Where the Eleventh Circuit's *Lunsford* analysis prevails over that of the Tenth Circuit in *Wilcox* or the Ninth Circuit in *Sherman* is its recognition that there is a two-part requirement to a §523(a)(19) discharge exception: (1) the debt that is presented for a finding of non-dischargeability must be incorporated into a judgment and the judgment must be for a securities violation; and (2) the debtor must be a party to that judgment. Failure of either prong eliminates non-dischargeability. In the Eleventh Circuit and arguably the Tenth Circuit, if the debt to be excepted from discharge is incorporated into a judgment or consent order for violation of the securities laws and the debtor is a party to the judgment or the consent order, then the debt is excepted from discharge under § 523(a)(19) – whether or not the debtor individually violated securities laws.

See Hester & Barber, *Section 523(a)(19) Conflicts with Two Circuit Interpretations*, American Bankruptcy Institute Journal (July 2017) page 38, 81.

The debt owed to Lilly is excepted from discharge. You, PIABA Pete now move forward in attempting to collect the debt. Burt's entire net worth is tied up in his newly remodeled home which he has claimed as exempt under state law.

B) BURT, HAND OVER YOUR HOMESTEAD, OR AT LEAST ALL VALUE ABOVE $170,350.00.

Burt claimed the full value of $5,000,000.00 as exempt as a homestead under Texas law. You and the Trustee proceed to file an objection to Burt's claimed homestead exemption[8]. The objection is in the form a contested matter—not an adversary proceeding, is done in the main case and typically is not subject to Fed. R. Civ. P. 26. Burt filed a reply, asserting that the homestead exemption protects his residence's full value, or in the alternative, the newly remodeled home is necessary to support him and his spouse. As an exhibit in support of the reply, Burt attaches a doctor's note saying it is necessary for Burt's health to swim in his resort-styled pool and play tennis at his private tennis court three times a week.

> Applicable statutory provision - 11 U.S.C. § 522(q)(1)(B):
>
> > (q)(1) As a result of electing under subsection (b)(3)(A) to exempt property under State or local law, a debtor may not exempt any amount of an interest in property described in subparagraphs (A), (B), (C), and (D) of subsection (p)(1) which exceeds in the aggregate $170,350[9] if—
> >
> > > (A) the court determines, after notice and a hearing, that the debtor has been convicted of a felony (as defined in section 3156 of title 18), which under the circumstances, demonstrates that the filing of the case was an abuse of the provisions of this title; or

[8] Objections to exemptions are typically due thirty days after the Trustee completes the first meeting of creditors. For objections to exemptions made under Section 522, the deadline is suspended until the case is closed. Fed. R. Bankr. P. 4003(a)(3). Don't wait until the end of the case. File the objection to exemption at the same time you file the exception to discharge as an adversary and ask the bankruptcy court to convert the contested matter to an adversary proceeding and consolidate it with the adversary proceeding.

[9] As adjusted under section 104, effective April 1, 2019. To be readjusted effective April 1, 2022.

(B) the debtor owes a debt arising from—

(i) any violation of the Federal securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934), any State securities laws, or any regulation or order issued under Federal securities laws or State securities laws;

(ii) ***fraud, deceit, or manipulation in a fiduciary capacity*** or in connection with the purchase or sale of any security registered under section 12 or 15(d) of the Securities Exchange Act of 1934 or under section 6 of the Securities Act of 1933[10];

(iii) any civil remedy under section 1964 of title 18; or

(iv) any criminal act, intentional tort, or willful or reckless misconduct that caused serious physical injury or death to another individual in the preceding 5 years.

(2) Paragraph (1) shall not apply to the extent the amount of an interest in property described in subparagraphs (A), (B), (C), and (D) of subsection (p)(1) is reasonably necessary for the support of the debtor and any dependent of the debtor.

The objecting party carries the burden in establishing a debtor's claimed exemption is improper. *In re Presto*, 376 B.R. 554, 563 (Bankr. S.D. Tex. 2007). The burden of proof is by a preponderance of the evidence. *Id.;* Fed. R. Bankr. P. 4003(c).

Bankruptcy courts can make findings or adopt rulings from other courts or arbitration panels to limit a debtor's homestead under § 522. To satisfy the requirements under § 522(q)(1)(B)(ii), a debtor must owe a debt arising from the act of fraud, deceit, or manipulation while acting in a fiduciary capacity or in connection with the purchase or sale of a registered security. *Presto*, 376 B.R. at 592. The Bankruptcy Code defines "debt" as "liability on a claim[.]" 11 U.S.C. § 101(12). Congress intended to adopt the broadest definition of the term "claim." *Johnson v. Home State Bank*, 501 U.S. 78, 83 (1991). Within the Bankruptcy Code, "claim" is defined as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured." 11 U.S.C. § 101(5).

If a party requests a debtor's homestead exemption to be capped under 11 U.S.C. § 522(q), a bankruptcy court may permit a debtor to retain the full value of a claimed homestead exemption if the homestead is reasonably necessary for the support of the debtor and debtor's dependents. *See In re Bounds*, 491 B.R. 440, 452-53 (W.D. Tex. 2013). The following factors are considered

[10] There is an argument to be made whether the element of the statute "fraud, deceit, or manipulation in a fiduciary capacity" modifies the two securities law violations or is its own stand-alone element. That question is not addressed here.

under the reasonably necessary standard: "(1) the debtor's present and anticipated living expenses, (2) the health of the debtor and his/her dependents, (3) debtor's job skills and education, (4) debtor's other assets, (5) debtor's ability to save for retirement, (6) the special needs of the debtor and his or her dependents, and (7) debtor's continuing financial obligations such as alimony or child support." *Id*. (citing *In re Jackson*, 376 B.R. 75, 80 (Bankr. D. Conn. 2007) *aff'd, Jackson v. Novak*, 593 F.3d 171 (2nd Cir.2010)).

Bankruptcy courts look at these factors strictly and tend to favor restricting the homestead. Within *Bounds*, the bankruptcy court granted an objection to a debtors' claimed homestead under § 522(q) because the home was more than reasonably necessary for the debtors' needs. *Id*. at 553. Specifically, the home consisted of 4,200 square feet of living space and had a tennis court, barn, a gated driveway, and a private pond. Since the debtors were soon to have no children living at home, had the ability to secure employment, and the capability to downsize to a smaller home, the court determined the homestead exemption should be limited. *Id.* at 453. The court further addressed how one debtor was convicted of fraud and theft in the amount of $500,000.00 against the objecting party, and that the objecting party would not obtain payment from the bankruptcy case if the debtors were entitled to keep the claimed homestead. *Id.* at 454.

Additionally, within *Presto,* the bankruptcy court determined that it was not reasonably necessary for a debtor with substantial income and future earning capacity to live in a two-story 3,400 square foot home with a custom pool in a gated community with a country club, especially when his children only stayed in the home during the summer. *Presto*, 376 B.R. at 599. The debtor argued that his pool, equipped with a slide and a hot tub, was medically necessary. *Id.* The court clarified the analysis for a medically necessary pool: "The only question this condition would raise is whether the Debtor had sufficient income and other assets to afford *any* house, not this specific house, that can provide a pool." *Id.* The court also included a footnote expressing doubt about the accuracy of the debtor's medical need for a pool, as debtor's application to build the pool requested expedited approval simply for his children and did not mention the medical necessity. ("If I didn't have my beautiful children to please, I would not be asking for accelerated approval, but please understand (like all good Daddy's [sic]), I want to put a big smile on my children all summer.") *Id.* at FN 51.

Outcome: The Homestead is sold for $5,000,000. After all of the closing costs and expenses are paid, Mr. Blackheart receives $170,350.00 for his homestead and Lilly and PIABA Pete receive a check for $1.5 million, the balance goes to the bankruptcy estate. Lilly is paid her $1,000,000. PIABA Pete makes a nice fee that just covers the actual time he has put in the case over the last five years.

Appendix I: Requirements for Approval of a Chapter 11 Plan of Reorganization.

Applicable statutory provision – 11 U.S.C. § 1126(c):

> (c) A class of claims has accepted a plan if such plan has been accepted by creditors, other than any entity designated under subsection (e) of this section, that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors, other than any entity designated under subsection (e) of this section, that have accepted or rejected such plan.

Applicable statutory provision – 11 U.S.C. §§ 1129(a)(8); (b):

(a) The court shall confirm a plan only if all of the following requirements are met:

(7) With respect to each impaired class of claims or interests—

5) Such class has accepted the plan; or

6) Such class is not impaired under the plan.

(b) [I]f all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair in equitable, with respect to each class or claims of interests that is impaired under, and has not accepted the plan.

For a plan to be confirmed one of the following must occur: 1) each class must be non-impaired; 2) each impaired class must vote to approve the plan; or 3) the requirements of "cramdown" contained in 11 U.S.C. § 1129(b) must be met. An impaired class accepts a plan if at least one-half of the class's claimants containing two-thirds of the aggregate dollar amount for the class's claims vote to approve the plan. 11 U.S.C. § 1126(c).

Although courts are divided, the majority of courts hold that a non-voting class is not deemed to have accepted the plan. *In re Vita Corp.*, 380 B.R. 525, 527 (C.D. Ill. 20008) (*citing In re Eagle-Picher Indus*., 203 B.R. 256 (S.D. Ohio 1996); *In re Westwood Plaza Apartments, Ltd.*, 192 B.R. 693 (E.D. Tex. 1996); *In re M. Long Arabians*, 103 B.R. 211 (9th Cir. 1989); *In re Smith*, 2006 Bankr. LEXIS 3196, 2006 WL 3627298 (Bankr. M.D. N.C. 2006); *In re Jim Beck, Inc.,* 207 B.R. 2010 (Bankr. W.D. Va. 1997); *In re Higgins Slacks Co.,* 178 B.R. 853 (Bankr. N.D. Ala. 1995); *In re 7th Street & Beardsley P'ship*, 181 B.R. 426 (Bankr. D.Ariz. 1994); *In re Adkisson Vill. Apts. of Bradley County, Ltd*., 133 B.R. 923 (Bankr. S.D. Ohio 1991); *In re Friese*, 103 B.R. 90 (Bankr. S.D. N.Y. 1989); *In re Townco Realty, Inc*., 81 B.R. 707 (Bankr. S.D. Fla. 1987)). Within the Southern District of Texas, a bankruptcy court ruled that a plan is not confirmable where no creditors vote on a plan, holding that each impaired class must affirmatively accept the plan. *In re Castaneda*, 09-50101, 2009 WL 3756569, at *1 (Bankr. S.D. Tex. Nov. 2, 2009). On the other hand, the Tenth Circuit Court of Appeals held that a creditor who is the sole member of a class is deemed to have accepted a plan of reorganization if it does not vote or object to the plan. *Heins v. Ruti—Sweetwater, Inc., (In re Ruti-Sweetwater, Inc.*), 836 F.2d 1263, 1267-68 (10th Cir. 1988).

Once a plan with a litigation trust is confirmed, a trustee will proceed in pursuing the claims in order to provide payout to the class. It is important to note that a litigation trust's standing to pursue a claim post-confirmation must be expressly provided for in the debtor's plan. *See Dynasty Oil & Gas, LLC v. Citizens Bank et al. (in re United Operating, LLC)*, 540 F.3d. 351, 355 (5th Cir. 2009). While some D&O carriers may have several exclusions in a policy, it is important to evaluate the exceptions to the exclusion. Several courts have concluded that the insured vs. insured exclusion is not trigged by a lawsuit brought by a successor-in-interest against former directors for breach of fiduciary duty. *In re Palmaz Scientific, Inc.*, 2018 WL 3343597, *13 (Bankr. W.D. Tex. 2018).

DETECTING PONZI SCHEMES, PURSUING LITIGATION CLAIMS, AND DEFENDING FRAUDULENT TRANSFER CLAIMS

Kathy Bazoian Phelps

A Ponzi scheme is a fictitious investment program with little to no underlying legitimate business operation to which the investment is connected. These fraudulent schemes invariably implode when the perpetrator loses the ability to lure in new investors to fund the fraud. Attorneys, auditors, brokers and financial institutions, among others, often become unwitting participants in the fraudulent scheme, having been duped by the perpetrator themselves and having failed to detect the fraud.

Ponzi schemes unfortunately are able to thrive because of a combination of the victims' unquestioning trust and their lack of due diligence. Ponzi perpetrators tend to prey upon people with whom they have an affinity or trusting connection and design their fraudulent schemes to lure in people in those groups. The intentionally targeted victims, therefore, have a heightened sense of trust in the Ponzi perpetrator, who has likely tailored the investment product to that particular group.

The perpetrator carefully choreographs circumstances that make it appear that the perpetrator is credible and is engaged in a legitimate and successful business. To do so, the perpetrator will hide behind apparent wealth by, for example, making grandiose charitable contributions, living an extravagant lifestyle, hiring well-known professionals, and using reputable financial institutions. The perpetrator will also pay back just enough money to earlier investors to instill confidence that the business is making money.

Meanwhile, the victims simply trust too much and investigate too little. Victims, who can range from unsophisticated family and friends to sophisticated hedge fund investors, often do not ask the hard but necessary questions, or any questions at all. The perpetrator generally appears so successful and confident that the victims are discouraged from confronting the perpetrator with questions or doubts. Rather, the victims are pleased to be in association with a successful person and business as they trust that they will receive their promised returns.

Defrauded victims will likely look for deep pockets to help cover their losses. Those plaintiffs may bring tort claims, such as negligence, fraud, or aiding and abetting liability theories, in seeking to be made whole. These materials will summarize some typical due diligence areas to be explored in investigating fraud, red flag warning signs of fraud, and the variety of claims for relief that may be brought against the professionals or others for their involvement in the scheme. On the flip side, investors must remain mindful of the risks for them that may arise once a Ponzi scheme is revealed as they may become targets of a fraudulent transfer claim by a bankruptcy trustee or receiver.

I. PONZI SCHEMES

A. Definition

Fundamentally, a Ponzi scheme is a financial scheme by which a dishonest fraudster steals money from his victims. There is not one definitive definition of a Ponzi scheme. Regulators and courts have crafted different variations on the definition. For example, the Securities and Exchange Commission describes a "Ponzi scheme" as follows:

> A Ponzi scheme is an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors. Ponzi scheme organizers often solicit new investors by promising to invest funds in opportunities claimed to generate high returns with little or no risk. In many Ponzi schemes, the fraudsters focus on attracting new money to make promised payments to earlier-stage investors and to use for personal expenses, instead of engaging in any legitimate investment activity.[1]

B. Common Characteristics and Red Flag Warning Signs

Sometimes a Ponzi scheme is a fraudulent scheme from its inception, with no intention to run a legitimate business. In other instances, the promoter sets out believing it has a legitimate business, but either it could not get the business off the ground as planned or the legitimacy of the business was lost in the wake of the fraudulent scheme. Yet other schemes involve both legitimate and illegitimate business operations. In each scenario, the seeds that motivate the fraud are generally greed and ego.

The facts considered by courts to determine whether a Ponzi scheme exists range in scope. One court created a four-factor analysis that many other courts have relied upon:

> (1) deposits were made by investors; (2) the Debtor conducted little or no legitimate business operations as represented to investors; (3) the purported business operations of the Debtor produced little or no profits or earnings; and (4) the source of payments to investors was from cash infused by new investors.[2]

The SEC has published red flag warning signs which many Ponzi schemes share in common:

- **High investment returns with little or no risk**. Every investment carries some degree of risk, and investments yielding higher returns typically involve more risk. Be highly suspicious of any "guaranteed" investment opportunity.

- **Overly consistent returns**. Investment values tend to go up and down over time, especially those offering potentially high returns. Be suspect of an investment that continues to generate regular, positive returns regardless of overall market conditions.

---

[1] SEC, Ponzi Schemes — Frequently Asked Questions, http://www.sec.gov/answers/ponzi.htm.

[2] *Rieser v. Hayslip* (*In re Canyon Sys. Corp.*), 343 B.R. 615, 630 (Bankr. S.D. Ohio 2006) (citation omitted).

- **Unregistered investments**. Ponzi schemes typically involve investments that have not been registered with the SEC or with state regulators. Registration is important because it provides investors with access to key information about the company's management, products, services, and finances.

- **Unlicensed sellers**. Federal and state securities laws require investment professionals and their firms to be licensed or registered. Most Ponzi schemes involve unlicensed individuals or unregistered firms.

- **Secretive and/or complex strategies**. Avoiding investments you do not understand, or for which you cannot get complete information, is a good rule of thumb.

- **Issues with paperwork**. Do not accept excuses regarding why you cannot review information about an investment in writing. Also, account statement errors and inconsistencies may be signs that funds are not being invested as promised.

- **Difficulty receiving payments**. Be suspicious if you do not receive a payment or have difficulty cashing out your investment. Keep in mind that Ponzi scheme promoters routinely encourage participants to "roll over" investments and sometimes promise returns offering even higher returns on the amount rolled over.[3]

II. TYPES OF DUE DILIGENCE

A lack of reasonable due diligence, especially in the face of red flag warning signs, is the primary reason that investors are scammed by Ponzi scheme perpetrators. Due diligence should be undertaken by investors considering an investment program. Some areas of due diligence designed to detect fraud are as follows:

A. Investigate Company's Auditor

- Is the auditor for the investment truly independent?
- Is the size of the audit shop proportionate to the size of the investment?
- Talk to the auditors

B Financial Statements

- Review audited financial statements
- Review tax returns
- Check for accuracy and completeness
- Call the auditor

C. Public Information About the Company

- Investigate negative news coverage
- Conduct nationwide litigation search

---

[3] SEC*, Ponzi Schemes — What are some Ponzi scheme "red flags*"?, http://www.sec.gov/fast-answers/answersponzhtmi.html.

- Conduct criminal background check

D. The Business Model

- Investigate the need for investor funds
- Is there a plausible, sustainable investment strategy?
- Is there independently verifiable performance?
- Are there unusual legal provisions?

E. Complicated Corporate Structure

- Who are the principals?
- Are there multiple levels of corporate ownership?
- Are there affiliated companies in the same business?
- Are there intercompany purchases and sales?

F. Operational Issues

- Investigate accounting and reporting systems
- Investigate reports made to customers
- Are operations consistent with reports?
- Is there micro management by owner?
- Is there turnover at significant financial positions?

G. Red Flags from Financial Transactions

- Customers who provide insufficient or suspicious information
- Customers who are reluctant to comply with reporting or record-keeping requirements
- Funds transferred to or from a financial secrecy haven
- Unusual transfers of funds between related entities
- Sudden inconsistencies in currency transaction patterns and shell company activities
- Significant increases in the number or amount of transactions
- Transactions that are not consistent with the customer's business or income level
- Transactions designed to lose the paper trail
- Circumvention of internal control procedures
- Lavish lifestyle of customers, which should not be supported by present income
- Customers with multiple accounts
- Diversion of funds to personal accounts
- Increases in the number or amount of transactions
- Transactions not consistent with company's business or income level
- Transactions designed to lose the paper trail
- Circumvention of internal control procedures.
- Irregular documentation
- Suspicious Intra-Company Transfers

III. POTENTIAL TORT THEORIES

When the low-hanging fruit is gone and all of the tangible assets and cash have disappeared, parties must look to litigation claims in order to recover lost funds and recoup damages. Third party tort claims can be pursued against a variety of targets on numerous different types of tort, statutory, and equitable theories available under federal and state laws. A few of the more common theories are discussed below.

A. Malpractice and Professional Negligence

Perpetrators of fraudulent schemes often solicit the assistance of attorneys, accountants, auditors, salespeople, and other professionals to give their fraudulent business an air of legitimacy. For example, the perpetrator asks the professional to issue private placement memoranda or audited financial statements so that the company can then distribute that documentation to its investors to solicit more investments. Those professionals often later find themselves the targets of malpractice lawsuits for the services they provided before the fraudulent scheme collapsed.

Malpractice, whether by an accountant or an attorney, is founded in state law and is based on a negligence theory of liability.[4] Under most state laws, the plaintiff must prove the following elements to establish a claim for professional negligence: "that the defendant failed to use the skill and care that a reasonably careful professional operating in the field would have used in similar circumstances, and that the defendant's failure proximately causes damage to plaintiff."[5]

Generally, an attorney or an accountant for a client perpetrating a fraudulent scheme owes duties only to the client and does not owe any duty to the investors of its client.[6] However, an investor may bring a claim against the perpetrator's professional in instances of fraud, or for conduct equivalent to fraud, such as gross negligence.[7]

In *Lautenberg Foundation v. Madoff*, the court declined to dismiss a negligence claim based on the court's holding that the complaint adequately alleged a fiduciary duty and breach of that fiduciary duty.[8] In that case, the plaintiff alleged a fiduciary duty to safeguard money entrusted to the debtor against fraud, misappropriation or other wrongdoing by the debtor and that this duty was breached by the defendant, causing the plaintiff's loss.

---

[4] *Seitz v. Detweiler, Hershey and Assocs., P.C*. (*In re CitX Corp*.), 448 F.3d 672, 677 (3d Cir. 2006).

[5] *See, e.g*., *Mosier v. Stonefield Josephson, Inc.,* 2011 U.S. Dist. LEXIS 124058, at *18 (C.D. Cal. Oct. 25, 2011) (citations omitted).

[6] *International Strategies Group, Ltd. v. Greenberg Traurig, LLP*, 482 F.3d 1 (1st Cir. 2007).

[7] *Silverman v. KPMG LLP* (*In re Allou Distributors, Inc*.), 395 B.R. 246, 259-60 (Bankr. E.D.N.Y. 2008) (citation omitted) ("A refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely on the balance sheet.").

[8] *Lautenberg Found. v. Madoff*, 2009 U.S. Dist. LEXIS 82084, at *20-25 (D.N.J. Sept. 9, 2009).

B. Negligent Misrepresentation

A claim for negligent misrepresentation may similarly be brought against professionals who misrepresented information upon which others relied upon in doing business with the wrongdoing defendant.

> The elements of a negligent misrepresentation claim are (1) the misrepresentation of a past or existing material fact, (2) without reasonable ground for believing it to be true, (3) with intent to induce another's reliance on the fact misrepresented, (4) justifiable reliance on the misrepresentation, and (5) resulting damage.[9]

As is the case with a malpractice claim, a claim for negligent misrepresentation may be brought by an investor only in limited circumstances. "The general rule is that a professional owes a duty to a third party only if that third party is within the "limited group of persons for whose benefit and guidance [the defendant] intends to supply the information or knows that the recipient intends to supply it."[10] Other courts have found that, "To state a claim for negligent misrepresentation against a professional defendant, the plaintiff must be in privity with the defendant or in a 'relationship "so close to approach that of privity.""[11]

C. Deepening Insolvency

Trustees, receivers, and even investors under some circumstances, can assert claims for damages to the corporate entity based on a "deepening insolvency" theory, either as a direct claim for relief or as a theory of damages. Deepening insolvency has been defined as "an injury to the Debtors' corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life."[12] In *Lafferty*, the creditors' committee brought an action against the debtor's officers, directors and outside professionals, alleging that through mismanagement and participation in a fraudulent Ponzi scheme, the defendants wrongfully prolonged the debtor's life and incurred debt beyond the debtor's ability to pay, ultimately forcing the debtor into bankruptcy.

Some courts have found that state law in their jurisdiction permits an independent claim for relief based on deepening insolvency, which generally require the following elements to establish the claim: (1) fraud, (2) which causes the expansion of corporate debt, and (3) which prolongs the life

---

[9] *Mosier v. Stonefield Josephson, Inc.,* 2011 U.S. Dist. LEXIS 124058, at *20 (C.D. Cal. Oct. 25, 2011).

[10] *Facciola v. Greenberg Traurig LLP*, 2011 U.S. Dist. LEXIS 61785, at *35 (D. Ariz. June 9, 2011); 2011); *see also Duke v. Touche Ross & Co*., 765 F. Supp. 69, 77 (S.D.N.Y. 1991) (investors stated negligent misrepresentation claim against accounting firm that prepared private placement memorandums because documentation was distributed to select group of qualified investors, rather than the public at large, and firm allegedly solicited some investors).

[11] *In re Colonial Ltd. Partnership Litigation,* 854 F. Supp. 64, 102 (D. Conn. 1994) (quotations omitted) (denying defendant's motion to dismiss and noting that, "plaintiffs allege that Arthur Andersen knew members of the class would rely on the representations contained in the PPMs in deciding whether to invest in the limited partnerships.").

[12] *Official Comm. Of Unsecured Creditors v. R.F. Laffferty & Co*., 267 F.3d 340, 347 (3d Cir. 2001).

of the corporation.[13] Other courts have found that negligence is sufficient to sustain a claim for deepening insolvency.[14] Some courts reject deepening insolvency as an independent cause of action,[15] and other courts recognize deepening insolvency as a theory of damages only.[16] Plaintiffs can allege that the tortuous conduct of the defendant caused the debtor to take on new liabilities which rendered the debtor unable to pay its creditors and the debtor's insolvent position increased over time.[17]

D. Fraud

In some circumstances, professionals may have knowingly and actively agreed to participate in the fraudulent activity themselves. In addition to claims for conspiracy, or aiding and abetting liability, discussed below, those defendants may find they have potential liability for fraud. To establish a claim of fraud (sometimes called "fraudulent misrepresentation"), under California law, the plaintiff must establish: "(a) misrepresentation (false representation, concealment, or nondisclosure); (b) knowledge of falsity (or 'scienter'); (c) intent to defraud, i.e., to induce reliance; (d) justifiable reliance; and (e) resulting damage."[18]

Knowledge of the fraud on the part of the professional is a key element in imposing liability on that professional. In connection with the *Madoff* Ponzi scheme, the court dismissed a fraud claim against the auditor because the complaint did "not allege facts from which the court could infer that the auditor actually knew about and ignored most of these warning signs."[19] The court noted:

> But an unseen red flag cannot be heeded. Hence courts in this Circuit have consistently dismissed fraud claims against auditors-including against auditors of BMIS feeder funds-that have not sufficiently alleged that an auditor knew of red flags. *See In re Beacon Assoc. Litig.*, No. 09-CV-777, 2010 WL 3895582, at *22 (S.D.N.Y. Oct. 5, 2010) ("Plaintiffs allege a litany of red flags, but fail to allege

---

[13] *Official Comm. Of Unsecured Creditors v. Foss* (*In re Felt Mfg. Co., Inc.),* 371 B.R. 589 (Bankr. D.N.H. 2007).

[14] *See, e.g., In re LTV Steel Co., Inc.*, 333 B.R. 397 (Bankr. N.D. Ohio 2005) (either fraudulent or negligent conduct that prolongs the life of corporation, thereby increasing the corporation's debt and exposure to creditors, may give rise to deepening insolvency claim).

[15] *See, e.g., Wooley v. Faulkner* (*In re SI Restructuring, Inc.*), 532 F.3d 355, 363 (5th Cir. 2008); s*ee also Torch Liquidating Trust v. Stockstill*, 561 F.3d 377 (5th Cir. 2009) (holding that Delaware does not recognize cause of action on behalf of corporation for deepening insolvency); *Fehribach v. Ernst & Young LLP*, 493 F.3d 905 (7th Cir. 2007) (rejecting a deepening insolvency claim against debtor's auditors because it was not based on an existing legal duty); *Trenwick Am. Litigation Trust v. Ernst & Young*, LLP, 906 A.2d 168, 204-205 (Del. Ch. 2006), *aff'd*, 931 A.2d 438 (Del. 2007).

[16] *Thabault v. Chait*, 541 F.3d 512, 522 (3d Cir. 2008); *see also Silverman v. KPMG, LLP* (*In re Allou Distribs., Inc.*), 395 B.R. 246, 264-65 (E.D.N.Y. 2008); *NCP Litig. Trust v. KPMG*, 945 A.2d 132 (N.J. Super. 2007).

[17] *See, e.g., Silverman v. KPMG LLP* (*In re Allou Distributors, Inc*.), 395 B.R. 246, 267 (Bankr. E.D.N.Y. 2008).

[18] *Lazar v. Superior Court*, 12 Cal. 4th 631, 638, 49 Cal. Rptr. 2d 377, 909 P.2d 981 (1996).

[19] *Stephenson v. PricewaterhouseCoopers LLP*, 768 F. Supp. 2d 562, 571 (S.D.N.Y. 2011).

sufficiently that Friedburg ever became aware of them. . . . Such allegations do not support a strong inference that Friedburg was aware of red flags and acted with scienter.").

E. Aiding and Abetting Fraud and Breach of Fiduciary Obligations

Aiding and abetting theories of recovery may provide for relief against third parties who have been involved in a fraudulent scheme. To prove aiding and abetting fraud, the plaintiff must establish these three elements: (1) the existence of a fraud; (2) the defendant's knowledge of the fraud; and (3) that the defendant provided substantial assistance to advance the fraud's commission.[20]

The elements of a claim of aiding and abetting a breach of fiduciary duty are: (1) a breach of fiduciary duty; (2) knowing participation or substantial assistance in that breach by the defendant; and (3) damages.[21]

1. The Knowledge Requirement

The first of the two elements required to establish aiding and abetting liability, knowledge (defendant's knowledge of the fraud or of the breach of fiduciary obligation), must be demonstrated by actual knowledge; constructive knowledge is insufficient.[22] In the Ponzi scheme case of Reed Slatkin, the court noted, "while aiding and abetting may not require a defendant to agree to join the wrongful conduct, it necessarily requires a defendant to reach a conscious decision to participate in tortious activity for the purpose of assisting another in performing a wrongful act."[23]

2. The Substantial Assistance Requirement

In additional to actual knowledge of the debtor's fraud or of an insider's breach of fiduciary duty, there must also be substantial assistance in the fraud, or inducement or participation in the breach of fiduciary duty.[24] "Substantial assistance" and "participation" have been found "to exist where a

---

[20] *Lerner v. Fleet Bank, N.A.*, 459 F.3d 273, 286 (2d Cir. 2006); *Lawrence v. Bank of America, N.A.*, 455 Fed. App'x 904 (11th Cir. 2012).

[21] *Terry v. SunTrust Banks, Inc.*, 2012 WL 2511066, at *8 (4th Cir. 2012) (affirming the dismissal of plaintiff's aiding and abetting breach of fiduciary duty claim, finding that the plaintiff failed to allege facts showing a fiduciary duty); *LaSala v. Bordier et Cie*, 519 F.3d 121, 130 (3d Cir. 2008) (applying Delaware law); *Facciola v. Greenberg Traurig LLP*, 2011 WL 2268950, at *10 (D. Ariz. 2011); *Fine v. Sovereign Bank*, 2011 WL 2134380, at *2 (D. Mass. 2011); *Mandelbaum v. Fiserv, Inc.*, __ F. Supp. 2d __, 2011 WL 1225549, at *11 (D. Colo. 2011).

[22] *Neilson v. Union Bank, N.A.*, 290 F. Supp. 2d 1101, 118-19 (C.D. Cal. 2003) ("knew or should have known" allegations were insufficient).

[23] *Id.* (citation omitted); *but see Marcelos v. Dominguez*, 2008 U.S. Dist. LEXIS 91155, at *26 (N.D. Cal. July 18, 2008) (finding actual knowledge despite plaintiff having included the phrase "knew or should have known" because plaintiff pled facts demonstrating actual knowledge).

[24] *See Sharp Int'l Corp. v. State Street Bank & Trust Co.* (*In re Sharp Int'l Corp.*), 403 F.3d 43, 52-53 (2d Cir. 2005) (concluding that it was unnecessary to resolve the issue of the defendant's knowledge because there was insufficient evidence of substantial assistance, and that even if the defendant knew of the fraud, it had no separate duty to disclose it.).

defendant 'affirmatively assists, helps conceal, or by virtue of failing to act when required to do so enables the fraud to proceed.'"[25]

IV. FRAUDULENT TRANSFER CLAIMS

As a Ponzi scheme progresses, the earlier investors are often paid back more money than they invested, receiving fictitious profits that they were promised (often referred to as "net winners"). Broker-dealers are often paid handsome commissions for soliciting the investments. High-powered lawyers and accountants are often engaged to add an air of legitimacy to the fraudulent enterprise. Banks handle the banking of the Ponzi perpetrator and either knowingly or negligently run millions of dollars of stolen investor funds through their accounts. So when the Ponzi scheme is disclosed and lands in an insolvency proceeding, the bankruptcy trustee or receiver will likely consider seeking recovery of, among other things: (1) the funds transferred to the investors (both principal repayments and fictitious profits); (2) commissions paid to the sales people and broker-dealers who solicited the investments for the Ponzi debtor; (3) gifts given to family and friends; and (4) charitable contributions.

To "claw back" the transfers that the Ponzi debtor made to investors, salespeople, friends, family, or others, a trustee or receiver commonly uses the fraudulent transfer laws available under applicable bankruptcy or applicable state law. Claw back claims can be based on either of two theories – actual intent to hinder delay or defraud creditors, or constructive fraudulent transfer theories.

A. Actual Fraudulent Intent

There is a unique presumption in Ponzi scheme cases in connection with fraudulent transfer laws. Where a Ponzi scheme has been established by the facts, there is a conclusive presumption that transfers made by a Ponzi debtor were made with the actual intent to hinder, delay or defraud creditors, which is sufficient to establish the claim to recover the transferred funds.[26]

Courts have found that, among other things, in order to establish a Ponzi scheme, a plaintiff must establish: "(1) deposits were made by investors; (2) the Debtor conducted little or no legitimate business operations as represented to investors; (3) the purported business operations of the

---

[25] *Cromer Finance Ltd. v. Berger*, 137 F. Supp. 2d 452, 470 (S.D.N.Y. 2001) (citations omitted); *see also Lautenberg Found. v. Madoff*, 2009 U.S. Dist. LEXIS 82084, at *50 (D.N.J. Sept. 9, 2009) (rejecting defendant's assertion that complaint asserted only mere inaction and finding allegations sufficient that defendant provided substantial assistance "by failing to maintain and enforce a system of internal controls, as he was required to do in his role as BMIS's compliance officer . . . .). Under California law, courts have found that "'ordinary business transactions' that a bank performs for a customer can satisfy the substantial assistance element of an aiding and abetting claim if the bank actually knew those transactions were assisting the customer in committing the specific tort." *Casey*, 127 Cal. App.4th at 1145; *see also Henry v. Lehman Commercial Paper, Inc.* (*In re First Alliance Mortg. Co.*), 471 F.3d 977, 994-95 (9th Cir. 2006) (noting that, while the definition of "substantial assistance" is not clear under California law, even "ordinary business transactions" can constitute substantial assistance).

[26] *See, e.g., Donell v. Kowell,* 533 F.3d 762, 770 (9th Cir. 2008); *see also Barclay v. Mackenzie (In re AFI Holding, Inc.)*, 525 F.3d 700, 704 (9th Cir. 2008) ("[T]he mere existence of a Ponzi scheme is sufficient to establish actual intent" to hinder, delay or defraud").

Debtor produced little or no profits or earnings; and (4) the source of payments to investors was from cash infused by new investors."[27]

If a Ponzi scheme cannot be conclusively established, then a plaintiff may try to establish actual fraudulent intent through a more customary "badges of fraud" analysis using circumstantial evidence. The Uniform Fraudulent Transfer Act[28] provides a non-exclusive list of badges of fraud as follows: (1) the transfer was to an insider; (2) the debtor retained possession or control of the property transferred after the transfer; (3) the transfer or obligation was not disclosed or concealed; (4) before the transfer or obligation was made or obligation was incurred, the debtor was sued or threatened with suit; (5) the transfer was of substantially all of the debtor's assets; (6) the debtor absconded; (7) the debtor removed or concealed assets; (8) the value of the consideration received by the debtor was [not] reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred; (9) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred; (10) the transfer occurred shortly before or shortly after a substantial debt was incurred; and (11) the debtor had transferred the essential assets of the business to a lienor who had transferred the assets to an insider of the debtor.[29]

Alternatively, a plaintiff can establish fraudulent intent by relying on an admission of the debtor, usually in a criminal plea agreement, or if the debtor is found criminally liable for fraud.[30]

B. Constructive Fraudulent Transfer

Under a constructive fraudulent transfer theory, a trustee or receiver must establish that the Ponzi debtor did not receive reasonably equivalent value in exchange for the transfers and that the Ponzi debtor was then insolvent or became insolvent as a result of the transfer.[31] A split of authority exists as to the analysis and meaning of 'reasonably equivalent value' in a Ponzi case relating to payments made to investors and the analysis can depend on whether those payments were a return of principal or fictitious profits.

---

[27] *Rieser v. Hayslip, et al. (In re Canyon Sys. Corp.),* 343 B.R. 615, 630 (Bankr.S.D.Ohio 2006).

[28] UFTA § 4(a)(1) lists "badges of fraud"; however, UFTA § 4 states that the presence of one or more of the enumerated factors is evidence relevant to the debtor's intent, but does not create a presumption that a fraudulent transfer was made.

[29] *See also In re Lull*, 386 B.R. 261, 270 (Bankr.D. Haw. 2008) (actual intent may be established where transfer wears a sufficient number of badges of fraud).

[30] *See, e.g., Santa Barbara Capital Management v. Neilson* (*In re Slatkin*), 525 F.3d 805, 814 (9th Cir. 2008) ("a debtor's admission, through guilty pleas and a plea agreement admissible under the Federal Rules of Evidence, that he operated a Ponzi scheme with the actual intent to defraud his creditors conclusively establishes the debtor's fraudulent intent under 11 U.S.C. § 548(a)(1)(A) and California Civil Code § 3439.04(a)(1), and precludes relitigation of that issue").

[31] *See, e.g.,* 11 U.S.C. § 548(a)(1)(A) and § Cal. Civ. Code § 3439.04(a)(2).

1. Issues Pertaining to Investors

Courts have critically distinguished between a transfer that was a return of the principal investment and a transfer that was a profit or "interest" paid in addition to the return of principal. The Ninth Circuit has held that, "Under the constructive fraud theory, the receiver may only recover 'profits' above the initial outlay, unless the receiver can prove a lack of good faith, in which case the receiver may *also* recover the amounts that could be considered return of principal."[32] Most courts find that a transfer to an investor as a return of principal is not recoverable because the transfer partially or fully extinguishes the investor's restitution claim against the debtor (assuming the subjective good faith of the investor), thereby providing value to the debtor.[33]

However, there is a split of authority over the issue of whether the payment to an investor of "interest" or "profits" on its investment was made in exchange for reasonably equivalent value. Some courts find that profits paid to an investor are recoverable as no value could be provided in exchange for the transfer which was made in a fraudulent scheme.[34] On the other hand, some courts have placed their focus not on public policy or an analysis of equity, but rather on the contractual relationship between the investor and the debtor. For example, in *Lustig v. Weisz & Assoc., Inc*. (*In re Unified Commercial Capital, Inc*.), the court found that the debtor's use of investor's funds for a period of time supported the payment of reasonable contractual interest and that courts cannot ignore what is clearly value and fair consideration under the fraudulent conveyance statutes.[35]

The debate turns to whether "value" can be provided for profits. The *Independent Clearing House* line of cases finds that the only value was to perpetuate the Ponzi scheme, and no value can be provided if the contract underlying the transaction is illegal. The *Unified Commercial* line of cases looks at the discrete transaction, finding that the court must measure what was given against what was received in that particular transaction, and concluding in some instances that the debtor's use of the investor's funds for a period of time supported the payment of reasonable contractual interest.

2. Issues Pertaining to Salespeople

A transfer that the Ponzi debtor makes to a sales person as a commission is also potentially recoverable. However, the courts are split on the question of reasonably equivalent value relative to broker's commissions as well, and a plaintiff's success in recovering a commission depends on the case law in the jurisdiction in which the claim is brought.

---

[32] *Donell v. Kowell*, 533 F.3d 762, 771 (9th Cir. 2008).

[33] *Barclay v. Mackenzie* (*In re AFI Holding, Inc*.), 525 F.3d 700, 704 (9th Cir. 2008).

[34] *Merrill v. Abbott* (*In re Independent Clearing House Co*.), 77 B.R. 843, 858 (D. Utah 1987) ("To allow an [investor] to enforce his contract to recover promised returns in excess of his [investment] would be to further the debtor's fraudulent scheme at the expense of other [investors]"); *see also Scholes v. Lehmann*, 56 F.3d at 757 ("A profit is not offset by anything; it is the residuum of income that remains when costs are netted against revenues. The paying out of profits . . . conferred no benefit on the [debtors] but merely depleted their resources faster.").

[35] *Lustig v. Weisz & Assoc., Inc.* (*In re Unified Commercial Capital, Inc*.), 260 B.R. 343, 350 (Bankr.W.D.N.Y. 2001).

Some courts have found that because a Ponzi enterprise has no legitimate purpose, there can be no value provided by a broker in furthering or assisting the debtor in perpetrating the fraud. Therefore, the commissions paid to the broker are recoverable as fraudulent transfers.[36]

Other courts, however, have looked more narrowly at the relationship between the debtor and the broker and measure "what was given and received" by the debtor and the broker. These courts compare market commission rates with what was paid. As one court observed, "Money is valuable even when used for illegal purposes."[37] This line of cases finds that value can be found in certain circumstances and the court must evaluate the consideration exchanged by the debtor and transferee in the specific transaction which is sought to be avoided, not the transaction's impact on the debtor's overall business.[38]

3. Issues Pertaining to Charitable Organizations

Courts have also found that, in some circumstances, no value is exchanged for a charitable contribution and, as such, the contribution is recoverable as a constructively fraudulent transfer.[39] Additionally, in several Ponzi cases, the courts found that the perpetrator's charitable donations were made with actual fraudulent intent.[40]

C. Good Faith Value Defense

Under either an actual fraudulent intent theory or a constructive fraudulent transfer theory of recovery against a transferee, the good faith of the investor-transferee is relevant, assuming value was provided, in establishing a partial or complete defense, depending on the circumstances.[41] The analysis regarding whether value was provided for purposes of a good faith value defense is essentially the same as a reasonably equivalent value analysis in connection with the *prima facie* case.[42]

---

[36] *See, e.g., Warfield v. Byron*, 436 F.3d 551, 560 (5th Cir. 2006) ("It takes cheek to contend that in exchange for the payments he received, the [debtor's] Ponzi scheme benefited from his efforts to extend the fraud by securing new investments.").

[37] *In re First Commercial Man. Group, Inc*., 279 B.R. 230, 237 (Bankr. N.D. Ill. 2002).

[38] *In re Churchill Mortgage Inv. Corp*., 256 B.R. 664, 680 (Bankr. S.D.N.Y. 2000).

[39] *See Scholes v. Lehman*, 56 F.3d 750, 761 (7th Cir. 1995)("The statute makes no distinction among different kinds of recipient of fraudulent conveyances").

40 *See, e.g., Hecht v. Malvern Preparatory School*, 2010 WL 2135626 at *4 -5 (E.D. Pa. 2010); *see also Liebersohn v. Campus Crusade for Christ, Inc*. (*In re C.F. Foods, L.P*.), 280 B.R. 103, 111-12 (Bankr. E.D. Pa. 2002) (Ponzi-debtor's payments of $1.7 million to charities during the four years prepetition were made as part of the fraudulent scheme to impress investors that the debtor was a profitable and charitable enterprise, and were therefore made with intent to defraud).

41 11 U.S.C. § 548(c). Most state statutes also create an exception for the transferee or obligee who takes the property in good faith and for value. *See, e.g*., Cal.Civ.Code § 3439.08(a). Another defense available in fraudulent transfer cases, not discussed herein, is the stockbroker defense under 11 U.S.C. § 546(e).

[42] *Barclay v. Mackenzie* (*In re AFI Holding, Inc*.), 525 F.3d 700, 707 (9th Cir. 2008) ("We find no

The focus of a courts' inquiry regarding good faith centers around the state of mind of the transferee -- whether the transferee has knowledge of the debtor's insolvency or fraudulent activity; whether that knowledge is actual or constructive, whether the transferee should have been placed on inquiry notice, and what type of investigation was conducting after the transferee was placed on inquiry notice. Most courts consider whether the transferee objectively knew or should have known of the debtor's fraudulent purpose in making the transfer.[43]

"Certainly, if a defendant knew that the debtor was running a Ponzi scheme when he advanced money to the debtor or knew of the debtor's insolvency at the time of the allegedly fraudulent transfer, that knowledge might indicate a lack of good faith."[44] If the circumstances would place a reasonable person on inquiry of the fraudulent scheme, then good faith will not likely be found.[45] Most courts have found that inquiry notice exists if there were red flags regarding the purpose of the transfer, the underlying fraud of the Ponzi scheme, the unfavorable financial condition of the transferor, the insolvency of the transferor, the improper nature of a transaction, or the voidability of the transfer.[46] Some of the factors which have been found sufficient to constitute "red flags" putting an investor on inquiry notice are:

-A promise of very high or exorbitant returns should put an investor on inquiry notice.[47]

-If the circumstances would place a reasonable person on inquiry notice and a diligent inquiry would have uncovered the fraud, then a finding of a lack of good faith will likely be made.[48]

-An investor's education and experience can preclude a finding of good faith.[49]

---

reason, in statute or case law, to treat 'reasonably equivalent value' differently for each of the Code provisions [§§ 548(a)(1)(B) and 548(c)].").

[43] *See, e.g., In re Agricultural Research and Technology Group, Inc*., 916 F.2d 528, 535 (9th Cir. 1990).

[44] *Merrill v. Abbott* (*In re Independent Clearing House Co.*), 77 B.R. 843, 861 (D. Utah 1987).

[45] *Jobin v. McKay* (*M & L Business Machine Co*.), 84 F.3d 1330, 1338 (10th Cir. 1996).

[46] *Plotkin v. Pomona Valley Imports (In re Cohen)*, 199 B.R. 709, 719 (B.A.P. 9th Cir. 1996)("Such inquiry notice suffices on the rationale that some facts suggest the presence of others to which a transferee may not safely turn a blind eye").

[47] *See*, *e.g*., *Jobin v. Lalan* (*In re M&L Bus. Mach. Co.*), 160 B.R. 851, 859 (Bankr. D. Colo. 1993), *aff'd* 167 B.R. 219 (D. Colo. 1994) (a Ponzi-scheme investor did not act in good faith in pursuing a supposedly risk-free investment promising profits of 125 percent to 512 percent); *Scholes v. Lehmann*, 56 F.3d at 760 ("Only a very foolish, very naïve, very greedy, or very Machiavellian investor would jump at a chance to obtain a return on his passive investment of 10 to 20 percent a month . . . It should be obvious that such returns are not available to passive investors in any known market, save from the operation of luck.").

[48] *Agric. Research*, 916 F.2d at 539; *McKay*, 84 F.3d at 1338-39 (implausible explanation by company officials as to how they could pay such high rates places investor on inquiry notice).

[49] *See, e.g., McKay*, 84 F.3d at 1333 (No good faith finding where investor attended college for three years, studied business administration and bookkeeping, operated his own construction business, a commercial and industrial real estate business, served as co-trustee for a family trust with assets in excess of $3,000,000, and owned a personal portfolio including a variety of stocks, bonds, mutual funds, raw land and promissory notes).

-If insufficient due diligence was done by the investor, then good faith may not be found.[50]

In the Madoff Ponzi scheme case, the issue of good faith was considered in the case of *Picard v. Katz*, which ultimately settled on the eve of trial.[51] In that case, the trustee advanced two theories to demonstrate a lack of good faith on the part of the defendants. First, the trustee argued "that if the defendants willfully blinded themselves to the fact that Madoff Securities was involved in some kind of fraud, this too might, depending on the facts, constitute a lack of good faith." Second, "defendants were on 'inquiry notice' of the fraud but failed to diligently investigate Madoff Securities and that this also constitutes lack of good faith." The court noted that, "The difference between the inquiry notice approach and the willful blindness approach is essentially the difference between an objective standard and a subjective standard." The court concluded:

> A securities investor has no inherent duty to inquire about his stockbroker, and SIPA creates no such duty. See generally In re New Times Sec. Servs., 371 F.3d 68, 87 (2d Cir.2004). If an investor, nonetheless, intentionally chooses to blind himself to the "red flags" that suggest a high probability of fraud, his "willful blindness" to the truth is tantamount to a lack of good faith. See United States v. Rodriguez, 983 F.2d 455, 458 (2d Cir. 1993) ("conscious avoidance," another term for willful blindness, means "that the defendant was aware of a high probability of the fact in dispute and consciously avoided confirming that fact"). But if, simply confronted with suspicious circumstances, he fails to launch an investigation of his broker's internal practices—and how could he do so anyway?—his lack of due diligence cannot be equated with a lack of good faith, at least so far as section 548(c) is concerned as applied in the context of a SIPA trusteeship.

In defining good faith, the court concluded: "If an investor, nonetheless, intentionally chooses to blind himself to the "red flags" that suggest a high probability of fraud, his "willful blindness" to the truth is tantamount to a lack of good faith."

---

[50] *Lalan*, 160 B.R. at 859(no good faith where investor "ignored his own initial intuition and plunged headlong into scam because of the huge profits he was promised, and which he received."); *see also Cuthill v. Kime* (*In re Evergreen Sec., Ltd*.), 319 B.R. 245, 253 (Bankr. M.D. Fla. 2003).

[51] *Picard v. Katz*, 462 B.R. 447 (S.D.N.Y. 2011).

DON'T CALL IT SELLING-AWAY – NEGLIGENT SUPERVISION AND AGENCY-BASED CLAIMS FOR PONZI SCHEMES AND SCAMS AGAINST BROKER/DEALERS BY NON-CLIENT PLAINTIFFS

Joseph R. Wojciechowski[1]

I. Introduction

Investors are frequently victimized by conmen who sell purported investments that appear legitimate and, in many instances, include indicia of being approved by brokerage firms and investment advisory firms. Experienced practitioners have taken many calls from these victims, excited at the prospect of representing clients in a FINRA claim against a viable broker/dealer for a scam run by the firm's registered representative. As the conversation continues, it turns out the victim of the scam had no accounts with the brokerage firm and this "investment" was the only product the victim invested in with the scam artist. Although the investor-victim insists he believed the investment that was sold to him by the broker was through the brokerage firm, there is virtually nothing in writing to support this contention. Still, it is clear this is not a one-off incident because there seem to be multiple victims; the broker is likely a dry-hole, who will probably face indictment or a regulatory action that will wipe him out, and the brokerage firm could be the only potential pocket to pursue recovery for the victims. The first question typically asked in this scenario is whether to file the claim in FINRA arbitration or in court? The answer is a complicated one and could be the difference between success and failure for your clients.

II. Jurisdictional Issues Confronting "Non-Clients" in Selling-Away Claims

In the more traditional "selling away" claim, the victims of the scam are clients of the firm, so it is a straight-shot to FINRA arbitration. In some instances, a firm may attempt to have the claim dismissed pursuant to FINRA Rule 12504, it is highly unlikely that will work, unless the Statement of Claim fails to adequately plead both agency-based claims and negligent supervision.[2] The non-eligibility grounds for dismissing an arbitration claim before the conclusions of the Claimant's case in chief are laid out in FINRA Rule 12504(6)(A)-(C) and are:

[1] This article is incorporated into the 2022 PIABA Annual Meeting materials to accompany the breakout session to be held on Wednesday, October 26, 2022 at 11:10-12:10, which will be moderated by Mr. Wojciechowski, at which time Sander Ressler, Jeff Erez, Esq., and Gary Saretsky, Esq., will be presenting a detailed presentation explaining their experience in various types of "selling away" cases. Adam Gana of Gana Weinstein deserves a "thank you" for providing some written materials that proved useful in preparing this submission. Included with the written materials which are attached as exhibits, is a sample Statement of Claim; sample motions to compel which include dozens of specific RFPs, a response to Rule 12504 Motion to Dismiss, and a motion for subpoena to FINRA.

[2] The written materials include a response in opposition to a Rule 12504 Motion to Dismiss in a selling-away case. There, the investor was solicited to surrender an annuity and invest in the "scheme" by a broker who had left the firm at issue about a year earlier. The facts of the case demonstrated that the broker had been running the scheme for several years while registered with the firm, was permitted to resign amid an internal investigation, and despite the fact that the firm was aware of the scope of the broker's selling away, never informed a single client about the reason for the broker's resignation. The investor was a client of the firm. The motion was denied.

(A) the non-moving party previously released the claim(s), security(ies), or conduct at issue; or

(B) the moving party was not associated with the account(s), security(ies), or conduct at issue; or

(C) the non-moving party previously brought a claim regarding the same dispute against the same party that was fully and finally adjudicated on the merits and memorialized in an order, judgment, award, or decision.

FINRA Rule 12504(6). Clearly, unless a claimant previously settled or fully adjudicated the claims, the only grounds for dismissal would be sub-section B. In the traditional client-brokerage firm selling away case, it is a tall order for the firm to successfully argue it was not "associated" at a minimum, with the "conduct at issue."

If your client was *not* a "customer" of the firm in the literal sense, meaning she did not have an account with the firm, then the risk of dismissal under Rule 12504 is a bit higher. Still, if pleaded correctly, this version of the facts is not so far off the traditional selling away case to cause any material difference in the Rule 12504 analysis. If the claim is based on the negligent supervision by the brokerage firm, the firm should not be able to win a 12504 dismissal.

Instead, firms may focus their energy in non-client selling away claims on jurisdiction arguments. If the investor/claimant is not a client of the firm in a literal sense – i.e., she did not sign a new account form or agreement – then there is no arbitration clause between the brokerage firm and the client. Still, FINRA Rule 12200 has been interpreted to include claims by non-clients against firms because they could still be considered "customers" from a merits perspective. FINRAA Rule 12200 says:

Arbitration Under an Arbitration Agreement or the Rules of FINRA:

Parties must arbitrate a dispute under the Code if:

Arbitration under the Code is either:

1) Required by a written agreement, or
2) Requested by the customer;

The dispute is between a customer and a member or associated person of a member; and

The dispute arises in connection with the business activities of the member or the associated person, except disputes involving the insurance business activities of a member that is also an insurance company.

FINRA Rule 12200. The subtitle of the rule makes it clear that arbitration under the FINRA Code does not require a pre-dispute arbitration agreement of any kind. Instead, the rule specifies that "parties must arbitrate a dispute under the code if" it is "requested by the customer." The FINRA rules define customer extremely broadly: "A customer shall not include a broker or dealer." FINRA Rule 12100(k). Obviously, FINRA could have included more clear language to define "customer" such as defining customer restrictively to mean only account-owners or those who have executed new account agreements and the attendant paperwork. Instead, FINRA chose to

define “customer” in the broadest sense possible to mean literally anyone who is not a broker or dealer. Because “customer” is so broadly defined, firms tend to argue that the “selling away” activity is not in connection with the business activities of the member or associated person.

Case law has taken several shots at determining what “in connection with the business activities of the member…” means in the context of parties seeking injunctive relief from FINRA arbitration claims and jurisdiction, or seeking to compel arbitration. For example, in *O.N. Equity Sales Co. v. Steinke*, 504 F.Supp.2 913, 916 (C.D. Cal. 2007), the court, interpreting former NASD Rule 10301(a), ruled that a “non-client” could compel arbitration against a brokerage firm based on allegations that the brokerage firm failed to supervise their registered representative. The court stated “a claim for failure to supervise clearly ‘arises in connection with the business’…for purposes of NASD Rule 10301(a).” Citing *USAllianz Secs., Inc. v. S. Mich. Bancorp., Inc.,* 290 F. Supp. 2d 827 (W.D. Mich. 2003); *World Group Sec., Inc. v. Sanders*, 2006 U.S. Dist. LEXIS 28733 (Dist. Utah, May 8, 2006); *Vestax Sec. Corp. v. McWood*, 280 F.3d 1078 (6th Cir. 2002).

More recently, in *NYLife Sec., LLC v. Suarez*, 2021 U.S. Dist. LEXIS 247737 (C.D. Cal. December 29, 2021), the court evaluated FINRA Rule 12200 and the definition of “customer” under Rule 12100(k). Here, the court relied on a statement from *Berthel Fisher & Co. Fin. Servs., Inc. v. Frandino*, 2013 U.S. Dist. LEXIS 68455 (D. Ariz. May 14, 2013) which said “[a] customer of an associated person of the member is a customer of the member.” The court continued to rely on the two-part analysis identified in *Berthel Fisher* to determine whether for jurisdictional purposes the investors were “customers” of NY Life.

The first factor is whether the “associated person of the FINRA member induces, or shepherds, the investment, then the investor is likely a customer of the firm.” *NYLife* at 10; *Berthel Fisher* at 5. Although the investor in *NYLife* never opened accounts at the firm, but rather the advisor had him open accounts at third-party firms, TD Ameritrade being one, the court still held that “establishing a customer relationship with the associated person of a FINRA member firm does not require that the investor directly open an account with the firm.” *Id* at 11, citing *Vestax Sec. Corp*. at 1081; and *John Hancock Life Ins. Co. v. Wilson*, 254 F.3d 48, 59 (2d Cir. 2001).

The second factor used by the court to determine whether investors were “customers” is “whether the associated person held himself out as a representative of the FINRA member or the investor relied upon his understanding that such an affiliation existed.” *NYLife* at 11-12; *Berthel Fisher* at 7. The unrebutted evidence established that the financial advisor held himself out as a NYLife representative, including showing the investor his business card, presenting marketing materials with the NYLife logo, and telling the investor that NYLife provided him with resources other stockbrokers did not have. The investors said they “would not have invested with [the financial advisor] if he had not been affiliated with NYLife.” *Id*.

Now that the court concluded the investors were “customers”, it went on to analyze whether the dispute arose under NYLife’s business activities. Once again, the court determined the allegations of negligent supervision were enough to satisfy the requirements of FINRA Rule 12200 that the dispute arises out of the broker/dealer’s business activities. *Id*. At 13-14. A similar analysis was undertaken by the court in *Raymond James Fin. Servs. V. Armijos*, 2020 U.S. Dist. LEXIS 74531 (S.D. Fla. April 27, 2020) when it denied Raymond James’s petition to stay a FINRA arbitration in a massive selling-away case.

This issue is far from settled however. In *Principal Sec., Inc. v. Agarwal*, 23 F.4th 1080 (8th Cir. 2022), the Eighth Circuit Court of Appeals upheld an order restraining investors from proceeding with a FINRA claim against a FINRA member firm. The court relied heavily on the alleged

business relationships between the financial advisor and the investor in determining Mr. Agarwal was *not* customer under FINRA Rule 12100(k). *Id.* At 1084-85. The court, relying on *Fleet Boston Robertson Stephens, Inc. v. Innovex, Inc.*, 264 F.3d 770, 773 (8th Cir. 2001), more narrowly interpreted "customer" under the FINRA code to mean "one involved in a business relationship with a FINRA member that is related directly to investment or brokerage services." *Id*. The court seemed to ignore the fact that Agarwal did extensive business – including the purchase of securities – with Principal's registered representative and instead focused on the allegations that they were "business partners". The case does not discuss the negligent supervision angle at all and clearly goes in the more conservative direction interpreting "customer" and arbitrability like *Citigroup Global Markets, Inc. v. Abbar*, 761 F.3d 268 (2d Cir. 2014).

Any practitioner should carefully consider their options to pursue their clients' claims in court rather than arbitration in the "non-customer" selling away case. In *McGraw v. Wachovia Securities, LLC*, 756 F.Supp. 2d 1053 (N.D. Iowa 2010), the investors were victims of a selling-away/Ponzi Scheme operated by an AG Edwards financial advisor, Paul Lovegren. If any members have not read this case in detail, it is about as good as it gets from the selling-away, negligent supervision perspective. In *McGraw*, the district court specifically held that brokerage firms have a duty, anchored in FINRA rules and regulations, to supervise the conduct of their financial advisors. *Id*. At 1073. *McGraw* held as a matter of law specific to outside business activities, the following:

> Although brokerage firms generally are not responsible for supervising any outside business activities or private securities transactions engaged in by their representatives, unless they have received notice of or have approved those activities, **they do have a duty to monitor and investigate activities for which they have had no proper notice, if there is evidence of 'red flags' that would alert the brokerage firm to the possibility of undisclosed outside activities**. Thus, **lack of notice or approval** of a representative's particular outside activity or private securities transaction **does not relieve a firm of its duty to monitor or investigate a representative's outside activities or private securities transactions. 'Red flags'** that would alert a brokerage firm to the possibility of undisclosed activities, and consequently give rise to a duty to monitor and investigate those activities, **include, but are not limited to, the following**:
>
> (i) correspondence from the customers or other individuals addressed to the broker at the firm's address referring to investments that are not reflected on the records to the brokerage firm;
>
> (ii) inquiries from customers or other individuals to supervisory or administrative personnel relating to investments not reflected on the records of the brokerage firm; and
>
> (iii) sales literature received in the firm's office or found in the broker's office relating to investments not approved for sale by the firm.

McGraw, 756 F. Supp. 2d at 1075 (Emphasis Added). With the right facts and great pleading, any selling away case can be a huge success in court, even when the investors are not "customers".

III. Use the FINRA Rules for What They Are – Evidence of the Standard of Care

The core claims in a non-client "selling away" case are negligent supervision, aiding and abetting breach of fiduciary duty, and control person liability under the state securities act. No matter what claim it is, establishing a violation of various FINRA rules will be outcome determinative to maintain liability against the brokerage firm. Of course, there is no "cause of action" for violating FINRA Rules – which is how respondents always frame the issue for an important reason: the case law is overwhelming that there is no "private right of action" for violation of FINRA rules. *See eg., Fox v. Lifemark Sec. Corp.*, 84 F. Supp.3d 239 (W.D.N.Y. 2015).

Do not fall for the trap – be precise. The FINRA rules are *evidence of the standard of care* owed by brokerage firms to clients and non-clients alike. *See McGraw v. Wachovia Sec., LLC*, 756 F.Supp.2d 1053, 1075 (N.D. Iowa 010); *Garrison v. Sagepoint Financial, Inc.*, 185 Wash. App. 461 (Wash. Ct. Ap. 2015); *Mihara v. Dean Witter 7 Co.*, 619 F.2d 814, 824 (9th Cir. 1980); *Rolf v. Blyth, Eastman, Dillon*, 424 F. Supp. 1021, 1041 (S.D.N.Y. 1977); *Scott v. Dime Savings Bank of N.Y.*, *FSB*, 886 F. Supp. 1073 (S.D.N.Y. 1995); and *Ginzkey v. National Securities Corp*., 2022 U.S. Dist. LEXIS 42985*11 (W.D. Wash. March 10, 2022). The case law is stacked in favor of using FINRA rules as evidence of the standard of care owed by brokerage firms and registered representatives. Make it clear in the Statement of Claim, or complaint if you're filing in court, that by introducing the FINRA rules in your pleading, it is to provide evidence of the standard of care.

Specific to "selling away" claims, there are three core FINRA rules that come into play: FINRA Rule 3010 – Supervision; FINRA Rule 3270 – Outside Business Activities; and FINRA Rule 3280 – Private Securities Transactions. Use SEC decisions and FINRA Regulatory Notices as further evidence in interpreting these rules.

> FINRA Rule 3010 which states:
>
> Each member shall establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules. Final responsibility for proper supervision shall rest with the member…

FINRA Rule 3010: Supervision.

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 a 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.'").

FINRA and the 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. *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 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…").

Under FINRA Rule 3270, member firms must undertake a review of all outside business activities ("OBAs") to determine: (1) whether the OBA would interfere with or otherwise compromise the registered person's responsibilities to the firm and the firm's customers; (2) whether the OBA could be viewed by customers or members of the public as part of the Firm's business; (3) the advisability of imposing specific conditions or limitations on its registered representatives' participation in a proposed OBA; and (4) whether the OBA should be viewed as an outside securities activity subject to the requirements of Rule 3280.

FINRA Rule 3280(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" By definition, all private securities transactions are outside the course and scope of a broker's employment with their firm.

If the OBA involves private securities transactions Rule 3280(c) requires:

> (2) If the member approves a person's participation in a transaction pursuant to paragraph (c)(1), the ***transaction shall be recorded on the books and records of the member and the member shall supervise the persons's participation in the transaction as if the transaction were executed on behalf of the member.***

(Emphasis added).

Further, "participation in a securities transaction includes not only making the sale, **but referring customers, introducing customers to the issuer, arranging and/or participating in meetings between customers and the issuer**, or receiving a referral or finder's fee from the issuer." NTM 01-79: Selling Away and Outside Business Activities, pg. 700, n.7 (Dec. 2001)(Emphasis Added).

Brokerage firms often falsely claim that it is the sole responsibility of the broker to disclose private securities transactions. As with all broker-dealer activity, final responsibility for supervision rests with the member. As far back as 1986, the NASD warned its members that the conduct of its registered representatives most frequently resulting in violations of NASD rules involved unauthorized private securities transactions. *See*, NASD Notice To Members 86-65. Indeed, the NASD explicitly warned that it is the firm that is "responsible for monitoring their activities in a manner reasonably intended to detect violations of Article III, Section 40 of the Rules of Fair Practice" (now codified as FINRA Rule 3270). *Id*.; *see also* NASD Notice to Members 01-79 (stating "members should review their supervisory and compliance procedures to make sure that their reporting requirements are clear and complete and that each associated person receives appropriate education and training regarding the sale of notes."); NTM 97-19: Heightened Supervision ("Firms are reminded of their long- standing responsibilities to implement reasonable procedures designed to detect and prevent rule violations and to correct deficiencies in, and violations of, relevant laws, rules, and regulations."); NTM 98-38 ("Rule 3010(c) imposes upon a

member the obligation to review the activities of each office, which includes the periodic examination of customer accounts to detect and prevent irregularities and abuses.")

1. FINRA and the SEC Regularly Fine, Suspend, and Bar Firms for Failing to Reasonably Supervise Outside Business Activities and Private Securities Transactions.

From a regulatory standpoint, stiff compliance with FINRA Rules 3270 and 3280 is the norm. *See, e.g., In re Kolar*, Exchange Act Rel. No. 46127, 2002 SEC Lexis 1647 (June 26, 2002)(suspending Dean Witter supervisor who failed to detect and prevent broker's sales of investments, promoted as collateral-backed promissory notes in "Lease Equity Fund, Inc."); *In re Kunz*, Exchange Act Rel. No. 45290, 2002 SEC Lexis 104 (Jan. 16, 2002)(disciplining broker-dealer that failed to prevent broker's sales of "Wholesale Mortgage Loan Participation Interests"); *In re Consolidated Investment Serv.*, Exchange Act Rel. No. 36687, 1996 SEC Lexis 83; 52 S.E.C. 582 (Jan. 5, 1996)(suspending firm for failing to detect and prevent broker's sales of $5 million of non-existent "Agency CD Nots"); *In re Royal Alliance Assoc.*, Exchange Act Rel. No. 38174, 1997 SEC Lexis 113 (Jan. 15, 2997)(disciplining firm that failed to stop two branch managers from selling Ponzi schemes); *In re Stuart, Coleman & Co.,* Exchange Act Rel. No. 38001, 1996 SEC Lexis 3266 (Dec. 2, 1996)(disciplining firm where branch manager had permitted registered representatives to sell fraudulent limited partnership interests, even though firm had explicitly refused written request for permission); *In re Prospera Financial Serv., Inc.*, Exchange Act Rel. No. 43352, 2000 SEC Lexis 2034 (Sept. 26, 2000)(holding firm responsible for failure to supervise part-time representatives, because "allowing a registered representative to engage in outside business activities involves the risk that the representative will use his outside business to carry out or conceal violation of the securities laws.").

It is clear as can be that brokerage firms have an obligation to employ effective supervisory procedures in order to monitor and detect outside business activities such as those conducted by financial advisors who "sell-away". The FINRA Rules provide the standard of care a firm must adhere to in order to reasonably supervise their agents. NASD NTM 99-45 states that: "[i]t is important that members not only review their supervisory systems and procedures to ensure that they are current and adequate, **but also conduct inspections to determine whether the systems and procedures are being follows.**" (Emphasis Added). Expert testimony, as explained in *McGraw v. Wachovia Securities*, is critical to developing and proving your case.

IV. Discovery Is Where You Win Your Case

It seems obvious – discovery is important to winning your case. But "selling away" cases are not suitability or trading cases. Much of the "List Items", especially in the "non-client" case, won't do you much good in a selling away case, so crafting supplemental discovery requests that are direct and request the right documents and information will put pressure on the brokerage firm, and will get you the evidence you need about the all-important "red flags".

1. Electronic Communications

Electronic communications are incredibly important and are part of virtually every case these days. A few decades ago, selling away case discovery tended to be about physical documents that were in the broker's office, like PPMs or promissory note agreements, oil/gas well surveys and things of that nature. Although still an important part of discovery, nowadays, almost every

document or record is in electronic format and communicated through electronic means. This is a net-positive because paper trials are easy to follow electronically.

Although financial advisors are not supposed to text with clients, they do, and those records are crucial evidence. Text messages can be pulled via software or by using a data-reclamation company to handle the data in a compliant manner. If the broker was texting with your client, every one of those texts is a "red flag". In many instances, brokers will include their cell-phone number on business cards or firm-approved email. The firms are almost always on notice that their financial advisors at a minimum, have provided their cell phone number to firm clients, which opens the door to questions about procedures used by the firm to monitor the written communications from those devices. The firm will surely argue that the advisor affirmed in some questionnaire that he did not communicate via text with clients. Remind your opponent that taking the broker's word for anything, alone, is not sufficient supervision. *See In re Prospera Financial Services, In.*, S.E.C. Release No. 43352, 2000 WL 1424360 at *6 (S.E.C. Sept. 26, 2000)(**firm sanctioned where it "relied upon the representative's unverified assertions regarding the propriety of his outside activities and the source and amount of his other income.**")(Emphasis Added); *PFS Investments, Inc.*, Exchange Act Release No. 40269, 67 SEC Docket 2032, 2038 (July 28, 1998); *In re Quest Capital Strategies, Inc.*, et al., SEC Release No. 1990, 2001 WL 1230619 at *6 (S.E.C. Oct. 15, 2001)(**"Relying on a subordinate's assurances is hardly an effective method of preventing or detecting violations."**)(Emphasis Added).

In *Consolidated Investment Services*, the SEC specifically rejected that supervision is adequate where "representatives were required, on an annual basis, to complete a compliance questionnaire….[because] **Applicants took no steps to verify the questionnaires and assumed that the registered representatives were answering them truthfully.**" (Emphasis Added). Exchange Act Release No. 36687, 1996 WL 20829, at *4 (Jan. 5, 1996). In sum, **"If a firm's established procedures for preventing and detecting fraud by employees come down l the last analysis to taking the employee's word on explanations when questionable events are looked into, then the procedures cannot be very effective**." *In Re Shearson, Lehman Brothers, Inc.*, 36 SEC Docket 754, 49 SEC 619, Admin. Proc. File No. 3-6733 (8-12324)(801-00517), Release No. 34-23640 (Sept. 24, 1986)(Emphasis Added).

Emails are another incredibly important source of communications for discovery. If your client was communicating with the financial advisor through the firm-sponsored or custodied email about the "selling away" activity, those red flags are extremely impactful because firms are under an obligation to review and supervise broker-emails. If your client was instead communicating with the broker's *personal email*, like a Gmail account, it is critical to gain access to annual compliance questionnaires on which advisors are asked to identify whether they use personal email and if so, to identify it. Some firms will monitor personal email if it is disclosed to them.

Logistically, it is important to meet and confer early and often with the firm on email search terms and custodians. It is also important to know what email data service the firm uses, like Smarsh or Global Relay, which are fairly common. If you know the service, you can independently verify how searches are performed within the system. Opposing counsel will constantly deflect and complain that email searching is too hard or too expensive. Document your interactions and file a motion to compel.

The compliance and supervision manuals will outline, sometimes in detail, the methods of supervising electronic communications. Mimic the phraseology, use the names of the reports and documents referenced in those manuals when drafting your discovery requests so that your opponent cannot make a well-grounded objection based on vagueness or overbreadth.

2. Broker's Personal Finances

Frequently, financial advisors that engage in selling away activity are poor producers and live a lifestyle detached from what their "legitimate" income would provide. Frequently, they will drive expensive cars or wear flashy watches as part of their scheme. The outward appearance of success to clients creates trust and confidence. After all, most people would prefer to invest with an advisor who appears successful than one who drives a 2002 Honda Accord. The financial advisor's income is critical to this analysis and requires discovery into his W-2s/1099s; his personal income tax returns, personal brokerage accounts, bank records, and credit reports. If it is revealed through tax returns for example, that the financial advisor had brokerage accounts away from the firm and did not disclose them, a motion for an order of production for those statements should be directed to that firm.

In Staff Bulletin No. 18, the SEC explains the importance of broker-dealers reviewing their agent's income and debts. As noted in paragraph four of the Bulletin, "a representative appearing to live more lavishly than his business income would allow might be a 'red flag' indicating pursuit of improper or outside business activities." *See also, In the Matter of PFS Investments, Inc.*, 67 S.E.C. 1502, 1998 WL 422161 (July 28, 1998) and *Consolidated Investment Services*, 58 S.E.C. Docket 699, Exchange Act Release No. ID-59, 1994 WL 707215 (Dec. 12, 1994).

Many of these records are actually maintained by the brokerage firm. If a financial advisor maintains securities accounts away from the firm, they are required to disclose them, and in many instances, the firm's compliance department will receive counter-part copies of the monthly statements. Further, most brokerage firms run random credit checks on their advisors and sometimes get full credit reports. There is nothing like obtaining credit reports the firm had on their broker, that show a credit score in the 500s. Credit reports can be an absolute boondoggle of red flags, including massive credit card debts and other financial delinquencies.

3. Regulatory Investigations

The next critical area for discovery has to do with regulatory investigations relevant to your case. If FINRA has already entered an AWC with either the firm or the broker, two steps must be taken, in order. First, specifically request from the firm all Rule 8210 requests, written responses, replies, and supplements. Be specific with the requests. Sure, you'd love "all documents" in connection with the requests, but initially, the best discovery lies in the questions asked by FINRA and the responses from the firm. These can lead to supplemental requests and if the requests are initially too broad, you run the risk of a Panel refusing to compel the production. After you've requested these documents from the firm and they've objected, a motion for a subpoena to FINRA for their records must be filed and served. FINRA will initially push back on producing documents, but after a meet and confer, will almost always produce valuable records, including OTR transcripts, if any OTRs were taken.

If the brokerage firm has previously stipulated to an AWC that is relevant to supervision, many times the AWC will include a corrective action statement, which is not made public, and sometimes requires the firm to retain a consultant to assist the firm in implementing new procedures. These records are ripe for discovery.

It is almost certain that the Respondent will throw roadblocks up regarding the discoverability of documents and information related to regulatory investigations. The firms will argue that they are forbidden by statute, usually Regulation SP, from producing the information, or they will cite to

some amorphous “regulatory privilege”. Take an opportunity like this to educate your panel on both the law and your opponent’s duplicitousness. These arguments have no merit whatsoever. *See Lamorte v. Mansfield*, 438 F.2d 448 (2d Cir. 1971) and its progeny.

V. Trying the Case – Conclusion

You’ve got your discovery, your expert, and you are ready to try your case. Respondent’s defense is likely based on ignorance – how could we know the broker was selling-away? Spend your case-in-chief going into painstaking detail every single step along the way where the firm should have been alerted to what the broker was up to. Cross-examine the branch manager or regional compliance director about every email that coursed through their firm’s system, and yet yielded no actions. Detailed timelines with supporting documents used a time-stamps are impactful presentation pieces to map it out for the Panel every opportunity the firm had to put a stop to their rogue advisor. Where supervision is so critical to the outcome of the case, having your expert testify first could be a smart move logistically. It is likely that the financial advisor will not attend a hearing because he or she will likely either be out of the industry or under indictment, so your client’s testimony on representations made by the broker will go unrebutted. The most critical issue of proof, especially in the “non-client” selling away case is the issue of causation. Where possible, really pull out details in your client’s testimony about representations the broker made about his affiliation with the firm and how that affiliation was important to your client and why. Do not forget your client is the victim of a scam and it was Respondent’s job to create and maintain a compliance apparatus that deterred and detected every violation that occurred.

“Selling away” cases are an absolute blast to prosecute because there is so much red-meat and there are legitimately challenging and interesting legal issues that pop-up. In order to successfully represent your client in a selling away case, whether your client was a “client” or a “non-client”, understanding these various challenges is critical. Being obsessive and aggressive in discovery can cause your opponent to wilt because many times, the red flags accumulate to such a massive volume, that their “how could we know” rhetoric is reduced to a lame excuse. Ensure you take advantage of your forum, whether in court or arbitration, to subpoena regulators for what they have in connection with their investigations into your case. You will get documents and information from them you will never get from the firm and in much shorter period of time.Last, PIABA has literally dozens of schooled practitioners who have tried many selling away cases. Do not hesitate to ask questions on the List Serve, or simply pick up the phone and call.

EXHIBIT A

BEFORE THE FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF DISPUTE RESOLUTION

In the Matter of the Arbitration Between [redacted] and [redacted] Claimants, vs. [redacted] INC. f/k/a [redacted] Respondent.	FINRA Case No. [redacted]

CLAIMANTS' RESPONSE TO RESPONDENT'S
RULE 12504 MOTION TO DISMISS

Claimants hereby respond to Respondent's Rule 12504 Motion to Dismiss. For the reasons stated below and due to its patent frivolity, this motion should be denied with all costs, including reasonable attorney's fees, assessed against [redacted]

I. Introduction

Claimants filed a Statement of Claim against Respondent making allegations in connection with dozens of solicitations by Agent [redacted] – one of the company's premier financial advisors – to invest tens of millions of dollars in side businesses being run openly and notoriously by [redacted] from the [redacted] branch office. Months of discovery, which has included the exchange of roughly 100,000 pages of records, clearly establishes that [redacted] was well aware of [redacted] illicit activities but looked inward at its bottom line. Instead of escorting him out of the building in October 2016 and reporting him to the regulators when [redacted] compliance department and firm supervisors knew beyond a shadow of a doubt that [redacted] was running a massive selling away scheme, they instead allowed him to remain registered with the firm, and engineered a soft landing for [redacted] and a very lucrative, smooth transition for [redacted] and [redacted] supervisor's son.

Instead of alerting Claimants and his clients that [redacted] was rightfully terminated for cause for engaging in a massive selling away scheme, [redacted] allowed [redacted] to waltz out the door peacefully, take with him his administrative team who were directly involved and further facilitated the schemes, and even allowed [redacted] to continue to receive trails

on his insurance lines of business. This ensured that his substantial book of business remained in-house. The direct beneficiary of this scheme, it turns out, was [redacted] supervisor's son. [redacted] was an "old boys club" designed to keep clients and cash in-house at all costs and to the detriment of the Claimants.

[redacted] motion must fail because the allegations specific to Mr. [redacted] do in fact involve [redacted] and their complicit financial advisors. What [redacted] failed to elucidate in its moving papers is that a transaction took place at [redacted] in order to free-up the $400,000 [redacted] would then invest in [redacted] scam. The money came from the surrender of an annuity which, given his advanced age, was a significant red flag in and of itself because it generated surrender charges and tax liability. [redacted] also failed to inform this Panel that neither [redacted] nor his wife [redacted] called their [redacted] financial advisor to request this annuity be surrendered. [redacted] handled that for them and no one at [redacted] batted an eye.

What this all means is [redacted] allowed a known financial predator to call its office and put in motion the surrender of an annuity for an elderly couple so that he could bilk them out of $400,000. He even had the checks filled out for [redacted] so that once the money hit his bank account from the [redacted] annuity surrender, all he had to do was sign the checks and give them to [redacted] At that time, [redacted] still believed [redacted] was operating at a minimum, as a licensed insurance representative for [redacted] if not a full-fledged financial advisor. He was not privy to nor ever informed by [redacted] that [redacted] had left the firm under highly questionable circumstances. [redacted] failed to warn [redacted] that it had determined more than a year before this transaction took place that [redacted] orchestrated a massive scheme that diverted [redacted] to [redacted] outside businesses. By January 2018, [redacted] had become increasingly desperate for funding for his businesses, which is why he went to [redacted] and had his annuity surrendered. [redacted] is trying to do whatever it can to wiggle off this hook, but because the facts are so clear, their motion is totally baseless and must be denied.

II. Standards for Dismissal Are Not Clear in FINRA Rules, so the Panel Should Apply Standards Used in a Court of Law when Ruling on Respondent's Motion to Dismiss.

FINRA Rule 12504(a)(6)(B) provides a motion to dismiss prior to a hearing can be granted when "the moving party was not associated with the account(s), security(ies) or conduct at issue." (*See* FINRA Rule 12504(a)(6)(B)). Although the grounds are clear and extremely limited, FINRA provides no insight into what standards should be applied when ruling on a motion to dismiss, i.e. what level of deference should be provided to the non-moving party. Since the evidence will be overwhelmingly clear that [redacted]

was "associated with 1) the accounts, security, and conduct at issue" the motion must be denied.

Certain legal axioms should govern the review of Respondent's Motion to Dismiss. The Statement of Claim should not be dismissed, even partially, "unless it appears beyond doubt that the plaintiff can prove no set of facts" which would entitle them to relief. *Conley v. Gibson*, 355 U.S. 41, 45-46, (1957). Additionally, "[i]n considering a motion to dismiss under *Federal Rule of Civil Procedure 12(b)(6)*, the averments of the complaint should be construed in the light most favorable to the plaintiff." *Scheuer v. Rhodes*, 416 U.S. 232, (1974). To be clear, this is not a motion for summary judgment or other summary adjudication for which the Panel would accept all undisputed material facts established by stipulation or submission of evidence. There are no stipulations here and there has been no evidence presented to the Panel.

FINRA Rule 12504(a)(6)(B) requires only that Respondent be "associated with the account(s), security(ies), or conduct at issue" to survive a motion to dismiss. What Respondent clearly does not understand is that this rule is a very limited "exception". **Cases may only be dismissed under Rule 12504 in instances of misidentification** (*See* FINRA, *Regulatory Notice 09-07* at 5, attached as **Exhibit A**). There is no misidentification here. The Rule does not permit dismissal when there are factual or legal disputes at issue regarding liability. This is not a motion for summary judgment and said motions are not allowed under FINRA Rules prior to the close of Claimants' case in chief.

Taking Rule 12504(a)(6)(B) one piece at a time eviscerates [redacted] motion. In order to survive this motion, Claimants need to only establish **one** of the following:

1) **Was [redacted] associated with the account at issue**? Clearly. It was a [redacted] non-qualified flexible Variable Annuity that was surrendered at [redacted] instruction that facilitated the $400,000 investment into his side businesses. Clearly identified on the annuity statement as [redacted] and [redacted] "financial professional" is [redacted] from the [redacted] branch. [redacted] doesn't even hide these facts; they are attached as Exhibit D to their motion. [redacted], it must be noted, was the co-beneficiary of the scheme to keep [redacted] book of business in-house. He worked under [redacted] thumb for many years and benefitted greatly once [redacted] left. It is no surprise that [redacted] accepted instructions from [redacted] to surrender this annuity; they were effectively co-conspirators.

2) **Was [redacted] associated with the securities at issue**? Again, that answer is a resounding yes. It is the surrender of the variable annuity that is at issue because that was the first, necessary step to facilitate the investment in [redacted] businesses. But-for the surrender of the annuity, [redacted] and [redacted] would not have invested in [redacted] businesses because they did not have any other substantial liquid assets, which is why

[redacted] needed them to surrender the annuity in the first place. Moreover, by surrendering the annuity, [redacted] and [redacted] paid surrender charges and wasted an unknown amount of money that they had paid over the years to [redacted] to own the annuity through fees and other charges. Likewise, they gave up the death benefit of this variable annuity which was purportedly one of the primary reasons the elderly [redacted] and [redacted] invested in it in the first place.

3) **Was [redacted] associated with the conduct at issue**? Quite obviously, this was a [redacted] variable annuity being managed by a [redacted] financial advisor. This same advisor accepted instructions from [redacted] his former boss and recently terminated long-time [redacted] representative, to start the process to surrender the annuity and have the cash deposited into [redacted] and [redacted] checking account.

Because Claimants clearly establish the answer is "yes" to all three questions asked by Rule 12504(a)(6)(B), this motion must be denied.

III. As Pleaded in the Statement of Claim, [redacted] Liability Does Not Cease When [redacted] Withdrew his Registration from the Firm.

[redacted] pedals in legal fictions with its argument that it has no liability for [redacted] misconduct after he "voluntarily" left the firm on [redacted]. As alleged in the Statement of Claim (SOC at 9-10) and as the evidence will prove at hearing, [redacted] actively engaged in a scheme to cover-up [redacted] misdeeds and fraudulently concealed facts from his entire client base, including Claimants, about the depths of his misconduct.

This is not a case where a broker "sold away" in the traditional sense. [redacted] approved of several of the outside businesses into which [redacted] invested [redacted] dollars Claimants' money. Eventually, [redacted] orchestrated the surrender of [redacted] and [redacted] variable annuity so that they could invest $400,000 into [redacted] too. What the evidence at hearing will prove are the following facts:

1) That as early as 2012, [redacted] was confronted with red flags that [redacted] was operating businesses and recommending investments in companies away from [redacted]

2) That throughout 2013, 2014, and 2015, literally hundreds of emails coursed through the [redacted] email system where [redacted] freely and openly discussed numerous companies, both disclosed and undisclosed, that made it obvious he was engaged in a massive amount of "selling away" in violation of both FINRA Rules and [redacted] policy.

3) By 2016, [redacted] finally learned of [redacted] selling away but tip-toed around it for fear of upsetting him. Even though [redacted] compliance had determined in May 2016 that [redacted] had violated the strict terms of an outside business activity approval, their primary concern was losing [redacted] as a [redacted] representative.

4) On June 3, 2016, [redacted], a [redacted] compliance analyst, expressed concern to his compliance team about an email [redacted] had sent with an attachment about [redacted] that made it clear he was actively engaged with [redacted] an LLC that he had not disclosed to [redacted] and that was the lynchpin to his entire selling away scam. A few days later, On June 17, 2016, [redacted] sent a message to compliance saying he spoke to Agent [redacted] about the email and that everything was fine. "Nothing to see here."

5) By October 18, 2016, [redacted] completed an internal investigation into [redacted] which included a report from a private investigator that revealed numerous previously unreported and undisclosed business affiliations. [redacted] did nothing with this report for a month. In the meantime, [redacted] offered his resignation on November 1, 2016 because he felt like [redacted] was impeding his business opportunities with their outside-business activity compliance. [redacted] was essentially gaslighting his [redacted] supervisors.

6) On or about December 5, 2016, [redacted] compliance interviewed [redacted] extensively in connection with his outside business. It was obvious at this point that he had sold-away and had invested substantial sums of [redacted] client money into these businesses.

7) On January 1, 2017, very quietly, [redacted] entered into a succession agreement with [redacted] and [redacted]. [redacted] was [redacted] underling and [redacted] was [redacted] direct supervisor's son. This agreement kept the waters calm with clients and allowed for a smooth business transition that ensured [redacted] best interests were protected. [redacted] quietly exited stage left, turning over his massive book of business to two underlings for nothing more than a diminishing commission trail. On January 5, 2017, [redacted] became the proud owner of the most expensive piece of residential real estate in the entire [redacted] area. On January 12, 2017, [redacted] registration with [redacted] formally ended. Two weeks later, FINRA sent [redacted] a Rule 8210 request. Possibly the most incredible fact in this case is that no one at [redacted] ever reached out to [redacted] to discuss his business dealings with [redacted]

The evidence is overwhelming that [redacted] knew [redacted] sold away and did nothing material about it. They conspired to put their interests ahead of Claimants' interests by failing to inform them that [redacted] business dealings had violated numerous securities

industry regulations, rules, and [redacted] internal rules and policies. [redacted] did this for one reason: To ensure [redacted] substantial book of business remained in-house. Warning clients that their long-time broker had been terminated for industry rule violations would have likely resulted in many clients taking their business elsewhere. As pleaded in the Statement of Claim, [redacted] breach of duty to warn Claimants about these violations results in ongoing and continuing liability to them even after [redacted] left [redacted]

The law in the Eighth Circuit is crystal clear that financial advisors like [redacted] are fiduciaries to their clients. *See Davis v. Merrill Lynch,* 906 F.2d 1206 (8th Cir. 1990) where the court ruled that brokers are fiduciaries to their clients. The *Davis* court reasoned:

> Securities brokers…at Merrill Lynch are licensed professionals holding themselves out as trained and experienced to render a specialized service. Like the clients of real estate agents, securities customers rely on the agent's expertise and expect the agent to act in their best interests. Because we see no significant difference between real estate brokers and securities brokers, we believe that if confronted with the question, the South Dakota Supreme Court would find that securities brokers are fiduciaries that owe their customers a duty of utmost good faith, integrity, and loyalty.

Davis at 1215. In *Baber v. First Republic Group, LLC*, 06-3076, 2008 U.S. Dist. LEXIS 45180*52 (N.D. Iowa, June 6, 2008), the court applied the logic deduced by the Eighth Circuit in *Davis,* to Iowa law. The court stated: "This court, like the Eight Circuit Court of Appeals, 'sees no significant difference between real estate brokers and securities brokers,' so that this court also 'believes that if confronted with the question, the Iowa Supreme Court would find that securities brokers are fiduciaries that owe their customers a fiduciary duty."

As fiduciaries to the Claimants, [redacted] had a duty to warn Claimants that [redacted] had violated numerous FINRA rules and regulations along with [redacted] internal policies specific to [redacted] ongoing outside business dealings with Claimants. One of the most fundamental responsibilities of a fiduciary is "…to communicate to the beneficiary material facts affecting the interest of the beneficiary which he knows the beneficiary does not know and which the beneficiary needs to know for his protection in dealing with a third person." *Restatement (Second) of Trusts § 173, Comment d* (1959). In *Glaziers & Glassworkers Union Local No. 252 v. Newbridge Securities*, 93 F.3d 1171 (3d Cir. 1996), the court held that a brokerage firm, Janney Montgomery Scott, had an obligation, as a fiduciary, to disclose to customers information about a broker whose ethics, at best, were questionable. Instead of warning its customer about a bad broker, Janney, in its own self-interest, merely sent boilerplate letters to its customers about a broker, Lloyd, leaving the firm, without describing in any way the reasons he left or that he was actually terminated. The customer, a pension fund, followed Lloyd to his next place of

business, a firm he founded, and Lloyd proceeded to steal from the Fund. Because the information Janney disclosed to the NASD on Lloyd's Form U-5 filing differed substantially from the boilerplate letter it sent to the Fund, the court determined Janney Montgomery withheld material facts from its customer, a breach of fiduciary duty, citing a quote from Judge Cardozo:

> The trustee is free to stand aloof, while others act, if all is equitable and fair. He cannot rid himself of the duty to warn and denounce, if there is improvidence or oppression, either apparent on the surface or lurking beneath the surface, but visible to his practiced eye.

Id. at 1182, citing *Globe Woolen Co., v. Utica Gas & Electric Co.*, 121 N.E. at 380 (N.Y. 1918). As a fiduciary, the court ruled, Janney "could not turn its 'practiced eye' to its self-interest, while turning a blind eye to the interests of its beneficiary."

Even if the Panel somehow concludes that [redacted] [redacted] claims are insufficient under FINRA Rule 12504(a)(6)(B), as a matter of law, his claims survive even after [redacted] disassociation from [redacted] The evidence will be overwhelming that [redacted] covered-up [redacted] scam to enrich itself. This is the foundation of any breach of fiduciary duty claim. As clearly stated by the court in *Baber*, Iowa imposes a fiduciary duty of loyalty upon securities brokerage firms.

IV. Conclusion.

There is clearly not a "misidentification" issue here. [redacted] [redacted] claims obviously involve [redacted] the security at issue (surrender of his variable annuity); and his [redacted] account. Beyond that, due to the fiduciary duty imposed upon [redacted] as a matter of Iowa law, [redacted] was duty-bound to warn and advise [redacted] [redacted] that [redacted] had engaged in a massive selling-away scheme that violated a number of securities industry regulations and internal policies. Evidence will establish that [redacted] kept [redacted] misdeeds quite intentionally to keep [redacted] substantial book of business inside the tent at [redacted] Therefore, Respondent is legally responsible for the damage done to Claimants after [redacted] was allowed to leave [redacted] The Panel should deny this motion and further order [redacted] to pay reasonable attorneys fees to Claimants for having to respond to such an obviously frivolous motion.

Respectfully Submitted:

/s/ Joseph R. Wojciechowski

One of the Claimants' Attorneys

Andrew Stoltmann
Joseph Wojciechowski
Deanna LaPage
Stoltmann Law Offices, P.C.
161 N. Clark St., 16th Floor
Chicago, IL 60601
T: (312) 332-4200
F: (312) 332-4201

Exhibit A

Regulatory Notice 09-07

Motion to Dismiss and Eligibility Rules

SEC Approves New Motion to Dismiss Rule and Amendment to the Eligibility Rule in Arbitration

FINRA Imposes Immediate 30-Day Moratorium on Motions to Dismiss; Effective January 23, 2009

Executive Summary

Effective February 23, 2009, FINRA will implement new procedures for handling motions to dismiss in arbitration. The SEC approved a proposal to adopt Rule 12504 of the Code of Arbitration Procedure for Customer Disputes and Rule 13504 of the Code of Arbitration Procedure for Industry Disputes (collectively, the Codes) to establish procedures that will govern motions to dismiss.[1] The proposal also amends Rules 12206 and 13206 to address motions to dismiss based on eligibility grounds.

The text of the amendment is set forth in Attachment A and will apply to motions to dismiss filed on or after the effective date.

This *Notice* also announces that FINRA is imposing a moratorium on filing motions to dismiss prior to the conclusion of a party's case-in-chief from the date of this *Notice*, January 23, 2009, until the effective date of the new rules, February 23, 2009.

Questions concerning this *Notice* should be directed to Richard W. Berry, Vice President and Director of Case Administration, at (212) 858-4307 or *richard.berry@finra.org*; or Mignon McLemore, Assistant Chief Counsel, FINRA Dispute Resolution, at (202) 728-8151 or *mignon.mclemore@finra.org*.

January 2009

Notice Type

- New Rule and Amendment

Suggested Routing

- Compliance
- Legal
- Senior Management

Key Topics

- Arbitration
- Code of Arbitration Procedure
- Eligibility Rule
- Dispute Resolution
- Motions to Dismiss

Referenced Rules & Notices

- FINRA Rule 12206
- FINRA Rule 12504
- FINRA Rule 13206
- FINRA Rule 13504

Background and Discussion

In new Rules 12504 and 13504, FINRA is adopting specific procedures to govern motions to dismiss. FINRA also is amending the dismissal provisions of Rules 12206 and 13206 (the eligibility rule) related to time limits on submissions of arbitration claims. The rules will ensure that parties have their claims heard in arbitration by significantly limiting motions to dismiss filed prior to the conclusion of a party's case-in-chief and by imposing stringent sanctions against parties for engaging in abusive practices under the rules.

Prior to the approval of the new rules, FINRA administered all motions, including motions to dismiss, under Rules 12503 and 13503 of the Codes. With the approval of the rules, Rules 12503 and 13503 no longer will apply to motions to dismiss; however, the rules will apply to all other motions filed in arbitration.

Under new Rules 12504 and 13504, motions filed before a hearing on the merits (*i.e.*, prehearing motions), or motions filed during the hearing on the merits but before a party has concluded its case-in-chief, will be referred to as a Rule 12504(a) motion.[2] Motions filed after a party has concluded its case-in-chief will be referred to as a Rule 12504(b) motion.[3]

New Rule 12206(b) will govern motions to dismiss based on eligibility grounds and will be referred to as eligibility motions.[4]

The new rules establish procedures that specifically address motions to dismiss. These procedures implement a number of changes from current motions practice, which are listed below:

- Parties must file the motions in writing, separately from the answer, and only after they file the answer.
- Parties must file any Rule 12504(a) motion at least 60 days in advance of a hearing.
- Parties will have 45 days to respond to a Rule 12504(a) motion.
- In the case of an eligibility motion, parties must file any motion to dismiss at least 90 days before a hearing, and the other parties will have 30 days to respond.
- The full panel will decide a Rule 12504(a) motion and an eligibility motion.
- The panel cannot act upon a motion to dismiss a party or claim under Rule 12504(a), unless the panel determines that: (1) the non-moving party signed a settlement and release, or (2) the moving party was not associated with the account, security, or conduct at issue.

- The panel cannot act upon a motion to dismiss a party or claim under Rule 12206(b) unless the panel determines that the claim is not eligible for arbitration because it does not meet the six-year eligibility requirement.
- If a party files a motion to dismiss on multiple grounds, including eligibility, the panel must decide eligibility first. If the panel grants the motion on eligibility, it must not rule on any other grounds for the motion.
- The panel must hold a hearing before it grants a Rule 12504(a) motion, unless the parties waive the hearing.
- If the panel grants a Rule 12504(a) motion, the decision must be unanimous and be accompanied by a written explanation.
- If the panel denies a Rule 12504(a) motion, a party may not re-file it, unless specifically permitted by panel order.
- If the panel denies a Rule 12504(a) motion, the panel must assess forum fees against the party who filed the motion.
- If the panel deems a Rule 12504(a) motion frivolous, it must also award reasonable costs and attorneys' fees to the party who opposed the motion.
- If the panel determines that a party filed a motion to dismiss under Rules 12206(b) and 12504(a) in bad faith,[5] it may issue other sanctions under Rules 12212 and 13212 of the Codes.

The following questions and answers provide more detail on the purpose of the new rules and how they will be applied.

What is a motion to dismiss?

A motion to dismiss is a request made by a party to the arbitrator(s) to remove some or all claims raised by a party filing a claim. Currently, motions to dismiss may be filed at any stage of an arbitration proceeding, but they are often filed before a hearing is held. If the single arbitrator or panel[6] grants a motion to dismiss before a hearing is held (a prehearing motion), the party filing a claim loses the opportunity to have his or her arbitration case heard by the arbitrator(s).

Why are the rules necessary?

FINRA received complaints that parties were filing prehearing motions routinely and repetitively in an apparent effort to delay scheduled hearing sessions on the merits, increase customers' costs, and intimidate less sophisticated customers. As a result, FINRA believes customers are spending additional resources to defend against these motions, increasing the costs and processing times of the arbitration process.

FINRA also learned through an independent study that the number of motions to dismiss filed in customer cases had begun to increase over a two-year period starting in 2004. Even though most motions to dismiss are denied, FINRA became concerned that, if left unregulated, this type of motion practice would limit investors' access to the forum, either by making arbitration too costly or by denying customers their right to have their claims heard in arbitration.

FINRA believes that the enforcement mechanisms in the rules will minimize parties' costs and ensure strict compliance with the rules. The risk of monetary penalties and sanctions, imposed either by the panel on its own initiative, or as a result of a party's motion, should deter parties from filing a Rule 12504(a) motion frivolously or in bad faith.

How will the rules affect motions to dismiss filed in FINRA's arbitration forum?

Rules 12504(a)(1) and 13504(a)(1) reinforce FINRA's position that parties have the right to a hearing in arbitration by clarifying that motions to dismiss filed prior to the conclusion of a party's case-in-chief, including prehearing motions, are discouraged in arbitration. The rules significantly limit motions to dismiss filed prior to the conclusion of a party's case-in-chief.[7] Under the rules, the panel cannot act upon a motion to dismiss a party or claim, unless the panel determines that: (1) the non-moving party previously released the claim(s) in dispute by a signed settlement agreement and/or written release; (2) the moving party was not associated with the account(s), security(ies) or conduct at issue; or (3) the claim does not meet the criteria of the eligibility rule.

How should arbitrators apply the three exceptions?

Prior settlement or release

A panel cannot act on a motion to dismiss under Rules 12504(a)(6)(A) and 13504(a)(6)(A) unless the panel determines that the non-moving party previously released the claims in dispute by a signed settlement agreement and/or written release. Parties seeking this exception should provide arbitrators with valid documents that indicate that the claims in the current dispute have been resolved in a previous dispute.

Not associated with the account, security or conduct at issue

A panel cannot act on a motion to dismiss under Rules 12504(a)(6)(B) and 13504(a)(6)(B) unless the panel determines that the moving party was not associated with the accounts, securities or conduct at issue. FINRA intends this exception to apply in cases involving issues of misidentification. For example, the panel could grant a motion to dismiss under this exception if a party files a claim against the wrong person or entity, or a claim names an individual who was not employed by the firm during the time of the dispute, or a claim names an individual or entity that was not connected to an account, security or conduct at the firm during the time of the dispute.

Eligibility

A panel may grant a motion to dismiss on eligibility grounds at any stage of the proceeding, including a prehearing motion, under Rules 12206(b)(7) and 13206(b)(7) if the claim is not eligible for submission to arbitration because six years have elapsed from the occurrence or event giving rise to the claim. Parties seeking this exception should provide arbitrators with valid documents that indicate when the occurrence or event took place.

FINRA emphasizes that these exceptions do not constitute an invitation to parties to file motions to dismiss. The fact that a motion may be filed under one of these exceptions does not mean that the panel should or will grant a motion that does not have merit.

How should a party file a Rule 12504(a) motion?

A Rule 12504(a) motion must be filed in writing, separately from the answer and filed only after the answer is filed. For a Rule 12504(a) motion, the party filing the motion must serve the other parties and the FINRA Director of Arbitration with the motion at least 60 days before a scheduled hearing.[8] The parties receiving the Rule 12504(a) motion will have 45 days to respond to the motion.[9] The filing and response deadlines are different under the eligibility rule and are discussed later in this *Notice*.

Are there procedures that a panel must follow to decide a Rule 12504(a) motion?

Yes. The full panel must decide a Rule 12504(a) motion.[10] Moreover, the panel may not grant a Rule 12504(a) motion unless the panel holds or the parties waive an in-person or telephonic prehearing conference on the motion.[11] In addition, FINRA will record prehearing conferences to decide these motions.[12]

What happens if the panel grants a Rule 12504(a) motion?

If the panel grants a Rule 12504(a) motion (in whole or part), the decision must be unanimous and accompanied by a written explanation.[13] FINRA believes that the type of relief requested by a Rule 12504(a) motion—the complete dismissal of a claim before an evidentiary hearing is completed—justifies the requirement that all arbitrators on the panel agree, based on the evidence presented by the party filing the motion, that the motion should be granted.

What happens if the panel denies a Rule 12504(a) motion?

If a panel denies a Rule 12504(a) motion, it must assess forum fees associated with the hearing(s) on the motion against the party who filed the Rule 12504(a) motion.[14]

May a party re-file a Rule 12504(a) motion that has been denied?

A party may not re-file a Rule 12504(a) motion that has been denied, unless specifically permitted by panel order.[15] If a panel denies a Rule 12504(a) motion that was filed before the effective date of the new rules but permits a party to re-file the motion after the effective date, the re-filed Rule 12504(a) motion will be governed by the new rules.

What happens if the panel determines that a party has filed a motion to dismiss frivolously?

If a panel determines that a party filed a Rule 12504(a) or eligibility motion frivolously, the panel must also award reasonable costs and attorneys' fees to any party that opposed the motion.[16]

What happens if the panel determines that a party has filed a motion to dismiss in bad faith?

If a panel determines that a party filed a Rule 12504(a) or eligibility motion in bad faith, the panel may also issue sanctions against the party that filed the motion.[17] Under the Codes, the panel may sanction a party for failure to comply with any provision in the Code, or any order of the panel or single arbitrator authorized to act on behalf of the panel.[18] Such sanctions may include, but are not limited to:

- assessing monetary penalties payable to one or more parties;
- precluding a party from presenting evidence;
- making an adverse inference against a party;
- assessing postponement and/or forum fees; and
- assessing attorneys' fees, costs and expenses.[19]

Do the rules prohibit a party from filing other motions to dismiss?

No. A party may file a Rule 12504(b) motion and such a motion will not be subject to the exceptions in Rule 12504(a).[20] Thus, a moving party may file a Rule 12504(b) motion based on any applicable theory of law. FINRA expects these motions to be relevant to the case and based on theories that are germane to the issues raised in the non-moving party's case. FINRA believes that by the close of the non-moving party's case, the panel will have heard enough evidence to decide whether a motion filed at this stage of the case should be considered and, if warranted, granted.

FINRA notes, however, that if a party files a Rule 12504(b) motion, the panel is not required to consider or grant the motion; rather, arbitrators will continue to control the hearing process, which includes deciding whether to hear such a motion. Further, the rule will not preclude a panel from assessing parties who file these motions with sanctions, costs or attorney's fees if the panel determines that a Rule 12504(b) motion filed at this time is frivolous or in bad faith.[21]

Are the changes under the eligibility rule the same as the provisions under the motion to dismiss rule?

Many of the changes under the eligibility rule are the same as those under the motion to dismiss rule, but there are some differences:

- First, the two exceptions to the motion to dismiss rule that prohibit arbitrators from acting on a motion to dismiss prior to the conclusion of party's case, including a prehearing motion (*i.e.*, a signed settlement agreement and/or written release and the contention that a moving party was not associated with the accounts, securities or conduct at issue), will not apply to eligibility motions.
- Second, the filing deadlines for eligibility motions are different from those in the motion to dismiss rule. Under the eligibility rule, a party may file a motion to dismiss on eligibility grounds at any stage of the proceeding, except that a party may not file this motion any later than 90 days before the scheduled hearing on the merits,[22] rather than the 60-day timeframe required under the motion to dismiss rule. The 90-day requirement will encourage parties wishing to file an eligibility motion to determine in the early stages of the case whether to pursue their claims in court or to proceed with the arbitration. Further, the rule also provides parties with 30 days to respond to an eligibility motion,[23] instead of the 45 days permitted under the motion to dismiss rule. The 30-day timeframe to respond to eligibility motions will expedite the process, so that the time between filing a claim and resolution of the dispute is shortened.

- Third, if a party files an eligibility motion that includes multiple other grounds (*i.e.*, a mixed motion), the panel must decide the eligibility issue first.[24] If the panel grants a mixed motion on eligibility grounds, it must not rule on any other grounds for the motion.[25] Further, if a party files a mixed motion, the party responding to the mixed motion will have 45 days to respond. FINRA believes the response time is appropriate in the case of a mixed motion, because the non-moving party will be required to prepare for and address each ground that the moving party uses to argue for dismissal.

Effective Date Provisions

The amendment becomes effective on February 23, 2009, and applies to motions to dismiss filed on or after the effective date.

30-Day Moratorium on Motions to Dismiss

FINRA is imposing a moratorium on filing motions to dismiss prior to the conclusion of a party's case-in-chief from the date of this *Notice*, January 23, 2009, until the effective date of the new rules, February 23, 2009. This means that parties may not file such motions from January 23, 2009 to February 23, 2009. The term "case-in-chief" means the main case presented by the party who files the statement of claim, through the use of documentary evidence and witnesses, at an arbitration hearing. FINRA believes that imposing a moratorium on such motions during this pre-effective period will make the arbitration process fair to all parties, will make the new rules simple for staff and arbitrators to apply and will prevent abuse during the time before the rules become effective.

Does the moratorium apply to all motions filed in arbitration?

No. The moratorium does not apply to the following motions:

- motions filed after a party has concluded its case-in-chief;
- motions filed under Rules 12503 and 13503 other than motions to dismiss;
- motions to compel discovery under Rules 12509 and 13509;
- motions for sanctions under Rules 12212 and 13212;
- motions for discovery sanctions under Rules 12511 and 13511;
- motions to withdraw a claim under Rules 12702 and 13702; and
- motions to submit documents after the case is closed under Rules 12905 and 13905.

Parties may file these motions during the moratorium and arbitrators may consider and act on them.

What happens to motions to dismiss filed prior to January 23, 2009?

The moratorium will not apply to motions to dismiss filed prior to the date of this *Notice*. Arbitrators may consider and act on motions filed prior to the date of the *Notice*, using the current procedures established for motions under the Codes, until the effective date of the new rules.

Do you have examples of how FINRA will apply the moratorium?

Yes. The following examples should help users of the forum understand how the moratorium will be applied.

- **Example 1:** A party filed an arbitration claim in 2008. The arbitration hearings have not begun. A moving party filed a motion to dismiss on January 19, 2009 and the arbitrators took it under advisement. The moratorium would not apply, and the arbitrators should address this motion using the current procedures established for motions under the Codes.
- **Example 2:** A party filed an arbitration claim in 2008. The arbitration hearings are scheduled to begin on January 28, 2009. A moving party files a motion to dismiss on January 26, 2009. The motion would be subject to the moratorium. Thus, the party filing the arbitration claim will not be required to respond to the motion and arbitrators will not consider it.
- **Example 3:** The same facts as Example 2, except that the party concludes its case-in-chief on January 30, 2009. A moving party files a motion to dismiss at the conclusion of the party's case-in-chief. The motion would not be subject to the moratorium because the party has finished presenting its case-in-chief. The arbitrators would address this motion using the current procedures established for motions under the Codes.

Endnotes

1 Exchange Act Release No. 59189 (December 31, 2008), 74 Federal Register 731 (January 7, 2009) (File No. SR-FINRA-2007-021).

2 FINRA describes this motion using the rule number from the Customer Code for simplicity. However, the description also applies to motions filed under Rule 13504(a) of the Industry Code.

3 *See* note 2. The same rationale applies to Rule 13504(b) of the Industry Code.

4 FINRA describes the eligibility motion using the rule number from the Customer Code for simplicity. However, the description also applies to eligibility motions filed under Rule 13206(b) of the Industry Code.

5 *See also* Rules 13206(b) and 13212(b) of the Industry Code.

6 A single arbitrator ordinarily hears cases involving $50,000 or less in dispute; a panel of three arbitrators hears larger cases. FINRA uses the term "panel" for both situations in this *Notice*. FINRA is proposing to raise the amount in controversy heard by a single chair-qualified arbitrator to $100,000. *See* SR-FINRA-2008-047.

7 Rules 12504(a)(6) and 13504(a)(6) of the motion to dismiss rule and Rules 12206(b)(7) and 13206(b)(7) of the eligibility rule.

8 Rules 12504(a)(3) and 13504(a)(3). Under this provision, parties may agree to or the panel may decide to modify this deadline.

9 *Id.*

10 Rules 12504(a)(4) and 13504(a)(4) of the motions to dismiss rule and Rules 12206(b)(3) and 13206(b)(3) of the eligibility rule.

11 Rules 12206(b)(4) and 13206(b)(4) of the eligibility rule and Rules 12504(a)(5) and 13504(a)(5).

12 *Id.*

13 Rules 12504(a)(7) and 13504(a)(7) of the motion to dismiss rule and Rules 12206(b)(5) and 13206(b)(5) of the eligibility rule.

14 Rules 12504(a)(9) and 13504(a)(9) of the motions to dismiss rule and Rules 12206(b)(8) and 13206(b)(8) of the eligibility rule.

15 Rules 12504(a)(8) and 13504(a)(8) of the motions to dismiss rule and Rules 12206(b)(6) and 13206(b)(6) of the eligibility Rule.

16 Rules 12504(a)(10) and 13504(a)(10) of the motion to dismiss rule and Rules 12206(b)(9) and 13206(b)(9) of the eligibility rule.

17 Rules 12504(a)(11) and 13504(a)(11) of the motion to dismiss rule and Rules 12206(b)(10) and 13206(b)(10) of the eligibility rule.

18 Rules 12212 and 13212 of the Codes.

19 *Id.*

20 Rules 12504(b) and 13504(b) of the motions to dismiss rule.

21 Note 18.

22 Rules 12206(b)(2) and 13206(b)(2) of the eligibility rule.

23 *Id.*

24 Rules 12206(b)(7) and 13206(b)(7) of the eligibility Rule.

25 *Id.* The rule also contains other criteria concerning motions to dismiss based on eligibility grounds.

©2009. FINRA. All rights reserved. *Regulatory Notices* attempt to present information to readers in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the rule language prevails.

Attachment A

New language is underlined.

Code of Arbitration Procedure for Customer Disputes

and

Code of Arbitration Procedure for Industry Disputes

* * *

Customer Code

12206. Time Limits

(a) No change.

(b) Dismissal under Rule

Dismissal of a claim under this rule does not prohibit a party from pursuing the claim in court. By filing a motion to dismiss a claim under this rule, the moving party agrees that if the panel dismisses a claim under this rule, the non-moving party may withdraw any remaining related claims without prejudice and may pursue all of the claims in court.

(1) Motions under this rule must be made in writing, and must be filed separately from the answer, and only after the answer is filed.

(2) Unless the parties agree or the panel determines otherwise, parties must serve motions under this rule at least 90 days before a scheduled hearing, and parties have 30 days to respond to the motion.

(3) Motions under this rule will be decided by the full panel.

(4) The panel may not grant a motion under this rule unless an in-person or telephonic prehearing conference on the motion is held or waived by the parties. Prehearing conferences to consider motions under this rule will be recorded as set forth in Rule 12606.

(5) If the panel grants a motion under this rule (in whole or part), the decision must be unanimous, and must be accompanied by a written explanation.

(6) If the panel denies a motion under this rule, a party may not re-file the denied motion, unless specifically permitted by panel order.

(7) If the party moves to dismiss on multiple grounds including eligibility, the panel must decide eligibility first.

- If the panel grants the motion to dismiss the case on eligibility grounds on all claims, it shall not rule on any other grounds for the motion to dismiss.
- If the panel grants the motion to dismiss on eligibility grounds on some, but not all claims, and the party against whom the motion was granted elects to move the case to court, the panel shall not rule on any other ground for dismissal for 15 days from the date of service of the panel's decision to grant the motion to dismiss on eligibility grounds.
- If a panel dismisses any claim on eligibility grounds, the panel must record the dismissal on eligibility grounds on the face of its order and any subsequent award the panel may issue.
- If the panel denies the motion to dismiss on eligibility grounds, it shall rule on the other bases for the motion to dismiss the remaining claims in accordance with the procedures set forth in Rule 12504(a).

(8) If the panel denies a motion under this rule, the panel must assess forum fees associated with hearings on the motion against the moving party.

(9) If the panel deems frivolous a motion filed under this rule, the panel must also award reasonable costs and attorneys' fees to any party that opposed the motion.

(10) The panel also may issue other sanctions under Rule 12212 if it determines that a party filed a motion under this rule in bad faith.

(c) - (d) No change.

* * * * *

Rule 12504. [Reserved] Motions to Dismiss

(a) Motions to Dismiss Prior to Conclusion of Case-in-chief

(1) Motions to dismiss a claim prior to the conclusion of a party's case-in-chief are discouraged in arbitration.

(2) Motions under this rule must be made in writing, and must be filed separately from the answer, and only after the answer is filed.

(3) Unless the parties agree or the panel determines otherwise, parties must serve motions under this rule at least 60 days before a scheduled hearing, and parties have 45 days to respond to the motion.

(4) Motions under this rule will be decided by the full panel.

(5) The panel may not grant a motion under this rule unless an in-person or telephonic prehearing conference on the motion is held or waived by the parties. Prehearing conferences to consider motions under this rule will be recorded as set forth in Rule 12606.

(6) The panel cannot act upon a motion to dismiss a party or claim under paragraph (a) of this rule, unless the panel determines that:

(A) the non-moving party previously released the claim(s) in dispute by a signed settlement agreement and/or written release; or

(B) the moving party was not associated with the account(s), security(ies), or conduct at issue.

(7) If the panel grants a motion under this rule (in whole or part), the decision must be unanimous, and must be accompanied by a written explanation.

(8) If the panel denies a motion under this rule, the moving party may not re-file the denied motion, unless specifically permitted by panel order.

(9) If the panel denies a motion under this rule, the panel must assess forum fees associated with hearings on the motion against the moving party.

(10) If the panel deems frivolous a motion filed under this rule, the panel must also award reasonable costs and attorneys' fees to any party that opposed the motion.

(11) The panel also may issue other sanctions under Rule 12212 if it determines that a party filed a motion under this rule in bad faith.

(b) Motions to Dismiss After Conclusion of Case-in-chief

A motion to dismiss made after the conclusion of a party's case-in-chief is not subject to the procedures set forth in subparagraph (a).

(c) Motions to Dismiss Based on Eligibility

A motion to dismiss based on eligibility filed under Rule 12206 will be governed by that rule.

(d) Motions to Dismiss Based on Failure to Comply with Code or Panel Order

A motion to dismiss based on failure to comply with any provision in the Code, or any order of the panel or single arbitrator filed under Rule 12212 will be governed by that rule.

(e) Motions to Dismiss Based on Discovery Abuse

A motion to dismiss based on discovery abuse filed under Rule 12511 will be governed by that rule.

* * *

Industry Code

13206. Time Limits

(a) No change.

(b) Dismissal under Rule

Dismissal of a claim under this rule does not prohibit a party from pursuing the claim in court. By filing a motion to dismiss a claim under this rule, the moving party agrees that if the panel dismisses a claim under this rule, the non-moving party may withdraw any remaining related claims without prejudice and may pursue all of the claims in court.

(1) Motions under this rule must be made in writing, and must be filed separately from the answer, and only after the answer is filed.

(2) Unless the parties agree or the panel determines otherwise, parties must serve motions under this rule at least 90 days before a scheduled hearing, and parties have 30 days to respond to the motion.

(3) Motions under this rule will be decided by the full panel.

(4) The panel may not grant a motion under this rule unless an in-person or telephonic prehearing conference on the motion is held or waived by the parties. Prehearing conferences to consider motions under this rule will be recorded as set forth in Rule 13606.

(5) If the panel grants a motion under this rule (in whole or part), the decision must be unanimous, and must be accompanied by a written explanation.

(6) If the panel denies a motion under this rule, a party may not re-file the denied motion, unless specifically permitted by panel order.

(7) If the party moves to dismiss on multiple grounds including eligibility, the panel must decide eligibility first.

- If the panel grants the motion to dismiss the case on eligibility grounds on all claims, it shall not rule on any other grounds for the motion to dismiss.
- If the panel grants the motion to dismiss on eligibility grounds on some, but not all claims, and the party against whom the motion was granted elects to move the case to court, the panel shall not rule on any other ground for dismissal for 15 days from the date of service of the panel's decision to grant the motion to dismiss on eligibility grounds.
- If a panel dismisses any claim on eligibility grounds, the panel must record the dismissal on eligibility grounds on the face of its order and any subsequent award the panel may issue.
- If the panel denies the motion to dismiss on eligibility grounds, it shall rule on the other bases for the motion to dismiss the remaining claims in accordance with the procedures set forth in Rule 13504(a).

(8) If the panel denies a motion under this rule, the panel must assess forum fees associated with hearings on the motion against the moving party.

(9) If the panel deems frivolous a motion filed under this rule, the panel must also award reasonable costs and attorneys' fees to any party that opposed the motion.

(10) The panel also may issue other sanctions under Rule 13212 if it determines that a party filed a motion under this rule in bad faith.

(c) - (d) No change.

*****

13504. [Reserved] Motions to Dismiss

(a) Motions to Dismiss Prior to Conclusion of Case-in-chief

(1) Motions to dismiss a claim prior to the conclusion of a party's case-in-chief are discouraged in arbitration.

(2) Motions under this rule must be made in writing, and must be filed separately from the answer, and only after the answer is filed.

(3) Unless the parties agree or the panel determines otherwise, parties must serve motions under this rule at least 60 days before a scheduled hearing, and parties have 45 days to respond to the motion.

(4) Motions under this rule will be decided by the full panel.

(5) The panel may not grant a motion under this rule unless an in-person or telephonic prehearing conference on the motion is held or waived by the parties. Prehearing conferences to consider motions under this rule will be recorded as set forth in Rule 13606.

(6) The panel cannot act upon a motion to dismiss a party or claim under paragraph (a) of this rule, unless the panel determines that:

(A) the non-moving party previously released the claim(s) in dispute by a signed settlement agreement and/or written release; or

(B) the moving party was not associated with the account(s), security(ies), or conduct at issue.

(7) If the panel grants a motion under this rule (in whole or part), the decision must be unanimous, and must be accompanied by a written explanation.

(8) If the panel denies a motion under this rule, the moving party may not re-file the denied motion, unless specifically permitted by panel order.

(9) If the panel denies a motion under this rule, the panel must assess forum fees associated with hearings on the motion against the moving party.

(10) If the panel deems frivolous a motion filed under this rule, the panel must also award reasonable costs and attorneys' fees to any party that opposed the motion.

(11) The panel also may issue other sanctions under Rule 13212 if it determines that a party filed a motion under this rule in bad faith.

(b) Motions to Dismiss After Conclusion of Case-in-chief

A motion to dismiss made after the conclusion of a party's case-in-chief is not subject to the procedures set forth in subparagraph (a).

(c) Motions to Dismiss Based on Eligibility

A motion to dismiss based on eligibility filed under Rule 13206 will be governed by that rule.

(d) Motions to Dismiss Based on Failure to Comply with Code or Panel Order

A motion to dismiss based on failure to comply with any provision in the Code, or any order of the panel or single arbitrator filed under Rule 13212 will be governed by that rule.

(e) Motions to Dismiss Based on Discovery Abuse

A motion to dismiss based on discovery abuse filed under Rule 13511 will be governed by that rule.

* * *

EXHIBIT B

Stoltmann Law Offices, P.C.

Willis Tower, 233 S. Wacker Drive, 84th Floor, Chicago, Illinois 60606
600 Hart Road, Suite 115, Barrington, IL 60010
Telephone 312-332-4200 Facsimile 312-332-4201
www.stoltmannlaw.com

February 18, 2019

Via FINRA Portal

Mr. Richard Berry
FINRA
Director of Arbitration
One Liberty Plaza
165 Broadway, 27th Floor
New York, NY 10006

RE: ------ --------- and ------ --------- ("Claimants") v. --------- --------, Inc. ("Respondent")

Dear Mr. Berry:

Stoltmann Law Offices, P.C. has been retained by ---- --------- and ------ --------- to recover damages caused by the negligence and breaches of duty of Respondent and their agents. Accordingly, we have prepared this Statement of Claim so that FINRA may commence these proceedings immediately.

JURISDICTION

The Financial Industry Regulatory Authority ("FINRA") has jurisdiction over this matter and the instant Statement of Claim is filed pursuant to the FINRA Code of Arbitration Procedure Rule 12200 and pursuant to the binding arbitration clause contained in --------- Securities' or its predecessor's new account documents and forms executed by the Claimants. As such, jurisdiction properly lies with FINRA Dispute Resolution.

PARTIES

Claimants

Mr. ------ --------- ("-----") was a resident of -------, Iowa at all times relevant. He is ---- years old. He was born and raised in ----------, Iowa where he attended -------- High School. Mr. --------- attended ---------- University and earned a BS in accounting. He worked at ---------- and Construction after college while studying to take his ----------. After passing, he worked for an accounting firm in ---------- until --------, at which point

he went back to ----------. ------- currently owns ----------, a -------- company in ----------. --------- has been happily married to his wife --------- for -- years, who was an elementary school teacher for 25 years which included teaching Title I reading. --------- and --------- have three adult children, two daughters and a son.

Mr. --------- --------- was a resident of ------, Iowa at all times relevant. He is -- years old and was born in -------, Iowa. He attended ---------High School and after graduation he worked at --------- --------. He was the 3rd generation to work in the family business. After a heart attack in ----- and the implantation of an internal defibrillator, he was no longer allowed to work in --------, and began farming full time. --------- has been married to his wife --------- for sixty years, who is a -------- and works as a cook for ----------. --------- and -------- have a son (Claimant --------- ---------) and a daughter.

Respondent --------- ---------, Inc.

--------- --------, Inc. ("---------") (CRD No. -------- and SEC No. --------) is a full-service securities brokerage firm headquartered in ---------, -----. The firm's main office is located at ---------- and its mailing address is ----------. --------- was known as ---------- from 1996 to January 2017. --------- is majority owned by --------- ------, Inc. which is in turn majority owned by --------- -------, a publicly traded company -------- with a market capitalization of nearly $----------. As of July 2017, --------- -------- had ---- branch offices and ------- registered persons.

--------- has struggled in recent years to comply with various supervision and compliance requirements as mandated by FINRA. On --------, --------- consented to a censure and a fine of $------ after a FINRA investigation revealed systemic failures related to ---------'s supervision of transactions to existing variable annuity contracts, affecting more than 4,000 transactions. *See FINRA AWC No.* ---------. The findings relate back to the time period October 2013 to September 2016. (Attached hereto as **Exhibit --**).

Further, in *FINRA AWC No.* ----------, --------- was censured and fined $------ for supervisory failures in connection with the use of consolidated client reports between July 2013 and February 2015. The systems permitted manual entries, which meant financial advisors could enter data into the consolidated reporting system to include, for example, assets held away from --------- into the client's overall financial plan, which would be delivered to the client, without any supervisory review of the entries. FINRA noted that --------- also "failed to enforce its written supervisory procedures, which required registered representatives to retain all customer correspondence, as well as records related to business transactions…" (See **Exhibit --**).

On ----------, --------- consented to a censure and restitution penalty of more than $------- in connection with thousands of mutual fund transactions which took place for

almost a decade, which failed to provide firm clients with various mutual fund share class and breakpoint discounts. *See FINRA AWC* ---------- attached hereto as **Exhibit --**.

On --------, --------- consented to a censure and a fine in the amount of $------ in connection with systemic failures to supervise the email correspondence of its registered representatives. *See FINRA AWC* ---------- attached hereto as **Exhibit --**. FINRA found that from October 1, 2011 through June 10, 2013, --------- failed to review approximately 2.7 million incoming email communications for approximately 2,100 email accounts due to a coding error in ---------'s email monitoring system. FINRA also found that --------- failed to adequately monitor and test its technology infrastructure to determine that emails were properly routed to its email monitoring system. FINRA concluded that these failures constituted violations for NASD Rule 3010 and FINRA Rule 2010. Importantly, the emails were retained but not reviewed. This was not the first time --------- had been fined in connection with email issues. (*See* Exhibit --- at 1).

These numerous supervisory and compliance related issues during the relevant time period establish that --------- had material flaws in its compliance apparatus. These flaws allowed for the propagation of the conduct at issue herein. As described in detail below, --------- allowed its registered representative to act outside of the firm in plain sight to the detriment of --------- clients.

Relevant Non-Party

--------- ("---------") CRD # --------, was a registered representative licensed through --------- from 1996 through January 2017. --------- has no previous registrations and spent his entire professional financial services career with ---------. On January 1, 2017, --------- voluntarily terminated his affiliation with the firm. He worked primarily from the ---------- branch office located at ----------.

--------- disclosed a number of outside business activities on his Form U-4, as reported by the CRD. These disclosures include ---------'s status as a board member of an entity called --------- and as a board member of a company called "---------". These outside activities were fully disclosed to --------- Securities.

On April 16, 2018, --------- consented to a three-month suspension from associating in any capacity with any FINRA member and a fine of $----- for failing to disclose his affiliation with a company involved in early-stage and distressed companies. FINRA also found that --------- failed to disclose more than two dozen purchases totaling

$----- ------ of ten companies' securities to ---------. *See FINRA AWC 2017052852801* attached hereto as **Exhibit 5**.

Factual Allegations

This case is about ---- --------- soliciting --------- --------- and his ---- --------- ---------- to fund his outside business adventures to the tune of more than $-- million. Agent ---------- was a successful financial advisor for --------- Securities and its predecessors for more than twenty years. He was one of the premier producers in the -------, ---- branch office. He lived an affluent lifestyle, but he was not satisfied. Agent --------- wanted more and to him, the only way to get to the "next level" was to swing for the fences.

Agent --------- facilitated his bid to get rich quickly by befriending --------- ---------, who was at one time a very wealthy client of his, and pitching him his plans involving multiple start-up companies engaged in all sorts of different businesses from mortgage financing to internet marketing. --------- --------- had been Agent ---------'s client for many years prior to these initial solicitations to invest in ---------'s business ventures and trusted his guidance in financial matters such as these.

--------- ---------, and before him his ----, previously owned a company called ----------. The company was founded by ---------'s -------- -------- in the 1930s. --------- specialized in drilled foundations. The company's 401K was managed by ---------. --------- worked for the company after college and into the 1990s at which point he engaged his family about buying-out his ----------. This happened in the late 1990s and --------- ---------- used the services of then---------- Securities[1] agent ---------- to help him structure this buyout plan.

After buying-out the company, --------- was the chief executive and owner until ----------at which point he sold the company to ---------- million in a 60/40 cash/stock transaction. --------- was the ---------- until 2011 when he hired a new President and assumed the duties of ----------, an electrical infrastructure company, until 2017. He then became more involved with ----------.

Not long after Mr. ---------- assisted --------- with the --------- buyout, Mr. --------- sold his book of business to another --------- agent, ---- ---------. At this point in the late 1990s, ----- --------- became --------- ---------'s primary --------- financial advisor. Over the course of the next several years, Agent --------- would act as ---------'s --------- financial advisor, soliciting him to invest in various annuities and life insurance products over time. He also assisted --------- with brokerage services and estate planning.

[1] ---------- was known as ---------- when this buyout occurred.

Agent --------- Begins his Selling-Away Scheme

Although he was one of the most successful financial advisors under the --------- Securities' umbrella from a gross commissions and fees standpoint, Agent --------- wanted to get to the "next level" of wealth. He did not believe he could accomplish this goal by selling annuities and life insurance policies. Instead, Agent --------- decided to leap into the high-stakes arena of venture capital finance. Agent --------- was looking to dramatically grow his personal assets so that he could be wealthy beyond any measure offered through legitimate means, so he chose the path of least resistance and did so in plain sight of --------- --------- supervisors.

In order to fulfil his fantasy of gaining a seat at the table with the super-wealthy, Agent --------- needed money. Although he did quite well at ---------, earning anywhere between $750,000 to $1 million per year, he was also a profligate spender. As such, Agent --------- did not have much to show for his successes. The most readily accessible source of funding for Agent ---------'s new business adventures were his --------- ----- clients, including the Claimants.

Beginning in March 2013, Agent --------- engaged in a solicitation campaign where he aggressively pitched his --------- clients, including Claimants, to invest money into his pet projects. Although as many as ten other --------- clients invested money in these entities, make no mistake about it, --------- --------- and his wealth was both the goal and the means to an end for Agent ---------.

a. Agent --------- was the Architect of This Investment Scheme

The first solicitation at issue took place on or about March 2013 and involved an investment in a company Agent --------- called ---------. This company, in which Agent --- ------ disclosed his involvement to --------- as a board member, was to be publicly traded and was involved in developing internet advertising data-mining. --------- was solicited by ---- --------- and another alleged owner of the company, ------. This initial investment was for $150,000 and Agent --------- touted the technology and prospects of this company, giving --------- the expectation of above-market returns.

Agent --------- continued to sell --------- about the prospects of --------- and several other fledgling companies he was involved in that needed that initial boost of investor capital to really get going. Agent --------- convinced --------- that the first step in beginning the process of investing more substantial sums of money in Agent ---------'s venture capital enterprises was to set up company through which the money could be funneled. To that end, Agent --------- incorporated ----------, LLC, an Iowa Limited Liability Company. According to publicly available documents filed with the --------

Secretary of State, ----------, LLC has a legal fictitious name, ---------, LLC, of which Agent --------- is identified as the manager.

Once this new LLC was incorporated in connection with Agent ---------'s solicitation of --------- to invest more money in his venture capital companies, --------- began investing substantial sums of money in various companies owned, managed, or controlled at least in part by Agent ---------, including but not limited to:

- -------
- -------
- -------
- --------
- ---------
- -----------
- --------------
- ----------------
- ---------------
- -----------

In total, --------- --------- invested approximately $---------- in these companies because of the solicitations by Agent ---------. The mechanics of these investments almost always began with a deposit of money from --------- --------- into the --------- account and from there, Agent --------- would allocate ---------'s money in whatever way he deemed necessary. In some instances, --------- believed his money was being invested in -----, for example, but would later find out that Agent --------- had allocated the money into another company, like ---------.

--------- ---------, upon solicitation by Agent ---------, invested over $400,000 in ------. In order to facilitate this investment, --------- had him surrender an annuity held at ----------. He represented to --------- --------- that his money would be invested in --------- and took the form of a bond, paying 17% interest per year. --------- --------- has not received any interest payments from ---------s to date.

---------'s investment in some of these entities was quite substantial and as such, part of the solicitation from Agent --------- would include a sweetener; in exchange for his investment, --------- could be a member of the board of directors, or in the case of --------, he would be named Chairman of the Board. Because --------- had experience running his --------- for many years, he admittedly liked the idea of having some modicum of control over the companies he was being asked to fund.

b. Agent --------- Actively Engaged in Soliciting Claimants and Other --------- Clients to Invest in his Outside Businesses on --------- Time.

Agent ---------'s selling away scheme was bold and brazen. He knew as one of the premier brokers with --------- ------- he had wide latitude to do business as he pleased so long as he continued to generate revenue for the company. He regularly scheduled meetings during business hours at the --------- office in ---------- with --------- --------- and officers from his various outside companies, like ----------, former CEO of ---------, along with ---------- and ----------. These meetings would take place in the --------- ---------- conference room and would regularly devolve into --------- --------- being actively solicited to invest more money in these companies.

Agent ---------'s --------- office was a large office broken into separate supervisory subunits. Agent ---------'s supervisory subunit operated as its own fiefdom inside of this office with minimal supervisory oversight because of his substantial annual production. They even had a separate, dedicated computer from which they could communicate using personal email, as opposed to communicating through --------- emails. This was not hidden or out of sight. Everyone in the office, from support staff to supervisors, knew Agent --------- had a second computer from which he conducted "personal" business. This computer even had a dedicated printer. Agent --------- would regularly utilize this "personal" computer located in a common area of the --------- office to conduct his selling-away activities.

Clearly, --------- --------- allowed Agent --------- to run his business as he saw fit. ---------- stayed out of his way because Agent --------- was a high earner for the company. Whether --------- sold-away was not important to --------- so long as his wealthy clients continued to buy annuities and other insurance products, filling the company coffers. The conflict internally at --------- --------- was clear. ---------'s obligation to adequately supervise and respond affirmatively to red-flags of potential violations of securities laws and regulations was diametrically opposed to ---------'s interests in ensuring one of their highest earning financial advisors remained happy.

c. Beginning in Early 2016, Things Began to Change at --------- ---------- Ultimately leading to ---------'s "Resignation."

Beginning in early 2016, things began to change at --------- -----. Upon information and belief, after FINRA fined --------- $--------- in October 2015 for supervisory failures in connection with firm email, *FINRA AWC* ---------(*See* Exhibit ---) the company also instituted certain remedial measures. One of those measures was to bring in --------- ----- (CRD # --------) whose new job was to monitor email at the --------- ----------office.

The ------ hiring sent a shockwave through the ---------- office because up to that point it was routine to use in-house computers specifically for outside business. Still, Agent --------- continued to actively solicit Claimants and other --------- Financial clients to invest in his outside ventures. He was emboldened by his immediate supervisors and his staff who grew used to Agent --------- working in gray areas. The fundamental failure of this office to detect, deter, and correct ongoing massive violations of FINRA Rules was institutional at the ------- office.

In late December 2016, Agent --------- finally slipped up enough to get the attention of ---------'s compliance department and specifically, Mr. -------. Upon information and belief, Agent --------- emailed a spreadsheet to his accountant which contained financial information about his outside business interests. This spreadsheet also identified --------- --------- and included dollar amounts reflecting tens of millions of dollars in purported "valuation" for this "----------" entity. This set off alarm bells because this spreadsheet included various entities which Agent --------- had disclosed to ---------- -------, and many that he did not disclose. The fact that this spreadsheet contained the name of a --------- client on it was a serious compliance issue. Yet no one at --------- ever reached out to --------- --------- to ask about any of the information contained on the spreadsheet. ---------'s supervisors effectively buried their heads in the sand to avoid upsetting one of its biggest producers.

--------- --------- had hard evidence in-hand that Agent --------- had engaged in a massive amount of fraud. The "valuations" he used on this document were fictional at best and simply made up without any basis, which is a clear indication he was committing fraud. He had engaged in selling millions of dollars of speculative investments in private companies that were not disclosed by Agent --------- on his Form U-4. These were clearly private securities transactions, commonly referred to as "selling-away," that were required to be disclosed by Agent --------- under FINRA Rule 3280 and Agent ---------'s involvement in these entities as manager, owner, or director required further disclosure as outside business activities under Rule 3270.

d. --------- --------- Quietly Swept Agent --------- out the Door and Failed to Warn Any Investors that he had Involved them in a Multimillion Dollar Securities Fraud

Agent --------- had a substantial (legitimate) book of business, so --------- handled the situation with caution in order to protect the firm's profits. At that time, Agent ---------'s direct supervisor was ----------. Once --------- was caught red-handed selling-away with tens of millions of dollars of --------- client money in outside businesses – some disclosed, some not disclosed – it was *fait accompli* that his --------- --------- career was over. But --------- did not want Agent --------- to head for the exits and move his substantial book of business to a competitor firm in ----------.

----------'s son, ----------, is also a financial advisor with --------- Securities in the ---------- office. --------- conspired with Agent --------- to orchestrate a quite exit from --------- ---------- so that he could sell his book of business to ----------. In this circumstance, everyone won but ---------'s clients: --------- --------- kept its clients, Agent ---------'s bosses' son received a massive influx of business for approximately $300,000, and Agent --------- could go about his fraudulent business elsewhere. Upon information and belief, ----------s' clients, including Claimants, were never contacted by anyone at --------- to discuss their interactions with Agent ---------, his outside businesses, or his blatant selling-away scheme. No one at --------- sought to interview Claimants to discuss the extraordinary investments their agent had solicited them to invest money into in clear violation of --------- ----------' policies and procedures. No one at --------- warned Claimants that Agent --------- had been "permitted to resign" because he had violated company policy and serious securities industry rules and regulations by selling away. As a result, Claimants continued to do business with Agent --------- and would invest more money into his speculative, personal business adventures. The scheme to keep victims of Agent ---------'s scheme in the dark worked.

e. --------- Conspires Further with Agent --------- to Coordinate their Response to the FINRA Investigation to Conceal the Truth.

--------- --------' dereliction of duty did not end with conspiring with a known securities law violator to orchestrate his smooth exit for the benefit of his supervisor's son. It also extended to the coming FINRA investigation into Agent ---------'s outside businesses. Shortly after Agent --------- left --------- in January 2017, FINRA launched an inquiry into what transpired.

In order to avoid unnecessary scrutiny from FINRA or clients, --------- and Agent --------- conspired to make one key misrepresentation: That ----------, LLC was --------- ----------'s idea and that he had requested Agent --------- put it together in connection with his tax and advisory services. This representation was false. --------- was Agent ---------'s idea, he was the manager of the entity, and he was responsible for it from inception in October 2014. No one at FINRA ever contacted Mr. --------- to discuss whether --------- was his idea or whether he instructed Agent --------- to put together the entity in furtherance of tax and business planning or strategy. FINRA accepted the unverified explanation of Agent ---------, and the inquiry ended with a slap-on-the-wrist penalty. *See* Exhibit ---.

This AWC completely misses the mark. In it, FINRA determines Agent --------- failed to disclose engaging in private securities transactions in violation of FINRA Rule 3270. The AWC references a "sophisticated investor" with whom Agent --------- engaged in some of these "private securities transactions" but fails to state Agent --------- had

solicited at least five --------- clients, in addition to Claimants, to invest in many of these outside entities. Either FINRA failed to ask the right questions during its inquiry or Agent ---------, with ---------'s assistance, withheld the information.

Agent --------- engaged in a widespread campaign to solicit --------- clients, other registered representatives, and --------- office personnel to invest in his undisclosed and disclosed outside businesses, and all FINRA did was suspend him for three months for failing to disclose private securities transactions. Agent ---------'s violations were far worse than that identified in the AWC and the penalty was based on inaccurate and intentionally misleading statements by Agent ---------. Upon information and belief, FINRA never interviewed any other --------- office personnel who worked for Agent ---------- and never interviewed any other --------- clients to determine the scope of his "selling away". FINRA was thrown off the scent by Agent --------- and --------- Securities.

<u>--------- Securities Failed to Adequately Supervise Agent ---------'s Disclosed Outside Business Activities</u>

--------- Securities affirmatively approved Agent ---------'s affiliation with --------- and ---------, two of the companies into which Agent --------- invested Claimants' money. According to Agent ---------'s CRD Report, these affiliations were approved by --------- on February 18, 2015 for --------- and December 23, 2015 for ---------. For both entities, Agent --------- is disclosed as a board member. In approving of these outside business activities, --------- ------ failed to perform any reasonable investigation or due diligence into these companies. Under FINRA Rule 3270, registered representatives are allowed to engage in business activities away from their firm for compensation so long as that activity is disclosed to the firm. The rule states:

> No registered person may be an employee, independent contractor, sole proprietor, officer, director or partner of another person, or be compensated, or have the reasonable expectation of compensation, from any other person as a result of any business activity outside the scope of the relationship with his or her member firm, unless he or she has provided prior written notice to the member, in such form as specified by the member.

In the Supplementary Materials under this Rule, FINRA imposed certain obligations upon member firms like --------- ------- after the Firm receives notice of an outside business activity. Those materials, found in FINRA Rule 3270.01, state:

> Upon receipt of a written notice under Rule 3270, a member shall consider whether the proposed activity will: (1) interfere with or otherwise compromise the registered person's responsibilities to the member and/or the member's customers or (2) be viewed by customers or the public as part

> of the member's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered. Based on the member's review of such factors, the member must evaluate the advisability of imposing specific conditions or limitations on a registered person's outside business activity, including where circumstances warrant, prohibiting the activity. A member also must evaluate the proposed activity to determine whether the activity properly is characterized as an outside business activity or whether it should be treated as an outside securities activity subject to the requirements of Rule 3280. A member must keep a record of its compliance with these obligations with respect to each written notice received and must preserve this record for the period of time and accessibility specified in SEC Rule 17a-4(e)(1).

In NASD Notice to Member 01-79, the NASD, the precursor to FINRA, reminded brokerage firms like --------- ----- that they must have supervisory procedures in place to ensure registered representatives are in compliance with the outside business activity disclosure rules. (*See* **Exhibit --**). Similarly, when these rules were passed and in accordance with NASD Notice to Members 88-86, NASD imposed a requirement that "appropriate supervision" be exercised as necessary on those outside business activities so disclosed by registered representatives. (*See* **Exhibit --**).

a. Numerous Red Flags Existed Requiring an Inquiry into Agent --------- Disclosed Outside Business Activities

--------- ------ ignored numerous red flags that Agent --------- was selling investments in securities offered by his outside businesses in violation of FINRA's rules and regulations. By ignoring these red flags, --------- Securities failed to uncover the scope of Agent ---------'s outside businesses, including numerous undisclosed activities like ------, --------- Enterprises, and -----, to name a few. Had --------- -------- peeled the onion one layer and requested basic financial information and formation documents for --------, for example, it would have discovered a tangled web of interrelated and undisclosed entities, like --------- Enterprises, and ---------. Once --------- ----- discovered the numerous entities Agent --------- was actually involved in, it would have been faced with the fact that Agent --------- had caused Claimants to invest over $---------- in his side businesses.

The litany of red flags that went ignored by --------- includes but is not limited to, the following:

- Agent --------- openly and notoriously used a separate computer at the ---------- --------- branch office for his outside activities, including the use of outside, undisclosed email correspondence.

- Agent --------- openly and notoriously used a dedicated printer at the ---------- office to print exclusively from this separate computer.
- Agent --------- held numerous meetings at his ---------- branch office with --------- --------- and executives or board members of both his disclosed and undisclosed outside businesses, to solicit Mr. --------- to invest money in securities offered by these companies.
- Agent ---------'s office associates and assistants were well aware of the scope of his outside activities, and in some instances, were even solicited to invest themselves.
- Agent ---------'s unsupervised personal email contained reams of evidence he was lying to --------- about his outside businesses and soliciting --------- clients to invest in numerous outside entities.
- Agent ---------'s personal investments in ---------, which he disclosed, were intertwined with --------- Enterprises and --------- ---------.
- The Certificate of Formation for --------- was publicly available and disclosed Agent --------- as the manager.
- --------- was a publically traded penny-stock which --------- sold to Claimants and his office personnel.
- Agent --------- solicited at least ten --------- clients and employees to invest in securities offered by his outside businesses.

The critical issue with these red flags is that all of them could have been easily discovered by --------- --------- but the company made the conscious decision for years to allow Agent --------- to do as he pleased because he was a high earner for the company. Because --------- failed to properly supervise Agent --------- and fully evaluate his outside businesses, he successfully solicited Claimants to invest over $--- million in numerous businesses. These extremely speculative and questionable business adventures have devastated Claimants financially because they have generated no return, have not paid any of the money back, and have, in some instances, been secured using bank loans obtained by --------- ---------. As such, the liability for Claimants in connection with these investments is ongoing and will require --------- --------- to put up more cash to prevent the banks from foreclosing on land he used to secure loans to invest in Agent ---------'s companies.

--------- Securities Had an Affirmative Obligation to Supervise ---------'s Conduct

The Securities and Exchange Commission adheres to the following statement with respect to supervision of representatives:

> Effective supervision by broker-dealers is a critical element in the regulatory scheme and its importance has increased as firms have grown in

> size. As broker-dealers expand their activities…, there must be a concomitant expansion of their supervisory procedures to insure regulatory compliance and sound internal controls. Apart from adopting effective procedures broker-dealers must provide effective staffing, sufficient resources and a system of follow up and review to determine that any responsibility to supervise delegated to compliance officers, branch managers and other personnel is being diligently exercised.

In the Matter of Mabon, Nugent & Co., Release No. 27301, Admin. Proc. File No. 3-6207 (Sep. 27, 1989). This basic responsibility is a foundational part of the securities regulatory scheme. Under Section 15(b) of the Securities Exchange Act of 1934,

> The Commission, by order, shall censure, place limitations on . . ., suspend . . . or revoke the registration of any broker or dealer if it finds . . .that such broker or dealer . . . (E) has failed reasonably to supervise, with a view to preventing violations, another person who is subject to his supervision.

15 U.S.C. § 78o(b)(4). "Reasonable supervision" is defined as:

> Established procedures and a system for applying such procedures which would reasonably be expected to prevent and detect, insofar as practicable, any…violation of the Act by an Associated Person.

See 15 U.S.C. § 78o(b)(4)(E)(i). Supervision is the cornerstone of the securities industry and has been since the founding of the SEC.

1) --------- Must Be Supervised, Regardless of His Compensation or Location

--------- ------- will repeatedly claim Agent ---------'s status as an "independent contractor" absolves it of liability in this case. To the contrary, FINRA and the NASD have long held that a firm has duties to supervise a registered representative, regardless of the location of his office or his compensation arrangement:

> Irrespective of an individual's location or compensation arrangements, **all associated persons are considered to be employees of the firm with which they are registered for purposes of compliance with NASD rules governing the conduct of registered persons and the supervisory responsibilities of the member.** The fact that an associated person conducts business at a separate location or is compensated as an independent contractor does not alter the obligations of the individual and the firm to comply fully with all applicable regulatory requirements.

See NASD Notice to Members 86-65 (emphasis in original), a copy of which is attached hereto as **Exhibit --**. *See also* NASD Notice 98-38 (**Exhibit --**) and Notice 99-45 (**Exhibit --**). The SEC does not recognize the concept of "independent contractors" for

purposes of the Exchange Act. *In re Giordano*, SEC Release No. 34-36742, Admin. Proc. File No. 3-8933 (Jan. 19, 1996). To the extent --------- argues that its duty to supervise Agent --------- is lower or absolved because he was an independent contractor, that argument is meritless.

Based on well-established principles which have consistently been espoused by the SEC, "[i]t is not sufficient for a broker dealer to establish a system of supervisory procedures which rely solely on supervision by branch managers." *In re Prudential-Bache Securities, Inc*., Release No. 34-22755, Admin. Proc. File No. 3-6600 and 3-6601 (Jan. 2, 1986). To the extent supervisory responsibilities are placed upon front line personnel, sufficient funds must be budgeted for these tasks, with efforts also being made to insure that these responsibilities are being properly discharged. *See Mabon, Nugent & Co.*, Release No. 34-19424 (Jan. 13, 1983) (noting that securities firms must "provide effective staffing, sufficient resources and a system of follow up and review to determine that any responsibility to supervise delegated to compliance officers, branch managers and other personnel is being diligently exercised"); *see also Dean Witter Reynolds, Inc*., Release No. 34-46578 (Oct. 1, 2002) (same).

2) --------- Must Follow Up on Red Flags

Supervisors who are confronted by "red flags" of possible misconduct have an obligation to investigate and act. Reasonable supervision requires a firm to take action when a review shows abnormal activities that should put the firm on notice of potential problems. See *In re Wedbush Sec., Inc*., 48 S.E.C. 963 (Mar. 24, 1988). Additionally, a firm can fail in its duty to supervise when it overlooks "red flags" that indicate possible misconduct. *See In re --------- H. Hume*, Rel. No. 34-35608 (Apr. 17, 1995); *In re Randolph K. Pace*, 51 S.E.C. 361, 370 (1993). On the other hand, if a firm is not following procedures designed to detect misconduct, and is therefore committing a supervision violation, the firm may never observe the "red flags" that indicate possible misconduct. *See In re Royal Alliance Assocs., Inc*., Rel. No. 34-38174 (Jan. 15, 1997).

Red flags, often described as "indications of violations" or "suggestions of irregularities", may be viewed as indicators that should alert a person familiar with the operations of a brokerage firm that further investigation of specific conduct is necessary to protect against the transgression of established standards. Once such an indication or suggestion manifests itself, the need for prompt action arises:

> Red flags and suggestions of irregularities 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 the federal securities laws.

Kantor, 51 S.E.C. 440, Rel. No. 34-32341 (May 20, 1993).

When suggestions of potential improprieties surface, the need for a substantive inquiry kicks in. Once the offensive conduct is tracked down and analyzed, proper supervisory measures must be implemented. *See Kernweis,* NASD Disciplinary Proceeding No. C02980024 (Feb. 16, 2000). In *Kernweis*, although the firm had committed to monitor the brokers at issue, there was no evidence that any meaningful actions were taken. The NAC further remarked that based upon the duties engendered by Rule 3010, **a supervisor must vigorously investigate red flags or suggestions of irregularities**. The NASD then went on to stress that the oversight measures which were implemented fell short of the mark, **while emphasizing that supervisory personnel must not simply rely upon the unverified representations of employees**.

Supervisory personnel are obligated to pursue events which may raise eyebrows even though there may be only subtle indications of an improper scheme which is still in its infancy:

> The supervisory obligations imposed by the federal securities laws require a **vigorous response even to indications of wrongdoing**. Many of the Commission's cases involving a failure to supervise arise from situations where supervisors were aware only of "red flags" or "suggestions" of irregularity, rather than situations where, as here, supervisors were explicitly informed of an illegal act.

Gutfreund, Release No. 34-31554, at 14 (emphasis added).

If no investigatory efforts are initiated as a result of "red flags" being overlooked, a failure to supervise finding is typically appropriate. *See DBCC v. Corporate Securities Group*, Complaint Number C3A960009, at 8[2]; see also *Bradford Titus*, 63 S.E.C. Docket No. 926, Rel. No. 34-38029 (Dec. 9, 1996). Moreover, an inquiry into the surrounding circumstances, standing alone, is not sufficient - effective supervision also requires effective follow-up and review. *See Department Of Market Regulation v. Yankee Financial Group, Inc.*, at 38 (Dec. 10, 2004); *see also Kirkpatrick Pettis, Smith et al.*, Release No. 34-48748 at 7.

The SEC fined a firm for failing to reasonably detect a Ponzi scheme when it failed to do unannounced audits of a broker's branch office and failed to review the broker's business accounts. *See In the Matter of 1st Discount Brokerage, Inc.,* Release No. 66212A, Admin. Proc. File No. 3-14710 (Jan. 23, 2012), (See **Exhibit 11**). The SEC stated that "**1DB [like ---------] employs an independent contractor broker model,**

[2.] In *Royal Alliance Associates, Inc*., Release No. 38174, 63 S.E.C. Docket No. 1606 (Jan. 15, 1997), the SEC observed that a defense consisting of "failure to detect" arguments by the brokerage firm does not pass muster. After taking all pertinent factors into account, the Commission rejected Royal Alliance's efforts to justify its inaction while instructing as follows: "Many failure-to-supervise cases involve indicators of misconduct, or red flags that should immediately alert management to potential wrongdoing. In circumstances where a firm's compliance and supervision system is inadequate to discover the indications of problematic conduct, **the personal responsibility for supervision cannot be fulfilled by a supervisor who is simply unaware of the indicators**." (emphasis added).

which requires greater supervision than that of a traditional wire house brokerage firm." *Id*. at 4 (emphasis added). The SEC faulted 1st Discount Brokerage for numerous factors:

> 1DB did not have policies and procedures reasonably designed to detect and prevent violations of the securities laws by registered representatives like Park. Had 1DB had such reasonable policies and procedures, it would have likely uncovered Park's fraud. Specifically, had 1DB had reasonable **policies and procedures in the review of the "doing business as" business accounts of its registered representatives, it is likely that 1DB would have observed a substantial influx of money from 1DB's existing customers into Park's business account**, **through which he conducted his Ponzi scheme**.
>
> * * *
>
> 1DB also **failed to conduct unannounced audits** in the Nashville office as specifically required in the firm's procedures. Had 1DB implemented a system to follow its own procedure of **conducting unannounced audits in the Nashville office, it is likely that 1DB would have found evidence of Park's Ponzi scheme**. For example, an unannounced audit would have revealed that Park did not consistently provide signs to indicate to customers his association with 1DB.
>
> * * *
>
> Had 1DB, through Fisher, developed such a system for periodic reviews of the activities of all of 1DB's registered representatives, the HSC would have reviewed Park's activities and would have found several red flags, including inadequate or missing signage that required Park to disclose his association with 1DB, a customer complaint of unauthorized trading, and declining commissions.

See *Id*. at 2-3 (emphasis added).

Respondent Can be Held Directly Liable for Failing to Supervise Agent --------

--------- will argue that it owed no duty to Claimants with respect to --------- 's outside business related investments because it did not approve of the transactions and received no compensation therefrom. This statement is not an accurate representation of the law. In *McGraw v. Wachovia Securities*, 756 F. Supp. 2d 1053 (N.D. Iowa 2010) (*See* **Exhibit --**), the court examined a case factually similar to the case before this Panel. In *McGraw,* the Plaintiffs sued Wachovia Securities and A.G. Edwards for losses sustained in a Ponzi scheme run by Paul Lovegren, a registered representative and employee of the defendants. The Plaintiffs alleged several causes of

action, including those based on *Respondeat Superior* or apparent agency, and secondarily, for negligent supervision, which the court reiterated is a direct cause of action distinct from those reliant upon apparent agency. *Id.* at 1066. The court denied summary judgment for Wachovia and held that it could be directly liable for negligent supervision over its registered representative who executed a Ponzi scheme while registered with the firm.

Thus, Claimants can take two distinct paths to recovery in this case. The first is through claims based on apparent agency or *Respondeat Superior*. The second path is for the direct liability of --------- -------- for negligently supervising Agent --------- who for more than three years illegally sold securities in multiple outside companies to the Claimants and several other --------- clients.

4) Besides Direct Liability for Failure to Supervise, --------- Can Be Liable as a Control Person

Claimants need not demonstrate that --------- actually controlled the specific transactions at issue. A person cannot lawfully engage in the securities business unless he or she is either registered with the NASD/FINRA as a broker-dealer or as a person associated with a broker-dealer. *Hollinger v. Titan Capital Corp*., 914 F.2d 1564, 1573 (9th Cir. 1990), citing 15 U.S.C. § 78o(a)(1) (holding that "a broker-dealer is a controlling person under § 20(a) with respect to its registered representatives"). The *Hollinger* case discusses a broker-dealer's actual control over a registered representative:

> Because a sales representative must be associated with a registered broker-dealer in order to have legal access to the trading markets, the broker-dealer always has the power to impose conditions upon that association, or to terminate it. The broker-dealer's ability to deny the representative access to the markets gives the broker-dealer effective control over the representative at the most basic level. Moreover, because the broker-dealer is required by statute to establish and enforce a reasonable system of supervision to control its representatives' activities, the broker-dealer necessarily exerts ongoing control over the types of transactions made by the representative and her ways of handling clients' accounts.

Id. at 1573-74. The Seventh Circuit has "long recognized that some indirect means of discipline or influence, although short of actual direction, is sufficient to hold a 'control person' liable". *Harrison v. Dean Witter Reynolds, Inc.*, 79 F.3d 609, 614 (7th Cir. 1996). It will be shown that --------- actually exercised general control over Agent ---------'s operations, and that --------- had the power or ability to control the specific transactions at issue, yet it failed to do so.

Good faith is an affirmative defense to control person liability. *Donohoe v. Consol. Operating and Production Corp.*, 30 F.3d 907, 912 (7th Cir. 1994). Because good faith is an affirmative defense, the burden of proving good faith is on the defendants. *Id*. Merely having supervisory manuals and procedures in place, however, may not be sufficient to establish the defense if the procedures are not actually followed in a reasonably diligent manner. *Hollinger*, 914 F.2d at 1576.

Causes of Action
Violation of the Iowa Uniform Securities Act

This is a claim pursuant to the Iowa Uniform Securities Act ("IUSA"), Iowa Code § 502.101, *et seq*. The IUSA, in part, provides that:

> It is unlawful for a person, in connection with the offer, sale, or purchase of a security, directly or indirectly:
>
> 1. To employ a device, scheme, or artifice to defraud;
>
> 2. To make an untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
>
> 3. To engage in an act, practice, or course of business that operates or would operate as a fraud or deceit upon another person.

See IA. Stat. § 502.501. Any person who violates § 502.501:

> may maintain an action to recover the consideration paid for the security, less the amount of any income received on the security, and **interest** at the legal rate from the date of the purchase, **costs**, and **reasonable attorney fees** determined by the court, upon the tender of the security, or for actual damages…

See IA. Stat. § 502.509(2) (emphasis added).

The aforementioned practices, representations and omissions by the --------- and its Agents tended to work a fraud and involved statements that lacked reasonable grounds, and also constituted fraudulent and deceitful practices in connection with the sale of a security. The Respondent's Agent obtained money by way of untrue statements of material facts. --------- is liable for aiding and participating in the violations. The

Claimants reasonably relied on the acts, practices, representations and omissions made by the Respondent and its Agents and as a direct and proximate cause thereof, they were financially damaged.

Should this Panel find the Respondent or its Agent violated the IUSA, the remedy afforded the Claimants is statutorily defined, and by law, the remedy outlined under the IUSA **shall** be awarded. Under the plain language of the statute, the Iowa legislature has mandated that investors who suffered losses in violation of the IUSA are statutorily entitled to a full return of their damages, plus interest, attorney fees and costs. *See* Iowa Code §502.509.

Courts have held that arbitrators, trial judges, and/or juries may not disregard the statutory measure of damages prescribed in securities laws. See *Ainsworth v. Skurnick*, 960 F.2d 939 (11th Cir. 1992); *Scheurenbrand v. Wood Gundy Corp*., 8 F.3d 1547 (11th Cir. 1993); *Specialized Tours, Inc. v, Hagen*, 392 N.W.2d 520, 539 (Minn. 1986); and *Lambrecht v. Bartlett*, 656 P.2d 269 (Okla. 1982). As such, if the Panel finds that the Respondent or its Agent violated the IUSA, they are statutorily mandated to award compensatory damages, interest, attorney's fees, and costs to the Claimants.

Breach of Fiduciary

Respondent owed Claimants fiduciary duties which were breached for the reasons described above. Claimants placed trust and confidence in Respondent and Agent --------- to provide professional, fiduciary investment advice to them, and there has been a breach of that trust to their detriment.

Agent --------- was a fiduciary to Claimants as a matter of law. Case law from around the country establishes that a Financial Advisor owes a legal fiduciary duty to his client. *See Schwartz v. Oberweis*, 826 F.Supp. 280 (N.D. Ind. 1993) ("Oberweis claims that there is no fiduciary duty between a broker and a customer. However, it is well accepted that a broker is a fiduciary to his client."). *See also U.S. v. Dial*, 757 F.2d 163, 168 (7th Cir. 1985) (stating that a securities broker stands in a fiduciary relationship with its customer, and such a duty imposes an affirmative duty of utmost good faith, and full and fair disclosure of all material facts); *Marchese v. Shearson Hayden Stone, Inc*., 734 F.2d 414, 418 (9th Cir. 1984); *Securities & Exchange Commission v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963); *Pfaff v. Petrie*, 71 N.E.2d 345, 348 (Ill. 1947) ("A fiduciary relation exists in all cases in which a confidential relationship has been acquired."); *Burdett v. Miller*, 957 F.2d 1375, 1381 (7th Cir. 1992) (imposing fiduciary duty on securities brokers because a fiduciary relationship arises in situations where "one person has reposed trust and confidence in another who thereby gains influence and superiority over the other."); *In Re Oberweis Securities, Inc.*, 1992 WL

119272 (Bankr. N.D. Ill. 1992); *Gochnauer v. A.G. Edwards & Sons, Inc*., 810 F.2d 1042, 1049 (11th Cir. 1987) (stating that "The law is clear that a broker owes a fiduciary duty of care and loyalty to a securities investor."); *Ward v. Atlantic Security*, 777 So.2d 1144 (Fla. App. 2001); *State ex. rel. PaineWebber v. Voorhees,* 891 S.W.2d 126 (Mo. 1995)*; Glisson v. Freeman*, 532 S.E.2d 442 (Ga. App. 2000); *Beckstrom v. Parnell*, 730 So.2d 942 (La. App. 1998).

Here, the relationship with Agent --------- went beyond that of a mere financial advisor. The Claimants relied on Agent --------- for business, consulting, and tax advice. Agent --------- wore many hats with Claimants, but nevertheless all of them were conducted either through --------- ------ or were approved of by --------- ------. Claimants reposed trust and confidence in Respondent and Agent ---------, especially in connection with the recommendations to invest in the various companies at issue herein. Respondent and agent --------- owed the Claimants several fiduciary duties, including, but not limited to: a) the duty to refrain from engaging in investment activity that was in violation of securities regulations and laws; b) the duty to refrain from engaging in investment activity that was in violation of --------- ----------' internal policies and procedures; c) the duty to disclose all material, known risks in the purchase or sale of a security; d) the duty to disclose every material fact to each transaction truthfully and honestly; e) the duty to perform at a minimum industry-standard supervision and compliance over Agent ---------; f) the duty to act in the best interest of the Claimants; and g) general duties of fair dealing which includes the duty to not only disclose, but to avoid conflicts of interest. Those duties were breached, for the reasons described above. As a direct and proximate result, Claimants have suffered substantial financial damage.

Violations of FINRA Rule 2010

The conduct of the Respondent constituted a willful violation of FINRA Rule 2010 in that, in connection with the purchase and sale of securities, Respondent, individually and/or collectively with its Agent, had the responsibility to observe high standards of commercial honor and just and equitable ---------s of trade; and engaged in acts, practices and courses of business which operated as a breach of such responsibility.

Violation of FINRA Rule 2120

The conduct of the Respondent constituted a willful violation of FINRA Rule 2120 in that, in connection with the purchase and sale of securities, Respondent, individually and/or collectively with its Agent, had the responsibility to not affect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or fraudulent device or contrivance; and engaged in acts, practices and courses of business which operated as a breach of such responsibility.

Violations of FINRA Rule 2111

The Respondent violated FINRA Rule 2111 which provides that "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." --------- -------, through its Agents, recommended that Claimants invest substantially in speculative, unregistered, investments. These recommendations effectuated by Agent --------- were grossly unsuitable and have put Claimants in a precarious financial position.

Violation of FINRA Rule 3110

Respondent violated FINRA Rule 3110 which mandates the implementation of supervisory systems. It is not enough to establish the system and then ignore a financial advisor who is obviously "selling away". There were a sufficient number of "red flags" to have elicited *some* response from supervisory personnel. Agent --------- openly solicited --------- clients to invest in his outside businesses on numerous occasions for years. He openly communicated about these companies through both his --------- and personal email for years. He invested --------- customer money in numerous unregistered securities issued by companies he was affiliated with in direct contravention of FINA Rules. Agent ---------'s brazenness exhibited in selling investments in his outside businesses is a reflection of ---------'s poor supervision and compliance structure, for which Agent --------- clearly had no fear or respect. If ---------- had a robust supervisory and compliance platform that acted as a deterrent in place over Agent ---------, he would have never sold these investments --------- clients.

NASD Notice to Members 98-96 provides that:

> appropriately designed and implemented supervisory systems and written supervisory procedures serve as a 'frontline' defense to protect investors from fraudulent trading practices and help to ensure that members are complying with rules designed to promote the transparency and integrity of the market . . . [I]t is a violation if the member and/or individual fails to enforce a supervisory system and/or written

supervisory procedures.

The Respondent violated each of these FINRA Conduct Rules, which directly and proximately resulted in financial harm to the Claimants.

Negligence and Negligent Supervision

Respondent owed Claimants a duty to use reasonable care in the conduct of their affairs and to abide by securities industry standards and rules. Respondent breached these duties which included the duty to supervise Agent --------- while he sold unregistered securities in his outside businesses to Claimants. As a result, Claimants have lost every dollar invested in these companies, which they would have never invested in had it not been for the solicitation by Agent --------- through --------- Securities. --------- and Agent --------- breached those duties, as previously described, and those breaches were the proximate cause of the Claimants damages.

Respondeat Superior

The conduct of Agent --------- was performed within the scope and course of his employment as an agent of --------- in that, in connection with the purchase and sale of securities, he directly and/or indirectly performed services on behalf of ---------- and --------- directly and/or indirectly induced the acts set forth above; all of the services were performed in the scope and course of the employment of Agent ----------; and therefore Respondent --------- is jointly and severally liable under the common law of the state of Iowa.

Damages

Because of the damages suffered by Claimants as a direct and proximate cause of the acts, omissions, breaches of duties and fraud perpetrated by the Respondent and its Agent, the Claimants requests an award against the Respondent in an amount that includes the following:[3]

1. Actual damages in the amount of $----------;
2. Punitive damages;
3. Interest on the foregoing amount, together with attorney's fees and the costs of this action, pursuant to IA. Stat. § 502.509(2); and

[3] Claimants reserve the right to amend their damages declaration and provide the Panel with a specific per-investment breakdown.

4. Such other and further relief as this Panel deems just and proper.

The Claimants request a hearing location of Des Moines, Iowa.

Respectfully Submitted,

/s/ Andrew Stoltmann
One of the Claimants' Attorneys
Stoltmann Law Offices, P.C.

EXHIBIT C

BEFORE THE FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF DISPUTE RESOLUTION

In the Matter of the Arbitration Between [redacted] and [redacted] Claimants, vs. [redacted]. f/k/a [redacted], Respondent.	FINRA Case No. [redacted] ORAL ARGUMENT REQUESTED

CLAIMANTS' MOTION TO COMPEL THE PRODUCTION OF DOCUMENTS AND INFORMATION

Now come the Claimants, [redacted] and [redacted] (hereinafter "Claimants" or "[redacted]" and "[redacted]") by and through their attorneys, and file the *Claimants' Motion to Compel the Production of Documents and Information.* In support of this motion, the Claimants state as follows:

I. Introduction

This case is about a scheme perpetrated by a long time [redacted] registered representative, [redacted] who used Claimants' access to capital to fund his fraudulent pet projects. This fraudulent scheme involved enticing the Claimants, and other [redacted] clients and employees, to invest substantially in a list of outside business activities being actively engaged in by Agent [redacted] Agent [redacted] managed and ran these various businesses right from his [redacted] Securities branch office. It was open and notorious and even approved of by [redacted] supervision. Over the course of five years, Agent [redacted] caused Claimants to invest upwards of $[redacted] in his side businesses, none of which have materialized into anything remotely successful. Evidence establishes that these entities co-mingled millions of dollars almost all of which was Claimants' money, including money to and from [redacted] – a publicly traded company in which [redacted] disclosed his involvement to [redacted]

Instead of being terminated for cause when it was blatantly clear that he had engaged in multiple violations of outside business and private securities transaction related securities rules, regulations, and [redacted] policies and procedures, [redacted] quietly exited "stage left" on

January 12, 2017. He sold his substantial book of business to a subordinate representative and his supervisor's son for nothing more than a commission trail. A few days later, Agent [redacted] closed on the largest mansion in [redacted] – a 12,175 square foot cathedral. Where Mr. [redacted] obtained the substantial funds to buy this gargantuan home is obvious. He paid himself handsomely for all the "work" he did for [redacted] and the other companies he was managing while affiliated with [redacted] He even put his son [redacted] [redacted] on the payroll of a few of these companies.

Shortly after he closed on the [redacted] mansion, FINRA launched an investigation into Mr. [redacted] and his substantial outside business dealings. Even though the evidence was overwhelming that [redacted] had committed numerous FINRA rule violations, FINRA never interviewed Claimants or Mr. [redacted]'s day-to-day administrative assistant, [redacted] Ms. [redacted] who also worked from the [redacted] office, was the primary administrator for [redacted]'s businesses, executing dozens of transactions, sometimes daily, for these entities during trading hours. FINRA did not believe it necessary to talk to her, or anyone else, as part of its investigation. After about a year, the FINRA investigation ended in an Acceptance, Waiver, and Consent (AWC) wherein [redacted] accepted a fine and a suspension.

[redacted] had knowledge of Agent [redacted]'s involvement with the primary investments at issue in this case, [redacted], and [redacted]. He literally asked for approval from [redacted] to engage in these activities and [redacted] approved them with virtually no due diligence or investigation. These investments were on [redacted]'s supervisory radar at all relevant times. All [redacted] had to do was go to www.Sec.gov and search publicly available filings, like Forms 8-K, 10-K, and 10-Q, that were filed for [redacted] to easily establish that [redacted] was lying to them about his involvement in the company. He disclosed these outside business activities, which were affirmatively approved by [redacted] and [redacted] took no steps to monitor, supervise, or investigate these entities as they were required to do. Had [redacted] simply monitored Agent [redacted]'s or his assistant's email traffic, it would have caught [redacted] red-handed. Instead, the firm buried its collective head in the sand as [redacted] operated brazenly as he used [redacted]'s name and reputation to reel in unsuspecting investors into his schemes.

II. Procedural History

The Claimants' First Request for Production of Documents and Information dated July 1, 2019 is attached as **Exhibit 1**. The Respondent's Response dated August 30, 2019 is attached as **Exhibit 2.** Claimants then forwarded a "meet and confer" letter specific to Claimants' First Request on October 25, 2019 (**Exhibit 3**) and asked that the Respondent respond and produce additional documents by November 4, 2019. A few days later, on October 28, 2019, Claimants served their Second Request for Production. (**Exhibit 4**). On December 11, 2019 the parties had a discussion about several discovery-related issues. On December 27, 2019, Respondent filed its Response to Claimants' Second Request for Production. (**Exhibit 5**). On January 2, 2020, Claimants followed-up with Respondent about

specific search-term and custodians to move the email search process forward, delivering the letter attached as **Exhibit 6**. On January 17, 2020, Claimants sent another "meet and confer" letter. This time, the letter addressed the status of additional discovery pursuant to the December 11, 2019 meeting, and Claimants' Second RFP. (**Exhibit 7)**. On January 20, 2020, Claimants submitted their Third RFP. (**Exhibit 8**). On January 22, 2020, the parties held another "meet and confer" call where they discussed the search terms and email production. The parties also agreed to allow Respondent until February 5, 2020 to formally respond to Claimants' meet and confer letters. On February 14, Respondent provided Claimants an update regarding the email searches, stating over 32,000 documents had been discovered and that the email searches needed to be tweaked some. Claimants conferred and confirmed with Respondent on February 17, 2020 that the tweaks to the search proposed by Respondent was fine with Claimants. On February 29, Respondent stated it hoped to have "all production complete in the next two weeks." Respondent's responded to Claimants' Third RFP on March 20, 2020 (**Exhibit 9**).

March 14 came and went without any additional material document production. To be clear, this production was due before the Covid-19 pandemic constrained working conditions. It was not until March 20, for example, when the State of Illinois banned all non-essential travel, issuing a "shelter in place" order. The State of [redacted] where Respondent's counsel work and reside have issued no such orders and neither has the State of [redacted] where [redacted] is headquartered. Claimants have run out of patience. Although Respondent has produced some responsive documents, Respondent's refusal to respond to any of Claimants' meet and confer letters, in writing, is unproductive. Furthermore, thus far, virtually no emails responsive to the lengthy attempts to meet, confer and narrow the parameters have been produced, notwithstanding Respondent stating there are thousands of responsive records. This hearing is right around the corner. Claimants now need an Order compelling Respondent to produce all documents and information as requested herein.

III. Claimants' First Requests for Documents & Information

As a preliminary point, in response to many requests, Respondent invoked attorney/client or work-product privileges. In the event documents are being withheld pursuant to privilege, Claimants request that Respondent be compelled to identify the privilege being asserted and the grounds for its application. In the event no documents are being withheld from production based on privilege, for those requests to which Respondent responded by invoking a privilege, Claimants request those objections be withdrawn for the sake of clarity.

Claimants' Request For Documents And Information Number 2:
Produce all documents in connection with Agent [redacted]'s disclosure of and any review by Respondent in determining whether to approve or disapprove, of the following outside business activities:

a. [redacted],

b. [redacted]
c. [redacted]
h. [redacted]
m. and any other outside business activity engaged in by [redacted]

Respondent's Response:
Mr. [redacted]'s U-4 and U-5 for the relevant time period (which reflect the disclosure of his OBAs) have been produced. Respondent further agrees to produce OBA approval forms submitted by Mr. [redacted] to Respondent and final OBA approvals for Mr. [redacted] Beyond the foregoing, Respondent objects to this Request as vague, ambiguous, overly broad, unduly burdensome, seeking irrelevant documents, seeking confidential and proprietary documents, and potentially seeking documents protected by privilege.

Discussion:
Respondent has produced [redacted]'s U-4 and U-5 that reflect the OBA disclosures, along with OBA approval forms, final approvals, and a handful of other related records. Beyond that, Respondent objected to producing any additional responsive documents. This request seeks internal documents specific to the deliberations, if any, by [redacted] in deciding to approve [redacted]'s OBAs. Responsive documents would include internal email and message correspondence amongst and between those decisionmakers at [redacted] responsible for approving, or disapproving, of any OBA request, and notes or other memoranda taken during any meetings where [redacted]'s request for OBAs were deliberated.

[redacted] was operating a massive multi-million scheme from his [redacted] Financial office in [redacted] and was recruiting individuals from his [redacted] office to invest in the deals The scam began with [redacted] – which was disclosed and approved of as an OBA by [redacted] [redacted] disclosed an affiliation with [redacted] [redacted], another scam. Claimants are therefore entitled to more discovery about the disclosure, approval, or disapproval of any OBAs requested by [redacted] than the selected documents volunteered by Respondent.

Claimants' Request For Documents And Information Number 3:
Produce all log-books, sign-in sheets, or any other written record of those in attendance at meetings held at Agent [redacted]'s [redacted] Office from 2013- 2017 which include Claimant, [redacted], and/or [redacted].

Respondent's Response:
Respondent has conducted a good-faith search for notes or records of meetings between Claimants and Mr. [redacted] and produced the responsive documents that were located. Beyond the foregoing, Respondent objects to this Request as vague, overly broad, unduly burdensome, and seeking irrelevant documents. Without waiving these objections or its general objections, Respondent states that no general "log books" or "sign-in sheets" were kept in the ordinary course of business recording meetings held at the [redacted] branch office.

Discussion:
Upon information and belief, the front desk at the [redacted] office had a guest sign-in log. [redacted] held numerous meetings – even "board" meetings for many of these outside companies – at the [redacted] office. He did not attempt to hide these meetings and multiple individuals, including his supervisors, knew about them. Those logs are relevant because they provide documentary evidence establishing that people known to have been at meetings at the [redacted] office, were in fact there, specifically [redacted] and [redacted]. If Respondent insists that no documents responsive to this request exist, then it should be compelled to provide an affirmation in writing to that effect.

Claimants' Request For Documents And Information Number 4:
Perform a system-wide email search and produce all emails which refer to or relate to any of the following entities:

a. [redacted]
.
m. and any other outside business activity engaged in by [redacted]

Respondent's Response:
Respondent will produce non-privileged emails sent or received by Mr. [redacted] during the time period at issue that contain the terms listed in items a through l above to the extent they exist and can be located after a reasonable search. Beyond the foregoing,

Respondent objects to this Request on the basis that it is vague, ambiguous, overly broad, unduly burdensome, seeks irrelevant documents, and potentially seeks the private and confidential documents of non-parties. Respondent further objects to this Request to the extent that it calls for the production of documents protected by the attorney-client privilege and/or work-product doctrine.

Discussion:
Initially, [redacted] only agreed to produce [redacted] specific emails. To date even those documents have not been produced. Additional efforts to meet and confer have provided Respondent with a list of custodians to search and to date, only a handful of responsive documents have been provided, even though [redacted] has represented to us that more than 20,000 email hits were returned for these search parameters. It is suspected [redacted] has thousands of documents responsive to this request. These documents must be produced immediately.

Claimants' Request For Documents And Information Number 5:
Produce the hard drive and any secondary storage drive or device for the "second computer", as pleaded in the Statement of Claim at 7, which was located in the [redacted] office for inspection by Claimants' Counsel.

Respondent's Response:
Respondent objects to this Request as overly broad, unduly burdensome, and seeking irrelevant documents. Respondent further objects to the extent the Request seeks documents protected by the work-product doctrine and/or the attorney-client privilege or documents that are confidential and proprietary. Respondent also objects to this Request insofar as the Request extends to private and confidential materials concerning individuals who are not parties to this litigation. Without waiving these objections or its General Objections, Respondent states that it does not have possession of a "second computer" as pleaded in the Statement of Claim.

Claimants' Request For Documents And Information Number 6:
Produce a mirror image copy (a bit-by-bit reproduction of a hard drive that ensures the computer system is not altered during the imaging process) of all electronic data contained on the "second computer" as pleaded in the Statement of Claim at 7. The mirror image should include active files, deleted files, deleted file fragments, hidden files, directories, and any other data.

Respondent's Response:
Respondent objects to this Request as overly broad, unduly burdensome, and seeking irrelevant documents. Respondent further objects to the extent the Request seeks documents protected by the work-product doctrine and/or the attorney-client privilege or documents that are confidential and proprietary. Respondent also objects to this Request insofar as the Request extends to private and confidential materials

concerning individuals who are not parties to this litigation. Without waiving these objections or its General Objections, Respondent states that it does not have possession of a "second computer" as pleaded in the Statement of Claim.

Discussion:
Respondent responded by levying largely inapplicable, contradictory, and unresponsive objections and stated further that it does not have possession of a "second computer" as pleaded in the Statement of Claim. First, [redacted] knows the computer existed because he saw it and [redacted] and his staff talked about it openly. That begs a very important question; where is the computer? If the computer was destroyed, without its contents being backed-up, then [redacted] has a serious spoliation issue on its hands. The interesting issue with Respondent's objections to this request, however, cannot have been levied in good faith unless Respondent had knowledge of this computer and its contents. Otherwise, Respondent could not invoke an attorney/client privilege or a third- party privacy objection unless it has in fact reviewed the contents of this computer. So, either Respondent has the computer, or makes objections in bad faith.

This computer is critical to this case. Respondent has since suggested that, when [redacted] left [redacted] he was able to waltz right out the door of [redacted] with this computer, without anyone at [redacted] searching it first to determine if he was stealing proprietary [redacted] information, like client lists, contact, and proprietary product information. It is simply unbelievable that this could be the case. In any event, thus far, Respondent has refused to reduce to writing what happened to this computer and it must be compelled to do so.

Claimants' Request For Documents And Information Number 7:
Produce all documents in connection with [redacted] [redacted]'s job description and duties beginning in early 2016. (CRD# [redacted]).

Respondent's Response:
Respondent objects to this request as vague, ambiguous, overly broad, unduly burdensome, seeking irrelevant documents and information, and seeking the private and confidential information of non-parties. Without waiving these objections and its General Objections, Respondent states that [redacted] [redacted]'s position in early 2016 was Field Supervisory Associate, and his role generally was to support supervision at the branch.

Discussion:
During the meet and confer process, Respondent stated it would produce documents reflecting Mr. [redacted]'s job description. To date, those documents have not been produced.

Claimants' Request For Documents And Information Number 9:
Produce all internal correspondence and emails that reference Claimants, their accounts, or the outside activities identified in Request 2.

Respondent's Response:

Nonprivileged correspondence and emails that was sent or received by Mr. [redacted] during the time period at issue and references Claimants or their accounts/contracts that exists and can be located after a good faith search will be produced. Further, Respondent will produce non-privileged emails sent or received by Mr. [redacted] during the time period at issue that contain the terms listed in Request No. 4, items a through l above, to the extent they exist and can be located after a reasonable search. Finally, Respondent will also produce OBA approval forms submitted by Mr. [redacted] to Respondent and final OBA approvals for Mr. [redacted] Beyond the foregoing, Respondent objects to this Request on the basis that it is vague, ambiguous, overly broad, unduly burdensome, seeks irrelevant documents, and seeks the private and confidential documents of non-parties. Respondent further objects to this Request to the extent that it calls for the production of documents protected by the attorney-client privilege and/or work-product doctrine.

Discussion:

The parties met and conferred extensively on search terms and custodians. To date, virtually no responsive documents have been produced. Claimants are entitled to a fulsome document production up through the date the Statement of Claim was filed.

Claimants' Request For Documents And Information Number 11:

Produce all notes, contemporaneous or otherwise, maintained by anyone at [redacted] including entries in any diary or calendar, referencing the Claimants, their accounts, Agent [redacted] or the outside activities identified in Request 2.

Respondent's Response:

Non-privileged documents responsive to this List Item created by Mr. [redacted] relating to Claimants, that were generated during the relevant time period, and were located after a reasonable search have been produced. Beyond the foregoing, Respondent objects to this Request as vague, ambiguous, overly broad, unduly burdensome, seeking irrelevant documents, seeking confidential and proprietary documents, and potentially seeking the confidential information of other customers.

Discussion:

[redacted] has produced some documents responsive to this request. Claimants seek an affirmation from [redacted] that all documents responsive to this request have been produced.

Claimants' Request For Documents And Information Number 13:

Produce the email sent by Agent [redacted] in late December 2016 to his accountant which attached a spreadsheet with information about his outside activities.

Respondent's Response:
To the extent such an email is in Respondent's possession, custody, or control, and can be located after a good faith search, it will be produced.

Discussion:
Claimants have since clarified, thanks to production made by FINRA in response to an Order of Production, that the email was actually sent by [redacted] to his [redacted] Securities' assistant, [redacted] on. December 29, 2016. This document has not been produced.

Claimants' Request For Documents And Information Number 14:
Produce all internal emails, letters, or other correspondence wherein this December 2016 email is referenced, discussed, or commented on in any way by any person.

Respondent's Response:
Respondent objects to this Request as vague, overly broad, unduly burdensome, seeking irrelevant documents, and seeking private and confidential documents of nonparties. Respondent further objects to the extent this Request seeks documents protected by privilege.

Discussion:
Respondent objected to producing any responsive documents based on questionable grounds. This request is not overly broad or unduly burdensome with which to comply. It seeks the production of a specific set of emails or other correspondence that reference or discuss the December 2016 email – the email that [redacted] sent that resulted in him leaving [redacted] weeks later and ultimately launched a FINRA probe. The circumstances around [redacted]'s sudden departure are deeply troubling considering the fact that he was engaging in a massive selling away scheme amounting to tens of millions of dollars and approximately a dozen outside entities at the time his registration with the firm was terminated. At the same time, [redacted] was buying the second largest mansion in [redacted].

There was no reference on his U-5 by [redacted] that [redacted] was terminated for cause or even that he was under an internal investigation at the time of his departure. The chain of events from the moment that email was flagged by compliance, all of the deliberations about it internally, and the actions taken by [redacted] from that point forward are relevant to Claimants' claims that [redacted] is liable for damages sustained even after [redacted] left [redacted] because there was no warning, no contact, no alert of any sort that [redacted] was actually busted red-handed in December 2016. Instead of being terminated for cause, he was allowed to sell his substantial book of business to his direct supervisors' son, all the while continue to defraud [redacted] [redacted] and then his father [redacted] and many other [redacted] and non-[redacted] clients.

Claimants' Request For Documents And Information Number 16:
Produce all emails, notes, letters, or other correspondence between Agent [redacted] and on the one end and [redacted] on the other.

Respondent's Response:
Respondent objects to this Request on the basis that it is overly broad, unduly burdensome, seeks irrelevant documents, and seeks the private and confidential documents of non-parties. Respondent further objects to this Request to the extent that it calls for the production of documents protected by the attorney-client privilege and/or work-product doctrine.

Discussion:
Respondent objected to producing any responsive documents, even invoking "attorney client privilege." [redacted] was not [redacted]'s attorney. The objections are baseless, frivolous, and not set forth in good faith. The parties discussed limiting these emails to those referencing Claimants, their accounts, or any of the outside business entities so identified. To date, very few documents responsive to this request have been produced.

Claimants' Request For Documents And Information Number 17:
Produce all emails, notes, letters, or other correspondence between [redacted] and on the one end and [redacted] on the other, from June 1, 2016 to June 1, 2018, which discuss or relate to Agent [redacted] his business, or Claimants in any way.

Respondent's Response:
Respondent objects to this Request on the basis that it is vague, ambiguous, overly broad, unduly burdensome, seeks irrelevant documents, and seeks the private and confidential documents of non-parties. Respondent further objects to this Request to the extent that it calls for the production of documents protected by the attorney-client privilege and/or work-product doctrine.

Discussion:
Once again, Respondent invokes baseless objections like the attorney/client privilege in response to a request that does not involve or even contemplate attorneys. [redacted] was [redacted]'s immediate supervisor at all times relevant. [redacted] is his son and was the young financial advisor that was the beneficiary of [redacted]'s massive book of business sold for a fraction of the true worth of the book when [redacted] walked out [redacted]'s door quietly on January 12, 2017. Any communications between [redacted] and [redacted] that reference [redacted] his business, or Claimants in any way are relevant and should be produced immediately.

Claimants' Request For Documents And Information Number 18:

Produce all documents in connection with the sale of Agent [redacted]'s book of business to [redacted].

Respondent's Response:

Respondent objects to this Request on the basis that it is vague, ambiguous, overly broad, unduly burdensome, seeks irrelevant documents, and seeks the private and confidential documents of non-parties. Respondent further objects to this Request to the extent that it calls for the production of documents protected by the attorney-client privilege and/or work-product doctrine.

Discussion:

Notwithstanding the baseless objections, Respondent has produced the documents memorializing the deal between [redacted] and [redacted]. Claimants' request seeks documents beyond this production, including discovery into negotiations, deliberations, compliance communications, and any other documents in connection with [redacted] selling his substantial book of business to his supervisor's son for nothing more than a graduated commission trail.

Claimants' Request For Documents And Information Number 19:

Produce all documents, including correspondence with Agent [redacted] or his representatives, attorneys, or anyone purporting to act on his behalf, having anything to do with: a) his outside businesses; b) his resignation from [redacted] or c) the information disclosed on Agent [redacted]'s Form U-5 regarding said registration.

Respondent's Response:

In response to other requests herein, as well as in its 12506 responses and objections, Respondent has agreed to produce a number of categories of responsive documents, including [redacted]'s Form U-5, his outside business activity forms, and communications regarding those outside activities, among other documents. If Claimants want to propound specific requests for specific categories of additional documents, Respondent will respond by either objection or production. Beyond the foregoing, Respondent objects to this Request as vague, ambiguous, overly broad, unduly burdensome, seeking irrelevant documents, and seeking private and confidential documents and information.

Discussion:

Respondent objected to this request by basically telling Claimants to request more specific documents. That, of course, is impossible since Claimants have no way of knowing what universe of documents may exist that are responsive to this request. As such, a broad request seeking the production of specific categories of relevant documents, such as those requests herein, is clearly permitted. What Claimants seek are communications between [redacted] and [redacted]'s attorneys at [redacted] in connection with the FINRA investigation, his resignation from [redacted] or the contents of his U-5 and the disclosures or non-disclosures made therein. Claimants are also entitled to documents evidencing when [redacted]'s clearance to access [redacted] clients' account information was formally revoked. Since he and his staff

were all apparently allowed to walk out the door with their computers that contained sensitive, confidential client information, the extent of the gross Regulation SP violations are certainly relevant to [redacted]'s overall compliance structure and its failures. Respondent should produce all documents responsive to this request immediately.

Claimants' Request For Documents And Information Number 20:
Produce all written correspondence with FINRA in connection with the AWC entered into by Agent [redacted] with FINRA.

Respondent's Response:
This Request appears to be duplicative of or overlapping with Request Nos. 2, 4, 9, and 11 above. As such, Respondent directs Claimants to its responses to those Requests. Beyond the foregoing, Respondent objects to this Request as vague, overly broad, unduly burdensome, seeking irrelevant documents, seeking private and confidential documents, and potentially seeking documents protected by the attorney-client privilege.

Discussion:
Respondent claims this request is duplicative of Nos. 2, 4, 9, and 11. This request is more nuanced than how [redacted] interprets it. By actually approving [redacted]'s affiliation with [redacted] and [redacted], Respondent also had a responsibility to determine the scope of those activities and to monitor them on an ongoing basis, through, amongst other things, follow-up questions, emails, meetings, anything that could be considered actual compliance and surveillance of [redacted] and his myriad businesses, in order to ensure he wasn't misleading clients, or engaging in business conduct that would conflict with [redacted]'s business. [redacted] also approved [redacted]'s affiliation with [redacted]. [redacted] cannot simply approve an OBA and then shut their eyes about those exact approved activities. To date, [redacted] has produced some documents responsive to this request. However, Claimants have no idea if [redacted] has produced the universe of documents responsive to its approval, supervision, and ongoing monitoring of [redacted]'s approved outside business activities, all of which led directly to every "non-disclosed" outside business.

Claimants' Request For Documents And Information Number 21:
Produce all documents, including internal emails, all answers and written responses to Rule 8210 requests for information, in connection with AWC # [redacted] (SOC Ex. 5).

Respondent's Response:
Respondent objects to this Request as overly broad, unduly burdensome, seeking irrelevant documents, and seeking private and confidential documents of nonparties. Respondent further objects that this Request seeks confidential communications and materials exchanged with regulators that Claimants are not entitled to obtain. *See, e.g.*, *Midwest Gas Servs., Inc. v. Indiana Gas Co.*, 2000 WL 760700, at *1 (S.D. Ind. 1999) ("Cloned discovery," requesting all documents produced or received during other

litigation or investigations, is irrelevant and immaterial unless the fact that particular documents were produced or received by a party is relevant to the subject matter of the instant case. . . . The plaintiffs' counsel must do their own work and request the information they seek directly."). Respondent also objects on the basis that the Request seeks documents protected by the attorney-client privilege and/or work-product doctrine. Without waiving its objections, Respondent states that pursuant to Claimants' request, the Chair in this matter has executed a subpoena to FINRA for documents in connection with AWC # [redacted].

Discussion:

Respondent objected by invoking privileges that do not exist as a matter of law. *See, e.g. LaMorte v. Mansfield*, 438 F.2d 448, 451 (2nd Cir. 1971), holding that documents in a party's possession are not privileged simply because they were exchanged with regulators; the privilege belongs to the regulator, not the party in possession. Moreover, Claimants also are not seeking "cloned discovery", even if they were, Claimants only need to establish the relevance of the records to Claimants' case. *See Peterson v. Wright Med. Tech., Inc.* 2013 U.S. Dist. LEXIS 23883 *14 (C.D. Ill. February 21, 2013), where the court distinguished overly broad requests "for all documents" or for "all investigations" as opposed to more narrowly tailored, specific requests like the request here.

[redacted] confuses this request with Claimants' subpoena to FINRA for the regulator's file in connection with this investigation. Those records have been produced, and have been provided to Respondent. This request, however, requests internal records from [redacted] not in FINRA's possession, like emails between [redacted] employees and potentially [redacted] and his lawyers, about this FINRA investigation. Claimants allege that there was essentially a cover-up conducted by [redacted] and [redacted] in order to insulate both parties from a wide ranging, publicized investigation into [redacted]'s fraudulent business activities and selling away scheme. Claimants are entitled to a fulsome document production into these factual allegations to determine the full scope of this scam.

Claimants' Request For Documents And Information Number 22 and 23:

22) Produce all sections of the Firm's Compliance Manual(s) that were in effect during the Time Period, including any separate or supplemental manuals governing the duties and responsibilities of the Financial Advisor and any bulletins (or similar notices) issued by the compliance, supervision, and/or legal departments of the Firm plus the entire table of contents of and index to each such Manual.

23) Produce all sections of the Firm's Supervision Manual(s) that were in effect during the Time Period, including any separate or supplemental manuals, any bulletins (or similar notices) issued by the compliance, supervision, and/or legal departments regarding supervision, which were in effect during the Time Period, plus the entire table of contents and index to each such Manual.

Respondent's Response:

Pursuant to the Parties' Confidentiality Agreement, Respondent produced the tables of contents to the appropriate compliance manuals that were in effect during the time period at issue. Claimants recently identified those sections that they believe to be related to the claims alleged in the Statement of Claim and Respondent will either produce the requested sections or notify Claimants of any sections that it objects to providing. Respondent otherwise objects to this Request as overbroad, unduly burdensome, and seeking irrelevant documents that are proprietary in nature.

Discussion:

Respondent has only produced responsive manual sections as requested by Claimants for years 2013-2014 and thus far have not produced required manuals for 2015 and 2016. These documents should have been produced several months ago. Claimants also request the list of applicable manuals and bulletins required for production under List 1, Item 11.

Claimants' Request For Documents And Information Number 24:

Identify every individual known to [redacted] who invested in any [redacted] outside business, including [redacted] [redacted].

Respondent's Response:

Respondent objects to this Request as vague, ambiguous, overly broad, unduly burdensome, and seeking irrelevant information. Respondent further objects to the Request as an impermissible interrogatory.

Discussion:

Respondent objected to this request in true boilerplate fashion. First, the request is not overly broad because it seeks the identification of select individuals who invested in [redacted] or any of [redacted]'s other outside businesses. The information is relevant to Claimants' supervision claims because the more people [redacted] knew invested in these deals, including [redacted] which was a disclosed OBA, the more widespread the red flags that [redacted] was running a massive selling away scheme. Furthermore, to the extent it is Respondent's contention that [redacted] was in fact driving these investment decisions, the existence of other [redacted] client investors would dictate a far different conclusion. Lastly, this "interrogatory" is precisely that which is allowed under Rule 12507(a) because it is limited to the identification of individuals related to the dispute.

Recently, a FINRA claim was filed against [redacted] on behalf of approximately a dozen [redacted] clients who invested in [redacted] [redacted] based on the solicitation of [redacted] Claimants are entitled to the production of that complaint, along with documents sufficient to identify those investors.

Claimants' Request For Documents And Information Number 25:
Produce all records reflecting supervision of Agent [redacted] and his office in [redacted], including branch examinations, audits, or checklists from 2013-2017.

Respondent's Response:
Please see Respondent's Rule 12506 Responses and Objections to List 1, Items 13(a), 13(b), and 14, and any documents produced therewith. Beyond the foregoing, Respondent objects to this Request as vague, ambiguous, overly broad, unduly burdensome, seeking irrelevant documents, seeking confidential and proprietary documents, and seeking the confidential information of other customers.

Discussion:
Thus far, [redacted]'s document production in response to this request has been underwhelming. Claimants expect a fulsome production of all documents reflecting supervision of any kind over [redacted] including notes from supervisors and other compliance personnel charged with supervising him and his office. [redacted] ran multiple companies right from the conference room in that office under the nose of his various supervisors. This scheme wasn't hidden in the least by [redacted] He held "board" meetings for these various companies from the [redacted] office. He recruited other investors in these schemes from his [redacted] office. He maintained and used a separate, segregated computer for his other businesses; an open "secret" in the [redacted] office. His administrative assistants were intricately involved in managing these entities, including writing hundreds of checks and wire transfer authorizations for "investments" into these entities during trading hours. Based on the brazen nature of [redacted]'s misconduct, it would make sense if there were not much evidence of actual supervision in this case. Claimants, however, are entitled to whatever documents do exist.

Claimants' Request For Documents And Information Number 28:
Produce all documents in connection with all customer complaints (regardless of whether the complaint was disclosable), whether written or verbal, made in any fashion against the Financial Advisor two years prior to the Claimants opening an account through the filing date of the Statement of Claim.

Respondent's Response:
Pursuant to the Parties' Confidentiality Agreement, Respondent will produce written letters of complaint or Statements of Claim against Mr. [redacted] generated during the relevant time period to the extent such documents exist, can be located after a reasonable search, and are in the possession, custody, and/or control of Respondent. Beyond the foregoing, Respondent objects to this Request as overly broad, unduly burdensome, seeking irrelevant documents, and seeking private and confidential

documents of nonparties. Respondent further objects to the extent the Request seeks documents protected by the attorney-client or work-product privilege.

Discussion:
In addition to the recently filed Statement of Claim mentioned above, there are two "denied" complaints on Agent [redacted]'s CRD Report. Also, there exists a complaint letter from [redacted], former CEO of [redacted], demanding [redacted] pay him "his money back" which curiously does not appear on Agent [redacted]'s CRD Report. Claimants are entitled to the production of documents specific to all of these complaints, including letters, responses, or pleadings from the complainants.

Claimants' Request For Documents And Information Number 29:
Produce all internal records of any disciplinary action ever taken against Agent [redacted] and his supervisors by any regulator or employer.

Respondent's Response:
No disciplinary action was taken against Mr. [redacted] by Respondent or any regulator for sales practice violations or conduct of a "similar" nature to that alleged in the statement of claim during the relevant time period. Beyond the foregoing, Respondent objects to this Request as vague, overly broad, unduly burdensome, and seeking irrelevant documents.

Discussion:
Respondents inappropriately re-wrote Claimants' request by limiting responsive documents to those involving conduct of a "similar" nature only. That is not what Claimants requested. If [redacted] was disciplined for any misconduct of any sort, it is relevant to supervision and character.

Claimants' Request For Documents And Information Number 33:
Produce all emails and other correspondence amongst and between the individual(s) identified in response to Request 28 and anyone at the Firm specific to Agent [redacted] or the outside activities identified in Request 2.

Respondent's Response:
Respondent objects to this Request as unclear, vague, ambiguous, overly broad, unduly burdensome, seeking irrelevant documents, and seeking private and confidential documents of nonparties.

Discussion:
During the meet and confer process, Claimants clarified that this request actually related back to Request 32, not Request 28. In Request 32, Claimants sought the identification of [redacted]'s supervisors. In response, Respondent identified [redacted], [redacted], and [redacted]. The parties further conferred and these individuals were specifically included in the

list of email custodians Respondent agreed to perform key-word searches. To date, and almost three months after Claimants identified the custodians and search terms, virtually no documents responsive to this request have been produced.

Claimants' Request For Documents And Information Number 35:
Produce W-2s or 1099s for Agent [redacted] from 2010- 2016.

> **Respondent's Response:**
> Respondent has produced Mr. [redacted]'s Producer Earnings Reports for the time period at issue. Beyond the foregoing, Respondent objects to this Request as overly broad, unduly burdensome, duplicative, seeking irrelevant documents, and seeking private and confidential documents of nonparties.

Discussion:
This is a simple request seeking seven documents that go directly to a key fact in this case. [redacted] lived an extravagant lifestyle beyond his means. Literally as he was negotiating his exit from [redacted] he bought the largest home in [redacted] a 12,000 square foot mega-mansion. His legitimate income earned from [redacted] is relevant to determine if his legitimate income could justify the lifestyle he lived, or if he openly lived beyond his legitimate means through absconding with [redacted] clients' funds. During the meet and confer process, Respondent indicated these documents would be produced. Several months later, responsive documents remain outstanding.

Claimants' Request For Documents And Information Number 36:
Produce all documents received from FINRA, the FBI, the SEC, or any state securities regulator, regarding Agent [redacted] or any of the entities identified in Request 2. This request includes, but is not limited to, notices, subpoenas, requests for information, or notice of investigation/inquiry.

> **Respondent's Response:**
> Respondent objects to this Request as overly broad, unduly burdensome, seeking irrelevant documents, and seeking private and confidential documents of nonparties. Respondent further objects that this Request seeks confidential communications and materials exchanged with regulators that Claimants are not entitled to obtain. *See, e.g.*, *Midwest Gas Servs., Inc. v. Indiana Gas Co.*, 2000 WL 760700, at *1 (S.D. Ind. 1999) ("Cloned discovery," requesting all documents produced or received during other litigation or investigations, is irrelevant and immaterial unless the fact that particular documents were produced or received by a party is relevant to the subject matter of the instant case. . . . The plaintiffs' counsel must do their own work and request the information they seek directly.").

Discussion:

Respondent's objections – based on the hocus-pocus "cloned discovery" argument from an unreported case from Indiana – has no application here, as argued above. Lastly, the request merely seeks correspondence or other requests for information, whether formal or informal, from the identified regulators and law enforcement. Claimants are not seeking "all documents" [redacted] sent in response to those letters, at least not in this request.

Claimants' Request For Documents And Information Number 37 and 38:
37) Produce any documents evidencing or identifying how many of the Firm's clients invested in any of the entities identified in Request No. 2.

Respondent's Response:
Respondent objects to this Request as vague, overly broad, unduly burdensome, and seeking irrelevant information. Respondent further objects to this Request as seeking the private and confidential information of other customers.

38) Produce any documents evidencing or identifying how many of the Firm's employees or agents invested in any of the entities identified in Request No. 2.

Respondent's Response:
Respondent objects to this Request as vague, overly broad, unduly burdensome, and seeking irrelevant information. Respondent further objects to this Request as seeking the private and confidential information of non-parties.

Discussion:
Respondent's response to these requests are interesting. Respondent objects to the requests based on the usual boilerplate reasons, but then invokes an objection based on client confidentiality and privacy of non-parties. That must mean, therefore, that in answering these requests for production, Respondent determined that other [redacted] clients and agents did indeed invest in some of the entities identified in Request No. 2. If not, then this is another example of Respondent making baseless objections in bad faith. The information and documents sought are relevant to the size and scope of [redacted]'s scheme. Furthermore, any other investor is potentially a fact witness whom Claimants are entitled to contact, interview, and subpoena if necessary.

Claimants' Request For Documents And Information Number 39:
Produce any and all copies of the Financial Advisor's electronic calendar and contact software, which reference the Claimants, their accounts, or any of the entities identified in Request No. 2.

Respondent's Response:
Respondent objects to this Request on the basis that it is vague, ambiguous, overly broad, unduly burdensome, duplicative, and seeks irrelevant documents. Notwithstanding these objections and the General Objections, Respondent will

produce calendar entries created or maintained by Mr. [redacted] that pertain to Claimants and that were generated during the time period at issue to the extent such documents exist and are located after a reasonable search.

Discussion:
Respondent again seeks to rewrite Claimants' request. Claimants know that [redacted] maintained a detailed electronic planner or calendar. Certainly, his many meetings both in and out of the office regarding [redacted], [redacted], [redacted] etc., are all over this day planner. These would likely include the multiple board of director meetings [redacted] hosted in the [redacted] conference rooms. [redacted] was far too meticulous about his schedule to leave half of his professional life off his day planner. Respondent stated during the meet and confer process that responsive documents would be produced, but thus far, the production is nonexistent. Another fundamental issue has arisen here which is whether [redacted] retained any computer used by [redacted] or his staff, or a backup thereof. During the meet and confer process, [redacted] stated it would report back to Claimants' Counsel about this issue, but thus far has provided no updates. Claimants request the immediate production of these documents.

Claimants' Request For Documents And Information Number 40:
Produce any documents relating to the Claimants in any manner that were received by Respondent via subpoena or Order of Production.

Respondent's Response:
Respondent agrees to produce any documents relating to Claimants received by subpoena under Rule 12512 or Order of Production under Rule 12513 in this matter.

Discussion:
Respondent moved for orders of production months ago seeking documents from Claimants' outside brokerage accounts. To date, it does not appear as if Respondent has served those orders and Respondent has not produced any documents received in connection thereto.

IV. Claimants' Second Request for Documents & Information

Claimants' Second Request Number 3-6:
Produce all 8210 requests, responses thereto, OTR transcripts, or OTR recordings in connection with FINRA AWC No. [redacted], [redacted], [redacted], and [redacted].

Respondent's Response:
Respondent objects to this Request as overly broad, unduly burdensome, seeking irrelevant documents, and seeking private and confidential documents of nonparties. Respondent further objects that this Request seeks confidential communications and materials exchanged with regulators that Claimants are not entitled to obtain. *See, e.g.*, *Midwest Gas Servs., Inc. v. Indiana Gas Co.*, 2000 WL 760700, at *1 (S.D. Ind. 1999)

("Cloned discovery," requesting all documents produced or received during other litigation or investigations, is irrelevant and immaterial unless the fact that particular documents were produced or received by a party is relevant to the subject matter of the instant case. . . . The plaintiffs' counsel must do their own work and request the information they seek directly.").

Discussion:
These FINRA AWCs are all referenced in the Statement of Claim, are attached as Exhibits thereto, and relate specifically to compliance and supervision issues at [redacted] during the relevant time period. Claimants seek specific, limited records directly from the party in possession, as opposed to seeking an Order of Production from FINRA. Respondent objected to these requests based on scope, confidentiality, and that it seeks documents "claimants are not entitled to obtain." In support of this baseless proposition, Respondent cites an unpublished case from the Southern District of Indiana which is about "cloned" discovery, and has no applicability to this case, as argued above.

First, as to scope, these requests are narrowly tailored, seeking specific records, not "all documents" or the proverbial document dump. The requests seeks Rule 8210 requests, written responses thereto, and any OTR transcripts or recordings of witness testimony taken in the course of those investigations. These are simple and direct requests.

Regarding the "cloned" discovery objection, which is absurd, during the meet and confer process, we encouraged Respondent to review *Lamorte v. Mansfield,* 438 F.2d 448 (2d Cir. 1971) and its judicial progeny. Clearly, supervision is the core issue in this case. Regulatory investigations into [redacted]'s supervisory failures are obviously relevant. Since there is no judicially recognized privilege preventing [redacted] from producing these specific records, they should be produced immediately.

Claimants' Second Request Number 8:
Produce all meeting notes or memoranda in connection with the required annual compliance meetings as referenced in Supplementary Material .04 to FINRA Rule 3130.

Respondent's Response:
Respondent objects to this Request on the basis that it is vague, ambiguous, overly broad, unduly burdensome, seeks irrelevant documents, and seeks confidential and proprietary documents.

Discussion:
In response to this request Respondent objected based on scope, relevance, and confidentiality. First, the notes or memoranda regarding the required compliance meetings under FINRA Rule 3130 are relevant to [redacted]'s overall compliance system and process. Supplemental Material .04 states:

Content of Meetings Between Chief Executive Officer and Chief Compliance Officer. Included in this processes requirement is an obligation on the part of the member to conduct one or more meetings annually between the chief executive officer(s) (or equivalent officer(s)) and the chief compliance officer(s) to: (1) discuss and review the matters that are the subject of the certification; (2) discuss and review the member's compliance efforts as of the date of such meetings; and (3) identify and address significant compliance problems and plans for emerging business areas.

[redacted] is required by rule to hold these meetings at least yearly, the annual compliance certificates produced attest to that fact. Surely there are notes or memoranda memorializing those meetings and what was discussed. The confidentiality objection is totally meritless since the parties to this case are bound by a confidentiality agreement. Claimants request an Order compelling the production of all responsive documents, from 2012-2017, immediately.

Claimants' Second Request Number 9:
Produce all reports required to be provided pursuant to FINRA Rule 3130 and Supplementary Material .10.

Respondent's Response:
Respondent objects to this Request on the basis that it is vague, ambiguous, overly broad, unduly burdensome, seeks irrelevant documents, and seeks the private and confidential information of nonparties. Respondent further objects to this Request to the extent that it calls for the production of documents or information protected by the attorney-client privilege and/or work- product doctrine.

Discussion:
In response to this request Respondent objected based on scope, relevance, and confidentiality. The compliance certificates produced confirm the existence of these reports. They are directly related to compliance and supervision on a macro level at [redacted] and are clearly relevant to this case. There is a confidentiality agreement in force so this objection has no merit. The reports should be produced immediately.

V. Claimants' Third Request for Documents & Information

Claimants' Third Request Number 2:
Produce all documents in connection with a life insurance policy on the life of [redacted] purchased by [redacted], procured by [redacted] and [redacted] and/or [redacted] in or about March 2016.

Respondent's Response:
Respondent objects to this Request on the basis that it is vague, ambiguous, overly broad, unduly burdensome, and seeks irrelevant documents. Respondent also objects

on the basis that the Request seeks the private and confidential information of nonparties.

Discussion:
Mr. [redacted] was an executive for [redacted], one of the massive selling-away companies at issue. In March 2016, [redacted] who was still a registered representative for [redacted] caused a key-man policy to be procured by [redacted] and another registered representative [redacted], for [redacted] with [redacted] being the beneficiary. Any documents, excluding any health-related information for [redacted], are relevant to this case because they related directly to one of the dozen undisclosed outside businesses being actively run by [redacted]

Claimants' Third Request Number 3:
Produce all documents in connection with [redacted]'s investments in [redacted] Innovation, or any of the investments at issue in this proceeding.

Respondent's Response:
Respondent objects to this Request on the basis that it is vague, ambiguous, overly broad, unduly burdensome, seeks irrelevant documents, and seeks the private and confidential information of nonparties. Subject to and without waiving the foregoing objections, [redacted] did not invest in [redacted] Innovation or any of the entities at issue through accounts with Respondent.

Discussion:
Notably, Respondent did not deny having documents responsive to this request, only that [redacted] apparently did not invest in [redacted] through her [redacted] Securities accounts. Ms. [redacted] was, and may still be, a [redacted] client. She invested substantially in [redacted] and upon information and belief was asked to be on the company's Board. Mr. [redacted] stated under oath to FINRA Enforcement that other than Mr. [redacted] no other clients invested in these outside businesses. Evidence establishing otherwise is clearly relevant to impeach both the credibility of Mr. [redacted] and constitute more red flags missed by [redacted]

Claimants' Third Request Number 6:
Produce a copy of [redacted] [redacted]'s computer used at the [redacted] Financial office. If the computer is either no longer in your client's possession, or it has been destroyed or repurposed, identify the date of the destruction or repurposing. If any backup storage was retained, please provide a mirror-image of said backup drives.

Respondent's Response:
Respondent states that it does not have the responsive computer. [redacted] [redacted]'s company-issued laptop was returned to the home office on July 14, 2017, and was

wiped clean at that time pursuant to Respondent's normal procedures. That same laptop remained in the home office with periodic use until late 2018, at which time it was retired.

Discussion:
This response is truly troubling for a number of reasons. First, as of July 2017, there was an ongoing investigation by FINRA into [redacted] and his outside business activities. Admitting that this laptop, which contained gigabytes of evidence, was "wiped clean" during a regulatory investigation is shocking. Respondent references its "normal procedures" but has not produced a single document establishing these procedures. Furthermore, Claimants are entitled to a more thorough response, notably one that explains who returned the laptop to the home office, because as written, this response suggests [redacted] was allowed to take this computer with him when he left, and he sent it back seven months later. Claimants request clarification along with the identification of the individuals at [redacted] – not their lawyers – who can testify about the chain of custody of this computer. Claimants are also entitled to know what happened to [redacted]'s computer, which upon information and belief was the nerve center for all of [redacted]'s businesses.

Claimants' Third Request Number 7:
Produce all documents reflecting any analysis or supervision of [redacted]'s computer(s), or those of his registered assistants ([redacted] and [redacted]) in use on the premises of the [redacted] branch office.

Respondent's Response:
Respondent objects to this Request on the basis that it is vague, ambiguous, overly broad, unduly burdensome, and seeks irrelevant documents. Subject to and without waiving the foregoing objections, Respondent points to its manuals and other supervisory documents, which have already been produced. Respondent further states that while various monitoring software was utilized for supervision at various times, there are no responsive materials in existence. Respondent further states that [redacted] and [redacted] were both non-registered fingerprint only (NRFO) assistants and were not [redacted]'s employees.

Discussion:
Respondent provides a glimpse into its alleged defenses in this response. The policy of both FINRA and the Securities and Exchange Commission in this regard has always been clear:

> Irrespective of an individual's location or compensation arrangements, **all associated persons are considered to be employees of the firm with which they are registered for purposes of compliance with NASD rules governing the conduct of registered persons and the supervisory responsibilities of the member. The fact that an associated person conducts business at a separate location or is compensated as an independent contractor does not**

alter the obligations of the individual and the firm to comply fully with all applicable regulatory requirements.

See NASD Notice to Members 86-65, NASD Notice 98-38 and Notice 99-45. The SEC does not recognize the concept of "independent contractors" for purposes of the Exchange Act. *In re Giordano*, SEC Release No. 34-36742, Admin. Proc. File No. 3-8933 (Jan. 19, 1996). Clearly, Respondent's suggestion that somehow its supervisory obligations are lower or lessened merely because [redacted] and [redacted] were independent contractors lacks merit. Moreover, the manuals that [redacted] has produced establish that they have all sorts of supervisory obligations over so-called NRFOs. It just so happens in this case that one of these NRFOs was devoting an unbelievable amount of time during trading hours running the books and records of Agent [redacted]'s substantial outside businesses that were used to defraud [redacted] clients out of millions of dollars of their hard-earned funds.

Claimants' Third Request Number 36:
Produce all documents in connection with the investment by [redacted] in [redacted] or any of the other investments at issue.

Respondent's Response:
Respondent objects to this Request as vague, ambiguous, overly broad, unduly burdensome, seeking irrelevant information, and seeking the private and confidential information of other customers who are not parties to this matter.

Discussion:
Similar to Third Request Number 3, Claimants are entitled to discovery into other [redacted] clients who invested in [redacted] or any of the outside businesses engaged in by Agent [redacted] Any privacy interests are remedied by the existence of a confidentiality agreement. [redacted] continuously hides behind vague privacy rights without identifying them or establishing how they apply. The discovery sought is relevant and should be produced.

Claimants' Third Request Number 38:
Produce the email, and all attachments, sent to [redacted]'s [redacted] email address from [redacted] on December 29, 2016 which contained a matrix of [redacted] assets.

Respondent's Response:
Respondent objects to this Request as overly broad, unduly burdensome, seeking irrelevant information, and seeking the private and confidential information of non-parties. Subject to and without waiving the foregoing objections, Respondent states that, after a good faith search, no responsive documents were located in its possession, custody, or control.

Discussion:

Respondent's response is problematic, because there is a serious disconnect between reality and [redacted]'s document retention. According to requests by FINRA sent to Mr. [redacted]

> Included with this letter as Attachment A is a matrix of [redacted] Assets that you e-mailed to [redacted]'s [redacted]-retained e-mail address on December 29, 2016.

This document is found in the FINRA production and is labeled FINRA-00000492. FINRA made sure in this request to specify that this email was sent to Ms. [redacted]'s "PSI-retained e-mail" ([redacted] referring to [redacted]). This email exists somewhere, and [redacted] is obligated by SEC document retention rules to preserve it. Only three business days after this email was sent, [redacted] walked out the door at [redacted] computers in hand, to continue to run his fraud ring to ruinous ends. Interestingly, [redacted]'s response to the letter where this information was posited by FINRA is dated July 14, 2017 – the very same day his laptop was wiped by [redacted]

Claimants' Third Request Number 39:
Produce all documents, emails, notes, or memoranda which reference or relate to the December 29, 2016 email delivered to [redacted] or its contents and attachments.

> **Respondent's Response:**
> Respondent objects to this Request as overly broad, unduly burdensome, seeking irrelevant information, and seeking the private and confidential information of non-parties. Subject to and without waiving the foregoing objections, Respondent states that, after a good faith search, no responsive documents were located in its possession, custody, or control.

Discussion:
The email at issue included an attachment that basically was the best evidence possible that Agent [redacted] was involved in a massive selling away scheme. It was a matrix identifying tens of millions of dollars in purported investments in numerous companies – some disclosed, others not disclosed. The compliance response from this, once [redacted] got around to finding it, should have been meteoric. Instead, [redacted] walked, along with his staff, a few weeks later and bought a multi-million-dollar house.

VI. Conclusion

WHEREFORE, Claimants respectfully request an Order from the Panel compelling all documents and information sought herein. Claimants also request oral argument on their motion.

Respectfully Submitted,

EXHIBIT D

BEFORE THE FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF DISPUTE RESOLUTION

In the Matter of the Arbitration Between

[redacted] et al,

Claimants,

FINRA Case No. [redacted]

vs.

[redacted] SERVICES, INC.,

Respondent.

CLAIMANTS' MOTION TO COMPEL DISCOVERY

Claimants hereby submit their Motion to Compel Discovery. In support of this motion, the Claimants state the following:

I. Introduction

This case is about a financial adviser, [redacted] ("Agent [redacted] a registered representative of Respondent [redacted] who sold his brokerage clients, including the Claimants, illegal, unregistered, and fraudulent private investment offerings. Agent [redacted] sold several [redacted] customers fraudulent investments in an entity called [redacted] Companies, Inc. ("[redacted] This alleged investment was fraudulent and resulted in a criminal investigation headed-up by the FBI. The owner of [redacted] was [redacted], who was Mr. [redacted] Uncle. He killed himself in his car, surrounded by FBI agents. To date, Claimants have not received a dollar back from [redacted] and there is no indication whatsoever that any funds will ever be available to reimburse these victims. This massive fraud was facilitated by Agent [redacted] who abused the trust and confidence reposed in him by his clients, many of whom he befriended. Agent [redacted] was a registered, licensed representative with [redacted] at all times relevant, who despite being warned on numerous occasions for his low production, did very little to dissuade him from "selling away". In fact, [redacted] sat idle while its clients were defrauded by Agent [redacted]

In order for the Panel to find [redacted] liable for Agent [redacted] misconduct, it must either find Agent [redacted] was acting as an apparent agent of [redacted] when selling securities issued by [redacted] Companies or, alternatively, find that [redacted] failed to reasonably supervise Agent [redacted] Further, [redacted] can be liable under the theory of *Respondeat Superior* if this Panel determines [redacted] business enterprise created and fostered [redacted] misconduct. Clearly, his registration with [redacted] allowed [redacted] to access clients like Claimants and their money to fund this fraudulent investment. Further, the lack of compliance and supervision failed to deter and detect [redacted] misconduct. Supervision, therefore, and the existence of "red flags" of potential misconduct are exceptionally relevant to this case. As such, Claimants are entitled to discovery into those issues.

In its Reply to Claimants' Objection to Respondent's Motion for Issuance of Subpoenas, [redacted] wrote the following:

> **The touchstone for all civil discovery is that the parties are entitled to unrestricted access to all sources of potentially relevant information.**

See *Reply* at 1. Claimants request the Panel use this standard as set forth by [redacted] in adjudicating this motion. Thus far, [redacted] has failed to produce numerous material and relevant sets of documents necessary for Claimants to effectively prosecute their claims.

II. Procedural History

On January 26, 2017, Respondent served its written responses and objections to the Discovery Guide, List 1. (**Exhibit 1**). On March 17, 2017, Claimants served [redacted] with their First Request for Documents and Information. (**Exhibit 2**). [redacted] provided written responses and objections to Claimants' First Request on May 16, 2017. (**Exhibit 3**). On July 6, 2017, almost seven months after the initial production was due under Rule 12506, Claimants sent a short letter to [redacted] informing them their Rule 12506 production was long overdue. (**Exhibit 4**). A week later Respondent produced 2,576 pages of documents, virtually all of it consisting of new account forms and account statements. On August 7, 2017, Claimants served their Second Request for Production. (**Exhibit 5**). On September 28, 2017, Claimants sent a "meet and confer" letter to Respondent, identifying specific List Items and discovery requests that had gone unsatisfied to date. (**Exhibit 6**). In response to the letter Counsel held a teleconference on October 2, 2017 to further the meet and confer process and some agreement was reached that resulted in the production of some additional discovery. To date, many of the items Respondent agreed to provide responsive documents for have still

gone unresolved. Further and unfortunately, the recent written response and objections to Claimants' Second Request for Production (**Exhibit 7)** has made any additional "meet and confer" efforts impossible given the proximity to the arbitration hearing.

a. Affirmation in the Event no Responsive Documents Exist.

To the extent Respondent contends "no responsive documents exist" to any specific List Item or Request for Production, Claimants request an affirmation from an [redacted] employee with knowledge of the search who can attest to the extent of the search (i.e., what search terms were used for an email pull for example), and that after said search, no responsive documents exist. Affirmations by Counsel will not suffice. Claimants need this signed affirmation from someone they can call as a witness to testify about the Firm's document retention procedures and search protocols.

b. Invocation of Privilege with Precision.

In response to numerous requests, Respondent objects and invokes blanket privileges without foundation. In the event Respondent has knowledge that documents responsive to a particular request exist – meaning [redacted] actually performed the search for them – and that after said search was performed, certain documents exempt from production based on a privilege were discovered, Claimants request an order compelling the following:

1) the identification of the document exempt from production based on privilege; and
2) the identification of the privilege, along with the basis for its application.

Claimants cannot adequately prosecute their case if documents are being withheld based on privilege without any basis. It is Respondent's burden to establish the grounds for the invocation of a specific privilege. [redacted] cannot simply state reams of documents are protected by a specific privilege without providing a basis for its application.

III. List Items and Document Requests For Which Respondent Agreed to Provide Documents or an Affirmation.

List 1, Item 7(a):

During our "meet and confer" conference on October 2, Respondent agreed to produce documents responsive to this List Item. To date, no responsive documents have been produced. This List Item clearly calls for "[a]ll notes or memoranda evidencing supervision, compliance, or managerial review…of the associated persons assigned to the customer parties' accounts…". This is not a Claimant-specific List Item. Claimants expect the production of every branch audit, checklist, Q/As, managerial reviews, or compliance analyses, having anything to do with Agent [redacted]

List 1, Item 7(b):
This Item calls for the production of "all correspondence between the customer parties and firm/associated persons relating to the customer parties' claims, accounts, transactions, or products or types of products at issue bearing indications of managerial, compliance, or supervisory review of such correspondence. During the Parties' meet and confer teleconference, Respondent agreed to perform an email pull for "[redacted] Companies", "[redacted] "[redacted]", and "[redacted]". No documents responsive to this List Item have been produced. Importantly, Agent [redacted] communicated via email with Claimants about the [redacted] Companies investment. The real issue at this late stage of the proceeding is that there is no indication [redacted] has even searched for these records, let alone produced responsive ones.

List 1, Item 9:
No responsive documents have been produced. The limitation placed on this List Item by [redacted] is inappropriate. All records of communications between [redacted] and his supervisors, branch managers, complex managers, regional managers, or anyone in compliance that at all touch on [redacted] Companies is relevant and must be produced. In the event [redacted] determines that no responsive documents exist, Respondent must provide an affirmation as requested above.

List 1, Item 13(b):
During the Parties' meet and confer conference, Respondent's Counsel stated he needed to double-check with his client about these records. To date, no documents responsive to this List Item have been produced. This List Item calls for the voluntary production, "[f]or claims alleging failure to supervise, 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…" As [redacted] knows, this is a supervision case. All documents and information having to do with Agent [redacted] and his supervision is relevant for discovery purposes.

List 1, Item 16:
This List Item requires the production of "All investigations, charges, or findings by any regulator (state, federal or self-regulatory organization) and the firm/associated persons' responses to such investigations, charges, or findings for the associated persons' alleged improper behavior similar to that alleged in the Statement of Claim."

Claimants expect the production of all responsive documents, including FINRA 8210 Requests and Responses, immediately. Furthermore, Claimants are certain the FBI and State of Missouri have ongoing investigations into [redacted] and potentially [redacted] Claimants are also aware that the Missouri Securities Department investigated [redacted] and [redacted] in connection with the allegations in this case. Any documents

reflecting written communications with any authorities in connection with [redacted] Companies and [redacted] must be produced immediately.

List 1, Item 17:
Claimants are entitled to any documents regarding any regulatory inspections of Agent [redacted] office, including copies of search warrants issued to search the premises and inventory lists identifying what materials were seized by any authorities. If no such inspections as contemplated by this List Item took place, Claimants request an affirmation to that end.

List 1, Item 21:
During the Parties' meet and confer conference, Respondent stated it would produce documents responsive to this List Item, which calls for the production of Agent [redacted] compensation agreement and all contracts between [redacted] and [redacted] To date, no responsive documents have been produced.

IV. Claimants' First Request For Production

Claimants' First Request No. 2:
Produce all documents seized from Agent [redacted] branch office having anything to do with Claimants, their accounts, or [redacted] Companies, LLC.

> **Respondent's Response:**
> [redacted] objects to Claimants' use of the word "seized" in their Request as it connotes certain implications. Subject to and notwithstanding the aforementioned objection, all responsive documents will be produced.

Discussion:
During the Parties' meet and confer conference, Respondent stated it would check and see if any responsive documents exist. To date, we have received no responsive documents and no affirmation that a search was performed. Respondent's objection to the word "seized" is noted, but this case is about an [redacted] FA selling investments in a criminal scheme to [redacted] clients. As an example of documents that could have been in [redacted] office, if a [redacted] Companies PPM or offering memorandum was confiscated from [redacted] office, that document is discoverable and must be produced. In order to fully comply with this request, Respondents must identify the [redacted] employees or agents who inspected [redacted] office who can testify to the search and what was collected during that process.

Claimants' First Request No. 6:
Produce copies of all emails between Claimants, [redacted] or Agent [redacted]

Respondent's Response:
[redacted] objects this request to produce as it seeks information that is vague and unclear as to what is sought to be produced. [redacted] further reserves its right to object at a later date should Claimants clarify their request to produce.

Discussion:
During the Parties' meet and confer conference, Respondent stated it would produce responsive emails if Claimants provided their email addresses to facilitate that search. Claimants did no on October 5. To date, not one email has been produced. Claimants also request [redacted] provide evidence that email "pulls" have been performed. Claimants know [redacted] communicated via [redacted] email with clients about [redacted] Companies. A search for all "[redacted] related" emails must also be performed and produced. To that end, Claimants also provided email addresses for [redacted] and [redacted], the two point men at [redacted]

Claimants' First Request Nos. 11-16: Identification of witnesses and production of U-4s and U-5s.

11) Identify the individual responsible for supervising Agent [redacted]

12) For all individuals identified in response to Request No. 11, produce all Forms U-4 and U-5 along with all amendments thereto and customer complaints referenced therein.

13) Identify the individuals who performed onsite supervision over Agent [redacted] office located at [redacted].

14) For all individuals identified in response to Request No. 13, produce all Forms U-4 and U-5 along with all amendments thereto and customer complaints referenced therein.

15) Identify all individuals who performed any onsite inspection or audit of Agent [redacted] office located at [redacted].

16) For all individuals identified in response to Request No. 15, produce all Forms U-4 and U-5 along with all amendments thereto and customer complaints referenced therein.

Respondent's Responses:
As to the identification requests, [redacted] stated "The responsive information will be produced."

As to the requested documents, "[redacted] objects to this request as it seeks information that is burdensome and irrelevant. Subject to and without waiving the aforementioned objections, [redacted] will produce the current CRD for each individual referenced in Request Number 11, 13, and 15."

Discussion:
Respondent agreed to identify the requested individuals but have failed to do so. The production of these witnesses' U-4s and U-5s are routine background documents containing information for cross examination and/or impeachment. These documents are executed under oath and as such go to the credibility of the individuals charged with supervising Agent [redacted]

Claimants' First Request No. 17:
Produce all internal reviews, exception reports, and/or activity reports that reference the Claimants, the Claimants' accounts, or Agent [redacted] in any way.

Respondent's Response:
[redacted] objects to this request as it seeks information that is irrelevant, burdensome, and overly broad. [redacted] further objects as the request seeks the disclosure of information related to non-party clients in violation of privacy laws. Subject to and notwithstanding the aforementioned objects, [redacted] will produce all responsive information related to and/or regarding Claimants and/or Claimants' accounts.

Discussion:
During the Parties' meet and confer conference, Respondent stated it would follow-up with its client about this request, but would not commit to producing responsive documents. [redacted] objection to this request is baseless. FINRA deems these exact documents to be "presumptively discoverable" in every failure to supervise case pursuant to FINRA Discovery Guide, List 1, No. 13(b). Claimants are entitled to the production of all exception/activity reports generated for ALL of [redacted] client accounts. Claimants' First Request 17 is essentially the same as List 1, Item 13(b), but expands the time period. Respondent's privacy objection is meritless because [redacted] through its privacy policy, informs clients that their information could be disclosed in legal or other judicial or quasi-judicial proceeding.

Claimants' First Request No. 18:
Produce all branch examinations, audits, interviews, or other documents establishing supervision of Agent [redacted]

Respondent's Response:
[redacted] objects to this request as it seeks information that is privileged and that it seeks the disclosure of information related to non- party clients. [redacted] will

produce the branch office reviews, branch audits, office examinations, or similar documents for the relevant period with the personal information related to non-party clients redacted.

Discussion:
During the Parties' meet and confer conference, it was determined this request is similar to List 1, Item 7(a). As stated *supra,* [redacted] committed to producing documents responsive to List 1, Item 7(a), but no responsive documents have been produced.

Claimants' First Request No. 19:
Produce all emails between Claimants and Agent [redacted]

Respondent's Response:
All responsive documents will be produced.

Discussion:
No responsive documents have been produced. Respondent must produce all emails immediately. What is disconcerting is the fact that there is no indication whatsoever that [redacted] has even performed the search for these records.

Claimants' First Request No. 20:
Identify all email addresses disclosed to [redacted] by Agent [redacted]

Respondent's Response:
[redacted] objects to this request to the extent that it is an impermissible interrogatory, vague, burdensome, not narrow in time and scope, and overly broad.

Discussion:
During the parties' meet and confer conference, Respondent stated it would provide this information. To date, the information has not been produced.

Claimants' First Request No. 21:
Produce all documents establishing income or commissions generated by Agent [redacted] throughout the course of his agency with [redacted]

Respondent's Response:
All responsive documents will be produced.

Discussion:
During the parties' meet and confer conference, Claimants requested the production of Agent [redacted] Form 1099s from [redacted] Respondent's Counsel stated they would check with their client, but to ate, these documents have not been produced. [redacted]

has produced low-production warning letters sent to [redacted] for failing to meet production quotas. But the simplest documents to provide here rare [redacted] 1099s.

Claimants' First Request No. 22:
Produce the employment agreement between Agent [redacted] and [redacted]

Respondent's Response:
[redacted] objects to this request as it seeks information that is privileged and confidential. [redacted] will produce the [redacted] employment agreements or independent contractor agreements, subject to Claimant executing a Confidentiality Agreement.

Discussion:
During the parties' meet and confer conference, Respondent stated all responsive documents would be produced. To date, nothing responsive has been provided.

Claimants' First Request No. 24:
Produce all documents which reference, in any way, [redacted] Companies, LLC, [redacted], [redacted], or [redacted].

Respondent's Response:
[redacted] objects to this request as it seeks information that is vague, overly broad, burdensome, and beyond the scope of permissible discovery.

Discussion:
During the parties' meet and confer conference, Respondent stated all responsive documents would be produced. The requested documents, which require an email pull, are relevant and could certainly lead to the discovery of admissible evidence. Claimants are willing to negotiate search terms and email custodians but [redacted] has failed to provide so much material discovery to date, we are unable to commit to that process.

Claimants' First Request No. 25:
Records of any disciplinary action or internal reprimand or notice of violation ever taken against Agent [redacted] and the Financial Advisor's supervisors by any regulator or employer.

Respondent's Response:
[redacted] objects to this request as is seeks information that is privileged and that it seeks the disclosure of information related to non- party clients. [redacted] will produce the current CRD for Mr. [redacted].

Discussion:
[redacted] objections are without merit. Blanket assertions of privilege to avoid producing relevant discovery can not be tolerated. Claimants expect the production of all FINRA Rule 8210 requests and responses in connection with Agent [redacted] AWC entered December 1, 2016. Respondent must also produce all documents in connection with [redacted] suspension and subsequent termination.

Claimants' First Request No. 26:
Identify all [redacted] agents and employees who were registered with the [redacted] office located at [redacted].

> **Respondent's Response:**
> [redacted] objects to this request for information as it is irrelevant, vague, burdensome, overbroad, not narrow in time and scope, and is an impermissible interrogatory.

Discussion:
During the meet and confer conference, Respondent indicated it would provide the requested information, but that this office had upwards of 20 to 30 people in it, but that Counsel was unsure and needed to discuss the request with [redacted] To date, no responsive information has been provided.

Claimants' First Request No. 27:
Identify the individuals responsible for [redacted] anti-money laundering (AML) compliance from 2011 through 2016.

> **Respondent's Response:**
> [redacted] objects to this request as it seeks information that is outside the scope of the Statement of Claim, irrelevant, privileged, confidential, vague, overbroad, burdensome, and beyond the scope of permissible discovery. [redacted] further objects that the request is an impermissible interrogatory.

Discussion:
Similar to Request No. 26, Claimants' request seeks the identity of potential witnesses, is limited in scope, and seeks readily identifiable information. The objections have no merit because FINRA Rule 12507(a) specifically authorizes information requests seeking the "identification of individuals, entities, and time periods…" This request is actually a "permissible" interrogatory.

Claimants' First Request No. 28:
Produce all internal manuals specific to AML policies and procedures.

Respondent's Response:

[redacted] objects to this request as it seeks information that is outside the scope of the Statement of Claim, irrelevant, privileged, confidential, vague, overbroad, burdensome, and beyond the scope of permissible discovery. [redacted] further objects on the grounds that AML procedures and guidelines are not discoverable. The courts have held that "[a]ny internal system a bank has established for detecting and investigating money laundering will, however it is labeled, be intertwined with the bank's obligation to report suspicious activity to the government." *Norton v. U.S. Bank, N.A.*, 324 P.3d 693, 699 (Wash. Ct. App. 2014). The court reasoned that "[d]iscovery into these matters will produce documents suggesting that a [SAR] has been or might be under consideration." Id. Then, without explaining how production of general policies inexorably leads to discovery of specific SARs filed with the Treasury Department, the court concludes that such information is privileged. *Id*. at 700.

Discussion:

Claimants are not seeking the production of actual SAR Reports, nor information that could lead to disclosing whether any particular SAR report was filed with the Treasury Department. The case [redacted] relies upon from the State of Washington is not controlling and is considered an outlier. *See, e.g., Ackner v. PNC Bank,* 2017 U.S. Dist. LEXIS 60500* fn. 1 (S.D. Fla. April 12, 2017) ("Defendant primarily relies on *Norton v. U.S. Bank Nat. Ass'n*, 179 Wash. App. 450, 461, 324 P.3d 693 (2014). The Court agrees with Plaintiffs that this case appears to be an outlier that more broadly interprets the privilege than the majority of courts. This Court does not interpret the SAR privilege so broadly.") The *Ackner* court specifically held that "Plaintiffs' argument that the policies and procedures regarding Defendant's fraud detection processes are not protected by the SAR privilege is correct." *Id.* at 4-5, citing numerous cases in support of Claimants' position in this case.

In this case, Claimants' investments in [redacted] Companies - a criminal enterprise – was facilitated by a transfer of funds from their [redacted] accounts to outside "Custodial" firms. In some instances, Claimants have no recollection of executing documents to facilitate these transfers. As such, [redacted] policies and procedures in connection with the transfer of client funds and AML detection are relevant to the firm's standard of care.

Claimants' First Request No. 29:

Produce all documents sent to the SEC, FINRA, State of Missouri, or any other regulator related to the allegations in the Statement of Claim.

Respondent's Response:

[redacted] objects to this request as it seeks information that is burdensome, irrelevant, vague, protected by attorney-client privileged, protected by the attorney

work-product doctrine, not narrow in time and scope, and is beyond the scope of permissible discovery. [redacted] further objects that the request seeks confidential information of non- party clients that is in violation and privacy laws.

Discussion:

During the parties' meet and confer conference, Respondent stated it would provide documents responsive to List 1, Items 15 and 16, but no responsive records have been produced to date. Respondent must produce documents in connection with any regulatory investigation into the misconduct at issue. These records are not privileged and are discoverable. Claimants limit this request to investigations specific to [redacted] Companies, which also includes information provided to the FBI or other criminal investigators. Claimants also seek documents in connection with the AWC entered against [redacted] and the investigation launched against [redacted] by the Missouri Securities Department.

Claimants' First Request Nos. 30-34:

30) Identify the date when [redacted] became aware that Agent [redacted] was "selling away".

Respondent's Response:

[redacted] objects to this request to the extent that it is an impermissible interrogatory, vague, burdensome, not narrow in time and scope, and overly broad.

31) Identify the individuals who received and reviewed the information in connection with Request No. 30.

Respondent's Response:

[redacted] objects to this request to the extent that it is an impermissible interrogatory, irrelevant, vague, burdensome, overbroad, and not narrow in time and scope.

32) Produce all documents in connection with Agent [redacted] termination for cause for "compliance policy violations related to selling away", including but not limited notes from meetings either with or about Agent [redacted]

Respondent's Response:

[redacted] will produce the U-5 for [redacted] related to his termination with [redacted] objects to the remainder of this request as privileged, burdensome, irrelevant and beyond the scope of permissible discovery.

33) Identify all individuals involved with the investigation and decision to terminate Agent [redacted] for cause.

Respondent's Response:
[redacted] objects to this request to the extent that it is an impermissible interrogatory, irrelevant, vague, burdensome, overbroad, and not narrow in time and scope.

34) Produce all emails and other correspondence between any of the individuals identified in response to Request No. 33 concerning the investigation into and eventual termination of Agent [redacted]

Respondent's Response:
[redacted] objects to this request as privileged, confidential, protected by attorney-client privilege, the attorney work-product doctrine, burdensome, vague, irrelevant, not narrow in time and scope, and beyond the scope of permissible discovery. [redacted] further objects that the request seeks confidential information of non-party clients that is in violation and privacy laws.

Discussion:
During the parties' meet and confer conference, Respondent stated the following: it maintained its objections to Nos. 30 and 31 and would "look into" Nos. 32, 33, and 34. In its Answer, [redacted] pleaded that it learned about [redacted] involvement in [redacted] Companies "in 2016". Claimants are entitled to a more narrow and specific date. As of today, no responsive documents or information have been provided. The requests are actually quite simple and each one leads into the next. The Claimants are entitled to discover 1) when [redacted] discovered [redacted] was "selling away"; 2) who learned of it; and 3) what was done about it. This information goes to the core of [redacted] compliance and supervision structure – its reaction to information that an FA was selling outside investments to firm clients. The misconduct is extremely serious and has already resulted in [redacted] being barred by FINRA.

V. Claimants' Second Request For Production

Unfortunately, Respondent objected to virtually every single one of Claimants' 29 supplemental requests for production. It is not Claimants' preferred method of handling discovery disputes, but because of the proximity of this motion to the hearing, with the Holidays between the dates, Claimants need a ruling on these requests.

Claimants' Second Request No. 1:
Identify from which institution Agent [redacted] received his MBA and the dates of attendance.

Respondent's Response:
Objection. Respondent objects to this Request to Produce to the extent that it is an improper interrogatory and irrelevant.

Discussion:
This is a very simple information request seeking the identification of the institution and dates of attendance when he allegedly received an MBA. This request falls squarely within Rule 12507(a)'s mandate, which says information requests seeking the identification of individuals, entities, and time periods are fair game.

Claimants' Second Request No. 2:
Identify the number of clients Agent [redacted] had on January 1, 2012, June 1, 2012, January 1, 2013, June 1, 2013, January 1, 2014, June 1, 2014, January 1, 2015, June 1, 2015, and January 1, 2016.

> **Respondent's Response:**
> Objection. Respondent objects to this Request to Produce to the extent that it is an improper interrogatory. Furthermore, Respondent objects to this Request to Produce as it is irrelevant, vague, overly broad, confidential, burdensome, irrelevant, and nothing more than a fishing expedition.

Discussion:
This information is directly relevant to supervision. Documents produced in this case indicate [redacted] was struggling mightily to keep up with even the lowest production quotas. Further, several Claimants had money transferred away from [redacted] to IRA custodial firms to facilitate the investment in the criminal enterprise, [redacted] Companies. So, [redacted] was a low-producing broker who had several clients transferring assets away from the firm during the same period of time, and yet there is no evidence whatsoever suggesting 1) [redacted] took notice of this exodus or 2) that [redacted] contacted a single one of these clients to inquire why they were transferring assets to a Custodial firm.

In Staff Bulletin No. 17, the Securities and Exchange Commission explained the importance of broker-dealers reviewing their agent's income and debts. As noted in paragraph four of the Bulletin, "A representative appearing to live more lavishly than his business income would allow might be a 'red flag' indicating pursuit of improper or outside business activities." *See also, In the Matter of: PFS Investments, Inc.* 67 S.E.C. 1502, 1998 WL 422161 (July 28, 1998) and *Consolidated Investment Services*, 58 S.E.C. Docket 699, Exchange Act Release No. ID-59, 1994 WL 707215 (Dec. 12, 1994). As such, the SEC has deemed issues like production relevant to supervision.

If [redacted] had 350 client accounts and seven of them transferred their IRAs to a custodial firm, then it would be difficult to establish [redacted] should have noticed something was awry. However, if [redacted] had 50 client accounts for example, then ten or more of those clients transferring assets away while he was already being warned for lack of production, should have alerted compliance that there was something worthy of investigation here.

Claimants' Second Request No. 3:
Of those clients identified in response to Request No. 2, identify the number of clients who transferred funds from their [redacted] accounts to Equity Trust.

Respondent's Response:
Objection. Respondent objects to this Request to Produce to the extent that it is an improper interrogatory. Furthermore, Respondent objects to this Request to Produce as it is irrelevant, vague, overly broad, confidential, burdensome, irrelevant, and nothing more than a fishing expedition.

Discussion:
See discussion to RFP No. 2 above. Equity Trust is the company to which Claimants' transferred their IRAs in furtherance of the [redacted] Companies investment. If a larger percentage of [redacted] clients were transferring IRAs to Equity Trust, that would be a serious red flag of potential misconduct on the part of [redacted]

Claimants' Second Request No. 4:
Identify the "automated reporting process that monitors for potential issues or trends associated with third-party wire transmittals from brokerage accounts" as referenced in the Corrective Action Statement of [redacted] Services incorporated into FINRA AWC No. [redacted].

Respondent's Response:
Objection. Respondent objects to this Request to Produce to the extent that it is an improper interrogatory. Furthermore, Respondent objects to this Request to Produce as it is irrelevant, vague, overly broad, confidential, burdensome, irrelevant, and nothing more than a fishing expedition.

Discussion:
Claimants discussed this AWC in their Statement of Claim. It is relevant to supervision and compliance in connection with transferring funds. Claimants are entitled to the identification of the report identified in this request. It is a very specific and narrowly tailored request for information.

Claimants' Second Request No. 5:
Produce all reports, as identified in response to Request No. 4, which were generated for Agent [redacted] from January 1, 2012 through January 1, 2016.

Respondent's Response:
Objection. Respondent objects to this Request to Produce as it is irrelevant, vague, overly broad, confidential, burdensome, irrelevant, and nothing more than a fishing expedition.

Discussion:
Request No. 5 is an obvious extension of information request number 4.

Claimants' Second Request No. 6:
Produce all documents establishing [redacted] compliance with NASD Rule 3012(a)(2)(B)(i), which specifically requires [redacted] to have procedures that are reasonable designed to review and monitor all transmittals of funds or securities from customer accounts to third-party accounts and outside entities.

> **Respondent's Response:**
> Objection. Respondent objects to this Request to Produce as it seeks information that is vague, overly broad, burdensome, irrelevant, protected by attorney-client privilege, protected by the work product doctrine, and outside the scope of and outside the scope of permissible discovery.

Discussion:
This request seeks documents specific to supervision mandated by FINRA/NASD Rule. Supervision over the transmittal of client funds to outside entities is material to this case. A low producing broker has a max exodus of clients transferring assets to the same Custodial firm during the same period of time, and there was no reaction from [redacted] whatsoever. Clearly, its supervisory and compliance system was deficient. The privilege-based objections are canned. There is no privilege that protects this information from discovery.

Claimants' Second Request No. 7:
Produce all documents reviewed by the Anti-Fraud Operations Group in connection with any Claimant, their accounts, or Agent [redacted]

> **Respondent's Response:**
> Objection. Respondent objects to this Request to Produce as it seeks information that is vague, overly broad, burdensome, irrelevant, protected by attorney-client privilege, confidential, protected by the work product doctrine, and outside the scope of and outside the scope of permissible discovery.

Discussion:
The Anti-Fraud Operations Group is a defined compliance group at [redacted] This is a specific request seeking clearly relevant documents.

Claimants' Second Request No. 8:
Identify "Report A" referenced on page 4 of AWC No. [redacted].

Respondent's Response:

Objection. Respondent objects to this Request to Produce as it seeks information that is vague, overly broad, burdensome, irrelevant, protected by attorney-client privilege, confidential, protected by the work product doctrine, and outside the scope of and outside the scope of permissible discovery.

Discussion:

The AWC referenced herein is attached as Exhibit 2 to Claimants' Statement of Claim. [redacted] was fined $[redacted] for supervisory failures in connection with transfers of client funds. This AWC refers to a "R eport A", which purports to be a compliance document on which [redacted] identified potential red flags involving wire transmittals from customer accounts. This request is narrowly tailored, specific, and seeks documents relevant to [redacted] compliance procedures.

Claimants' Second Request No. 9:

Produce all sections of "Report A" that identify or otherwise reference any Claimant, any Claimant-account, or Agent [redacted]

Respondent's Response:

Objection. Respondent objects to this Request to Produce as it seeks information that is vague, overly broad, burdensome, irrelevant, protected by attorney-client privilege, confidential, protected by the work product doctrine, and outside the scope of and outside the scope [sic] of permissible discovery.

Discussion:

This request is an even more narrow request seeking specific sections of "Report A" that are clearly and obviously relevant to this case.

Claimants' Second Request No. 10:

Identify "Report B" referenced on page 4 of AWC No. [redacted].

Respondent's Response:

Objection. Respondent objects to this Request to Produce to the extent that it is an improper interrogatory. Furthermore, Respondent objects to this Request to Produce as it is irrelevant, vague, overly broad, confidential, protected by the work product doctrine, burdensome, irrelevant, and nothing more than a fishing expedition.

Discussion:

Similarly to Report A, "Report B" is identified in the aforementioned AWC as another compliance report implemented to "identify potential red flags involving wire transmittals from customer accounts." FINRA concluded this report was faulty and flawed because it "did not identify all of the wire transmittals it was intended to flag for

further review." Much like Report A, this request seeks specific documents relevant to [redacted] compliance process during the relevant time period that FINRA determined to be inadequate.

Claimants' Second Request No. 11:
Produce all sections of "Report B" that identify or otherwise reference any Claimant, any Claimant-account, or Agent [redacted]

> **Respondent's Response:**
> Objection. Respondent objects to this Request to Produce as it seeks information that is vague, overly broad, burdensome, irrelevant, protected by attorney-client privilege, confidential, protected by the work product doctrine, and outside the scope of and outside the scope of [sic] permissible discovery.

Discussion:
This request is an even more narrow request seeking specific sections of "Report B" that are clearly and obviously relevant to this case.

Claimants' Second Request No. 12:
Identify the individuals responsible for monitoring "Report A" and "Report B" specific to Agent [redacted] clients from January 1, 2013 through January 1, 2016.

> **Respondent's Response:**
> Objection. Respondent objects to this Request to Produce to the extent that it is an impermissible interrogatory, is vague, overly broad, burdensome, irrelevant, protected by attorney-client privilege, confidential, protected by the work product doctrine, and outside the scope of and outside the scope of [sic] permissible discovery.

Discussion:
The response to this request is obviously a copy and paste job. First, the response has clear typographical errors that are repeated over and again. Second, it is hard to image someone's identity being protected by either the Work-Product Doctrine or the Attorney-Client Privilege. This is a boilerplate objection. The request seeks the identification of relevant witnesses and must be provided.

Claimants' Second Request No. 17:
Produce all documents reviewed by [redacted] in connection with its review of Agent [redacted] involvement in [redacted] Companies, as pleaded in the Answer at 10.

> **Respondent's Response:**
> Objection. Respondent objects to this Request to Produce as it seeks information that is vague, overly broad, burdensome, irrelevant, protected by attorney-client

privilege, confidential, protected by the work product doctrine, and outside the scope of and outside the scope of [sic] permissible discovery.

Discussion:
This request seeks documents specific to fact pleaded in [redacted] Answer. It is incredible that [redacted] would object to this request based on relevance. Claimants request an order compelling the production of all responsive documents or an order striking this statement from Respondent's Answer.

Claimants' Second Request No. 18:
Identify all individuals who reviewed Agent [redacted] involvement in [redacted] Companies.

Respondent's Response:
Objection. Respondent objects to this Request to Produce to the extent that it is an impermissible interrogatory, is vague, overly broad, burdensome, irrelevant, protected by attorney-client privilege, confidential, protected by the work product doctrine, and outside the scope of and outside the scope of [sic] permissible discovery.

Discussion:
This request is an obvious corollary to Request 17 and seeks the identification of relevant witnesses.

Claimants' Second Request No. 19:
Produce all notes, internal correspondence, or other documents generated from this review. If Respondent contends these documents are protected by some privilege, Claimants request the creation of a simple privilege log that identifies the contents of the privileged document, the author, all recipients, and the date of the document.

Respondent's Response:
Objection. Respondent objects to this Request to Produce as it seeks information that is vague, overly broad, burdensome, irrelevant, protected by attorney-client privilege, confidential, protected by the work product doctrine, and outside the scope of and outside the scope of [sic] permissible discovery.

Discussion:
This request is an extension of Requests 17 and 18. [redacted] pleaded in its Answer that it examined and reviewed [redacted] involvement with [redacted] Companies in 2016. [redacted] put that fact at issue in its Answer, and Claimants are entitled to all discovery in connection with that statement.

Claimants' Second Request No. 20:
Produce all documents reviewed to verify the accuracy of [redacted] representations to [redacted] that he received no compensation from [redacted] Companies, as pleaded in the Answer at 10.

Respondent's Response:
Objection. Respondent objects to this Request to Produce as it seeks information that is vague, overly broad, burdensome, irrelevant, protected by attorney-client privilege, confidential, protected by the work product doctrine, and outside the scope of and outside the scope of [sic] permissible discovery.

Discussion:
This is another fact pleaded by [redacted] in its Answer. Unless it took Agent [redacted] word for it, there must be documents responsive to this request. By pleading this fact, [redacted] has made discovery into it fair game and must provide the requested information.

Claimants' Second Request No. 21:
Produce the bank records reviewed in connection with the verification of Agent [redacted] representations that he never received any compensation for the [redacted] Companies investments.

Respondent's Response:
Objection. Respondent objects to this Request to Produce as it seeks information that is vague, overly broad, burdensome, irrelevant, protected by attorney-client privilege, confidential, protected by the work product doctrine, and outside the scope of and outside the scope of [sic] permissible discovery.

Discussion:
Obviously, the first set of records [redacted] would have reviewed to determine whether Agent [redacted] received compensation for his role with [redacted] Companies, would have been his bank records. Claimants seek an order compelling the production of the records or an admission from [redacted] that it did not review [redacted] bank records.

Claimants' Second Request No. 22:
Identify all banks used by Agent [redacted] from January 2012 through June 2016.

Respondent's Response:
Objection. Respondent objects to this Request to Produce to the extent that it is an improper interrogatory, irrelevant, vague, overly broad, confidential, burdensome, irrelevant, and nothing more than a fishing expedition.

Discussion:
This information request is not an improper interrogatory. It clear seeks the identification of "entities". Further, this request seeks relevant discovery into facts pleaded by [redacted] in its Answer. If [redacted] states that it did not retain copies of the bank records it reviewed, then Claimants will seek an Order of Production for these documents, which first requires them to be identified.

Claimants' Second Request No. 23:
Produce Agent [redacted] personal income tax returns, including all K-1s received from [redacted] Companies, for tax years 2013 through 2016.

> **Respondent's Response:**
> Objection. Respondent objects to this Request to Produce as it seeks information that is irrelevant, confidential, burdensome, and outside the scope of permissible discovery. Moreover, this request seeks the disclosure of personal and confidential information of a non-party that is protected by state and federal privacy laws.

Discussion:
First, there are no privacy laws that apply to this request or this case frankly. "Privacy laws" is simply another generic excuse for not producing relevant documents. [redacted] Companies generated (fraudulent) K-1s. In the event [redacted] invested in it, his income tax returns will reveal that. Further, the income tax returns will identify any non-qualified brokerage accounts maintained by [redacted] at which point it can be determined whether he was accurately disclosing his outside accounts pursuant to FINRA Rule 3040. If it is [redacted] position it does not have [redacted] income tax returns, which is not believable to the extent they actually sought proof he received no compensation from [redacted] Companies, then Claimants will seek an order of production directed to Agent [redacted]

Claimants' Second Request No. 25:
Produce the Form U-6 submitted by [redacted] in connection with the AWCs referenced in the Statement of Claim on page 20.

> **Respondent's Response:**
> Objection. Respondent objects to this Request to Produce as it seeks information that is irrelevant, confidential, burdensome, and outside the scope of permissible discovery.

Discussion:
Form U6 is the "Uniform Disciplinary Action Reporting Form". It is a foundational document filed under oath by firms subject to a disciplinary action. It is relevant to the AWCs identified and attached as Exhibits to the Statement of Claim. This is not a burdensome request, the Form U6 is approximately 10 pages long.

Claimants' Second Request No. 26:
Produce all FINRA Rule 8210 requests and responses thereto in connection with the AWCs referenced in the Statement of Claim on page 20.

Respondent's Response:
Objection. Respondent objects to this Request to Produce as it seeks information that is vague, overly broad, burdensome, irrelevant, protected by attorney-client privilege, confidential, protected by the work product doctrine, and outside the scope of and outside the scope of permissible discovery.

Discussion:
These are simple requests seeking what information FINRA sought from [redacted] and what information [redacted] provided FINRA in connection with the AWCs attached as Exhibits to the Statement of Claim. Claimants are not seeking "all documents" in connection with those AWCs. Instead, they are merely seeking the requests for information and the responses thereto submitted by [redacted]

Claimants' Second Request No. 27:
Identify all brokerage accounts maintained by Agent [redacted] disclosed to [redacted] pursuant to FINRA Rule 3040.

Respondent's Response:
Objection. Respondent objects to this Request to Produce to the extent that it is an improper interrogatory, irrelevant, vague, overly broad, confidential, burdensome, irrelevant, and nothing more than a fishing expedition.

Discussion:
This request is in connection with statements made in [redacted] Answer that Agent [redacted] did not receive compensation for his involvement in [redacted] Companies. Pursuant to FINRA Rule 3040, registered representative are obligated to identify all brokerage accounts maintained away from the firm so that the firm can request duplicate copies of the statements for supervision. If [redacted] maintained outside accounts, [redacted] would have surely reviewed those records to determine if he made deposits that were questionable and potentially from [redacted] or [redacted] Companies.

Claimants' Second Request No. 28:
For all accounts identified in response to Request No. 25, produce all monthly statements from January 2012-January 2016.

Respondent's Response:
Objection. Respondent objects to this Request to Produce to the extent that it is an improper interrogatory, irrelevant, vague, overly broad, confidential, burdensome,

irrelevant, and nothing more than a fishing expedition. Moreover, this request seeks the disclosure of personal and confidential information of a non-party that is protected by state and federal privacy laws.

Discussion:
This request is an obvious extension of No. 27. If Respondent contends it did not maintain copies of his accounts, Claimants will seek an order of production.

Claimants' Second Request No. 29:
Produce Agent [redacted] brokerage account statements, either held individually, jointly with another, or in trust, from January 1, 2012 through January 31, 2016.

Respondent's Response:
Objection. Respondent objects to this Request to Produce to the extent that it is an improper interrogatory, irrelevant, vague, overly broad, confidential, burdensome, irrelevant, and nothing more than a fishing expedition. Moreover, this request seeks the disclosure of personal and confidential information of a non-party that is protected by state and federal privacy laws.

Discussion:
If [redacted] maintained accounts with [redacted] these accounts would be an obvious source for [redacted] to begin its investigation into [redacted] involvement with [redacted] Companies, including whether he received compensation.

VI. Conclusion.

Claimants respectfully request that the Chairperson grant their motion and order [redacted] to produce the documents identified herein as soon as possible.

Respectfully Submitted:

/s/ Joseph R. Wojciechowski
One of Claimants' Attorneys

Andrew Stoltmann
Joseph Wojciechowski
Alexander Loftus
Deanna Besbekos
Stoltmann Law Offices, P.C.
10 S. LaSalle Street, Suite 3500
Chicago, IL 60603

EXHIBIT E

BEFORE THE FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF DISPUTE RESOLUTION

In the Matter of the Arbitration Between

[redacted] and [redacted],

Claimants,

FINRA Case No. [redacted]

vs.

[redacted], INC. f/k/a [redacted]
[redacted],

Respondent.

CLAIMANTS' MOTION FOR THE EXECUTION OF A SUBPOENA *DUCES TECUM* TO FINRA ENFORCEMENT

Claimants hereby submit their Motion for the Execution of a Subpoena *Duces Tecum* to FINRA Enforcement. In support of this motion, the Claimants state the following:

I. This Case Requires the Production of Documents and Information From FINRA.

Respondent stated during the initial prehearing conference that this case will require a lot of discovery. Being proactive about the discovery process, including identifying potential targets for third-party production, is part of this process. As pleaded in the Statement of Claim with substantial detail, FINRA investigated Agent [redacted] and his selling away/outside business activity issues. Upon information and belief, Claimant [redacted] records and information were also part of that investigation, but no one from FINRA ever requested to speak to [redacted] during the course of this investigation. Claimants' Statement of Claim alleges that [redacted] and [redacted] misrepresented key facts regarding [redacted]'s schemes, including the foundational fact that it was Mr. [redacted] who was directing the traffic with these outside business deals, not Agent [redacted]. That is flatly and demonstratively false and will be proven so at hearing. Because this is such a critically important and obviously relevant area for discovery in this case, Claimants seek a *subpoena duces tecum* to FINRA for the release of all documents in connection with AWC # [redacted], which is attached hereto as **Exhibit 1**.

II. The Subpoena Seeks Relevant and Admissible Evidence or is Calculated to Lead to the Discovery of Admissible Evidence

Pursuant to Rule 12512(b) of the FINRA Code of Arbitration Procedure, the Claimants respectfully request that the Arbitrators issue a subpoena to FINRA Enforcement. Claimants filed this case against Respondent [redacted] seeking damages in the amount of $[redacted] million sustained as a result of the outside investments solicited by Agent [redacted]. According to the Acceptance, Waiver and Consent dated [redacted], FINRA Disciplinary No. [redacted] (**Exhibit 2**), FINRA launched an investigation into Mr. [redacted] for this very misconduct. Agent [redacted] and [redacted] actively participated in the investigation which led to FINRA's fine and censure of Agent [redacted].

The issue Claimants take with this AWC and FINRA's conclusions is that FINRA got it wrong. FINRA either relied on false information provided to it by [redacted] and [redacted], or it simply missed the mark with its conclusions. Claimants do not seek to re-investigate what FINRA did here. What Claimants seek with this subpoena is full access to FINRA's investigatory file to the extent permitted by applicable law and the FINRA Rules.

Furthermore, Claimants request the production of any documents that FINRA has in its possession regarding Mr. [redacted]'s outside businesses, including but not limited to:

a. [redacted].

m. and any other outside business activity engaged in by [redacted].

Claimants also seek documents sufficient to establish Agent [redacted]'s solicitations to other clients to invest in his businesses. Recall, it is Respondent's contention that [redacted] and Mr. [redacted] are long-time associates and business partners and that these outside investment deals were between them, and had nothing to do with [redacted]. The trouble with these allegations is that they are simply not factually accurate. In fact,

several other [redacted] clients invested in [redacted], to name one contradiction. Claimants seek these documents in order to provide the panel with the full scope of Mr. [redacted]'s selling away schemes, the red flags of his misconduct, and the complicit-nature of [redacted]'s conduct.

Importantly, Respondents are required to produce these documents pursuant to the FINRA Discovery Guide, List 1, Nos. 15 and 16, which require the production of the following documents by FINRA members and associated persons:

15) Records of disciplinary action taken against associated persons by any regulator (state, federal or self-regulatory organization) or employer for all sales practice violations or conduct similar to the conduct alleged in the Statement of Claim.

16) All investigations, charges or findings by any regulator (state, federal, or self-regulatory organization) and the firm/associated persons' responses to such investigations, charges, or findings for the associated persons' alleged improper behavior similar to that alleged in the Statement of Claim.

The documents sought by this subpoena are considered presumptively discoverable by FINRA. To date, Respondent has not produced these documents. In order to relieve the burden of production from [redacted] and to ensure that the responsive documents produced are a complete record, Claimants require this production to be provided directly from the third party, FINRA.

III. Conclusion

WHEREFORE, the Claimants respectfully request that the Chairperson execute the attached Subpoena and return it to Claimants' counsel for proper service.

Respectfully Submitted,

/s/ Joseph Wojciechowski
Joseph Wojciechowski

CERTIFICATE OF SERVICE

I, Joseph Wojciechowski, an attorney, certify that I caused copies of the forgoing document to be served on July 17, 2019 upon:

Ms. Elizabeth Muldoon
FINRA Dispute Resolution
55 W. Monroe St., Suite 2600
Chicago, IL 60603
(Via Portal)

[redacted]
(Via Portal)

/s/ Joseph Wojciechowski
Joseph Wojciechowski

EXHIBIT 1

FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER, AND CONSENT
NO. [redacted]

TO: Department of Enforcement
Financial Industry Regulatory Authority ("FINRA")

RE: [redacted]

Pursuant to FINRA Rule 9216 of FINRA's Code of Procedure, I submit this Letter of Acceptance, Waiver, and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described below. This AWC is submitted on the condition that, if accepted, FINRA will not bring any future actions against me alleging violations based on the same factual findings described in this AWC.

I.

ACCEPTANCE AND CONSENT

A. I hereby accept and consent, without admitting or denying the findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of FINRA, or to which FINRA is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by FINRA:

BACKGROUND

[redacted]

RELEVANT DISCIPLINARY HISTORY

[redacted] does not have any relevant disciplinary history.

OVERVIEW

[redacted] without notifying it about those activities or purchases, violating NASD Rule 3040 and FINRA Rules 2010, 3270, and 3280.

FACTS AND VIOLATIVE CONDUCT

1. Outside business activities

Between April 2014 and January 2017, [redacted] served as an officer or a director of four companies, including one that invested in early-stage and distressed companies, and which he owned jointly with a wealthy, sophisticated customer. [redacted] activities for those companies were outside the scope of his relationship with [redacted], but he did not notify the firm about them, even though he disclosed other outside business activities to the firm during the same period. As a result, [redacted] prevented [redacted] from considering issues such as whether his outside business activities would interfere with his responsibilities to the firm or its customers, and whether customers or the public would incorrectly view the activities as part of the firm's business.

FINRA Rule 3270 requires every registered person to notify his or her firm in writing before engaging in an outside business activity, such as serving as an officer or a director of a company. FINRA Rule 2010 requires every registered person to observe high standards of commercial honor and just and equitable principles of trade. By failing to give his firm prior written notice of four outside business activities, [redacted] violated FINRA Rule 3270 and consequently FINRA Rule 2010.

2. Private securities transactions

Between December 2012 and December 2016, [redacted] made more than two dozen purchases totaling [redacted] companies' securities. Those purchases were outside the scope of [redacted] employment with [redacted] and he did not notify his firm about those transactions, his role in them, and whether he had received or expected to receive selling compensation. [redacted] made some of those purchases through the investing company that he owned jointly with a customer, as described above.

FINRA Rule 3280 prohibits every associated person from participating in a private securities transaction without first notifying his or her firm in writing about details of the proposed transaction, his or her proposed role, and whether he or she has received or may receive selling compensation in connection with the transaction. Before September 21, 2015, NASD Rule 3040 imposed similar requirements. By failing to notify his firm about more than two dozen private

personal purchases of securities [redacted] violated NASD Rule 3040 with respect to the transactions before September 21, 2015 and FINRA Rule 3280 with respect to the transactions after that date, and consequently he also violated FINRA Rule 2010.

B. I also consent to the imposition of the following sanctions:

- Suspension of three months from associating in any capacity with any FINRA member
- Fine of $10,000

I understand that if I am suspended from associating with any FINRA member, I become subject to a statutory disqualification as that term is defined in Article III, Section 4 of FINRA's By-Laws, incorporating Section 3(a)(39) of the Securities Exchange Act of 1934. Accordingly, I may not be associated with any FINRA member in any capacity, including clerical or ministerial functions, during the period of the suspension (see FINRA Rules 8310 and 8311).

The fine imposed in this matter shall be due and payable either immediately upon reassociation with a member firm, or prior to any application or request for relief from any statutory disqualification resulting from this or any other event or proceeding, whichever is earlier. I specifically and voluntarily waive any right to claim that I am unable to pay, now or at any time hereafter, that fine.

The sanctions imposed in this AWC shall be effective on a date set by FINRA staff.

II.

WAIVER OF PROCEDURAL RIGHTS

I specifically and voluntarily waive the following rights granted under FINRA's Code of Procedure:

A. To have a Complaint issued specifying the allegations against me;

B. To be notified of the Complaint and have the opportunity to answer the allegations in writing;

C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and

D. To appeal any such decision to the National Adjudicatory Council ("NAC") and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, I specifically and voluntarily waive any right to claim bias or prejudgment of the Chief Legal Officer, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

I further specifically and voluntarily waive any right to claim that a person violated the ex parte prohibitions of FINRA Rule 9143 or the separation of functions prohibitions of FINRA Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

III.

OTHER MATTERS

I understand that:

A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the NAC, a Review Subcommittee of the NAC, or the Office of Disciplinary Affairs ("ODA"), pursuant to FINRA Rule 9216;

B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against me; and

C. If accepted:

1. this AWC will become part of my permanent disciplinary record and may be considered in any future actions brought by FINRA or any other regulator against me;

2. this AWC will be made available through FINRA's public disclosure program in accordance with FINRA Rule 8313;

3. FINRA may make a public announcement concerning this agreement and the subject matter thereof in accordance with FINRA Rule 8313; and

4. I may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any finding in this AWC or create the impression that the AWC is without factual basis. I may not take any position in any proceeding brought by or on behalf of FINRA, or to which FINRA is a party, that is inconsistent with any part of this AWC. Nothing in this provision affects my testimonial obligations or right to take legal or factual positions in litigation or other legal proceedings in which FINRA is not a party.

D. I may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. I understand that I may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by FINRA, nor does it reflect the views of FINRA or its staff.

I certify that I have read and understand all of the provisions of this AWC and have been given a full opportunity to ask questions about it; that I have agreed to its provisions voluntarily; and that no offer, threat, inducement, or promise of any kind, other than the terms set forth in this AWC and the prospect of avoiding the issuance of a Complaint, has been made to induce me to submit it.

[redacted]

[redacted]

Reviewed by:

[redacted]

Accepted by FINRA:

[redacted]

[redacted]

authority

ment

EXHIBIT 2

BEFORE THE FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF DISPUTE RESOLUTION

In the Matter of the Arbitration Between

[redacted],

Claimants,

FINRA Case No. [redacted]

vs.

[redacted]

Respondent.

To: FINANCIAL INDUSTRY REGULATORY AUTHORITY
Registered Agent
Corporation Service Company
505 5th Avenue, Suite 729
Des Moines, IA 50309

YOU ARE HEREBY COMMANDED, pursuant to the authority granted under Rule 12512(b) of the Financial Industry Regulatory Authority Code of Arbitration Procedure, to produce to counsel for Claimants, Joseph Wojciechowski, Esq., Stoltmann Law Offices P.C., 600 Hart Road, Suite 115, Barrington, Illinois 60010, within fourteen days of the date of this subpoena, all of the documents listed on the attached Schedule A.

ORDER OF THE CHAIR:

By: _____
[redacted]

Dated: _____

Prepared by:
Joseph Wojciechowski, Esq.
Stoltmann Law Offices, PC
600 Hart Road, Ste. 115
Barrington, IL 60010

SCHEDULE A - DOCUMENTS TO BE PRODUCED

Please provide us the following documents:

1) All documents referencing or relating to any investigation of [redacted], CRD # [redacted], in connection with Letter of Acceptance, Waiver, and Consent No. [redacted]. This request includes, but is not limited to the following:

    a. All Rule 8210 Requests and responses thereto;
    b. All transcripts of testimony or other statements made under oath to FINRA during the course of this investigation.

2) All documents received from [redacted] in connection with Letter of Acceptance, Waiver, and Consent No. 2[redacted].

3) All documents received from [redacted] in connection with Letter of Acceptance, Waiver, and Consent No. [redacted].

4) All documents received from any third party in connection with Letter of Acceptance, Waiver, and Consent No. [redacted].

5) All documents in FINRA's possession that reference or relate to [redacted] or [redacted].

6) All documents in FINRA's possession that reference or relate to:

    a. [redacted]
    b. [redacted]
    m. and any other outside business activity identified by FINRA in the course of its investigation of [redacted].

MY CLIENT JUST DIED - NOW WHAT?

Debra G. Speyer

Representing Estates, Trusts and Beneficiaries after the death of the Account Holder. What are the ethical and practical ramifications of the death of an Account Holder? This presentation will provide some of those answers.

Introduction:

The death of a client can be a complicated matter. After their family contacts you to tell you the bad news, then what? What if your hearing is about to start next week? What if your mediation is about to start the next day? What if you have a settlement on the table and were waiting for the client to return the settlement agreement. Your state's law, the Rules of Professional Responsibility, the rules of agency, and how the account is titled will dictate how you may proceed.

When a client dies, based on the law of agency (Restatement (Third) of Agency (see also Restatement (Third) of the Law Governing Lawyers), the actual authority permitting the attorney to proceed terminates with the clients death. The attorney may be able to continue the representation with a substituted client such as a personal representative, a successor trustee, etc. The attorney must take action to protect the interests of the deceased client while this transition is taking place. On a practical level, immediate notification to FINRA to advise of the situation would be prudent so that all actions and deadlines can cease while the substitution process is taking place, and to advise that a substituted client will be put in place.

But what if a settlement has taken place and the client dies just before the signatures are inked. The doctrine of apparent authority exists in order to allow third parties to depend on agents without investigating their agency before every transaction. Would that suggest that the substituted party can unravel the settlement agreement? Can the Respondent do so as they may believe they now have a stronger case without a live Claimant.

The answers may depend on the circumstances and your state's laws. The ABA and state bars have guidelines as to how to proceed in different professional responsibility situation. As well, the state's bar associations have legal ethics hotlines as part of membership to provide guidance to their members.

The Rules of Professional Responsibility:

Rule. 1.0 (e) Terminology:

Practical Ramification: Since the client relationship involves informed consent of the client, upon the death of the client, that informed consent terminates.

The Rule: "Informed consent" denotes the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct.

Rule 1.2: Scope of Representation & Allocation of Authority Between Client & Lawyer:

Practical Ramification: The client determines whether to proceed with a case or even settle a matter. The death of a client terminates the ability for the attorney to proceed with entering into any further matters. The attorney may not take any further steps even if the parties were in settlement negotiations. Once a qualified person is put in place, then the attorney may proceed.

The Rule:

(a) Subject to paragraphs (c) and (d), a lawyer shall abide by a client's decisions concerning the objectives of representation and, as required by Rule 1.4, shall consult with the client as to the means by which they are to be pursued. A lawyer may take such action on behalf of the client as is impliedly authorized to carry out the representation. A lawyer shall abide by a client's decision whether to settle a matter. In a criminal case, the lawyer shall abide by the client's decision, after consultation with the lawyer, as to a plea to be entered, whether to waive jury trial and whether the client will testify.

(b) A lawyer's representation of a client, including representation by appointment, does not constitute an endorsement of the client's political, economic, social or moral views or activities.

(c) A lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent.

(d) A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

Rule 1.4 Communications:

Practical Ramification: Because the client determines whether to proceed with a case or even settle a matter, the death of a client terminates the ability to communicate with the client, and therefore terminates the ability to enter into any further matters with the client. The attorney may not take any further steps even if the parties were in settlement negotiations. Once a qualified person is put in place, then the attorney may proceed.

The Rule:

[1] Reasonable communication between the lawyer and the client is necessary for the client effectively to participate in the representation. Communicating with Client

[2] If these Rules require that a particular decision about the representation be made by the client, paragraph (a)(1) requires that the lawyer promptly consult with and secure the client's consent prior to taking action unless prior discussions with the client have resolved what action the client wants the lawyer to take. For example, a lawyer who receives from opposing counsel an offer of settlement in a civil controversy or a proffered plea bargain in a criminal case must promptly inform the client of its substance unless the client has previously indicated that the proposal will be acceptable or unacceptable or has authorized the lawyer to accept or to reject the offer. See Rule 1.2(a).

[3] Paragraph (a)(2) requires the lawyer to reasonably consult with the client about the means to be used to accomplish the client's objectives. In some situations — depending on both the importance of the action under consideration and the feasibility of consulting with the client — this duty will require consultation prior to taking action. In other circumstances, such as during a trial when an immediate decision must be made, the exigency of the situation may require the lawyer to act without prior consultation. In such cases the lawyer must nonetheless act reasonably to inform the client of actions the lawyer has taken on the client's behalf. Additionally, paragraph (a)(3) requires that the lawyer keep the client reasonably informed about the status of the matter, such as significant developments affecting the timing or the substance of the representation.

[4] A lawyer's regular communication with clients will minimize the occasions on which a client will need to request information concerning the representation. When a client makes a reasonable request for information, however, paragraph (a)(4) requires prompt compliance with the request, or if a prompt response is not feasible, that the lawyer, or a member of the lawyer's staff, acknowledge receipt of the request and advise the client when a response may be expected. A lawyer should promptly respond to or acknowledge client communications. Explaining Matters

[5] The client should have sufficient information to participate intelligently in decisions concerning the objectives of the representation and the means by which they are to be pursued, to the extent the client is willing and able to do so. Adequacy of communication depends in part on the kind of advice or assistance that is involved. For example, when there is time to explain a proposal made in a negotiation, the lawyer should review all important provisions with the client before proceeding to an agreement. In litigation a lawyer should explain the general strategy and prospects of success and ordinarily should consult the client on tactics that are likely to result in significant expense or to injure or coerce others. On the other hand, a lawyer ordinarily will not be expected to describe trial or negotiation strategy in detail. The guiding principle is that the lawyer should fulfill reasonable client expectations for information consistent with the duty to act in the client's best interests, and the client's overall requirements as to the character of representation. In certain circumstances, such as when a lawyer asks a client to consent to a representation affected by a conflict of interest, the client must give informed consent, as defined in Rule 1.0(e).

[6] Ordinarily, the information to be provided is that appropriate for a client who is a comprehending and responsible adult. However, fully informing the client according to this standard may be impracticable, for example, where the client is a child or suffers from diminished capacity. See Rule 1.14. When the client is an organization or group, it is often impossible or inappropriate to inform every one of its members about its legal affairs; ordinarily, the lawyer should address communications to the appropriate officials of the organization. See Rule 1.13. Where many routine matters are involved, a system of limited or occasional reporting may be arranged with the client. Withholding Information

[7] In some circumstances, a lawyer may be justified in delaying transmission of information when the client would be likely to react imprudently to an immediate communication. Thus, a lawyer might withhold a psychiatric diagnosis of a client when the examining psychiatrist indicates that disclosure would harm the client. A lawyer may not withhold information to serve the lawyer's own interest or convenience or the interests or convenience of another person. Rules or court orders governing litigation may provide that information supplied to a lawyer may not be disclosed to the client. Rule 3.4(c) directs compliance with such rules or orders.

Rule 1.6 Confidentiality of Information:

Practical Ramification: Because a lawyer shall not reveal information unless the client gives consent, the death of the client terminates the ability for that client to give consent regarding the release of confidential information.

The Rule:

[1] This Rule governs the disclosure by a lawyer of information relating to the representation of a client during the lawyer's representation of the client. See Rule 1.18 for the lawyer's duties with respect to information provided to the lawyer by a prospective client, Rule 1.9(c)(2) for the lawyer's duty not to reveal information relating to the lawyer's prior representation of a former client and Rules 1.8(b) and 1.9(c)(1) for the lawyer's duties with respect to the use of such information to the disadvantage of clients and former clients.

[2] A fundamental principle in the client-lawyer relationship is that, in the absence of the client's informed consent, the lawyer must not reveal information relating to the representation. See Rule 1.0(e) for the definition of informed consent. This contributes to the trust that is the hallmark of the clientlawyer relationship. The client is thereby encouraged to seek legal assistance and to communicate fully and frankly with the lawyer even as to embarrassing or legally damaging subject matter. The lawyer needs this information to represent the client effectively and, if necessary, to advise the client to refrain from wrongful conduct. Almost without exception, clients come to lawyers in order to determine their rights and what is, in the complex of laws and regulations, deemed to be legal and correct. Based upon experience, lawyers know that almost all clients follow the advice given, and the law is upheld.

[3] The principle of client-lawyer confidentiality is given effect by related bodies of law: the attorney-client privilege, the work product doctrine and the rule of confidentiality established in professional ethics. The attorney-client privilege and work product doctrine apply in judicial and other proceedings in which a lawyer may be called as a witness or otherwise required to produce evidence concerning a client. The rule of client-lawyer confidentiality applies in situations other than those where evidence is sought from the lawyer through compulsion of law. The confidentiality rule, for example, applies not only to matters communicated in confidence by the client but also to all information relating to the representation, whatever its source. A lawyer may not disclose such information except as authorized or required by the Rules of Professional Conduct or other law. See also Scope.

[4] Paragraph (a) prohibits a lawyer from revealing information relating to the representation of a client. This prohibition also applies to disclosures by a lawyer that do not in themselves reveal protected information but could reasonably lead to the discovery of such information by a third person. A lawyer's use of a hypothetical to discuss issues relating to the representation is permissible so long as there is no reasonable likelihood that the listener will be able to ascertain the identity of the client or the situation involved. Authorized Disclosure

[5] Except to the extent that the client's instructions or special circumstances limit that authority, a lawyer is impliedly authorized to make disclosures about a client when appropriate in carrying out the representation. In some situations, for example, a lawyer may be impliedly authorized to admit a fact that cannot properly be disputed or to make a disclosure that facilitates a satisfactory conclusion to a matter. Lawyers in a firm may, in the course of the firm's practice, disclose to each other information relating to a client of the firm, unless the client has instructed that particular information be confined to specified lawyers. Disclosure Adverse to Client

[6] Although the public interest is usually best served by a strict rule requiring lawyers to preserve the confidentiality of information relating to the representation of their clients, the confidentiality rule is subject to limited exceptions. Paragraph (b)(1) recognizes the overriding value of life and physical integrity and permits disclosure reasonably necessary to prevent reasonably certain death or substantial bodily harm. Such harm is reasonably certain to occur if it will be suffered imminently or if there is a present and substantial threat that a person will suffer such harm at a later date if the lawyer fails to take action necessary to eliminate the threat. Thus, a lawyer who knows that a client has accidentally discharged toxic waste into a town's water supply may reveal this information to the authorities if there is a present and substantial risk that a person who drinks the water will contract a life-threatening or debilitating disease and the lawyer's disclosure is necessary to eliminate the threat or reduce the number of victims.

[7] Paragraph (b)(2) is a limited exception to the rule of confidentiality that permits the lawyer to reveal information to the extent necessary to enable affected persons or appropriate authorities to prevent the client from committing a crime or fraud, as defined in Rule 1.0(d), that is reasonably certain to result in substantial injury to the financial or property interests of another and in furtherance of which the client has used or is using the lawyer’s services. Such a serious abuse of the client-lawyer relationship by the client forfeits the protection of this Rule. The client can, of course, prevent such disclosure by refraining from the wrongful conduct. Although paragraph (b)(2) does not require the lawyer to reveal the client’s misconduct, the lawyer may not counsel or assist the client in conduct the lawyer knows is criminal or fraudulent. See Rule 1.2(d). See also Rule 1.16 with respect to the lawyer’s obligation or right to withdraw from the representation of the client in such circumstances, and Rule 1.13(c), which permits the lawyer, where the client is an organization, to reveal information relating to the representation in limited circumstances.

[8] Paragraph (b)(3) addresses the situation in which the lawyer does not learn of the client’s crime or fraud until after it has been consummated. Although the client no longer has the option of preventing disclosure by refraining from the wrongful conduct, there will be situations in which the loss suffered by the affected person can be prevented, rectified or mitigated. In such situations, the lawyer may disclose information relating to the representation to the extent necessary to enable the affected persons to prevent or mitigate reasonably certain losses or to attempt to recoup their losses. Paragraph (b)(3) does not apply when a person who has committed a crime or fraud thereafter employs a lawyer for representation concerning that offense.

[9] A lawyer's confidentiality obligations do not preclude a lawyer from securing confidential legal advice about the lawyer's personal responsibility to comply with these Rules. In most situations, disclosing information to secure such advice will be impliedly authorized for the lawyer to carry out the representation. Even when the disclosure is not impliedly authorized, paragraph (b)(4) permits such disclosure because of the importance of a lawyer's compliance with the Rules of Professional Conduct.

[10] Where a legal claim or disciplinary charge alleges complicity of the lawyer in a client's conduct or other misconduct of the lawyer involving representation of the client, the lawyer may respond to the extent the lawyer reasonably believes necessary to establish a defense. The same is true with respect to a claim involving the conduct or representation of a former client. Such a charge can arise in a civil, criminal, disciplinary or other proceeding and can be based on a wrong allegedly committed by the lawyer against the client or on a wrong alleged by a third person, for example, a person claiming to have been defrauded by the lawyer and client acting together. The lawyer's right to respond arises when an assertion of such complicity has been made. Paragraph (b)(5) does not require the lawyer to await the commencement of an action or proceeding that charges such complicity, so that the defense may be established by responding directly to a third

party who has made such an assertion. The right to defend also applies, of course, where a proceeding has been commenced.

[11] A lawyer entitled to a fee is permitted by paragraph (b)(5) to prove the services rendered in an action to collect it. This aspect of the rule expresses the principle that the beneficiary of a fiduciary relationship may not exploit it to the detriment of the fiduciary.

[12] Other law may require that a lawyer disclose information about a client. Whether such a law supersedes Rule 1.6 is a question of law beyond the scope of these Rules. When disclosure of information relating to the representation appears to be required by other law, the lawyer must discuss the matter with the client to the extent required by Rule 1.4. If, however, the other law supersedes this Rule and requires disclosure, paragraph (b)(6) permits the lawyer to make such disclosures as are necessary to comply with the law. Detection of Conflicts of Interest

[13] Paragraph (b)(7) recognizes that lawyers in different firms may need to disclose limited information to each other to detect and resolve conflicts of interest, such as when a lawyer is considering an association with another firm, two or more firms are considering a merger, or a lawyer is considering the purchase of a law practice. See Rule 1.17, Comment [7]. Under these circumstances, lawyers and law firms are permitted to disclose limited information, but only once substantive discussions regarding the new relationship have occurred. Any such disclosure should ordinarily include no more than the identity of the persons and entities involved in a matter, a brief summary of the general issues involved, and information about whether the matter has terminated. Even this limited information, however, should be disclosed only to the extent reasonably necessary to detect and resolve conflicts of interest that might arise from the possible new relationship. Moreover, the disclosure of any information is prohibited if it would compromise the attorney-client privilege or otherwise prejudice the client (e.g., the fact that a corporate client is seeking advice on a corporate takeover that has not been publicly announced; that a person has consulted a lawyer about the possibility of divorce before the person's intentions are known to the person's spouse; or that a person has consulted a lawyer about a criminal investigation that has not led to a public charge). Under those circumstances, paragraph (a) prohibits disclosure unless the client or former client gives informed consent. A lawyer’s fiduciary duty to the lawyer’s firm may also govern a lawyer’s conduct when exploring an association with another firm and is beyond the scope of these Rules.

[14] Any information disclosed pursuant to paragraph (b)(7) may be used or further disclosed only to the extent necessary to detect and resolve conflicts of interest. Paragraph (b)(7) does not restrict the use of information acquired by means independent of any disclosure pursuant to paragraph (b)(7). Paragraph (b)(7) also does not affect the disclosure of information within a law firm when the disclosure is otherwise authorized, see Comment [5], such as when a lawyer in a firm discloses information to another lawyer in the same firm to detect and resolve conflicts of interest that could arise in connection with undertaking a new representation.

[15] A lawyer may be ordered to reveal information relating to the representation of a client by a court or by another tribunal or governmental entity claiming authority pursuant to other law to compel the disclosure. Absent informed consent of the client to do otherwise, the lawyer should assert on behalf of the client all nonfrivolous claims that the order is not authorized by other law or that the information sought is protected against disclosure by the attorney-client privilege or other applicable law. In the event of an adverse ruling, the lawyer must consult with the client about the possibility of appeal to the extent required by Rule 1.4. Unless review is sought, however, paragraph (b)(6) permits the lawyer to comply with the court's order.

[16] Paragraph (b) permits disclosure only to the extent the lawyer reasonably believes the disclosure is necessary to accomplish one of the purposes specified. Where practicable, the lawyer should first seek to persuade the client to take suitable action to obviate the need for disclosure. In any case, a disclosure adverse to the client's interest should be no greater than the lawyer reasonably believes necessary to accomplish the purpose. If the disclosure will be made in connection with a judicial proceeding, the disclosure should be made in a manner that limits access to the information to the tribunal or other persons having a need to know it and appropriate protective orders or other arrangements should be sought by the lawyer to the fullest extent practicable.

[17] Paragraph (b) permits but does not require the disclosure of information relating to a client's representation to accomplish the purposes specified in paragraphs (b)(1) through (b)(6). In exercising the discretion conferred by this Rule, the lawyer may consider such factors as the nature of the lawyer's relationship with the client and with those who might be injured by the client, the lawyer's own involvement in the transaction and factors that may extenuate the conduct in question. A lawyer's decision not to disclose as permitted by paragraph (b) does not violate this Rule. Disclosure may be required, however, by other Rules. Some Rules require disclosure only if such disclosure would be permitted by paragraph (b). See Rules 1.2(d), 4.1(b), 8.1 and 8.3. Rule 3.3, on the other hand, requires disclosure in some circumstances regardless of whether such disclosure is permitted by this Rule. See Rule 3.3(c). Acting Competently to Preserve Confidentiality

[18] Paragraph (c) requires a lawyer to act competently to safeguard information relating to the representation of a client against unauthorized access by third parties and against inadvertent or unauthorized disclosure by the lawyer or other persons who are participating in the representation of the client or who are subject to the lawyer’s supervision. See Rules 1.1, 5.1 and 5.3. The unauthorized access to, or the inadvertent or unauthorized disclosure of, information relating to the representation of a client does not constitute a violation of paragraph (c) if the lawyer has made reasonable efforts to prevent the access or disclosure. Factors to be considered in determining the reasonableness of the lawyer’s efforts include, but are not limited to, the sensitivity of the information, the likelihood of disclosure if additional safeguards are not employed, the cost of employing additional safeguards, the difficulty of implementing the safeguards, and the extent to which the safeguards adversely affect the lawyer’s ability to represent clients (e.g., by making a device or important piece of software excessively difficult to use). A client may require the lawyer to implement special security measures not required by this Rule or may give informed consent to forgo security measures that would otherwise be required by this Rule. Whether a lawyer may be required to take additional steps to safeguard a client’s information in order to comply with other law, such as state and federal laws that govern data privacy or that impose notification requirements upon the loss of, or unauthorized access to, electronic information, is beyond the scope of these Rules. For a lawyer’s duties when sharing information with nonlawyers outside the lawyer’s own firm, see Rule 5.3, Comments [3]-[4].

[19] When transmitting a communication that includes information relating to the representation of a client, the lawyer must take reasonable precautions to prevent the information from coming into the hands of unintended recipients. This duty, however, does not require that the lawyer use special security measures if the method of communication affords a reasonable expectation of privacy. Special circumstances, however, may warrant special precautions. Factors to be considered in determining the reasonableness of the lawyer's expectation of confidentiality include the sensitivity of the information and the extent to which the privacy of the communication is protected by law or by a confidentiality agreement. A client may require the lawyer to implement special security measures not required by this Rule or may give informed consent to the use of a

means of communication that would otherwise be prohibited by this Rule. Whether a lawyer may be required to take additional steps in order to comply with other law, such as state and federal laws that govern data privacy, is beyond the scope of these Rules. Former Client
[20] The duty of confidentiality continues after the client-lawyer relationship has terminated. See Rule 1.9(c)(2). See Rule 1.9(c)(1) for the prohibition against using such information to the disadvantage of the former client.

Rule 1.9 Duties to Former Clients:

Practical Ramification: Due to the death of the clietn, this is now your former client. The issue to determine is what information can you now reveal, to whom and what is the timing to reveal it. This will depend on the information and when a successor will step in on behalf of the deceased client.

The Rule:

(a) A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client gives informed consent, confirmed in writing.

(b) A lawyer shall not knowingly represent a person in the same or a substantially related matter in which a firm with which the lawyer formerly was associated had previously represented a client (1) whose interests are materially adverse to that person; and (2) about whom the lawyer had acquired information protected by Rules 1.6 and 1.9(c) that is material to the matter; unless the former client gives informed consent, confirmed in writing.

(c) A lawyer who has formerly represented a client in a matter or whose present or former firm has formerly represented a client in a matter shall not thereafter: (1) use information relating to the representation to the disadvantage of the former client except as these Rules would permit or require with respect to a client, or when the information has become generally known; or (2) reveal information relating to the representation except as these Rules would permit or require with respect to a client.

Rule 3.3: Candor Toward the Tribunal Share:

Practical Ramifications: Any appearance by the lawyer before the court without disclosing the client's death would be tantamount to making a "false statement of material fact...to a tribunal" within the meaning of Rule 3.3.

The Rule:

(a) A lawyer shall not knowingly:

(1) make a false statement of fact or law to a tribunal or fail to correct a false statement of material fact or law previously made to the tribunal by the lawyer;

(2) fail to disclose to the tribunal legal authority in the controlling jurisdiction known to the lawyer to be directly adverse to the position of the client and not disclosed by opposing counsel; or

(3) offer evidence that the lawyer knows to be false. If a lawyer, the lawyer's client, or a witness called by the lawyer, has offered material evidence and the lawyer comes to know of its falsity, the lawyer shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal. A lawyer may refuse to offer evidence, other than the testimony of a defendant in a criminal matter, that the lawyer reasonably believes is false.

(b) A lawyer who represents a client in an adjudicative proceeding and who knows that a person intends to engage, is engaging or has engaged in criminal or fraudulent conduct related to the proceeding shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal.

(c) The duties stated in paragraphs (a) and (b) continue to the conclusion of the proceeding, and apply even if compliance requires disclosure of information otherwise protected by Rule 1.6. (d) In an ex parte proceeding, a lawyer shall inform the tribunal of all material facts known to the lawyer that will enable the tribunal to make an informed decision, whether or not the facts are adverse.

Rule 4.1 Truthfulness in Statement to Others:

Practical Ramification: The Rule's commentary is below. When should the Respondent be advised, immediately or after a person has been substituted for the deceased client. There are differing interpretations of this rule by various bar associations. The ABA Formal Opinion 95-397 dated September 18, 1995 - Duty to Disclose Death of Client addressed this in the context of a personal injury action. This opinion has been made a part of your materials.

Misrepresentation [1] A lawyer is required to be truthful when dealing with others on a client's behalf, but generally has no affirmative duty to inform an opposing party of relevant facts. A misrepresentation can occur if the lawyer incorporates or affirms a statement of another person that the lawyer knows is false. Misrepresentations can also occur by failure to act partially true but misleading statements or omissions that are the equivalent of affirmative false statements. For dishonest conduct that does not amount to a false statement or for misrepresentations by a lawyer other than in the course of representing a client, see Rule 8.4.

Statements of Fact [2] This Rule refers to statements of fact. Whether a particular statement should be regarded as one of fact can depend on the circumstances. Under generally accepted conventions in negotiation, certain types of statements ordinarily are not taken as statements of material fact. Estimates of price or value placed on the subject of a transaction and a party's intentions as to an acceptable settlement of a claim are ordinarily in this category, and so is the existence of an undisclosed principal except where nondisclosure of the principal would constitute fraud. Lawyers should be mindful of their obligations under applicable law to avoid criminal and tortious misrepresentation.

The Rule:

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 when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6.

The Estate Process:

For those unfamiliar with the estate probate process or probate and non probate assets, the below will explain some of the concepts and how they will be addressed regarding the death of your client. Some of these issues may be easier to deal with depending upon how the account in dispute was titled.

Joint Account with Rights of Survivorship

If the account that is in dispute was set up as a Joint Account with Rights of Survivorship, the remaining account holder can continue as the client. A joint account is a non-probate asset. No estate needs to be raised. You can proceed with your arbitration with the remaining account holder. You can attend the mediation with the remaining account holder. The remaining account holder can sign the settlement agreement. The issue you may run into for example is, if the deceased client was your more sympathetic client and the Respondent recognizes that as well, the Respondent may not wish to settle or settle for less.

Payable on Death Accounts

If the account was set up as a Payable on Death Account, the designated beneficiary on the Account is now the new owner of the Account upon the death of the account owner. A Payable on Death Account is a non-probate asset. The transfer is immediate. No estate needs to be raised. The deceased person no longer owns the account.

IRA with Beneficiary

Like the Payable on Death Account, upon the death of the IRA account holder, the new beneficiary is the owner of the account. An IRA Account is a non-probate asset. The transfer is immediate. No estate needs to be raised. The deceased person no longer owns the account.

Trusts

When a Trustee dies, there is generally a Successor Trustee named in the Trust document who has authority over the Trust. If there is no named Successor Trustee, the Trust itself may have language that determines how to proceed. For example the Settlor (person who initially set up the Trust) based on language in the Trust may have the right to appoint a new Trustee if that Settlor is still alive. The Trust language may provide for the beneficiary to serve as Trustee if the Trustee is deceased.

If the Settlor is deceased or there is no named Successor Trustee, the involved parties can turn to the Courts to appoint a Successor Trustee by filing a Petition To Appoint a Successor Trustee.

If the deceased Trustee had Co-Trustees, the Joint Trustees take over the Trust without involving the Courts.

Deceased Individual account

If the account was set up in the client's individual name, an estate will need to be raised. Generally to raise an estate, a Petition for Probate is filed with the Court.

If the deceased client had a Will, that Will shall be submitted to the Court with a Petition for Probate and an original death certificate. The Executor of the Estate will be sworn in by the Court. Shortly after that, the Court shall issue Letters of Testamentary. Some problems may arise such as the family only has a photocopy or the Will. Then a Petition to Probate a Photo Copy of a Will needs to be filed. Your client will now be the Executor of the Estate.

If the deceased client had no Will, then the next of kin determined by state specific law will be sworn in as the Administrator. If there are more than one next of kin i.e. multiple children. Each one has the right to be the Administrator. The next of kin may sign a Renunciation to allow someone else to serve as Administrator. If there a disagreement as to who will serve, a Petition can be filed with the Court to determine who will serve as Administrator.

It is possible that your client will have a Pour-Over Will which is a testamentary device where the Testator (writer of the Will) bequested the assets to a Trust. Those assets will be distributed by a Trustee of the Trust.

Conclusion:

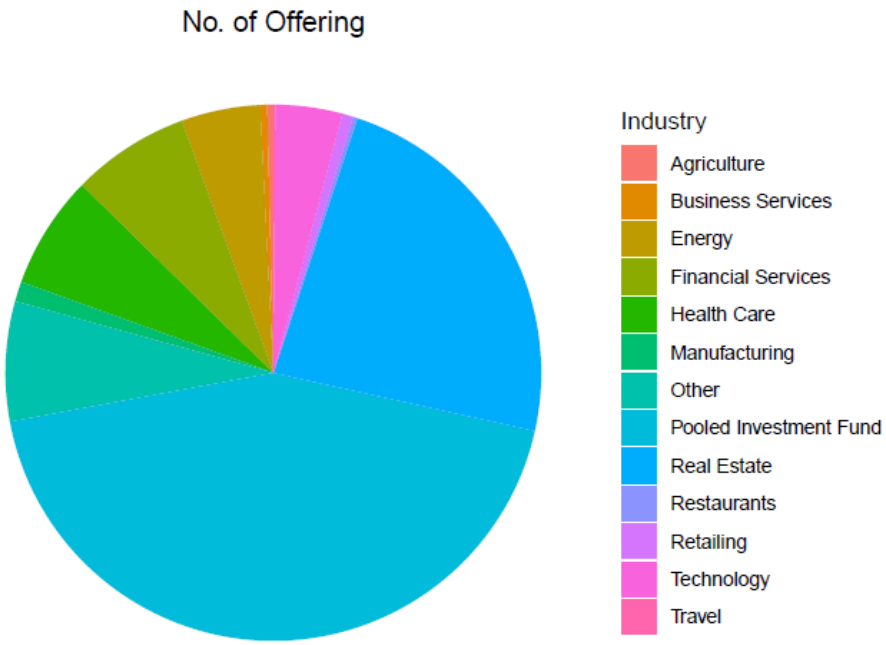
In conclusion, the death of a client can be complicated on many levels. This one hour presentation will likely raise more questions regarding your ethical obligations regarding the death of a client.

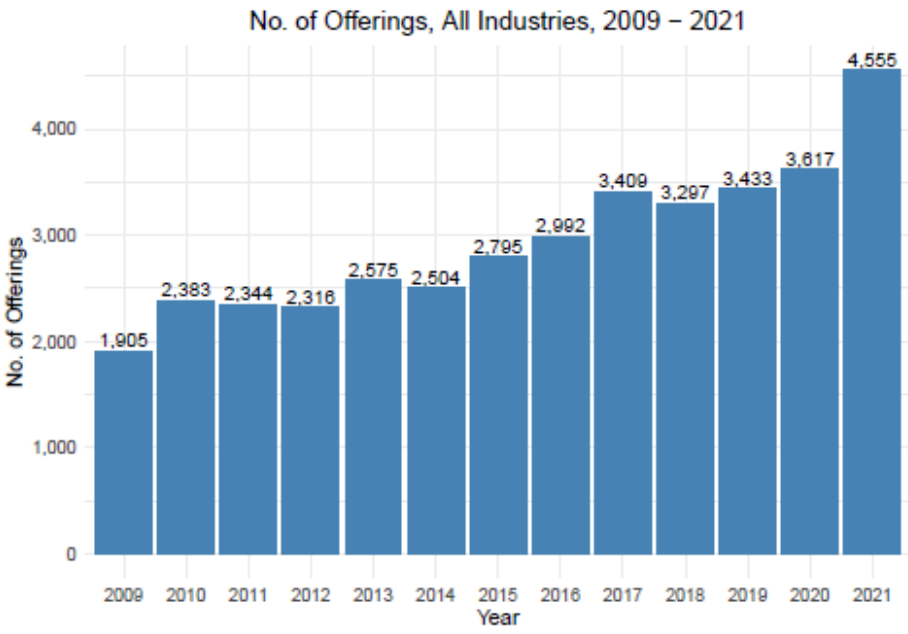
Introduction: Regulation D Offerings & Customer Complaints

Mike Yan, Ph.D., CFA, FRM
SLCG Economic Consulting, LLC

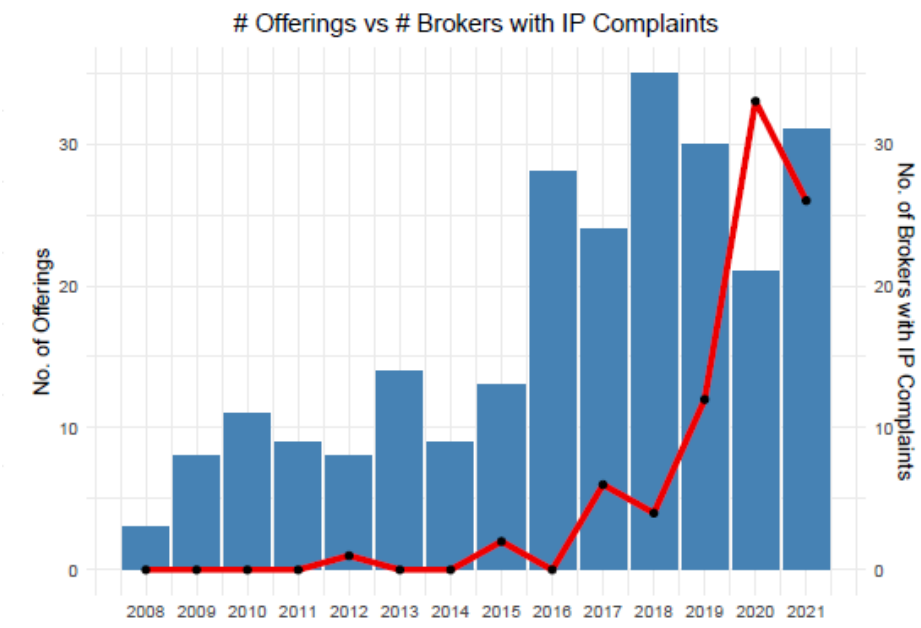
Regulation D offerings, filed through the SEC's EDGAR system, allow companies to offer their securities without having to register them with the SEC. We found that 43,058 Regulation D offerings of total $9.3 trillion have been sold to over 3 million investors between 2009 and 2022, with sales commissions exceeding $37 billion.

We also found a positive relationship between certain characteristics of Regulation D offerings and the likelihood of the broker-dealer receiving customer complaints involving an illiquid product such as private placement and non-traded REIT. Based on this research, we ranked those broker-dealers. For example, Kalos Capital, Inc, which filed 251 Regulation D offerings, is ranked 4th and has been having a spike of complaints in recent years after sharply increasing the number of Regulation D offerings in 2016. Concorde Investment Services, LLC, ranked 9th, is another broker-dealer seeing a sharp increase in IP complaints in recent years while having been steadily selling more Regulation D offerings since 2009.

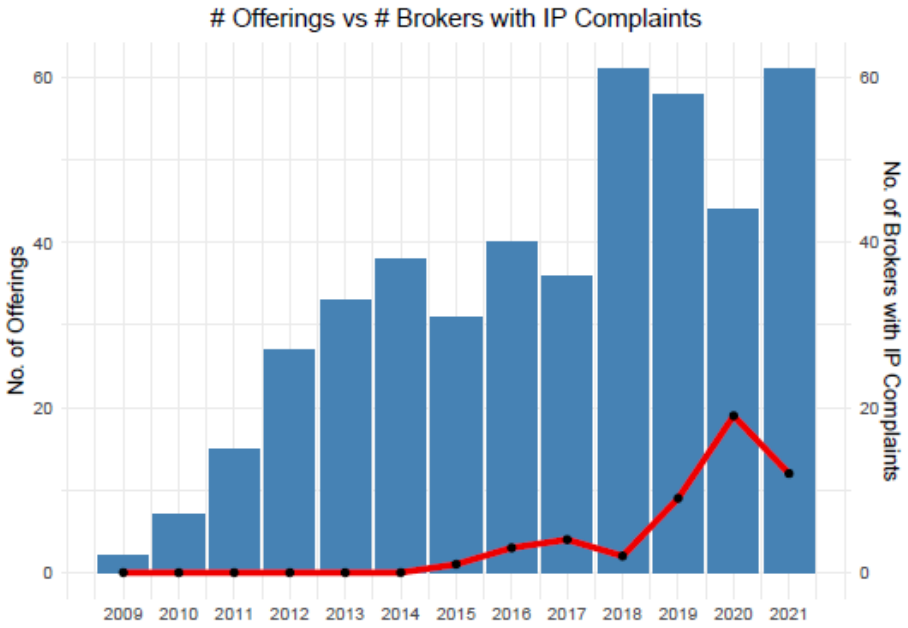

No. of Offering
Industry
Agriculture
Business Services
Energy
Financial Services
Health Care
Manufacturing
Other
Pooled Investment Fund
Real Estate
Restaurants
Retailing
Technology
Travel


No. of Offerings, All Industries, 2009 – 2021
No. of Offerings
0
1,000
2,000
3,000
4,000
1,905
2,383
2,344
2,316
2,575
2,504
2,795
2,992
3,409
3,297
3,433
3,617
4,555
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
2020
2021
Year

Kalos Capital, Inc.



Concorde Investment Services, LLC



Valuation of Distressed Securities

Fair Market Value

The amount at which a property would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts.

American Society of Appraisers

Yale Forensics

The definition implies:

-- Arm's length transaction.

-- Existing economic and market conditions at the date of valuation.

-- Buyer and seller are well informed and well advised.

-- Payment in cash.

-- Price unaffected by special or creative financing or sales concessions.

Premise of Value

Can apply to any standard of value.

-- Value as a going concern.

-- Value as an assemblage of assets.

-- Value as an orderly disposition.

-- Value as a forced liquidation.

Generally Accepted Valuation Theory

Value of an interest in a business depends upon the **future** benefits that will accrue to the owner of it.

Typically involves the estimation of future:

-- Net Income

-- Dividends

-- Cash flows

Thus, the theoretically correct approach is to **project** some category or categories of the future benefits of ownership and **estimate** the present value of those future benefits by discounting them based upon the time value of money and the **risks** associated with ownership.

"Getting two or more parties with different economic and business expectations to agree on projected future benefits and the risks associated with achieving those projections is, perhaps, the most difficult task for the business appraiser."

Valuing a Business

Shannon P. Pratt et al.

For example, Griffin Realty Trust, the non-traded REIT, is:

-- Paying Dividends.

-- Experiencing vacancies in single digits.

-- Delinquencies around 2 percent.

-- Majority of tenants are investment-grade.

So Why Not Value at Net Asset Value?

Net Asset Value

$$NAV = \frac{(\text{FMV of Assets} - \text{FMV of Liabilities})}{\text{Number of Shares Outstanding}}$$

Yale Forensics

	Griffin Realty Trust			
Offeror	**Date**	**Tender Price/Bid**	**NAV**	**% of NAV**
MacKensie Realty Capital	6/30/20	$ 6.25	$ 8.92	29.9%
CMG Partners	4/9/21	$ 4.08	$ 8.97	54.5%
Comrit Investments I, LP	8/27/21	$ 6.91	$ 9.04	23.6%
MacKensie Realty Capital	11/23/21	$ 4.69	$ 9.12	48.6%
Comrit Partners	3/3/22	$ 7.21	$ 9.04	20.2%
Direct Investments Spectrum	6/30/22	$ 7.64	$ 9.04	15.5%
Central Trade and Transfer	7/28/22	$ 7.60	$ 9.04	15.9%
Signal Securities (sellmyreit.com)	7/28/22	$ 6.75	$ 9.04	25.3%
Partnership Marketing Company	8/2/22	$ 6.25	$ 9.04	30.9%
1st Trade	8/3/22	$ 7.09	$ 9.04	21.6%

Annual third-party appraisals of our properties using an appraisal report format are conducted on a rolling basis, such that properties will be appraised at different times throughout any given year with each property generally appraised at least once per calendar year. These appraisals involve subjective judgements and are not necessarily representative of the price at which an asset or liability would sell pursuant to negotiation between an arms' length buyer and seller. We will not retroactively adjust the NAV per share of any class reported. Therefore, because a new annual appraisal may differ materially from the prior appraisal or the actual results from operations may be better or worse than what we previously assumed, the adjustment to reflect the new appraisal or actual operating results may cause the NAV per share for any class of our common stock to increase or decrease, and such increase or decrease will occur on the day the adjustment is made. Additionally, notification of property and real estate market events may lag the actual event and events may be missed, unknown or difficult to value. Furthermore, the NAV per share that we publish will not reflect changes in NAV, including potentially material changes, that are not immediately quantifiable, and the NAV per share of each class published after the announcement of a material event may differ significantly from our actual NAV per share for such class until such time as the financial impact is quantified and our NAV is appropriately adjusted in accordance with our valuation procedures. The resulting potential disparity in our NAV may inure to the benefit of redeeming stockholders or non-redeeming stockholders and new purchasers of our common stock, depending on whether our published NAV per share for a given class is overstated or understated.

Griffin Realty Trust
10-K for the Year Ended December 31, 2020

So Why Not Value Griffin at NAV?

-- There is no industry standard nor regulatory guidance for the calculation of NAV.

-- The process is generally opaque so the reasonableness of the underlying assumptions is often not knowable.

-- Broker and other fees may not have been deducted.

So Why Is NAV not a fair measure of Fair Market Value? (cont.)

-- Investment is illiquid and redemption programs are limited.

-- Even with extensive SEC disclosure, we typically don't know:

- Property condition and appropriate replacement reserves.
- Whether NAV is net of substantial advisor disposition and/or incentive fees if REIT is externally managed.
- NAV is often based on appraisals up to one year in arrears and market conditions, including interest and cap rates, may have changed substantially.
- NAV is not discounted for lack of marketability or lack of control.

So Why Not Value Griffin at NAV? (cont.)

-- Griffin suspended NAV calculations and share repurchase programs in 2020.

-- The initial dividend rate of 6 percent on $10 offering price was reduced to 3.9 percent $9.04 NAV.

-- Average yield as of June, 2022 on all traded REITs was 3.8 percent.

-- Discount for lack of marketability is often 30 to 50 percent and is not fully reflected in Griffin Realty pricing at auction.

Griffin Realty FMV at Central Trade and Transfer Pricing

$7.60 - $.38 = $7.22 to Seller or approximately a 21 percent discount to NAV.

Current Dividend Yield for Purchaser is 4.39 percent.

Yale Forensics

	Griffin Realty Trust			
Offeror	**Date**	**Tender Price/Bid**	**NAV**	**% of NAV**
MacKensie Realty Capital	6/30/20	$ 6.25	$ 8.92	29.9%
CMG Partners	4/9/21	$ 4.08	$ 8.97	54.5%
Comrit Investments I, LP	8/27/21	$ 6.91	$ 9.04	23.6%
MacKensie Realty Capital	11/23/21	$ 4.69	$ 9.12	48.6%
Comrit Partners	3/3/22	$ 7.21	$ 9.04	20.2%
Direct Investments Spectrum	6/30/22	$ 7.64	$ 9.04	15.5%
Central Trade and Transfer	7/28/22	$ 7.60	$ 9.04	15.9%
Signal Securities (sellmyreit.com)	7/28/22	$ 6.75	$ 9.04	25.3%
Partnership Marketing Company	8/2/22	$ 6.25	$ 9.04	30.9%
1st Trade	8/3/22	$ 7.09	$ 9.04	21.6%

Primary Methodologies:

Income Approach or discounting some measure of future benefits to present value.

Market Approach utilizes capitalization rates or multiples of earnings for similar businesses.

Asset-Based Approach utilizes M & A pricing for similar assets.

Discounting Economic Income

-- Net Income

-- Cash Flow

-- Dividends

-- Any Measure Can Work if the Discount Rate is Appropriate

Income Method Requires:

-- Estimate of Future Cash Flows.

-- Estimate of Sales Proceeds from the Entity at Some Terminal Point.

-- Estimate of an Appropriate Discount Rate which includes quantifying risk.

-- Estimate Proper Discount for Lack of Control.

-- Estimate of Proper Discount for Lack of Marketability.

Estimate of Future Cash Flows

-- Seemingly straightforward for a leased portfolio of rental properties, but becomes more speculative when reducing cash flows by reserves for replacements, debt rollovers, leasing expenses, and rental defaults.

-- Estimates of future cash flows for a distressed business is highly speculative so each assumption of the projection should be questioned closely.

Estimate of Sales Proceeds from the Entity at Some Terminal Point

-- Even more speculative because discount or capitalization rates to determine terminal value involve estimates further into the future.

-- Thus, every assumption must be questioned closely.

Estimate Proper Discount for Lack of Control

-- Analyses of publicly-held companies purchasing non-controlling interests shows little difference in deal pricing.

-- Studies of limited partnerships in the 1990's indicated discounts of 30 percent or more. TIC discounts were 35 percent or more.

-- Updated studies from Mergerstat and others indicate general lack of control discounts range from 5 to 15 percent.

Estimate of Proper Discount for Lack of Marketability

-- Scores of studies have been conducted, typically comparing restricted stock transactions to publicly traded securities of the same issuer and other methods.

-- Typical discounts range from 30 to 50 percent.

-- Is not a component of NAV.

-- Need to question which surveys and what methodologies were relied upon.

Estimate of Discount Rates

Components include:

-- Risk-Free Rate of Return

-- Systematic Risk (often Beta)

-- Size Effect on Risk

-- **Investment Specific Risk**

GWG Holdings, Inc. L Bonds

	2018	2019	2020	9/ 30/ 21
Total Revenue	$ (390,000)	$ 92,276,000	$ 124,371,000	$ 37,259,000
Interest Expense	$ 67,058,000	$ 102,202,000	$ 131,516,000	$ 128,605,000
Premium Expense	$ 49,467,000	$ 68,467,000	$ 70,243,000	$ 56,388,000
Cash Flow from Operations	$ (95,479,054)	$ (142,830,000)	$ (182,400,000)	$ (176,286,000)

SECONDARY MARKET PARTICIPANTS

Pacific Partnership Group
Signal Securities
www.sellmyreit.com
(800) 727-7244

Partnership Marketing Co.
(888) 824-8600
http://lpsales.com/

CMG Partners, LLC
425-376-0693
www.cmginvestments.com

Comrit Investments I, LP
Tel Aviv, Israel

SECONDARY MARKET PARTICIPANTS (Cont.)

1st Trade
(800) 700-7998
https://www.1st-trade.com/

Central Trade & Transfer
(877) 704-6737
www.cttauctions.com

Direct Investments Spectrum
https://www.dispectrum.com/

Mackenzie Capital Management
(800) 854-8357
www.mackenziecapital.com

INFORMATION SOURCES AND
POTENTIAL SECONDARY MARKETS OR BROKERS
FOR ILLIQUID PRIVATE PLACEMENTS

1st Trade
(800) 700-7998
https://www.1st-trade.com/

Central Trade & Transfer
(877) 704-6737
www.cttauctions.com

CMG Partners, LLC
425-376-0693
www.cmginvestments.com

Direct Investments Spectrum
https://www.dispectrum.com/

Mackenzie Capital Management
(800) 854-8357
www.mackenziecapital.com

Pacific Partnership Group
Signal Securities
www.sellmyreit.com
(800) 727-7244

Partnership Marketing Co.
(888) 824-8600
http://lpsales.com/

THE ANATOMY OF A FINRA ARBITRATION

Adam Gana

Suitability

All advisers and brokerage firms have a fundamental responsibility to deal fairly with investors and to make "suitable" investments. The Financial Industry Regulatory Authority, or "FINRA" sets the standards in the brokerage industry for the suitable sale of investments to brokerage clients. FINRA's suitability rule contains three primary brokerage responsibilities: 1. To perform reasonable-basis suitability analysis, 2. To perform customer-specific suitability analysis, and 3. To perform quantitative suitability analysis.

Reasonable-Basis Suitability: All brokers and broker-dealers must have a reasonable basis to believe, based on appropriate research and diligence, that all recommendations are suitable for at least some investors. FINRA recognizes that there are some investment products and strategies that are inappropriate for all investors and other investments that are only appropriate for a very small group of investors.

The standards for reasonable diligence vary depending on the complexity of the investment product or the investment strategy employed. Regardless of the specific product or investment strategy being recommended, investment advisers and broker-dealers must properly convey the potential risks and rewards associated with the recommended security or strategy before bringing it to an investor's attention. Therefore, the broker-dealer at a minimum must fully understand all of the contours of the investments it recommends to its clients to meet the most basic of suitability requirements.

Customer-Specific Suitability: All brokers and broker-dealers must have a reasonable basis to believe that the recommended investment strategy is suitable for the particular customer. All sales efforts must be reasonable and appropriate for the investor based upon the investor's risk tolerance, investment objectives, age, tax consequences, financial circumstances, other investment holdings, and experience. An advisor must attempt to obtain and analyze a broad array of customer-specific factors to provide suitable investment advice. This prong of the suitability rule requires detailed and specific analysis of the customer and his or her specific situation and to create an investment recommendation that is tailored to the client.

Quantitative Suitability: Under FINRA's Rule 2111 quantitative suitability prong "a broker who has control over a customer account must have a reasonable basis to believe that a series of recommended securities transactions are not excessive." Essentially, all brokers and broker-dealers must have a reasonable basis for recommending a series of transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's objectives. Thus, while a small investment in a particular product may be suitable for the investor, a large portfolio concentration in the same or similar products may be unsuitable for the same investor.

In addition, the pattern and type of securities activity in the account can also be unsuitable for the investor. Arbitrators are not required to use a single to determine whether a broker excessively traded a client's account. Many factors can be used to determine whether an account has been excessively traded by a broker such as turnover rate, cost-equity ratio, and use of in-and-out trading tactics indicate excessive activity that violates quantitative suitability standards. This prong

of the suitability rule is similar to the analysis of a churning claim. Churning, or excessive trading, when a broker-dealer buys and sells securities for the purpose of generating commissions for the broker's benefit. The real difference between a churning claim and a claim for excessive trading under FINRA's suitability rule is that "scienter," or intent, is not a necessary element to establish an excessive trading violation.

Institutional- Investor Exemption: Under FINRA Rule 2111(b), a broker or broker-dealer fulfills the customer-specific suitability obligation for institutional investors differently than with individual customers. For institutional customers the broker or broker-dealer must have a reasonable basis to believe the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular investment strategies and also the institutional customer must affirmatively indicate that it is exercising independent judgment in evaluating the broker's recommendations.

Fiduciary Duties – Brokers

When a broker recommends an investment to an investor, the broker has a duty to:

- Understand the nature of the investment's risks, rewards, and strategy before recommending the investment;
- Make only suitable recommendations to the investor based upon the investor's objectives, needs, and circumstances;
- Furnish information to the investor that would be material to the investor's decision about the investment recommendation; and
- Not misrepresent or omit material information.

These fiduciary duties are "point of sale" duties. That is, each duty exists at the time the broker recommends a transaction to an investor. Generally, courts have found that a non-discretionary broker-investor relationship, without more, does not create a duty to continually furnish the client with information about the recommended transactions. However, courts impose ongoing fiduciary duties on brokers when:

- The investor is very young or old, has never employed a broker before or has very little general knowledge investment experience, and completely relies upon the expertise and knowledge of the broker. In these cases, it is assumed that the broker exercised a high degree of direction and control over the account's investments;
- The broker and investor have been long-time friends and enjoy a social trust because the investor is relying upon the relationship in accepting the recommendations of the broker; or
- The broker assumes actual control over the account.

Churning (Excessive Trading)

"Churning" is essentially investment trading activity that is excessive and serves little useful purpose and is conducted solely to generate commissions for the broker. The elements to establish a churning claim are:

- Excessive purchases and sales of securities for the purpose of generating commissions; and
- Broker control.

a. Excessive Trading

According to FINRA, there is not one single test that ultimately determines whether trading has been excessive. In order to determine whether trading has been excessive, there are two commonly measured metrics: the account's 'annualized turnover ratio' and its 'cost to equity ratio,' which is also known as its 'break even percentage.'

The turnover ratio of the account is widely regarded as the litmus test for determining whether an account has been churned. Depending upon the objectives of the account, a turnover ratio as much as 1 to 1 can support a finding of churning. However, churned accounts typically will experience turnover ratios in the 3 to 6 range. However, some courts have found that an annualized turnover rate of between two and four is sufficient to gain a presumption that an account has been churned by a broker and requires the broker or brokerage firm to then prove it did not churn the account. The burden shifts.

The cost to net equity ratio measures how expensive the trading strategy was in the account. For example, an annual cost to net equity ratio that is 5% would require the account to earn a 5% profit to breakeven. The more expensive the trading strategy is to employ in the account the more likely excessive trading will be found. However, as the total value of the assets under management increases, the client ought to be able to achieve economies of scale and discounts sufficient to lower the cost of trading.

When reviewing churning cases, it is important to determine the broker's commission rate and total commissions in the account as well as the excessive trading in the account. When the commissions are high, it serves as additional evidence for a claim of churning.

b. Broker Control

Broker control is established by the broker's solicitation of the transactions or discretion over account activity. If the customer accepts the recommendations of the broker to trade in the account control may be found. Control of the customer account can either be expressed or implied. Express control exists where the customer has a discretionary account established pursuant to a written agreement giving the broker discretionary trading authority without first consulting with the investor. Implied authority, or de facto control, is determined by the investors: 1) age; 2) education; 3) business acumen; 4) investment experience; 5) knowledge of investments; 6) frequency of trades; and 7) initiation of trades versus the broker's initiation of trades.

Generally speaking, under FINRA Rule 2110 brokers are required to "observe high standards of commercial honor and just and equitable principles of trade." FINRA Rule 2111 provides that in

recommending securities, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer based upon the customer's financial situation and needs. This rule requires a broker to conduct "quantitative suitability" analysis. Quantitative suitability focuses on whether the number of transactions within a given timeframe is suitable in light of the customer's financial circumstances and investment objectives and is similar to a claim of churning, but generally is easier to prove at an evidentiary hearing.

Failure to Supervise

A broker-dealer owes a duty to all of its customers under FINRA Rule 3010 to properly monitor and supervise its employees. FINRA Rule 3010 states:

> Each member shall establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules. Final responsibility for proper supervision shall rest with the member…

In short, a brokerage firm owes a duty to all of its customers to properly monitor and supervise its employees. A failure to supervise claim requires: (1) an underlying securities law violation; (2) association of the registered representative or other person who committed the violation; (3) supervisory jurisdiction over that person; and (4) failure of the broker-dealer and/or supervisory personnel to reasonably supervise the person who violated the securities laws.

An Underlying Securities Violation

The underlying securities violation to show a broker-dealer failed to supervise a broker can be a host of violations including: violations of a state blue sky laws, churning, securities fraud, or a violation of FINRA's suitability rule. This will be very case specific.

Association With a Brokerage Firm

Under FINRA Rule 12100® a "Person Associated with a Member" includes "a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member, whether or not any such person is registered or exempt from registration with FINRA under the By-Laws or the Rules of FINRA." Further, "a person formerly associated with a member is a person associated with a member."

Supervisory Jurisdiction

In addition to FINRA Rule 3010, numerous other notices to members, FINRA, SEC, and court decisions hold the securities laws impose upon broker-dealers the duty and obligation to properly monitor and supervise its employees. FINRA Rule 3010 requires that broker-dealers review the activities of each office and branch and every broker in the branch. Broker-dealers must supervise by conducting periodic examination of customer accounts to detect and prevent irregularities and abuses. Broker-dealers must also supervise outside businesses including registered investment advisory firms and review those records as if the securities transactions were on the broker-dealer's own books and records.

Broker-dealers must also inspect unregistered offices and review any on-site customer account documentation and other books and records, meet with individual registered representatives to discuss the products they are selling and their sales methods, and a examine correspondence and sales literature. Furthermore, firms should have unannounced visits to the branch office the firm is required to supervise where appropriate, particularly where there are indicators of misconduct or potential misconduct, or 'red flags.'

Failure to Supervise

Broker-dealers violate the supervisory standard when either: (1) awareness of 'red flags' are not followed up with proper supervision; and (2) policies and procedures are deficient resulting in failure to detect 'red flags.'

The duty to supervise is a critical component of the securities regulatory scheme. Regulatory authorities such as the SEC and FINRA have steadily heightened the supervisory obligations of brokerage firms in recent years. Supervisors have an obligation to respond vigorously to indications of irregularity, often times referred to as "red flags." A supervisor cannot ignore or disregard red flags and must act decisively to detect and prevent improper activity.

It is important that members review their supervisory procedures and systems that are in place to conduct adequate inspections and determine whether the systems are being followed. Failure to have systems in place to adequately supervise or failure to follow those systems lead to claims that a broker-dealer failed to follow the law.

The importance of proper supervision is manifested in various types of securities activities. Brokerage firms are responsible for monitoring a broker's investment recommendations to clients, outside business activities, and representations to investors among other obligations. In addition, brokerage firms are responsible for conducting due diligence on the securities products they sell and devising a written supervisory system to achieve compliance with the securities laws.

THE NEWSLETTER FOR FINRA NEUTRALS

Financial Industry Regulatory Authority

Volume 2 – 2016

The Neutral Corner

What's Inside

Expedited Proceedings 3
All in the Details 5
Dispute Resolution and FINRA News 7
Mediation Update 10
Questions and Answer 11
Education and Training 12
Arbitrator Tips 13

Mission Statement

We publish *The Neutral Corner* to provide arbitrators and mediators with current updates on important rules and procedures within securities dispute resolution. FINRA's dedicated neutrals better serve parties and other participants in the FINRA forum by taking advantage of this valuable learning tool.

The 20-Day Exchange: Identification of Expert Witnesses

By Ryan K. Bakhtiari and Greg Curley

Rule 12514 of the Code of Arbitration Procedure for Customer Disputes requires parties, at least 20 days before the first hearing, to serve on each other copies of documents that they intend to present at the hearing and to identify witnesses they intend to call, including expert witnesses. FINRA staff sends the witness lists to the arbitrators to review prior to a hearing. FINRA asks arbitrators to look for any potential conflicts when reviewing names on the witness lists.

It has come to our attention that some expert witnesses have been designated as witnesses on a 20-day list when in fact they have not actually been retained. This practice has a number of potential adverse consequences. A phantom listing can lead to unnecessary arbitrator recusals. Such practice can also lead counsel to retain a rebuttal expert unnecessarily or perhaps to prepare for the examination of a witness that will never testify at the actual arbitration hearing. Phantom listings can also contribute to the miscalculation of the duration of the hearing and cause the scheduling of witnesses to be more burdensome and difficult than necessary.

The phantom designation of an expert witness in a FINRA arbitration compromises the integrity of the process. We remind parties that best practices dictate that a party only identify and designate expert witnesses that a party has retained. Arbitrators should be aware of this practice. FINRA has updated the Initial Prehearing Conference Script for arbitrators to remind parties to identify only those expert witnesses they have actually retained. FINRA has also updated the letter that notifies parties of the location of the hearing to remind them of best practices in connection with the designation of expert witnesses.

Ryan Bakhtiari is a partner at Aidikoff, Uhl & Bakhtiari, an "AV" rated law firm with a worldwide practice representing individuals and institutions in disputes with Wall Street and the financial services industry. The firm

next page ▶

Comments, Feedback and Suggestions

Please send your suggestions and comments to:

Jisook Lee, Editor
The Neutral Corner
FINRA Dispute Resolution
One Liberty Plaza
165 Broadway, 27th Floor
New York, New York 10006

You may also email Jisook at *Jisook.Lee@finra.org*.

regularly appears before FINRA as well as in numerous state and federal courts to resolve financial disputes between customers, employees, banks, brokerage firms and insurance companies. Mr. Bakhtiari presently serves as the Chairman of FINRA's National Arbitration and Mediation Committee.

Greg Curley is Senior Litigation Counsel for Advisor Group, Inc., overseeing litigation involving the four Advisor Group broker-dealers: Royal Alliance Associates, Inc., FSC Securities Corp., SagePoint Financial, Inc. and Woodbury Financial, Inc. Simultaneous to his litigation responsibilities, Mr. Curley has served roles for Advisor Group relating to business development, acquisitions and representative recruiting. Prior to joining Advisor Group, Mr. Curley was a litigation associate with the Law Offices of Joseph D'Elia in Huntington, NY.

Expedited Proceedings for Seniors and Seriously Ill Parties

By Kelly Unger, Regional Manager, FINRA Office of Dispute Resolution's Northeast Regional Office

FINRA provides expedited proceedings for senior and seriously ill parties. As soon as FINRA learns that a matter involves an elderly or seriously ill party, the case is flagged as an expedited case, and staff endeavors to complete the arbitrator selection process, schedule the Initial Prehearing Conference (IPHC) and serve the final award on an expedited basis.

FINRA recently formed a committee to examine its procedures to look for ways to process expedited cases more efficiently. Although staff cannot change the time requirements set forth in the Code of Arbitration Procedure, the committee identified several opportunities to shorten the processing time on expedited cases. As a first step, FINRA modified its internal reports to help staff identify expedited cases and get them on the expedited track. In addition, we put several procedural improvements in place.

The committee also created an Expedited Procedures Stipulation that staff sends to parties in expedited cases. The parties can agree to reduce the deadline to submit arbitrator ranking forms, waive the required 20-day notice of the IPHC, provide mutually agreeable hearing dates and direct FINRA to appoint arbitrators who are available on the parties' agreed hearing dates.

Staff will notify arbitrators when contacted to serve on a case whether the case is proceeding on an expedited track. To keep the case moving, arbitrators should let staff know as quickly as possible if they are available to serve. After appointment, arbitrators will receive a letter with the case packet that discusses the expedited procedures in more detail.

Arbitrators are expected to be sensitive to the needs of senior or seriously ill parties, and every effort should be made to expedite these cases particularly in the areas described below.

Discovery Deadlines

Arbitrators should take all steps within their authority to help expedite the exchange of documents and the identification of witnesses. During the IPHC, the panel should establish a discovery cut off as close to the IPHC as possible. FINRA recommends that the panel set the deadline to file discovery motions no more than three months after the IPHC.

Scheduling the Hearing

Arbitrators should schedule dates that will expedite the process but still provide a reasonable amount of time for case preparation. FINRA encourages parties and arbitrators to schedule the hearing within six months from the date of the IPHC. FINRA also recommends setting aside extra hearing dates to avoid unanticipated delays.

Adjournments

When deciding adjournment requests, arbitrators should be mindful of the age and health of parties or key witnesses. In addition, arbitrators are expected to avoid causing postponements absent a genuine emergency.

Direct Communication

Parties and arbitrators should consider agreeing to direct communication if all parties are represented by counsel.

Decisions

As with all cases, arbitrators should return orders and decisions to FINRA as soon as possible, preferably by email or through the portal (on DR Portal cases). To facilitate prompt return, arbitrators can sign orders and awards electronically.

FINRA intends for these measures to speed the processing of cases involving senior or seriously ill parties, while maintaining procedural balance and fairness for all parties. Arbitrators should contact the case administrator with any questions about serving on an expedited case.

All in the Details: Award Information Sheet

*By Narielle Robinson, Analyst, FINRA Securities Helpline for Seniors**



Pursuant to FINRA Rule 12904, after an evidentiary hearing has concluded, arbitrators have 30 days to render an award. Rendering an award includes:

- post-hearing deliberations;
- the chairperson's completion and submission of the Award Information Sheet (AIS) to FINRA;
- staff preparation of the award with information from the AIS;
- panel review and execution of the award; and
- FINRA's service of the award on the parties, which happens simultaneously with case closure.

Arbitrators can help expedite the process by submitting a completed and detailed AIS and providing staff with all necessary clarifications immediately upon request.

The AIS contains questions to ensure that the panel has reviewed and considered all necessary items to render the award. Certain questions may have clear answers; however, some questions require more detailed responses. For example, granting attorneys' fees or punitive damages requires arbitrators to cite authority (provided by the parties) and provide a brief explanation. Arbitrators and staff must work closely to ensure that the award reflects all accurate and relevant information. The following suggestions provide guidance for common questions during the award stage.

Damages

The AIS specifically asks if a party changed its final damage request at the hearing on the merits from the amount requested in the pleadings. If so, the panel must explicitly note any changes in the AIS.

Award Offsets

If there is an award to both parties, the arbitrators should note whether amounts should be offset. Arbitrators should review the recent rule filing and refer to the article on this topic previously published in The Neutral Corner - Volume 1—2013.

Motions

If a party files a motion to dismiss, arbitrators should note whether the party made the filing before or after the conclusion of the non-moving party's case-in-chief. If the party filed the motion before the conclusion of the claimant's case-in-chief, the panel's decision to grant the motion must be unanimous and a brief written explanation must accompany any decision to grant the motion. If the party filed the motion after the claimant's case-in-chief, the majority decision prevails and no explanation is required.

If there were any motions pending prior to the hearing, the panel must address them with the parties and reflect its final resolution in the AIS.

Expungement

FINRA Rule 12805 requires the panel to indicate in the arbitration award which of the Rule 2080 grounds for expungement serve(s) as the basis for its expungement recommendation and provide a brief written explanation of the reason(s) for its finding that one or more Rule 2080 grounds for expungement applies to the facts of the case. Therefore, arbitrators must specifically cite the ground and provide an explanation of its findings in the AIS.

The panel should note in the AIS all of the documents it reviewed when making its decision on expungement. This will include, among other things, the associated person's most recent BrokerCheck report and any settlement documents. The panel should specify whether the party seeking expungement contributed to the settlement and state that the panel considered the amount of payments made to any party in the settlement and any other terms and conditions of the settlement. Arbitrators should review FINRA's Expanded Expungement Guidance for the latest information about addressing expungement.

FINRA hopes these reminders will help arbitrators complete the AIS thoroughly and efficiently in order to render an award expeditiously. Arbitrators should feel free to contact the assigned case administrator if they require any additional information or need assistance in completing the AIS.

**Until recently, Narielle worked as a Case Assistant for FINRA Office of Dispute Resolution's Southeast Regional Office.*

DR Portal Update

Neutral Portal

As a reminder, we strongly encourage arbitrators and mediators to register with the DR Portal. Portal benefits include:

- viewing and updating your profile information;
- viewing and printing your disclosure report;
- accessing information about your cases, including upcoming hearings and payment information;
- scheduling hearings;
- viewing case documents; and
- filing case documents.

Submitting Documents Through the Portal

Please note that FINRA cannot retrieve documents through file-sharing sites such as Google Docs or Dropbox. Documents must be uploaded directly to the portal to ensure that FINRA receives them.

FINRA is actively reaching out to arbitrators serving on portal cases to encourage them to register. Portal registration will be noted on the arbitrator disclosure report that parties review during arbitrator selection.

continued

Dispute Resolution and FINRA News

Case Filings and Trends

Arbitration case filings from January through May 2016 reflect a 20 percent increase compared to cases filed during the same five-month period in 2015 (from 1,243 cases in 2015 to 1,486 cases in 2016). Customer-initiated claims increased by 29 percent through May 2016 compared to cases filed in 2015 (from 811 cases in 2015 to 1,050 cases in 2016).

Updated Dispute Resolution Statistics Page

FINRA has updated the Dispute Resolution Statistics page. The new page now includes an interactive map displaying all hearing locations, cases per hearing location and arbitrators per hearing location. In addition, FINRA has added new charts detailing the top 15 most common case filing controversy types and security types in customer and industry cases.

Practising Law Institute's Securities Arbitration 2016: September 28, 2016

PLI's Securities Arbitration 2016 provides an opportunity to hear about the latest developments and hot topics directly from FINRA Office of Dispute Resolution leadership, arbitrators, noted academics and experienced attorneys who represent both customers and industry players. PLI's distinguished faculty will provide you with best practices from an arbitrator's perspective, tips for preparing for employment disputes and a practicum on the use of experts and crafting effective closings. In addition, attendees will take away a top-ten list of ethics issues practitioners should always keep in mind.

Please visit PLI's website for more information about the Securities Arbitration 2016 program.

If you have not registered with the DR Portal, please send an email to Dispute Resolution Neutral Management to request an invitation. Please include "request portal invitation" in the subject line.

Arbitrator List Statistics

You may now review your list selection statistics in the portal. By selecting "view my Arbitrator List Statistics" from the left hand menu, you can see how often your name has appeared on arbitrator ranking lists sent to parties and how often you are ranked or struck on those lists.

Updating Email Addresses in the Portal

FINRA has simplified email maintenance by removing the ability to store multiple email addresses in a neutral's profile. Therefore, each neutral will have only one email address on file, which is the same email address used to register in the DR Portal. All other email addresses have been deleted.

FINRA staff cannot make any changes to a neutral's email address after the neutral has registered in the portal. If you have already registered in the portal and need to update your email address, you must update

continued

SEC Rule Filing

Award Offsets in Arbitration

FINRA filed with the Securities and Exchange Commission (SEC) a proposed rule change to amend Rule 12904 of the Code of Arbitration Procedure for Customer Disputes and Rule 13904 of the Code of Arbitration Procedure for Industry Disputes (Codes) to address award offsets in arbitration. Specifically, the proposal provides that, absent specification to the contrary in an award, when arbitrators order opposing parties to pay each other damages, the monetary awards would offset, and the party that owes the larger amount would pay the net difference. Please view rule proposal SR-FINRA-2016-015 for more information.

Rulemaking Items Approved at the May 2016 FINRA Board of Governors Meeting

Broadening Chairperson Eligibility in Arbitration

The Board authorized filing with the SEC proposed amendments to Rules 12400 and 13400 (Neutral List Selection System and Arbitrator Rosters) to revise the arbitration forum chairperson eligibility requirements. Specifically, an attorney arbitrator would be eligible for the chairperson roster if he or she completes chairperson training and serves as an arbitrator through award on at least one arbitration, instead of two arbitrations, administered by a self-regulatory organization in which hearings were held.

Motions to Dismiss in Arbitration

The Board authorized filing with the SEC proposed amendments to Rules 12504 and 13504 (Motions to Dismiss) to provide that arbitrators in its forum may act upon a motion to dismiss prior to the conclusion of a party's case-in-chief if the arbitrators determine that the non-moving party previously brought the same dispute against the same party, and the dispute was fully and finally adjudicated on the merits.

it by logging into the portal. From the homepage, select the "manage my account" link from the left-hand navigation panel. After you update your email address, press the "save" button and confirm that your data has been saved.

We strongly recommend that you use a personal email address rather than a work address. This will ensure that despite any changes in employment, your email address will remain current.

Please contact the Neutral Management department by email or by telephone (855-209-1620) if you have any questions. You may also review the Frequently Asked Questions and User Guides for any help with the portal.

Panel Selection in Customer Cases with Three Arbitrators

The Board authorized filing with the SEC proposed amendments to Rule 12403 (Cases with Three Arbitrators) to increase the number of public arbitrators on the list that FINRA sends parties during the panel selection process in customer cases. Specifically, FINRA would increase the number of public arbitrators on the list from 10 to 15. FINRA would also increase the number of strikes to the public list from four to six, to keep the proportion of strikes the same under the amended rule as it is under the current rule.

Mediation Update

Mediation Statistics

From January through May 2016, parties initiated 285 mediation cases, an increase of 43 percent compared to cases filed in 2015. FINRA closed 266 cases during this time. Approximately 73 percent of these cases concluded with successful settlements, and the average case turnaround time was 109 days.

FINRA Small Claims Mediation Program

FINRA's Small Claims Mediation Program continues to offer parties in active arbitration cases free or low-cost telephone mediation for cases with initial claim amounts of $50,000 or less. Claims of $25,000 or less are eligible for mediation at no cost, while claims over $25,000 through $50,000 are eligible for mediation at a reduced fee of $50 per hour (divided equally by the parties). FINRA collects no mediation filing fees for these cases.

Telephone mediation provides parties with convenience and flexibility. The program also offers seniors or those with difficulty traveling, the option to participate in a mediation without having to travel to an on-site meeting. To date, more than 90 percent of the cases that mediate through this program have reached a settlement. The settlement rate is higher than in mediations conducted through our regular program and emphasizes that mediations can be conducted telephonically with great success.

Not only do FINRA parties benefit from working with a qualified, experienced FINRA mediator, but FINRA mediators with fewer opportunities to mediate cases due to their geographic location, or who are new to the roster, increase their visibility with party representatives that mediate in our forum. If you are a FINRA mediator and want more information about this program, please email *SmallClaims@finra.org*.

Mediator Tip: Keep It Current

Keeping your mediator disclosure report current—including the number of times you have mediated cases, your success rate and types of cases mediated—matters to parties selecting a mediator. Mediators frequently update their mediator rate, present employment, disclosure/conflict information, current cancellation policy, but sometimes forget to describe their success as a mediator. For the quickest way to update your mediator report, use the FINRA Dispute Resolution Portal.

Question and Answer

Electronic Signatures

Question: I am about to upload the Oath of Arbitrator through the DR Portal. Do I need to sign the Oath before I upload it?

Answer: No, when you submit the Oath and other documents through the portal, you are using your unique and secure DR Portal account. Therefore, there is no need to physically sign the document by hand or to insert a digital signature or graphic image of your signature before you upload the document. You can simply type your name on the signature line by entering your first name, middle initial and last name, preceded by /s/: "/s/ Jane Q. Public." After you save the document on your computer, you can upload it in the portal. For more information about submitting documents through the portal, please review the portal FAQ and User Guide.

Arbitrator Disclosure Reminder

As a reminder, arbitrators should review their disclosure reports regularly to ensure that all information is accurate and current. Even if arbitrators are not currently assigned to cases, their disclosure reports may be sent to parties in their hearing locations during arbitrator selection. Parties should have the most current and complete information about an arbitrator to make an informed decision when selecting arbitrators.

Education and Training

Spring 2016 Neutral Workshop—Practical Tips For Arbitrators From Arbitrators



FINRA's latest Neutral Workshop video features tips for arbitrators. In this workshop, Anna Lyons, Associate Director of the Office of Dispute Resolution's Southeast Regional Office, discusses best practice tips with FINRA arbitrators: Nancy Cliff, Steve Goerke and B.J. Krintzman. Based on their years of experience conducting FINRA arbitrations, the panelists provide guidance on how to conduct efficient initial prehearing conferences and successful hearings, discuss tips for working with co-panelists and share their experiences using the Dispute Resolution Portal.

FINRA Regulatory Trainings

In addition to arbitrator trainings, FINRA offers podcasts and webinars on timely regulatory and compliance topics. Please visit FINRA's online learning page for more information about these training opportunities.

Arbitrator Tips

Managing the Deliberation



After the hearing has concluded and the parties have left the room together, the arbitrators generally should commence the deliberation on the merits of the case. It is best to begin immediately because the panel has just heard the parties' summations, and the evidence is fresh in everyone's minds. While deliberating, the arbitrators should carefully listen to their co-panelists. Each panel member's observations and opinions should be heard, acknowledged and considered. The panel should work as a team and exchange ideas freely.

To help facilitate discussion, be sure to:

- present your views in turn;
- openly discuss your differences;
- do not judge other panel members' opinions; and
- use phrases such as, "please explain" or, "what evidence supports that idea?" when questioning other panelists.

The panel owes it to the parties, and to the arbitration process, to engage in full and fair discussions concerning the issues raised by the parties and to ensure that every panel member's opinions are heard and considered in the deliberation.

Turn the Recorder *Off* During Executive Sessions and Deliberations

FINRA cannot emphasize enough the importance of turning off the recorder during executive sessions and deliberations. Like the importance given to turning on the recorder to ensure that the proceedings are recorded pursuant to the Code of Arbitration Procedure, turning off the recorder during executive sessions and deliberations is equally important.

During these private conversations, arbitrators generally feel free to speak openly about the merits of the case with their co-panelists knowing that the parties are out of the room, and their conversations will not be recorded. This is exactly what should happen. Unfortunately, if arbitrators forget to turn the recorder off, their candid conversations will be recorded.

Consequently, if parties request copies of the recordings to review the testimony or prepare for a possible challenge to the award, they will not only receive the hearing record but also the arbitrators' private conversations. If the deliberation is recorded, parties might use this information in support of a motion to vacate.

Recording these private sessions has the potential to weaken the finality of an arbitration award. Further, it reveals the workings of the deliberative process that should remain private, so that arbitrators can talk freely and exchange ideas. To avoid these unintended consequences, arbitrators should always make sure that the recorder is turned off before engaging in executive sessions, deliberations or any off-the-record conversations. Arbitrators should also consider leaving the hearing room to deliberate in a secure location outside the range of the recorder.

The recorder shows a red light when it is on and recording. Be sure to look for the red light and confirm that it is **off** before starting a private conversation with your co-panelists. For further guidance, please review the article, Properly Recording the Arbitration Hearing previously published in Volume 2, 2012 of The Neutral Corner.

Directory

Richard W. Berry
Executive Vice President and Director of Dispute Resolution

Kenneth L. Andrichik
Senior Vice President – Chief Counsel and Director of Mediation and Strategy

Todd Saltzman
Vice President
Case Administration, Operations and Neutral Management

James Schroder
Associate Vice President
DR Product Management

Katherine M. Bayer
Regional Director
Northeast Region

Carolann Gemski
Regional Director
Midwest Region

Laura D. McNamire
Regional Director
West Region

Manly Ray
Regional Director
Southeast Region

Jisook Lee
Associate Director of Neutral Management and Editor of *The Neutral Corner*

FINRA Dispute Resolution Offices

Northeast Region
FINRA Dispute Resolution
One Liberty Plaza, 27th Floor
165 Broadway
New York, NY 10006
Phone: (212) 858-4200
Fax: (301) 527-4873
neprocessingcenter@finra.org

West Region
FINRA Dispute Resolution
300 S. Grand Avenue, Suite 1700
Los Angeles, CA 90071
Phone: (213) 613-2680
Fax: (301) 527-4766
westernprocessingcenter@finra.org

Southeast Region
FINRA Dispute Resolution
Boca Center Tower I
5200 Town Center Circle, Suite 200
Boca Raton, FL 33486
Phone: (561) 416-0277
Fax: (301) 527-4868
fl-main@finra.org

Midwest Region
FINRA Dispute Resolution
55 West Monroe Street, Suite 2600
Chicago, IL 60603-1002
Phone: (312) 899-4440
Fax: (312) 236-9239
midwestprocessingcenter@finra.org

Editorial Board

Arthur Baumgartner	Northeast Region
David Carey	Case Administration
William Cassidy	Southeast Region
Christina Gates	West Region
Mignon McLemore	Office of Chief Counsel
Marilyn Molena	Mediation
Patrick Walsh	Midwest Region

©Volume 2 – 2016 FINRA.
All rights reserved.

FINRA is a registered trademark of Financial Industry Regulatory Authority. MediaSource is a service mark of FINRA.

The Neutral Corner is published by FINRA Dispute Resolution in conjunction with FINRA Corporate Communications. Send all correspondence to Jisook Lee, Associate Director of Neutral Management and Editor of *The Neutral Corner*:

FINRA Dispute Resolution
One Liberty Plaza
165 Broadway, 27th Floor
New York, NY 10006

Or call (212) 858-4400.

No part of this publication may be copied, photocopied or duplicated in any form or by any means without prior written consent from FINRA. Unauthorized copying of this publication is a violation of the federal copyright law.

16_0224.1—06/16



Investor protection. Market integrity.

FINRA
One Liberty Plaza
165 Broadway
New York, NY 10006

www.finra.org
© 2016 FINRA. All rights reserved.
FINRA and other trademarks of the
Financial Industry Regulatory Authority, Inc.
may not be used without permission. 16_0224.1–06/16

WORKING WITH EXPERTS

Expert Witness Cross Examination: The Ultimate Guide

Cross-examining experts can be a daunting task.



Written by Joseph B. Evans, J.D.
— Updated on April 11, 2022



Due to the technical subject matter, it can feel as though the cross-examiner is walking into a college classroom and telling the professor how to teach the class. If an expert witness cross examination is not well-prepared and planned, a cross-examiner can find themselves wandering into the weeds in a technical area in which the expert witness's knowledge on the topic is far superior to the cross-examiner's.

It's not exactly a level playing field. However, a well-prepared cross-examination of opposing counsel's expert witness can be debilitating to the opposition. Here,

BECOME AN EXPERT (888) 858-9511

Be Prepared

It is critical to research the expert's qualifications, community standing in the expert's own field and prior testifying experience. Perhaps the most important place to look for useful information is in the expert's prior testimony. Finding a similar case in which the expert gave conflicting expert testimony is effective ammunition for cross-examination. It is also important to identify and read the expert's prior writings. Many experts maintain their own webpages and draft a number of articles that can be used during cross-examination.

Here is an example of how a prior conflicting article was used to dismantle an expert witness who was called to the stand to opine that the plaintiff's T-cell lymphoma cancer was caused by the defendant's product:

Q. You are on staff at M.D. Anderson Cancer Hospital?
A. Yes.
Q. Isn't it true that M.D. Anderson Cancer Hospital has a web page?
A. Yes.
Q. Have you ever had any articles published on the M.D. Anderson web page?
A. A few.
Q. Do you remember one of your articles that appeared on the web page just three months ago?
A. I think so.
Q. In that article, you talked about T-cell lymphoma, the very type of cancer involved in this case?
A. I believe so.
Q. Let's be sure. Is this the article that was published on the web page?
A. Yes, that's my article; it has my name on it.
Q. I assume you knew that physicians and others might read this article?
A. Yes, I assume so.
Q. And, therefore, you wanted to be as accurate as possible?
A. Of course.

Skip to content

BECOME AN EXPERT (888) 858-9511

Q. In this article, which you published on the web page just three months ago, you talk about what is known regarding the cause of T-cell lymphoma, isn't that right?
A. Yes.
Q. Isn't it true that you said the following: "No one knows what causes T-cell lymphoma." Is that what you wrote just three months ago?
A. That's what it says.

Ultimately, this cross-examination not only lost the credibility of the expert witness in front of the jury, it caused the trial judge to conclude that the expert lacked reliable scientific support for her opinions and, shortly thereafter, judgment was entered for the defendant.

Box in the Expert at Deposition

The framework for the effective cross-examination happens long before trial during the expert's deposition. As stated by the American Bar Association, it is absolutely critical that the cross-examiner "box in" the expert at the deposition. This includes asking the expert during the deposition the exact opinions that he/she intends to give at trial, the basis for those opinions and the assumptions made in connection with that opinion.

It is also helpful to sum up the deposition with catch-all questions such as "other than the opinions you have already expressed today, are there any other opinions that you intend to give at trial?" This allows the cross-examiner to exploit any changes from the deposition testimony and also to explore any new or nuanced opinions that the expert did not disclose at the deposition. Also, once the deposition is over, it is important to master the deposition testimony because it is important to highlight any differences between the deposition testimony and the testimony given at trial.

Skip to content

As required by Federal Rule of Civil Procedure 26(a)⑵(B)(i)-(vi), Federal Criminal Rule of Procedure 16(a)⑴(G), (b)⑴(C) and individual State statutes, the expert is required to submit an expert report outlining the opinions the expert intends to give and the basis for those opinions, as well as other useful information. It also outlines the expert's qualifications. The cross-examiner should review this report in painstaking detail and try to uncover every error, large and small. However, when cross-examining, be careful to not just use the expert report as a roadmap. This can run the risk of letting the expert essentially repeat his direct testimony. Instead the cross-examiner should be leading the expert to reveal the errors and weaknesses in the report.

Develop a Theory

There must be a theory for the cross-examination. It is not enough to simply poke holes in the expert's testimony or report. An effective cross-examination tells the jury a story and explains to them why the expert's opinion is not credible and should not be believed. The question to answer is: what am I trying to tell the jury with this cross-examination? Is the expert honest but mistaken? Is the expert purposely exaggerating or shading his testimony? Is the expert relying on a faulty factual assumption? Once the cross-examiner has identified the goal, it is critical to focus the cross-examination on building on this central theme.

Yes or No Questions

Experts are smart. Really smart. And, with few exceptions, the expert will be far more experienced in the subject matter than the attorney asking the questions. It may seem rudimentary, but it is critical that the attorney cabin the possible responses to the questions to be "yes" or "no" questions. Allowing the expert to opine with open-ended questions can result in the expert displaying to the jury his/her expertise and credibility on the subject.

One way to build upon the cross-examiner's theory is through the use of cross-examination by a collateral attack, focusing less on the case at hand, and more on the expert and his potential biases. The experts' financial bias is a common ground for a collateral attack. The expert is, after all, providing his opinion on behalf of a party for a fee. This financial bias can also be shown by the number of cases in which the expert has testified, the number of Courts in which he or she has testified and also the areas of expertise which he or she has claimed to be an expert.

At bottom, this line of questioning is to show that the expert is not an objective expert simply teaching the jury the subject matter as if he is a professor in a classroom, but rather a hired gun for opposing counsel to mislead the jury.

Stick To A Few Points

Some expert testimony can be meticulous, highly technical and, to some jurors, downright boring. In fact, there are a number of reported cases where jurors have even fallen asleep during expert testimony. That is why it is crucial to pick the three or four best cross-examination points and stick to them. An overly long and confusing cross-examination runs the risk of boring the judge and the jury and, perhaps most critically, could end up hiding the most important points of cross-examination.

Attack the Expert's Qualifications

A key point to discredit expert witnesses is to attack their qualifications. If the cross-examiner can establish exaggerations in the expert's qualifications not only will that expert's credibility quickly fade, but the attorney who called that witness

field and the training and testing required for such certifications. It can display to the jury that experts in the field do in fact exist, however, the expert testifying in Court is not one of those experts.

Relatedly, expert witnesses often hold themselves out to be experts in many different areas. Exploring and identifying the other fields in which the expert claims he is an expert in can show the jury that the expert cannot possibly be an expert in all of these fields, but rather he is just an expert in getting hired to testify.

Call Out Assumptions

Experts typically do not have personal knowledge of the facts of the case. Rather they are relying on facts that are provided by the hiring attorney and the experts generally are basing their opinions on the assumption that those facts are true. Since many experts are qualified in their field, and, at least have knowledge far superior to the cross-examining attorney, it may be easier to attack the facts that the expert is assuming to be true, rather than a deep analysis into his area of expertise. This is particularly true if the expert's track record and qualifications are beyond reproach.

Also, if the particular expert is very qualified and likeable, it points the finger at the opposing counsel and his client for feeding the expert facts that are inaccurate. Ultimately, if the expert is shown to have relied on facts that are not true, their opinions may no longer be credible or reliable.

Cross-examining expert witnesses is no easy task. The cross-examining attorney can find himself or herself wading into technical areas in which the expert's knowledge is far superior. That is why it is critical to prepare and plan the attack long before stepping into the courtroom. Following the tips in this article is by no

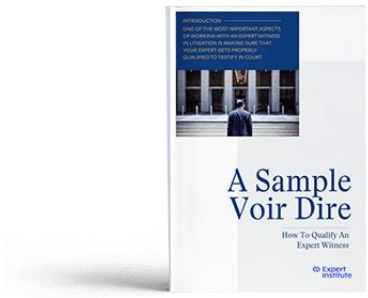
BECOME AN EXPERT (888) 858-9511

Get a winning edge in the courtroom

Access extensive background data and real-time intelligence on opposing experts

Activate Expert Radar

ADDITIONAL RESOURCES



WHITE PAPER

A Sample Voir Dire: How To Qualify An Expert Witness

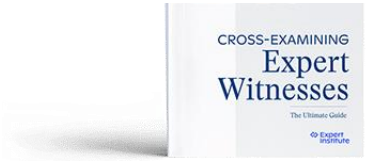
Download free white paper



WHITE PAPER

Challenging Opposing Experts: Advanced Research Techniques

Download free white paper



Guide

Download free white paper

RELATED POSTS

JANUARY 31, 2017 WORKING WITH EXPERTS

Drafting Expert Witness Reports: Pitfalls and Best Practices

Mistakes in an expert report could preclude the expert from testifying; while a clear and comprehensive expert report could tip the scales in litigation. Experts and attorneys should be aware of what is required and should also take note…

Read More

FEBRUARY 7, 2017 WORKING WITH EXPERTS

Can an Expert Witness be Sued?

greater value on an expert's testimony. This reliance on expert testimony can, however, be ruinous…

Read More

COMMENTS

Leave a Reply

Your email address will not be published. Required fields are marked *

Leave a Comment *

First Name *

Last Name*

Email *

Law Firm / Company*

Attorney

Expert

Post Comment

Request an Expert

Become an Expert

CONTACT

48 Wall Street, 16th Floor
New York, NY 10005

(888) 858-9511

info@expertinstitute.com

SUBSCRIBE TO OUR NEWSLETTER

Email*

Subscribe

FOR ATTORNEYS

Case Management

Expert Radar

SERVICES

Expert Witness Search

Case Clinics

Strategic Research



2022 Expert Institute

Privacy Policy

Compliance

Terms & Conditions

Rule 1.8: Current Clients: Specific Rules

Share:



Client-Lawyer Relationship

(a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:

(1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client;

(2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel on the transaction; and

(3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction.

(b) A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client gives informed consent, except as permitted or required by these Rules.

(c) A lawyer shall not solicit any substantial gift from a client, including a testamentary gift, or prepare on behalf of a client an instrument giving the lawyer or a person related to the lawyer any substantial gift unless the lawyer or other recipient of the gift is related to the client. For purposes of this paragraph, related persons include a spouse, child, grandchild, parent, grandparent or other relative or individual with whom the lawyer or the client maintains a close, familial relationship.

(d) Prior to the conclusion of representation of a client, a lawyer shall not make or negotiate an agreement giving the lawyer literary or media rights to a portrayal or account based in substantial part on information relating to the representation.

(e) A lawyer shall not provide financial assistance to a client in connection with pending or contemplated litigation, except that:

(1) a lawyer may advance court costs and expenses of litigation, the repayment of which may be contingent on the outcome of the matter;

(2) a lawyer representing an indigent client may pay court costs and expenses of litigation on behalf of the client; and

(3) a lawyer representing an indigent client pro bono, a lawyer representing an indigent client pro bono through a nonprofit legal services or public interest organization and a lawyer representing an indigent client pro bono through a law school clinical or pro bono program may provide modest gifts to the client for food, rent, transportation, medicine and other basic living expenses. The lawyer:

(i) may not promise, assure or imply the availability of such gifts prior to retention or as an inducement to continue the client-lawyer relationship after retention;

(ii) may not seek or accept reimbursement from the client, a relative of the client or anyone affiliated with the client; and

(iii) may not publicize or advertise a willingness to provide such gifts to prospective clients.

Financial assistance under this Rule may be provided even if the representation is eligible for fees under a fee-shifting statute.

(f) A lawyer shall not accept compensation for representing a client from one other than the client unless:

(1) the client gives informed consent;

(2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and

(3) information relating to representation of a client is protected as required by Rule 1.6.

(g) A lawyer who represents two or more clients shall not participate in making an aggregate settlement of the claims of or against the clients, or in a criminal case an aggregated agreement as to guilty or nolo contendere pleas, unless each client gives informed consent, in a writing signed by the client. The lawyer's disclosure shall include the existence and nature of all the claims or pleas involved and of the participation of each person in the settlement.

(h) A lawyer shall not:

(1) make an agreement prospectively limiting the lawyer's liability to a client for malpractice unless the client is independently represented in making the agreement; or

(2) settle a claim or potential claim for such liability with an unrepresented client or former client unless that person is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel in connection therewith.

(i) A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client, except that the lawyer may:

(1) acquire a lien authorized by law to secure the lawyer's fee or expenses; and

(2) contract with a client for a reasonable contingent fee in a civil case.

(j) A lawyer shall not have sexual relations with a client unless a consensual sexual relationship existed between them when the client-lawyer relationship commenced.

(k) While lawyers are associated in a firm, a prohibition in the foregoing paragraphs (a) through (i) that applies to any one of them shall apply to all of them.

Comment | Table of Contents | Next Rule

ABA American Bar Association |
/content/aba-cms-dotorg/en/groups/professional_responsibility/publications/model_rules_of_professional_conduct/rule_1_8_current_clients_specific_rules

Rule 1.8 Conflict of Interest: Current Clients: Specific Rules - Comment

Share:

Client-Lawyer Relationship

Business Transactions between Client and Lawyer

[1] A lawyer's legal skill and training, together with the relationship of trust and confidence between lawyer and client, create the possibility of overreaching when the lawyer participates in a business, property or financial transaction with a client, for example, a loan or sales transaction or a lawyer investment on behalf of a client. The requirements of paragraph (a) must be met even when the transaction is not closely related to the subject matter of the representation, as when a lawyer drafting a will for a client learns that the client needs money for unrelated expenses and offers to make a loan to the client. The Rule applies to lawyers engaged in the sale of goods or services related to the practice of law, for example, the sale of title insurance or investment services to existing clients of the lawyer's legal practice. See Rule 5.7. It also applies to lawyers purchasing property from estates they represent. It does not apply to ordinary fee arrangements between client and lawyer, which are governed by Rule 1.5, although its requirements must be met when the lawyer accepts an interest in the client's business or other nonmonetary property as payment of all or part of a fee. In addition, the Rule does not apply to standard commercial transactions between the lawyer and the client for products or services that the client generally markets to others, for example, banking or brokerage services, medical services, products manufactured or distributed by the client, and utilities' services. In such transactions, the lawyer has no advantage in dealing with the client, and the restrictions in paragraph (a) are unnecessary and impracticable.

[2] Paragraph (a)(1) requires that the transaction itself be fair to the client and that its essential terms be communicated to the client, in writing, in a manner that can be reasonably understood. Paragraph (a)(2) requires that the client also be advised, in writing, of the desirability of seeking the advice of independent legal counsel. It also requires that the client be given a reasonable opportunity to obtain such advice. Paragraph (a)(3) requires that the lawyer obtain the client's informed consent, in a writing signed by the client, both to the essential terms of the transaction and to the lawyer's role. When necessary, the lawyer should discuss both the material risks of the proposed transaction, including any risk presented by the lawyer's involvement, and the existence of reasonably available alternatives and should explain why the advice of independent legal counsel is desirable. See Rule 1.0(e) (definition of informed consent).

[3] The risk to a client is greatest when the client expects the lawyer to represent the client in the transaction itself or when the lawyer's financial interest otherwise poses a significant risk that the lawyer's representation of the client will be materially limited by the lawyer's financial interest in the transaction. Here the lawyer's role requires that the lawyer must comply, not only with the requirements of paragraph (a), but also with the requirements of Rule 1.7. Under that Rule, the lawyer must disclose the risks associated with the lawyer's dual role as both legal adviser and participant in the transaction, such as the risk that the lawyer will structure the transaction or give legal advice in a way that favors the lawyer's interests at the expense of the client. Moreover, the lawyer must obtain the client's informed consent. In some cases, the lawyer's interest may be such that Rule 1.7 will preclude the lawyer from seeking the client's consent to the transaction.

[4] If the client is independently represented in the transaction, paragraph (a)(2) of this Rule is inapplicable, and the paragraph (a)(1) requirement for full disclosure is satisfied either by a written disclosure by the lawyer involved in the transaction or by the client's independent counsel. The fact that the client was independently represented in the transaction is relevant in determining whether the agreement was fair and reasonable to the client as paragraph (a)(1) further requires.

Use of Information Related to Representation

[5] Use of information relating to the representation to the disadvantage of the client violates the lawyer's duty of loyalty. Paragraph (b) applies when the information is used to benefit either the lawyer or a third person, such as another client or business associate of the lawyer. For example, if a lawyer learns that a client intends to purchase and develop several parcels of land, the lawyer may not use that information to purchase one of the parcels in competition with the client or to recommend that another client make such a purchase. The Rule does not prohibit uses that do not disadvantage the client. For example, a lawyer who learns a government agency's interpretation of trade legislation during the representation of one client may properly use that information to benefit other clients. Paragraph (b) prohibits disadvantageous use of client information unless the client gives informed consent, except as permitted or required by these Rules. See Rules 1.2(d), 1.6, 1.9(c), 3.3, 4.1(b), 8.1 and 8.3.

Gifts to Lawyers

[6] A lawyer may accept a gift from a client, if the transaction meets general standards of fairness. For example, a simple gift such as a present given at a holiday or as a token of appreciation is permitted. If a client offers the lawyer a more substantial gift, paragraph (c) does not prohibit the lawyer from accepting it, although such a gift may be voidable by the client under the doctrine of undue influence, which treats client gifts as presumptively fraudulent. In any event, due to concerns about overreaching and imposition

on clients, a lawyer may not suggest that a substantial gift be made to the lawyer or for the lawyer's benefit, except where the lawyer is related to the client as set forth in paragraph (c).

[7] If effectuation of a substantial gift requires preparing a legal instrument such as a will or conveyance, the client should have the detached advice that another lawyer can provide. The sole exception to this Rule is where the client is a relative of the donee.

[8] This Rule does not prohibit a lawyer from seeking to have the lawyer or a partner or associate of the lawyer named as executor of the client's estate or to another potentially lucrative fiduciary position. Nevertheless, such appointments will be subject to the general conflict of interest provision in Rule 1.7 when there is a significant risk that the lawyer's interest in obtaining the appointment will materially limit the lawyer's independent professional judgment in advising the client concerning the choice of an executor or other fiduciary. In obtaining the client's informed consent to the conflict, the lawyer should advise the client concerning the nature and extent of the lawyer's financial interest in the appointment, as well as the availability of alternative candidates for the position.

Literary Rights

[9] An agreement by which a lawyer acquires literary or media rights concerning the conduct of the representation creates a conflict between the interests of the client and the personal interests of the lawyer. Measures suitable in the representation of the client may detract from the publication value of an account of the representation. Paragraph (d) does not prohibit a lawyer representing a client in a transaction concerning literary property from agreeing that the lawyer's fee shall consist of a share in ownership in the property, if the arrangement conforms to Rule 1.5 and paragraphs (a) and (i).

Financial Assistance

[10] Lawyers may not subsidize lawsuits or administrative proceedings brought on behalf of their clients, including making or guaranteeing loans to their clients for living expenses, because to do so would encourage clients to pursue lawsuits that might not otherwise be brought and because such assistance gives lawyers too great a financial stake in the litigation. These dangers do not warrant a prohibition on a lawyer lending a client court costs and litigation expenses, including the expenses of medical examination and the costs of obtaining and presenting evidence, because these advances are virtually indistinguishable from contingent fees and help ensure access to the courts. Similarly, an exception allowing lawyers representing indigent clients to pay court costs and litigation expenses regardless of whether these funds will be repaid is warranted.

[11] Paragraph (e)(3) provides another exception. A lawyer representing an indigent client without fee, a lawyer representing an indigent client pro bono through a nonprofit legal services or public interest organization and a lawyer representing an indigent client pro bono through a law school clinical or pro bono program may give the client modest gifts. Gifts permitted under paragraph (e)(3) include modest contributions for food, rent, transportation, medicine and similar basic necessities of life. If the gift may have consequences for the client, including, e.g., for receipt of government benefits, social services, or tax liability, the lawyer should consult with the client about these. See Rule 1.4.

[12] The paragraph (e)(3) exception is narrow. Modest gifts are allowed in specific circumstances where it is unlikely to create conflicts of interest or invite abuse. Paragraph (e)(3) prohibits the lawyer from (i) promising, assuring or implying the availability of financial assistance prior to retention or as an inducement to continue the client-lawyer relationship after retention; (ii) seeking or accepting reimbursement from the client, a relative of the client or anyone affiliated with the client; and (iii) publicizing or advertising a willingness to provide gifts to prospective to clients beyond court costs and expenses of litigation in connection with contemplated or pending litigation or administrative proceedings.

[13] Financial assistance, including modest gifts pursuant to paragraph (e)(3), may be provided even if the representation is eligible for fees under a fee-shifting statute. However, paragraph (e)(3) does not permit lawyers to provide assistance in other contemplated or pending litigation in which the lawyer may eventually recover a fee, such as contingent-fee personal injury cases or cases in which fees may be available under a contractual fee-shifting provision, even if the lawyer does not eventually receive a fee.

Person Paying for a Lawyer's Services

[14] Lawyers are frequently asked to represent a client under circumstances in which a third person will compensate the lawyer, in whole or in part. The third person might be a relative or friend, an indemnitor (such as a liability insurance company) or a co-client (such as a corporation sued along with one or more of its employees). Because third-party payers frequently have interests that differ from those of the client, including interests in minimizing the amount spent on the representation and in learning how the representation is progressing, lawyers are prohibited from accepting or continuing such representations unless the lawyer determines that there will be no interference with the lawyer's independent professional judgment and there is informed consent from the client. See also Rule 5.4(c) (prohibiting interference with a lawyer's professional judgment by one who recommends, employs or pays the lawyer to render legal services for another).

[15] Sometimes, it will be sufficient for the lawyer to obtain the client's informed consent regarding the fact of the payment and the identity of the third-party payer. If, however, the fee arrangement creates a

conflict of interest for the lawyer, then the lawyer must comply with Rule 1.7. The lawyer must also conform to the requirements of Rule 1.6 concerning confidentiality. Under Rule 1.7(a), a conflict of interest exists if there is significant risk that the lawyer's representation of the client will be materially limited by the lawyer's own interest in the fee arrangement or by the lawyer's responsibilities to the third-party payer (for example, when the third-party payer is a co-client). Under Rule 1.7(b), the lawyer may accept or continue the representation with the informed consent of each affected client, unless the conflict is nonconsentable under that paragraph. Under Rule 1.7(b), the informed consent must be confirmed in writing.

Aggregate Settlements

[16] Differences in willingness to make or accept an offer of settlement are among the risks of common representation of multiple clients by a single lawyer. Under Rule 1.7, this is one of the risks that should be discussed before undertaking the representation, as part of the process of obtaining the clients' informed consent. In addition, Rule 1.2(a) protects each client's right to have the final say in deciding whether to accept or reject an offer of settlement and in deciding whether to enter a guilty or nolo contendere plea in a criminal case. The rule stated in this paragraph is a corollary of both these Rules and provides that, before any settlement offer or plea bargain is made or accepted on behalf of multiple clients, the lawyer must inform each of them about all the material terms of the settlement, including what the other clients will receive or pay if the settlement or plea offer is accepted. See also Rule 1.0(e) (definition of informed consent). Lawyers representing a class of plaintiffs or defendants, or those proceeding derivatively, may not have a full client-lawyer relationship with each member of the class; nevertheless, such lawyers must comply with applicable rules regulating notification of class members and other procedural requirements designed to ensure adequate protection of the entire class.

Limiting Liability and Settling Malpractice Claims

[17] Agreements prospectively limiting a lawyer's liability for malpractice are prohibited unless the client is independently represented in making the agreement because they are likely to undermine competent and diligent representation. Also, many clients are unable to evaluate the desirability of making such an agreement before a dispute has arisen, particularly if they are then represented by the lawyer seeking the agreement. This paragraph does not, however, prohibit a lawyer from entering into an agreement with the client to arbitrate legal malpractice claims, provided such agreements are enforceable and the client is fully informed of the scope and effect of the agreement. Nor does this paragraph limit the ability of lawyers to practice in the form of a limited-liability entity, where permitted by law, provided that each lawyer remains personally liable to the client for his or her own conduct and the firm complies with any conditions required by law, such as provisions requiring client notification or maintenance of adequate liability insurance. Nor does it prohibit an agreement in accordance with Rule 1.2 that defines the scope of

the representation, although a definition of scope that makes the obligations of representation illusory will amount to an attempt to limit liability.

[18] Agreements settling a claim or a potential claim for malpractice are not prohibited by this Rule. Nevertheless, in view of the danger that a lawyer will take unfair advantage of an unrepresented client or former client, the lawyer must first advise such a person in writing of the appropriateness of independent representation in connection with such a settlement. In addition, the lawyer must give the client or former client a reasonable opportunity to find and consult independent counsel.

Acquiring Proprietary Interest in Litigation

[19] Paragraph (i) states the traditional general rule that lawyers are prohibited from acquiring a proprietary interest in litigation. Like paragraph (e), the general rule has its basis in common law champerty and maintenance and is designed to avoid giving the lawyer too great an interest in the representation. In addition, when the lawyer acquires an ownership interest in the subject of the representation, it will be more difficult for a client to discharge the lawyer if the client so desires. The Rule is subject to specific exceptions developed in decisional law and continued in these Rules. The exception for certain advances of the costs of litigation is set forth in paragraph (e). In addition, paragraph (i) sets forth exceptions for liens authorized by law to secure the lawyer's fees or expenses and contracts for reasonable contingent fees. The law of each jurisdiction determines which liens are authorized by law. These may include liens granted by statute, liens originating in common law and liens acquired by contract with the client. When a lawyer acquires by contract a security interest in property other than that recovered through the lawyer's efforts in the litigation, such an acquisition is a business or financial transaction with a client and is governed by the requirements of paragraph (a). Contracts for contingent fees in civil cases are governed by Rule 1.5.

Client-Lawyer Sexual Relationships

[20] The relationship between lawyer and client is a fiduciary one in which the lawyer occupies the highest position of trust and confidence. The relationship is almost always unequal; thus, a sexual relationship between lawyer and client can involve unfair exploitation of the lawyer's fiduciary role, in violation of the lawyer's basic ethical obligation not to use the trust of the client to the client's disadvantage. In addition, such a relationship presents a significant danger that, because of the lawyer's emotional involvement, the lawyer will be unable to represent the client without impairment of the exercise of independent professional judgment. Moreover, a blurred line between the professional and personal relationships may make it difficult to predict to what extent client confidences will be protected by the attorney-client evidentiary privilege, since client confidences are protected by privilege only when they are imparted in the context of the client-lawyer relationship. Because of the significant danger of

harm to client interests and because the client's own emotional involvement renders it unlikely that the client could give adequate informed consent, this Rule prohibits the lawyer from having sexual relations with a client regardless of whether the relationship is consensual and regardless of the absence of prejudice to the client.

[21] Sexual relationships that predate the client-lawyer relationship are not prohibited. Issues relating to the exploitation of the fiduciary relationship and client dependency are diminished when the sexual relationship existed prior to the commencement of the client-lawyer relationship. However, before proceeding with the representation in these circumstances, the lawyer should consider whether the lawyer's ability to represent the client will be materially limited by the relationship. See Rule 1.7(a)(2).

[22] When the client is an organization, paragraph (j) of this Rule prohibits a lawyer for the organization (whether inside counsel or outside counsel) from having a sexual relationship with a constituent of the organization who supervises, directs or regularly consults with that lawyer concerning the organization's legal matters.

Imputation of Prohibitions

[23] Under paragraph (k), a prohibition on conduct by an individual lawyer in paragraphs (a) through (i) also applies to all lawyers associated in a firm with the personally prohibited lawyer. For example, one lawyer in a firm may not enter into a business transaction with a client of another member of the firm without complying with paragraph (a), even if the first lawyer is not personally involved in the representation of the client. The prohibition set forth in paragraph (j) is personal and is not applied to associated lawyers.

Back to Rule | Table of Contents | Next Comment

American Bar Association |
/content/aba-cms-dotorg/en/groups/professional_responsibility/publications/model_rules_of_professional_conduct/rule_1_8_current_clients_specific_rules/comment_on_rule_1_8

September 04, 2019

PRACTICE POINTS

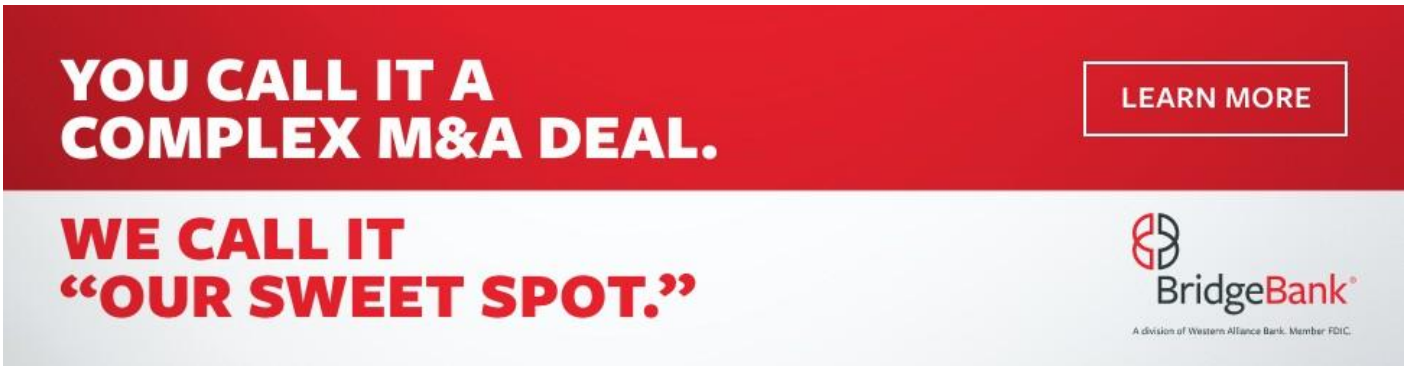
Five Tips for an Effective Mediation Statement

A carefully drafted mediation statement can help a mediator plan strategy for a successful settlement.

By Mark A. Romance

Share:

Few commercial litigation cases proceed to trial—the risk of leaving the fate of a case to a group of citizens who did not volunteer to decide your case is just too great. Accordingly, mediation is one of the most critical points in a case, and one of the key moments for a lawyer to achieve success in a commercial litigation matter. A good confidential mediation statement can be a roadmap to help the mediator help you obtain a successful result.



Here are five tips to for a more effective confidential mediation statement:

1 Be upfront. Your first paragraph should tell the mediator who you represent, who the opponent is, summarize the claims and explain what is at stake. This should be short and to the point. This suggestion may seem obvious, but too many lawyers start their statement with multiple paragraphs of background facts without giving a brief summary up front about who the parties are and what the case is about. The mediator is then left to sift through pages of facts and wonder why they matter. Start with a summary of who the parties are and what is at issue before getting into the facts and the details of the claims.

2 Provide a concise summary of the facts and claims. The next section should provide details to help the mediator quickly learn the key facts and how they relate to what is at issue. No mediator will know the facts as well as the lawyers, nor do they need to. The mediator needs to understand the basic facts and background about the parties to develop strategies to help the parties resolve the case. The mediator will not have the patience or need to read an appellate brief. Avoid prose but use headings and bullet points to organize the section, and to summarize the claims, defenses and background about the parties. This style makes it much easier for the mediator to quickly get the key information. Using the same format, you should also include a summary of the posture of the case and describe the status of discovery and key dates such as summary judgment hearings or trial.

3 Summarize prior settlement discussions. It is important for the mediator to know the history of efforts to resolve the case. This section should be specific as to all demands and offers, including details that affected the prior discussions, such as key rulings or depositions that occurred before or after a demand or offer was made. If no settlement discussions have occurred, explain why. This information will help the mediator craft a strategy in advance of the mediation based on prior efforts.

4 Identify strengths and weaknesses. This is a critical component of a mediation summary. A good lawyer will not only focus on the strengths of her case but will also recognize weaknesses, whether in facts or law. Often a client has tunnel vision and sees a case from an emotional or narrow point of view and even his own lawyer cannot help him see the other side. A mediator can help a lawyer convince both an opponent and even her own client that weaknesses exist and compromise may be necessary. In a confidential mediation statement, it is helpful to include factual and legal weaknesses to allow the mediator to begin developing a strategy to help both sides compromise. If key documents or deposition testimony are important, this is a good place to summarize them. But keep in mind that most mediators will not take the time to master the facts, so be brief and use a summary format. During the mediation, you can then bring out the details, and the mediator will be somewhat familiar with them already.

5 Bring it home. Close your mediation statement with a suggested path forward. For example, if you think starting the mediation with both sides making opening statements would be helpful, explain why and what you hope to accomplish. If you think that opening statements might drive the parties farther apart given the hostilities to that point, or that the parties have

seen their lawyers in action and it would waste valuable time, say so. But your conclusion should offer the mediator a suggested starting point to kick off the session and indicate how you hope it will lead to a resolution.

Make the mediation statement your roadmap to a successful settlement. This is your chance to get the mediator focused on how you think she can help you resolve the case. Be brief, be specific and be strategic to get the mediator focused and ready in advance of the session to help resolve the case.

Mark A. Romance is a partner with Day Pitney LLP in Miami, Florida.

ENTITY:

LITIGATION

TOPIC:

LITIGATION & TRIALS, BUSINESS & CORPORATE, ALTERNATIVE DISPUTE RESOLUTION

The material in all ABA publications is copyrighted and may be reprinted by permission only. Request reprint permission here.

Copyright © 2019, American Bar Association. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or downloaded or stored in an electronic database or retrieval system without the express written consent of the American Bar Association. The views expressed in this article are those of the author(s) and do not necessarily reflect the positions or policies of the American Bar Association, the Section of Litigation, this committee, or the employer(s) of the author(s).

Strategy-proof and Efficient Mediation: An Ordinal Market Design Approach*

Onur Kesten† Selçuk Özyurt‡

October 2021

Abstract

Mediation, also known as assisted negotiation, is the preferred alternative dis- pute resolution approach that has given rise to a multi-billion-dollar industry world- wide. Online dispute resolution providers, in particular, rely heavily on mechanized e-Negotiation systems. We develop a novel ordinal framework where negotiators with conflicting preferences seek resolution over multiple issues. The mediation process is represented by a mechanism with voluntary participation. We characterize the full class of efficient, individually rational, and strategy-proof mediation protocols. A nec- essary and sufficient condition for the existence of such protocols is the so-called quid pro quo property that allows negotiators to compromise between issues.

JEL Codes: C78; D47; D74; D78; D82

Keywords: Market design, online dispute resolution, mediation, negotiation, e-Negotiation systems, alternative dispute resolution, logrolling, quid pro quo, outside options, strategy- proofness, efficiency.

1 Introduction

The classic bestseller book *Getting to Yes*, by Roger Fisher and William Ury, is one of the most famous references on the topic of negotiation. The authors identified conflict as a growth industry, and the last few decades have proved them right. Judicial systems of developing and emerging economies are often challenged with a large backlog of cases, and efficiency concerns fueled implementation of reforms that have focused on increased usage of alternative dispute resolution (ADR) processes.[1] Mediation is often the preferred form

*We thank Johannes H¨orner, Mehmet Ekmek¸ci, Kalyan Chatterjee, Hu¨lya Eraslan, Paola Manzini, Utku U¨ nver, Tayfun S¨onmez, Rakesh Vohra, George Mailath, Vijay Krishna, Herv´e Moulin, Larry Ausubel, Michael Ostrovsky, Ed Green, Ron Siegel, Luca Rigotti, Sevgi Yu¨ksel, Alexey Kushnir, Alex Teytelboym, William Thomson, Peter Troyan, Charlie Holt, Ruben Juarez, Francis Bloch, Leeat Yariv, Laura Doval, Piotr Dworczak, Nicholas Yannelis, and all seminar participants at Stanford (NBER Market Design Workshop), NYU, Rice, Maryland, Boston College, University of Pittsburgh, Carnegie Mellon, Penn State (PETCO), Virginia, Durham, Sydney, University of Technology Sydney, Bilkent, ITU, Paris Dauphine, York, Dalhoise, Sussex, and SAET for many useful discussions and suggestions. Sel¸cuk Özyurt especially thanks M. Remzi Sanver, David Pearce, Eric Maskin, Harvard University Department of Economics, Tepper School of Business, and Sabancı University Economics Group for their mentoring, support and hospitality during this project, and the European Commission for the funding from European Union Horizon 2020 research and innovation programme under the Marie Sklodowska-Curie grant agreement No 659780.

†(Corresponding author) University of Sydney, School of Economics (onur.kesten@sydney.edu.au)

‡York University, Department of Economics (ozyurt@yorku.ca)

[1]See, for example, Ali (2018) for an extensive account of the recent mediation reforms.

of ADR due to its cost-effectiveness (timewise and financially),[2] flexibility,[3] and confidentiality. Since 1990s a significant number of countries have implemented both mandatory and voluntary mediation programs to improve the efficacy of their legal systems.[4]

Mediation is a consensual negotiation process in which a neutral third party (i.e., mediator) assists disagreeing parties to identify the underlying interests, issues, and solutions, and help them reach an agreement short of litigation. Notwithstanding the practical conveniences it affords, the mediation process is often considered less formal and less transparent than binding adjudication processes such as litigation and arbitration. Traditional legal theorists argue[5] that the low visibility and lack of formal rules and structure in traditional mediation reduce the rights of less powerful participants. In a seminal work, LaFree and Rack (1996) provide empirical evidence from the small claims court mediation program in Bernalillo County in Albuquerque, New Mexico, and conclude that ethnicity and gender could be more important determinants in informal mediation than they are in adjudication. In particular, they report that white males receive significantly more favorable outcomes in mediation than minority females.[6]

A structured and rigorous view of mediation is pioneered in online dispute resolution (ODR) that often rely on automation. ODR systems resolve disputes that arise both online and off-line. In a standard ODR system, parties interact through an online platform and the mediator is usually a patented software, also known as e-Negotiation system (ENS), that follows predetermined sets of rules embodied in a mechanized algorithm. During the Internet "bubble" of 1999-2000, many ODR start-ups appeared and then disappeared, but since then interest in ODR has grown and its focus has expanded (Wahab et al., 2012). Over 134 ODR platforms currently operate worldwide,[7] while SquareTrade, Cybersettle and SmartSettle are the oldest and probably the most famous ones. It is estimated that e-commerce platforms like eBay, Paypal, Uber and Amazon resolved more than a billion disputes in 2017 through their ODR systems (Habuka and Rule, 2017). Since its founding, Cybersettle handled over 200,000 claims combined value in excess of $1.6B, and the City of New York uses the system since 2004 to speed their settlement process for a backlog of

[2]According to Hadfield (2000), it costs a minimum of $100,000 to litigate a straightforward business claim in the US, whereas a mediation session varies from few hours to a day and even the most reputable mediators charge around $10,000 - $15,000 for a day. Also, disputants do not pay any fees for experts, witnesses, document preparation, investigation, or paralegal services, which easily make the costs pile up.

[3]It is impossible to discuss a legally "irrelevant" issue in litigation/arbitration. In mediation, however, parties can discuss and negotiate issues that are not directly linked to the case.

[4]Several provinces of Canada, most notably Ontario, refer civil actions, which are subject to case management, to mandatory mediation. The mediation is conducted by a private-sector mediator and the disputants are responsible with the corresponding fees: https://www.attorneygeneral.jus.gov.on.ca/english/courts/manmed/notice.php. In the US, 63 federal district courts authorized the required use of mediation, out of which 12 courts mandated the use of mediation for some or all civil cases. In UK, the Small Claims Mediation Scheme is funded by HMCS (Her Majesty's Courts Service) and provides a free service for small claims cases operating in all court centers. If the parties' claim does not exceed £10,000 and agree to mediate, then a phone-based or face-to-face mediation session is arranged. In Singapore, Australia, Italy, and India court-annexed mediation takes place in the courts after parties have commenced legal proceedings, and serves as the primary method of civil dispute resolution. See Ali (2018) for an extended discussion on mandatory mediation practices in the US, UK, and aforementioned other countries.

[5]See, for example, Damaska (1975).

[6]In a similar vein, many others emphasize the factors that can cause disputant dissatisfaction that are under the direct control of mediators. As a remedy, Tyler and Huo (2002) advocate the use of fair procedures that are described as those in which decisions are viewed as *neutral, objective, and consistent*.

[7]See http://odr.info/provider-list/ (last visit August 12, 2021).

40,000 personal injury claims.[8] Government use of ODR promises to be a very large market as well (Wahab et al., 2012). Government agencies, such as the National Mediation Board[9] and the Office of Government Information Services[10] in the United States, are adopting and promoting ODR as an effective method of resolving problems with citizens. In the US and Canada, 27 courts either partially or fully integrated ODR into their systems.[11] Rapid technological developments and worldwide changes brought by Covid-19 pandemic have shown that ODR is the inevitable future of dispute resolution in the new millennium.[12]

In principle, ODR systems are ideal platforms to deliver impartial, consistent, and fair outcomes since the human factor (i.e., the mediator) is taken out of the equation and replaced with a set of reliable and objective rules and procedures. The task of automating a negotiation process is not a simple one, and this is evidenced by a myriad of systems (mostly still research efforts) around the world (Thiessen et al. 2012). However, these systems are vulnerable to strategic manipulation, and negotiators face a daunting task of finding optimal strategies. This weakness is acknowledged by the experts in the field:

> "*A concern with the use of ENS is the possible effects of gaming and cheating. By supplying false information concerning the range of issues over which they are willing to negotiate, the results will be distorted.*" Thiessen et al. (1998).

These distortions may cause severe inefficiencies: Negotiators may fail to achieve the best possible solution, although they successfully reach a resolution. Thiessen et al. (1998), the founders of the popular SmartSettle algorithms, defend the current systems in this account as follows:

> "*It is not clear from various experiments carried out that these distortions will always be to the benefit of the cheater. It may turn out, however, that if everyone cheats, the alternatives ENS generates may be acceptable and therefore useful in the negotiation process even though they may not be truly equivalent or efficient.*"

ODR systems would help parties resolve disputes that are otherwise doomed to fail, and this may be a significant efficiency gain. Nevertheless, we find the view in the quote above rather optimistic. Systems that are prone to gaming may produce systematically unfair outcomes. Infrequent users (e.g., customers in e-commerce disputes, individual plaintiffs against companies and government agencies) may be hurt under current systems when they face experienced users who have accumulated enough expertise about how to game the system. Although the design of *fair* and *efficient* e-Negotiation systems is an active research area within the management information systems literature, existing frameworks do not take incentive considerations into account. We are inspired by the structured mediation programs that are offered by the ODR systems, and follow a market design approach to

[8]Online Dispute Resolution Advisory Group 2015 report: https://www.judiciary.uk/wp-content/uploads/2015/02/Online-Dispute-Resolution-Final-Web-Version1.pdf (last visit August 12, 2021).

[9]See https://nmb.gov/NMB_Application/ (Last visit August 14, 2021).

[10]See https://www.archives.gov/ogis (Last visit August 14, 2021).

[11]See http://odr.info/courts-using-odr/ (last visit August 12, 2021).

[12]One of the pioneers and the first director of the ODR systems at eBay and PayPal, Colin Rule, famously wrote (see Rule (2014)) "*Now that society has embraced technology so thoroughly, the key question for dispute resolution professionals is, how can we leverage technology to best assist parties in resolving their disputes? Online Dispute Resolution is no longer a novelty—it is now arguably the future of Alternative Dispute Resolution.*"

develop a tractable framework in search for efficient, incentive compatible, and impartial mediation (recommendation) mechanisms.

Mechanism design has been successful in many applications, most notably in market design for auctions and matching. Unlike the traditional mechanism design approach to bargaining (i.e., Myerson and Satterthwaite (1983)) we adopt an *ordinal* approach in the context of mediation for three reasons. First, rather than restricting players' preferences to a specific transferable utility setting, we maintain a basic common implication of any monotonic preferences in a conflict situation. In doing so, we characterize all classes of preferences that would support a possibility result and thereby allow for both transferable and nontransferable utility.[13] Second, it is genuinely simple to implement ordinal mechanisms, which is particularly important when agents are boundedly rational.[14] Third, the ordinal approach together with dominant strategy implementation makes it possible to avoid the famous Wilson critique by providing "detail-freeness" and "robust incentives" to participants.[15]

The backbone of our formal setting consists of two negotiators that are in a dispute over an issue X. Each negotiator has a commonly known ranking over the discrete set of solutions (alternatives) that are available for issue X, and the negotiators' rankings are diametrically opposed. In keeping with the practice of ODR, we assume that negotiators have private bargaining ranges for issue X. In other words, negotiators come to the mediation table with a privately known "least acceptable outcome." We capture such circumstances by assuming that each negotiator has an *outside option*, what is referred as the BATNA (Best Alternative to a Negotiated Agreement) in the field.[16] How a negotiator ranks her outside option is her private information. Depending on the type realizations, the private bargaining ranges may not overlap and a mutually acceptable alternative need not always exist. For this reason, we say that issue X has *uncertain gains from mediation*. A mediation rule is a systematic way of choosing an outcome for any reported pair of types of the two negotiators. By using a standard revelation principle, we denote the mediation mechanism by the mediation rule whose outcome may be vetoed by either negotiator, in which case the mediation fails and both negotiators receive the outside option.

In line with ODR practices, we constrain our attention to mechanisms that never suggest an alternative falling outside of the declared bargaining ranges. This requirement corresponds to individual rationality of the mediation mechanism. We easily conclude that it is impossible to find a "good" mediation mechanism in a single-issue dispute, which is *Pareto efficient*, *individually rational*, and *strategy-proof* (i.e., no negotiator ever gains from a misreport). This conclusion should not be surprising. For mediation practitioners, single

[13]Although money is an important issue in disputes, it is rarely the only issue (Malhotra and Bazerman, 2008). This underscores the necessity of a setting that can also admit nontransferable utility specifications.

[14]There is a large body of experimental evidence that finds that the representation of preferences by VNM utility functions may be inadequate; see, for example, Kagel and Roth (2016). This literature argues that the formulation of rational preferences over lotteries is a complex process that most agents prefer not to engage in if they can avoid it.

[15]While stressing the powerful insights that mechanism design offers in bargaining problems, Ausubel et al. (2002) voice a similar concern: "*... Despite these virtues, mechanism design has two weaknesses. First, the mechanisms depend in complex ways on the traders' beliefs and utility functions, which are assumed to be common knowledge. Second, it allows too much commitment. In practice, bargainers use simple trading rules—such as a sequence of offers and counteroffers—that do not depend on beliefs or utility functions.*"

[16]See, for example, Fisher and Ury (1981).

issue disputes are often bound to fail because they are extremely competitive; parties see them as win-lose contests. From a mechanism design perspective, this negative result is also not surprising in light of the well-known impossibility of Myerson and Satterthwaite (1983) that there is no incentive compatible and efficient bilateral trading mechanism.[17]

According to negotiation experts, success in mediation lies in parties' ability of expanding the pie and finding integrative (win-win) outcomes, which necessitates the idea of multi-issue negotiation and logrolling (Malhotra and Bazerman, 2008). From a technical perspective, relaxing the tension between efficiency, individual rationality and strategy-proofness by introducing an additional issue makes perfect sense as negotiators could then be asked to consider concessions in one issue for a favorable treatment (i.e., compensation) in the other so they will be disincentivized from gaming the system. However, we show that the impossibility continues if each additional issue also exhibits uncertain gains from mediation. This is simply because it is impossible to guarantee that the new issue always contains mutually acceptable alternatives that can be used for compensation. This case and the corresponding impossibility result is deferred to Section 6.

Naturally, we then study a framework with two issues, X and Y, where issue Y exhibits *certain gains from mediation*: Namely, it is common knowledge that a set of mutually acceptable alternatives exist for issue Y. As is the case for issue X, negotiators' preferences over the alternatives for issue Y, except the outside option, are diametrically opposed. Therefore, types of each negotiator differ only by their rankings of the outside option in issue X. The mediation mechanism maps the negotiators' private information to a recommendation bundle (i.e., a solution for each issue) that never includes an unacceptable alternative. Efficiency, individual rationality and strategy-proofness of the mediation mechanism necessitate a certain discipline on negotiators' preferences over bundles, and a key assumption for this is *monotonicity*; bundles with better alternatives are always better.

Our first main result is a complete characterization of the class of strategy-proof, efficient, and individually rational mediation mechanisms (Theorem 1). These mechanisms operate through an exogenously specified *precedence order* (i.e., sequential hierarchy) over a special set of bundles, which we call *logrolling bundles*. As the precedence order varies, the characterized class of mechanisms span what we refer to as the *family of logrolling mechanisms*. A visual characterization of this family demonstrates that a mediation mechanism belongs to the family if and only if its matrix representation can be partitioned into rectangular regions (Theorem 3). The visual characterization simplifies the mechanics of the logrolling mechanisms and transform them into easy-to-read diagrams that can be sequentially implemented as a menu of offers. This should make mediation more accessible and comprehensible.

On the contrary, algorithms of current ODR platforms are unknown to users (see Section 1.1 for a brief overview). Some platforms (e.g., Cybersettle) choose not to disclose their algorithms because of patent infringement concerns. Others (e.g., SmartSettle) also adopt this "black box" approach because their algorithms involve sophisticated and unintuitive integer optimization techniques. Designers of SmartSettle admit that their multi-issue e-

[17]For this reason, we briefly discuss and illustrate the impossibility in the single-issue case with the help of a simple example in Section 2.

Negotiation system cannot be used to its full potential by novices without the assistance of a facilitator (Lodder and Thiessen, 2003). This may pose a serious concern from an economic design perspective because it is widely acknowledged in the literature that the simplicity and the transparency of the underlying mechanics of a mechanism is crucial for its efficacy.[18]

Our second main result (Theorem 2) is a complete characterization of the class of preference domains that admit strategy-proof, efficient, and individually rational mediation mechanisms. The necessary and sufficient condition is the so-called *quid pro quo* property. This property imposes a form of substitutability between issues X and Y.[19] It entails that issue Y is rich enough so that a negotiator is able to make concessions in issue X for a more preferred alternative in issue Y; e.g., for any pair of (acceptable) alternatives x and x^i of X, there exists a corresponding pair of alternatives y and y^i of Y such that when bundled together, (x^i, y^i) is preferred over (x, y), although x is preferred over x^i. Such reversals in the preference domain should induce a partial order and a semilattice structure on issue X. An important takeaway from Theorem 2 is that not all multi-issue disputes admit good mechanisms, and in this sense, not all cases are *solvable*, despite the best efforts of the designers. It all boils down to the negotiators' underlying interests and substitutability of the issues.[20] Quid pro quo constitutes the limits of solvable disputes. If we map our discrete model into a classic exchange economy, where alternatives represent quantities of goods, then quid pro quo is compatible with well known utility functions, such as CES and quasi-linear. In such an environment, quid pro quo hinges on the availability of a set of (logrolling) bundles and certain restrictions on the rates of substitution at these bundles.

Finally, we introduce an ordinal fairness criterion that is useful in judging impartiality of the mediation processes. The family of logrolling mechanisms nests interesting special members. When the precedence order is in line with the preference of a given negotiator over the logrolling bundles, we obtain the corresponding *negotiator-optimal mechanism*. A negotiator-optimal mechanism represents situations when a mediator may be categorically biased toward one party in the dispute. It turns out there is a central member of the family of strategy-proof, efficient, and individually rational mediation mechanisms that satisfies our fairness criterion (Theorem 4). This is the so-called *constrained shortlisting* mechanism, which recommends the *median logrolling bundle* when it is mutually acceptable, and when it is not, favors the least-accepting negotiator.

1.1 Online Dispute Resolution and e-Negotiation Systems

Before presenting our model and theoretical results, we provide a brief overview of the fundamental aspects of e-Negotiation protocols. The essential features of these protocols

[18]To this end, Li (2017) introduces the notion of obvious strategy-proofness which allows to distinguish even among those mechanisms that are strategy-proof. See also Pycia and Troyan (2019) and Pycia and Ünver (2020).

[19]It can be viewed as the nontransferable utility analogue of the *possibility of compensation* assumption in a transferable utility model, see, e.g., Thomson (2016).

[20]Consider, for example, a scenario where alternatives of issue Y have little appeal for the negotiators compared to those in issue X (e.g., preferences are lexicographic over the two issues). Then there is little reason to suspect that the impossibility in the single-issue case will be overturned in the two-issue world. In fact, quid pro quo property fails to hold in such preference domains.

will also motivate some of our modeling choices.[21] ODR protocols usually take issues and possible alternatives in every single issue as given. This information is often solicited when parties describe the dispute when they first request the service of the ODR platform. The negotiation problem is then created by populating this information on the system. Aside from this preliminary step, protocols generally involve three common steps: (1) *elicitation*, (2) *proposal*, and (3) *ratification*. The process ends either when parties unanimously accept a proposal, or if no mutual agreement is reached after several iterations of an "*elicitation-proposal-ratification*" cycle.

The goal of the elicitation step is to obtain parties' private information. First, parties are asked about their bargaining ranges for each issue, with the understanding that the mediator's proposal will never include an alternative outside this range. Negotiators' bargaining ranges are elicited by asking each negotiator to choose an alternative that is least acceptable for her. Given the negotiators' positions (i.e., how negotiators rank the alternatives) the system infers the set of acceptable alternatives once they declare their bargaining ranges. ODR platforms commonly make the implicit assumption that negotiators' ordinal rankings over alternatives are monotonic in the sense that an alternative that delivers more is always better. This automatically implies that negotiators' rankings of the available alternatives in a given issue are diametrically opposed.[22] Depending on the ODR platform, parties may be further asked to report their preferences over issues to indicate how they trade off one issue against another. SmartSettle, for example, elicits cardinal preferences in the form of utility (satisfaction) points over issues and alternatives. Namely, each negotiator is asked to "bid" a point value (between 0 and 100) for each alternative in each issue.

Protocols usually differ in how they process all this information to make recommendations, and majority of the existing e-Negotiation protocols use a combination of cooperative game-theoretic and optimization techniques. In all existing protocols, a common theme is that any aspect of a user's input (e.g., bargaining ranges) may be modified at any time during the negotiation before a proposal is accepted by both negotiators. To illustrate we discuss three examples.

The protocols used by the popular SmartSettle system are based on optimization algorithms that use mixed-integer programming techniques.[23] The system categorizes solution packages (bundles of alternatives) unacceptable if they include alternatives that are outside of the declared bargaining ranges or utility points fall short of the minimum scores privately declared by the disputants. The system never recommends these bundles.

A second well-known example is the Family Winner by Bellucci and Zeleznikow (2005), which is based on cooperative game-theory. The protocol was first developed to model Australian family law based on the repository of cases in the Australian Institute of Family Studies. It was subsequently applied to international disputes, enterprise bargaining, and company mergers. The algorithm is a point allocation procedure that aims to distribute items to the negotiators on the premise of who values the issue the most. At the outset the

[21]This overview is particularly inspired by SmartSettle (Thiessen and Loucks, 1992), which is successfully commercialized in multi-issue dispute resolution and offers a great deal of publicly available information regarding its protocols.

[22]See Section 2 for an illustration of this implication, which also forms the basis of our model.

[23]Although the complete details of the algorithm is not publicly available, a subset of the linear equations are provided in Thiessen and Loucks (1992).

negotiators are required to distribute 100 points across the range of issues. The algorithm first identifies the issue that the disputants are furthest apart and allocates the item in this issue to the party who values it the most. Then it finds the next issue where the disputants are furthest apart and allocates the item in that issue to the party who values it the most, and so on.

A third example is SquareTrade, a platform that has been eBay's contractor on dispute resolution and the leading ODR provider for consumer mediation since 1999.[24] The main difference of the SquareTrade from the previous two examples is that it does not involve any preference elicitation. Specifically, the SquareTrade dispute resolution process consists of two stages. In first stage it presents the claimant a list of possible solutions (alternatives or bundles) and asks her to select the ones that she finds acceptable. Upon agreeing to participate in the process, the other party is then asked to do the same. If at least one solution is mutually acceptable, then the process ends. Incidentally, this process is a simpler and less refined version of the central mechanism (i.e., the logrolling mechanism) we propose and characterize in this paper.[25] If parties cannot reach an agreement in the first stage, then the protocol allows parties to exchange visible optimistic proposals, defining the bargaining range in the second stage. The system then generates suggestions that fall into the bargaining range. Parties may continue to exchange visible proposals or contribute their own suggestions to the mixture of standing proposals. The process terminates when all parties accept at least one standing proposal.

A strand of market design literature that can offer valuable insights in the context of ODR includes the recent works on *multi-item assignment*, such as course allocation at business schools. A common allocation method in practice is a *course-bidding mechanism* where students are asked to allocate an artificial currency endowment across different courses, and courses are assigned to highest bidders. Both theoretical and experimental research have shown that such auction mechanisms can perform rather poorly due to the perverse incentives they generate.[26] A major insight from that context immediately carries over to dispute resolution: When a bidding mechanism is used, a disputant can find it strategically advantageous not to "waste" points on less contested issues despite having a truly high valuation of these issues. This in turn translates into strategic reports that are not representative of true preferences. Such incentive shortcomings of point-based course allocation systems played role in the recent replacement of the course-bidding mechanism at the Wharton School (University of Pennsylvania) with the Approximate Competitive Equilibrium from Equal Incomes (A-CEEI) mechanism of Budish (2011), which has better incentive properties.

2 An Example

This section is intended for readers who may not be proficient with the methodology of market/mechanism design, or those who would like to grasp the basic insights behind our results. Proficient readers may prefer to skip to the next section.

[24] SquareTrade has resolved millions of disputes across 120 countries in 5 different languages. See https://www.worldarbitration.center/on-line-disputes/ (Last visit September 13, 2021.)

[25] See Section 4.4 for a detailed discussion.

[26] See, for example, S¨onmez and Ünver (2010) and Krishna and Ünver (2008).

In the simplest possible form, consider a single issue dispute where there are only two available solutions, x_1 and x_2. It is possible to think of this case as a dispute over the division of some jointly owned assets in the dissolution of a partnership, where alternative x denotes the percentage of the assets negotiator 1 gets, and so 2 gets the remaining $100 - x$ percent. Negotiator 1 prefers alternative x_1 to x_2 and negotiator 2 prefers x_2 to x_1.[27] The ranking of the *outside option*, denoted by o, is each negotiator's private information and each negotiator ranks any "unacceptable" alternative below the outside option. Hence, this private outside option determines a negotiator's *bargaining range*.[28] Let set $\overline{X} = \{x_1, x_2, o\}$ denote the set of all possible outcomes of the mediation process. Each negotiator has two types, where L_i and M_i refer to the "least-accepting" and "most-accepting" types of negotiator i, respectively:[29]

L_1	M_1
x_1	x_1
o	x_2
x_2	o

L_2	M_2
x_2	x_2
o	x_1
x_1	o

The mediation mechanism f maps the negotiators' private information to an outcome in $\overline{X}$, and we use the following matrix to represent it:

	M_2	L_2
L_1	$f_{1,1}$	$f_{1,2}$
M_1	$f_{2,1}$	$f_{2,2}$

where $f_{£,j} \in \overline{X}$ for all $£, j \in \{1, 2\}$.

Since a mutually acceptable alternative does not always exist (e.g., when negotiator types are L_1 and L_2), we say that issue X has *uncertain gains from mediation.* A mediation process that respects negotiators' bargaining ranges (i.e., always suggests an *individually rational* outcome) should, therefore, suggest the outside option at this type profile (i.e., $f_{1,2} = o$). If the mediation process is *efficient*, then we should have $f_{1,1} /= o$. Furthermore, if the process is expected to be individually rational, then we have $f_{1,1} = x_1$. Likewise, an efficient and individually rational mediation process must satisfy $f_{2,2} = x_2$ and $f_{2,1} \in \{x_1, x_2\}$. Therefore, there are only two (deterministic) mechanisms satisfying individual rationality and efficiency in this simple framework.

However, neither of these mechanisms is immune to strategic manipulation. Namely, it is not a dominant strategy for the negotiators to report their types truthfully. To see this point, suppose that $f_{2,1} = x_1$. In this case, the most-accepting type of negotiator 2 (i.e., M_2) would misreport her type when negotiator 1 is of type M_1 because she guarantees her favorite outcome x_2 by reporting L_2 instead. Symmetrically, if $f_{2,1} = x_2$, then the most-accepting type of negotiator 1 (i.e., M_1) would lie about her type. We conclude, therefore, that it is impossible to find an efficient, individually rational, and strategy-proof mediation mechanism in a single-issue dispute. It is straightforward to extend this impossibility to the case with more than two alternatives.[30]

[27]Here we implicitly assume that each negotiator only cares about her own share.

[28]In line with the interpretation we adopted for this specific example, the outside option may be a vector indicating each negotiator's BATNA.

[29]We assume, without loss of generality, that there is at least one acceptable alternative for each negotiator.

[30]This impossibility also prevails when we allow stochastic mechanisms. In that case, the only difference in the argument would be that $f_{2,1}$ is a lottery over x_1 and x_2. However, the above deviations would still remain profitable.

Next, consider the framework with two issues, X and Y, with the set of outcomes $\overline{X} = \{x_1, x_2, o_X\}$ and $\overline{Y} = \{y_1, y_2, o_Y\}$, respectively. Suppose issue Y represents the time of dissolution of the partnership, where outcomes y_1, y_2 and o_Y denote "sooner", "later", and "never", respectively. It is common knowledge that negotiator 1 prefers x_1 to x_2 and y_1 to y_2, negotiator 2's preferences are diametrically opposed in each issue, and both negotiators find y_1 and y_2 acceptable. Hence, issue Y has *certain gains from mediation*. Thus, publicly known preferences are as follows:

Negotiator 1	
X	Y
x_1	y_1
x_2	y_2
	o_Y

Negotiator 2	
X	Y
x_2	y_2
x_1	y_1
	o_Y

As before, types of each negotiator differ only by their rankings of the outside option in issue X, so each negotiator has two types. Now the mediation mechanism maps the negotiators' private information to a bundle (x, y) in $\overline{X} \times \overline{Y}$. We maintain individual rationality (i.e., mechanism f should never offer a bundle that includes an unacceptable alternative). This implies that $f_{1,2} = (o_X, y)$, where y is either y_1 or y_2. We now also assume that negotiators' preferences over bundles are *monotonic* (i.e., bundles with (weakly) better alternatives are always more preferred).

Under these assumptions, by the efficiency, individual rationality and strategy-proofness of f, we must have $f_{1,1} = (x_1, y_2)$ and $f_{2,2} = (x_2, y_1)$. To see this, consider $f_{1,1}$. An efficient mechanism that respects the declared bargaining ranges should suggest a bundle with x_1 at this entry because only x_1 is declared mutually acceptable in issue X. If $f_{1,1}$ is (x_1, y_1), then monotonicity and strategy-proofness will necessitate that both $f_{2,1}$ and $f_{2,2}$ are (x_1, y_1). However, $f_{2,2}$ corresponds to the profile where x_1 is declared unacceptable by negotiator 2. Thus, the mechanism must bundle x_1 either with y_2 or o_Y. Monotonicity and efficiency eliminate the latter possibility. Hence, $f_{1,1}$ must be (x_1, y_2), and symmetrically $f_{2,2} = (x_2, y_1)$. A similar logic implies that $f_{2,1}$ must be either (x_1, y_2) or (x_2, y_1). We call these two bundles *logrolling bundles* since they pair a higher ranked alternative in one issue with a (relatively) lower ranked alternative from the other.

A good mechanism f will always suggest a logrolling bundle whenever a mutually acceptable alternative exists. Thus, strategy-proofness requires that if $f_{2,1} = (x_1, y_2)$, then M_2 should prefer (x_1, y_2) over (x_2, y_1) so that she prefers to reveal her type truthfully, and if $f_{2,1} = (x_2, y_1)$, then M_1 should prefer (x_2, y_1) over (x_1, y_2) so that she prefers to reveal her type truthfully. This discipline on preferences is the essence of what we call as the *quid pro quo* property, which turns out to be equivalent to a certain semilattice structure when there are more than two alternatives.

3 The Main Setup: Multi-Issue Mediation

The first part of this section presents the terminology and notation adopted throughout this paper. We defer our interpretation and discussion of key assumptions to the second part.

3.1 Preliminaries

There are two negotiators, N = {1, 2}. We refer to negotiators as "she" and to the mediator as "he". Let $\overline{X} = \{x_1, \ldots, x_m, o_X\}$ and $\overline{Y} = \{y_1, \ldots, y_n, o_Y\}$ denote the finite set of potential outcomes in the **main issue** and **second issue**, respectively, where $n \geq m \geq 2$. The sets $X = \overline{X} \setminus \{o_X\}$ and $Y = \overline{Y} \setminus \{o_Y\}$ are the sets of available **alternatives**. We denote the **outside options** in issue X and Y by o_X and o_Y, respectively. For any issue $Z \in \{X, Y\}$, let Θ_i^Z denote the set of all linear orders (i.e., preference relations) of negotiator i over issue Z, and θ_i^Z denote an ordinary element of the set Θ_i^Z.[31]

It is publicly known that for all $k = 1, \ldots, |Z|$ and all $Z \in \{X, Y\}$, $z_k \; \theta_1^Z \; z_{k+1}$ for negotiator 1, $z_{k+1} \; \theta_2^Z \; z_k$ for negotiator 2, and $y_k \; \theta_i^Y \; o_Y$ for all $i \in N$. Namely, the negotiators' preferences over the alternatives are diametrically opposed in each issue, and any alternative in issue Y is acceptable for both negotiators (in which sense Y exhibits *certain gains from mediation*). The ranking of the outside option in issue X, o_X, is the negotiators' private information, and so it exhibits *uncertain gains from mediation*. Therefore, $\Theta_i = \Theta_i^X$ denotes the set of all **types** of negotiator i and $\Theta = \Theta_1 \times \Theta_2$ is the set of all type profiles. Without loss of generality, we ignore those types that declare all alternatives of X unacceptable.[32] We use θ_i for the rest of the paper instead of θ_i^X to indicate negotiator i's preferences over the outcomes in issue X. Whenever we need to distinguish i's preferences over issue X and Y, we then use θ_i^X and θ_i^Y, respectively.

For any negotiator i and type $\theta_i \in \Theta_i$, let $A(\theta_i) = \{x \in X | \; x \; \theta_i \; o_X\}$ denote i's **bargaining range** (i.e., set of **acceptable** alternatives) in issue X. For any type profile $(\theta_1, \theta_2) \in \Theta$, let the set $A(\theta_1, \theta_2) = \{x \in X | \; x \; \theta_i \; o_X \text{ for all } i \in N\}$ denote the set of all **mutually acceptable** alternatives in issue X. In case we need to specify the **bargaining range of type** θ_i of player i, where alternative $x \in X$ is her least acceptable alternative, we use $\theta_i^x \in \Theta_i$. Namely, for any $x' \in X$, $x \; \theta_i^x \; x'$ implies $o_X \; \theta_i^x \; x'$.

A mediation mechanism $f : \Theta \to \overline{X} \times \overline{Y}$ asks each negotiator to report her type and proposes a **bundle** (x, y) that specifies an outcome for each issue. For convenience, a mediation mechanism f can be equivalently represented by an $m \times m$ matrix $f = [f_{\ell,j}]_{(\ell,j) \in M^2}$, where $f_{\ell,j} = f(\theta_1^{x_\ell}, \theta_2^{x_j})$ and $M = \{1, \ldots, m\}$. The rows of this matrix correspond to types of negotiator 1 and the columns to types of negotiator 2. The row (respectively, column) ℓ indicates the type of negotiator 1 (respectively, 2) that finds all alternatives $\{x_k \in X | k \leq \ell\}$ (respectively, $\{x_k \in X | k \geq \ell\}$) acceptable: See Figure 1 for an illustration. For any reported pair of types $(\theta_1^{x_\ell}, \theta_2^{x_j})$, mechanism f chooses an outcome $f_{\ell,j} \in \overline{X} \times \overline{Y}$. We use f_θ^Z or $f_{\ell,j}^Z$ to denote the alternative that the mediation mechanism f offers in issue $Z \in \{X, Y\}$ when type profile is $\theta = (\theta_1^{x_\ell}, \theta_2^{x_j})$. Therefore, $f(\theta) = f_{\ell,j} = \begin{matrix} \ddot{A} \\ f_{\ell,j}^X \end{matrix}, \begin{matrix} \ddot{a} \\ f_{\ell,j}^Y \end{matrix} = (f_\theta^X, f_\theta^Y)$.

The set of all bundles is denoted by $\overline{X} \times \overline{Y}$ and Φ denotes the set of all linear orders over $\overline{X} \times \overline{Y}$. Relation R is a standard element of the set Φ, and for any two bundles $b, b' \in \overline{X} \times \overline{Y}$, $b \; R \; b'$ means "b is at least as good as b'." Let P denote the strict counterpart of R.[33] A preference (extension) map is a correspondence Λ that assigns to every negotiator i and

[31] A binary relation θ on set Z is called a **linear order** on Z if θ is complete, transitive, reflexive, and antisymmetric.

[32] Therefore, there are m possible orderings in Θ_i^X and a unique preference ordering in Θ_i^Y.

[33] That is, $b \; P \; b'$ if and only if $b \; R \; b'$ but not $b' \; R \; b$.

type $\theta_i \in \Theta_i$ a nonempty set $\Lambda(\theta_i) \subseteq$ ◆ of admissible orderings over bundles. $\bigcup_{\theta \in \Theta} \Lambda(\theta) \subseteq$ ◆^{2}

is the domain of admissible preference profiles that is restricted by the preference map Λ.[34] Let $B(\theta_i) = \{(x, y) \in X \times Y \mid x\ \theta_i\ o_X\}$ denote the set of all **acceptable bundles** for type θ_i. A bundle b **Pareto dominates** a bundle b^i if for all $(\theta_i, \theta_{-i}) \in \Theta$, where $b, b^i \in B(\theta_i)$ for $i = 1, 2$, $b\ R_i\ b^i$ for all $i \in N$ and $R_i \in \Lambda(\theta_i)$, and $b\ P_i\ b^i$ for some $i \in N$ and $R_i \in \Lambda(\theta_i)$. Let $\Lambda(\theta_i)|_B$ denote the restriction of all admissible preference relations over $X \times Y$ to a subset $B \subseteq X \times Y$.[35]

Definition 1. *A preference map Λ is **regular** if the following hold for all $i \in N$ and $\theta_i \in \Theta_i$:*

i. ***Monotonicity (M):*** *For any $x, x^i \in \overline{X}$ and $y, y^i \in \overline{Y}$ with $(x, y) \neq (x^i, y^i)$,*
$(x, y)\ P_i\ (x^i, y^i)$ *for all $R_i \in \Lambda(\theta_i)$ whenever $x\ \theta_i^X\ x^i$ and $y\ \theta_i^Y\ y^i$.*

ii. ***Consistency (C):*** *For any $\theta_i^i \in \Theta_i$ with $B(\theta_i) \subseteq B(\theta_i^i)$,*
$\Lambda(\theta_i^i)|_{B(\theta_i^i)} = \Lambda(\theta_i)|_{B(\theta_i^i)}$.

iii. ***Bargaining ranges (BR):*** *For any $y \in Y$, $y^i \in \overline{Y}$, and $x, x^i \in X$ with $x\ \theta_i\ o_X\ \theta_i\ x^i$,*
$(x, y)\ R_i\ (o_X, y^i)\ R_i\ (x^i, y)$ *for all $R_i \in \Lambda(\theta_i)$.*

The mediation mechanism f is **strategy-proof** if for all $i \in N$ and all $\theta_i \in \Theta_i$, $f(\theta_i, \theta_{-i})\ R_i\ f(\theta_i^i, \theta_{-i})$ for all $R_i \in \Lambda(\theta_i)$, $\theta_i^i \in \Theta_i$ and all $\theta_{-i} \in \Theta_{-i}$. It is **individually rational** if for all $i \in N$ and all $(\theta_i, \theta_{-i}) \in \Theta$, $f(\theta_i, \theta_{-i})\ R_i\ (o_X, o_Y)$ for all $R_i \in \Lambda(\theta_i)$. Finally, the mediation mechanism f is **efficient** if there exists no $(\theta_i, \theta_{-i}) \in \Theta$ and $(x^i, y^i) \in X \times Y$ such that $(x^i, y^i)\ R_i\ f(\theta_i, \theta_{-i})$ for all $R_i \in \Lambda(\theta_i)$ and all $i \in N$, and for at least one i and $R_i \in \Lambda(\theta_i)$, $(x^i, y^i)\ P_i\ f(\theta_i, \theta_{-i})$.

A function $t : X \to Y$ is called **order-reversing** if for all $x, x^i \in X$ and all $i \in N$, $x\ \theta_i^X\ x^i \iff t(x^i)\ \theta_i^Y\ t(x)$. For any $\pounds, j$ with $1 \leq j \leq \pounds \leq m$ the nonempty subset

$X_{j\pounds} = \{x_k \in X \mid j \leq k \leq \pounds\}$ of X is called a **connected** subset of X. Put differently, $X_{j\pounds}$ is the set of mutually acceptable alternatives in issue X at the type profile $(\theta_1^{x\epsilon}, \theta_2^{x'})$. For any nonempty subset S of X and a partial order ◆ on X, let $\max_S$ ◆ denote the maximal element in S with respect to ◆.[36] Namely, if $x_S^* = \max_S$ ◆, then x_S^* ◆ x for all $x \in S$. Note that such a maximal element is not guaranteed to exist under an arbitrary (e.g., incomplete) partial order.

Finally, the tuple $(X,$ ◆$)$ is called a **poset** (short for partially ordered set) if ◆ is a partial order on X. For a poset $(X,$ ◆$)$, we say that an element $x \in X$ is an **upper bound of a subset** $S \subseteq X$ when x ◆ x^i for all $x^i \in S$. The **least upper bound** of S is the upper bound of S that is less than or equal to every upper bound of S. Namely, x is a least upper bound of S if x^i ◆ x for all upper bounds x^i of S. Given a doubleton $\{x, x^i\} \subseteq X$, let the join of x and x^i, denoted by $x \vee x^i$, be the least upper bound of the doubleton. A

[34] For all $\theta = (\theta_1, \theta_2) \in \Theta$ we have $\Lambda(\theta) = \Lambda(\theta_1) \times \Lambda(\theta_2)$.

[35] The restriction of a binary relation over a set $X \times Y$ to a subset $B \subseteq X \times Y$ is the set of all pairs of bundles (b, b^i) in the relation for which b and b^i are in B.

[36]A binary relation ◆ on set *X* is called a *partial order* on *X* if ◆ is transitive, reflexive, and antisymmetric.

poset $(X, \succeq)$ is called a **join semilattice** if every doubleton $\{x, x'\} \subseteq X$ has a least upper bound in X.

3.2 Discussion

We study disputes with two issues and finite sets of alternatives, but our results can easily be extended to cases with more than two issues (see Section 6.3) or continuum of alternatives (see the Supplementary Appendix). In keeping with the practice of mediation, we assume that each negotiator has a bargaining range for each issue, and a negotiator's bargaining range for an issue is determined by how she ranks her outside option for that issue. The outside option in issue Y need not the be the worst outcome for our results to go through. All that is needed is the availability of a sufficiently large set of alternatives in Y that are efficient and individually rational.[37] The assumption that preferences over alternatives in each issue are diametrically opposed is without loss of generality. Under efficiency, any dispute where preferences over alternatives are not diametrically opposed can be equivalently represented by a "reduced dispute" where "reduced preferences" are diametrically opposed (see Section 6.1).

Although we notationally distinguish between the two outside options, o_X and o_Y, our model allows for interdependence of the resolutions in these two issues. We say that two issues are **joint** if whenever the outside option in one issue is selected, the outside option in the second issue must also be selected.[38] Otherwise, we say that the two issues are **separate**.[39] Since whether issues are joint or separate makes little difference in our analysis, we assume for expositional simplicity that the issues are separate in the remainder of the paper. Nevertheless, we delegate the discussion of the resulting differences to footnotes.

Mediation would potentially be a very complicated, multistage game between the negotiators and the mediator. The mediation protocol, whatever the details may be, produces proposals for agreement that are always subject to unanimous approval by the negotiators. That is, before finalizing the protocol, each negotiator has the right to veto the proposal and exercise her outside option. A version of the revelation principle, which we prove in the Supplementary Appendix, guarantees that we can stipulate the following type of a direct mechanism without loss of generality when representing mediation.

The direct mechanism consists of two stages, an *announcement* stage and a *ratification* stage, and it is characterized by a mediation rule $f : \Theta \to \overline{X} \times \overline{Y}$. After being informed of her type, each negotiator i privately reports her type θ_i to the mediator who then proposes a bundle $f(\theta_1, \theta_2) \in \overline{X} \times \overline{Y}$. In the ratification stage, each party simultaneously and independently decides whether to accept or veto the proposed bundle. If both negotiators accept the proposed bundle, then it becomes the final outcome. If either or both negotiators veto the proposal, each party gets the outside option for both issues (i.e., (o_X, o_Y)). Such two-stage mechanisms will be called *direct mechanisms with veto rights*. We seek direct

[37] More formally, the number of efficient and mutually acceptable alternatives in Y should be no less than the cardinality of X.

[38] For example, in a multi-unit trade negotiation between a buyer and a seller over price and quantity, if the two sides cannot agree on price, then the quantity issue becomes obsolete, and so may be set to zero.

[39] For example, in a family dispute where the issues are division of assets and terms of child custody, despite failing to reach an agreement in the former issue, the two sides may have a mutual interest in a quick resolution in the latter.

mechanisms with veto rights in which truthful reporting of types at the announcement stage is a *dominant strategy equilibrium* and the mediator's proposals are never vetoed in equilibrium. It immediately follows from the definitions that such an equilibrium exists if and only if the mediation rule f is strategy-proof and individually rational.[40] For the rest of the paper we denote a mediation mechanism by the mediation rule f and, with slight abuse of language, refer to both as a mediation mechanism.

In our formulation, the mediation mechanism asks each negotiator to report her bargaining range as her type rather than her full-fledged preferences over all bundles. Negotiators' underlying preferences over bundles are then assumed to be compatible with the reported types and to satisfy certain regularity conditions. While an appealing alternative and worthy of future investigation, learning parties' preferences over bundles together with bargaining ranges requires a two-layer information elicitation. From a both practical and theoretical standpoint, this is a much difficult task since it entails further complications and restrictions on preference reporting language.[41] Our formulation is in line with some of the existing ODR practices[42] and our objective of detail-freeness.[43] Our simpler approach provides an added advantage of studying the trade-offs between incentives and efficiency in dispute resolution in isolation while searching for family of preference domains that admit positive results. This is a particularly useful exercise to be able to design an effective preference reporting language.

To obtain the set of possible preferences compatible with the reported types, we invoke a preference map that satisfies three regularity conditions.[44] Our interpretation of the preference map is that although negotiator i knows her exact preferences over the bundles, the opponent and the mediator (or the designer) believe that i's preferences belong to the set $\Lambda(\theta_i)$ conditional on i's type being θ_i. In a cardinal setup, where the modeler assumes a specific utility function for each negotiator, Λ would generate a unique ordering for each type θ_i. However, our setup allows for more general domain specifications. For example, if the modeler only knows that the negotiators' preferences are consistent with expected utility theory or additively separable, then Λ is a multi-valued function. Our results hold for *all* "regular" preference maps.

Monotonicity is a standard requirement and simply demands that a bundle with (weakly) better outcomes in both issues is always more preferred. Consistency requires that all types of the same negotiator rank the acceptable bundles in the same way. Bargaining ranges is a requirement we adopt in keeping with the practice of mediation to respect the bargaining

[40]This result immediately follows from the proof of the revelation principle we provide in the Supplementary Appendix.

[41]Such concerns are actively debated and in need of further research (Milgrom 2011). It also is an open question in the related problem of combinatorial assignment problems (Budish et al. 2017).

[42]Many ODR platforms including the previously discussed SquareTrade and e-commerce platforms that are used by Amazon, eBay, Netflix, and Walmart generate a menu of recommendations without direct preference elicitation.

[43]Asking negotiators to report full preferences over $m \times n$ bundles even in the simplest case with two issues is arguably impractical and cognitively complex. Such pursuit of full preference elicitation conflicts with the ease and convenience expected from the mediation process, which is also admitted by the designers of some ODR platforms (e.g., Lodder and Thiessen, 2003).

[44]Using preference maps to deduce complete preferences is a common tool in social choice theory pioneered by Barber`a (1977) and Kelly (1977) as a way to explore the strategy-proofness of social choice correspondences. For such an analysis to be carried out, individual preferences over sets are required. A typical approach is to infer this information from individual preferences over alternatives through certain extension axioms which assign to every ordering over alternatives a list of acceptable orderings over sets.

ranges reported by the negotiators. It allows us to incorporate the negotiators' bargaining ranges into their preferences and requires that each negotiator prefers bundles that are in agreement with her bargaining range to those that violate them. Specifically, a bundle with an acceptable alternative in the main issue is always preferred over a bundle with the outside option, which in turn is always preferred over a bundle with an unacceptable alternative, regardless of the alternatives chosen for the second issue. In other words, a bundle is unacceptable to a negotiator if it includes an alternative outside her bargaining range in issue X. This requirement together with individual rationality ensures that a proper mediation mechanism never proposes bundles that are not compatible with the bargaining range declared by either negotiator.

Our definitions for strategy-proofness, efficiency, and individually rationality are standard. Strategy-proofness requires truthful revelation of one's type to be her dominant strategy regardless of her underlying preferences and the type of the opposite negotiator. Individual rationality guarantees an outcome at least as good as what each negotiator would receive if she were to walk away from mediation. Efficiency says that it should not be possible to find an alternative proposal that would make both parties better off at all possible preferences and one party strictly better off at some preference profile.

4 Main Results

4.1 Strategy-Proof Mediation

We start with the characterization of the necessary conditions on strategy-proof, efficient, and individually rational mediation mechanisms.

Theorem 1. *Suppose that the preference map Λ is regular and f is a strategy-proof, efficient, and individually rational mediation mechanism. Then there exists an injective and order-reversing function $t: X \to Y$, a partial order $\succeq$ on X, and an alternative $y \in Y$ such that*

$$f_{\pounds j} = f(\theta_1^{x^{\epsilon}}, \theta_2^{x^{j}}) = \begin{cases} x_{X_{j\ell}}, t\ x_{X_{j\ell}} & \text{if } j \le \pounds \\ (o_X, y) & \text{otherwise;} \end{cases}$$

where $x^*_{X_{j\ell}} = \max_{X_{j\ell}} \succeq$ is well-defined.

Theorem 1 states that a desired mediation mechanism must always make selections from a special set of bundles when the set of mutually acceptable alternatives in issue X is nonempty. At these bundles, for each alternative in X, there is a corresponding distinct alternative in Y with which it must be paired, and the order-reversing property implies that a more preferred alternative from issue X must be paired with a less preferred alternative from issue Y. We interpret these bundles as representing possible "compromises" between the two issues. As such, we henceforth call a bundle $(x^*, t(x^*)) \in X \times Y$ a **logrolling bundle**. For a given order-reversing function t, let B^t be the set of all the logrolling bundles. When $n = |Y| = |X| = m$, this set is unique and $t(x_k) = y_{m-k+1}$. Otherwise (i.e., when $n > m$), there can be multiple such t's, hence multiple classes of mechanisms.

The set B^t of logrolling bundles constitutes the "backbone" of every strategy-proof,

efficient, and individually rational mechanism in the sense that the diagonal of any such

mechanism (i.e., when $\pounds = j$ or there is a unique mutually acceptable alternative) must always be comprised of these bundles. The mediator has discretion over the choice of the **precedence order** $\succ$ on X. Which logrolling bundle is selected below the diagonal (i.e., when $\pounds > j$ or there are multiple mutually acceptable alternatives) depends on the chosen precedence order $\succ$. Specifically, the mediator selects the highest precedence alternative among the set of mutually acceptable alternatives in the main issue and pairs it with its corresponding alternative in the second issue according to t. Intuitively, the logrolling bundles on the diagonal "propagate" in the southwestern direction following the precedence order $\succ$. Theorem 3 provides a complementary visual characterization of these mechanisms based on this insight.

When there is no mutually acceptable alternative in issue X (i.e., when $\pounds < j$), the mediation mechanism always chooses a designated disagreement bundle at which the outside option in X is coupled with some efficient alternative in Y. In this case, the mediation mechanism provides only a partial resolution to the dispute because of the severity of the disagreement on issue X.

For the rest of the paper, we refer to f as a **logrolling mechanism** if it satisfies the properties described in Theorem 1, and denote it by $f^{\succ}$. The choice of the set of logrolling bundles together with the precedence order characterizes each mediation mechanism. Before giving a sketch of the proof of Theorem 1, we provide an example of these mechanisms.

Example 1 (A logrolling mechanism): Suppose the main issue X consists of five alternatives, i.e., $m = 5$, and the second issue Y has at least five alternatives. Take a possible set of logrolling bundles

$$B^t = \{(x_1, t(x_1)), (x_2, t(x_2)), (x_3, t(x_3)), (x_4, t(x_4)), (x_5, t(x_5))\}$$

for some injective and order-reversing function $t : X \to Y$. Let us construct the logrolling mechanism $f^{\succ}$ associated with the precedence order $\succ$ where

$$\succ: x_5 \succ x_1 \succ x_4 \succ x_2 \succ x_3.$$

The main diagonal is filled with the members of the set of logrolling bundles, B^t, e.g., we have $f^{\succ}_{1,1} = (x_1, t(x_1))$ in the first diagonal entry, $f^{\succ}_{2,2} = (x_2, t(x_2))$ in the second diagonal entry, and so on. Suppose we would like to determine $f^{\succ}_{3,1}$. The set of mutually acceptable alternatives are $X_{13} = \{x_1, x_2, x_3\}$. The highest precedence alternative in this set is x_1. Thus, $f^{\succ}_{3,1} = (x_1, t(x_1))$. Similarly, to determine $f^{\succ}_{4,2}$ we maximize $\succ$ on $X_{24} = \{x_2, x_3, x_4\}$, which yields x_4. Hence, $f^{\succ}_{4,2} = (x_4, t(x_4))$.

Alternatively, we can start from the diagonal and let the logrolling bundles spread in the southwestern direction following $\succ$. Since alternative x_5 has higher precedence than all other alternatives in X, the corresponding logrolling bundle claims all the entries to its southwest, which amounts to the set of all entries on the bottom row to the left of $f^{\succ}_{5,5}$. The second-highest precedence belongs to x_1; and the corresponding logrolling bundle similarly claims all the unfilled entries to its southwest. Thus, starting from the entry $f^{\succ}_{1,1}$ on the

main diagonal, all the remaining empty entries on the first column fill up with $(x_1, t(x_1))$.

Finally, whenever the negotiators have no mutually acceptable alternative in X, suppose the mechanism picks the bundle (o_X, y) for some $y \in Y$. The following matrix shows this logrolling mechanism.

	$\theta_2^{x_1}$	$\theta_2^{x_2}$	$\theta_2^{x_3}$	$\theta_2^{x_4}$	$\theta_2^{x_5}$
$\theta_1^{x_1}$	$(x_1, t(x_1))$	(o_X, y)	(o_X, y)	(o_X, y)	(o_X, y)
$\theta_1^{x_2}$	$(x_1, t(x_1))$	$(x_2, t(x_2))$	(o_X, y)	(o_X, y)	(o_X, y)
$\theta_1^{x_3}$	$(x_1, t(x_1))$	$(x_2, t(x_2))$	$(x_3, t(x_3))$	(o_X, y)	(o_X, y)
$\theta_1^{x_4}$	$(x_1, t(x_1))$	$(x_4, t(x_4))$	$(x_4, t(x_4))$	$(x_4, t(x_4))$	(o_X, y)
$\theta_1^{x_5}$	$(x_5, t(x_5))$	$(x_5, t(x_5))$	$(x_5, t(x_5))$	$(x_5, t(x_5))$	$(x_5, t(x_5))$

Figure 1: *A standard member of the logrolling mechanisms family*

Sketch of the proof of Theorem 1: The proof follows four main steps: (1) establishing an injective and order-reversing map t from X to Y, and thus the set B^t; (2) proving that each entry of the lower half of the matrix f comes from the set B^t; (3) establishing the binary relation $\succeq$ over X that is transitive and antisymmetric; and (4) proving that each entry of the lower half of the matrix f is in fact the maximal element of a particular subset of X with respect to the partial order $\succeq$.

These four steps prove particular claims by utilizing the following core idea, which we call the **weak axiom of revealed precedence (WARP)**: If two distinct alternatives x, x^i in issue X are mutually acceptable at some type profile and f suggests x (as part of a bundle) at that profile, then it cannot be the case that f suggests x^i at another type profile where both x and x^i are mutually acceptable. Therefore, whenever the set of mutually acceptable alternatives in issue X is nonempty, a strategy-proof, efficient and individually rational mediation mechanism behaves as if it is a single valued "choice mechanism" that satisfies the weak axiom of revealed preference (see Rubinstein 2012).

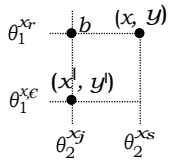


Figure 2

The intuition behind WARP is simple. Suppose it does not hold, e.g., Figure 2 indicates some entries at the lower half of the matrix f, where distinct alternatives x and x^i of issue X are mutually acceptable by all the type profiles represented in this figure. Note that all three bundles, i.e., b, (x, y), and (x^i, y^i), are acceptable by both types of negotiator 1 because f is individually rational and type θ^{x_c} is more accepting than type θ^{x_r}. Strategy-proofness implies that $b \; R_1 \; (x^i, y^i)$ for all $R_1 \in \Lambda(\theta_1^{x_r})$, which is also true for all $R_1 \in \Lambda(\theta_1^{x_c})$ since preferences are consistent. The converse is also true, i.e., $(x^i, y^i) \; R_1 \; b$ for all $R_1 \in \Lambda(\theta_1^{x_c})$; since f is strategy-proof and f suggests the bundle (x^i, y^i) when player 1 announces her type

as $\theta_1^{x^c}$. Thus, we must have $b = (x^i, y^i)$ since preferences over bundles are antisymmetric. By repeating the symmetric arguments for negotiator 2 and recalling that b and (x^i, y^i) are the same, we conclude that all these three bundles must be the same, contradicting our presumption that x and x^i are distinct.

Individual rationality and efficiency of f (together with **BR** and **M**) imply that every alternative $x_k \in X$ must appear on the main diagonal of f once. We construct the injective and order-reversing function $t: X \to Y$ by setting $t(f^X_{k,k}) = f^Y_{k,k}$ for $k = 1, \ldots, m$. WARP implies that any entry on the second diagonal of f is equal to the main diagonal entry that is located either to its right or above. If, for example, $f_{2,1}$ and $f_{1,1}$ are the same, then negotiator 2 would profitably deviate if the function t is not order-reversing. This is true because negotiator 2 would get better alternatives in both issues by deviating to type $\theta_2^{x^2}$ rather than declaring her true type $\theta_2^{x^1}$. We denote the set of all bundles on the main diagonal by B^t (Step 1). Given that, WARP implies that each entry of the lower half of the matrix f is equal to an entry on the main diagonal of f (Step 2).

Much like the case in rationalizable choice mechanisms, WARP implies that f behaves as if it follows a binary relation (which we call a precedence order) over the set of alternatives in issue X such that it always picks the alternative in issue X that is revealed to be "better" than any other mutually acceptable alternative. Therefore, we construct the partial order as follows. Take any type profile $\theta = (\theta_1^{x^c}, \theta_2^{x^j})$ that corresponds to an entry in the lower half of the matrix f and consider the set of all acceptable alternatives in issue X at that profile (i.e., $X_{f(\theta)}$). We say $f^X_{f(\theta),j} \succ x$ whenever $x \in X_{f(\theta)}$. It follows from construction that the binary relation $\succ$ is antisymmetric and transitive and each entry of the lower half of the matrix is indeed the maximal element of a particular subset of X with respect to the partial order.

By individual rationality, f must choose o_X above the diagonal when there is no mutually acceptable alternative in X. Then the fact that there must be a unique designated disagreement bundle is shown by iterating strategy-proofness along the rows and columns above the diagonal.

4.2 Full Characterization and Quid Pro Quo

Theorem 1 characterizes the necessary conditions that a strategy-proof, efficient, and individually rational mediation mechanism must satisfy. However, a logrolling mechanism is not guaranteed to be strategy-proof in general. Therefore, we now search for a condition on preferences that guarantees strategy-proofness. Since the class of logrolling mechanisms contains the only candidates that can achieve the properties in Theorem 1, ensuring that a logrolling mechanism is strategy-proof automatically entails imposing a discipline on preference profiles regarding how negotiators rank the logrolling bundles. To this end, we define a key notion.

Definition 2. *The preference map Λ satisfies **quid pro quo** if there exists an injective and order-reversing function $t: X \to Y$ and a partial order $\succ_t$ over X such that:*

i. For any distinct $x, x^i \in X$, $x \succ_t x^i$ if there exists $i \in N$ such that $x^i \succ_i x$ and

1. *$(x, t(x)) \succ_i (x^i, t(x^i))$ for all $\succ_i \in \Lambda(\theta_i)$ and $\theta_i \in \Theta_i$ satisfying $x, x^i \in A(\theta_i)$,*

2. *there is no* $y \in Y$ *with* $t(x)\ \theta_i^{\gamma}\ y\ \theta^{\gamma}\ t(x^i)$ *such that* (x^i, y) *Pareto dominates* $(x, t(x))$.

ii. The poset $(S, '?_t)$ *is a join semilattice for all connected* $S \subseteq X$.

Given a preference map Λ satisfying quid pro quo, let Π_Λ denote the set of all partial orders induced by Λ. Namely, Π_Λ is the set of all partial orders $'?_t$ over X such that the order-reversing function t and $'?_t$ satisfy Definition 2.

Quid pro quo is a property for the domain of preference profiles (not just for individual preferences). It says that the preference domain should permit the possibility that the negotiators are willing to make compromises in issue X for a more favorable treatment in issue Y. Put differently, it should be possible to find some alternatives in issue Y that are sufficiently attractive for at least one of the negotiators to reverse her ranking of some alternatives in issue X when they are bundled together. Specifically, condition (*i.*1) says that for some pairs of acceptable alternatives x, x^i in X, there must be a negotiator such that although she ranks x^i above x, there is a pair of alternatives y, y^i in Y with the property that she (weakly) prefers (x, y) to (x^i, y^i) at all admissible preferences. Such possibility of a preference reversal induces the partial order $x\ '?_t\ x^i$. Condition (*i.*2) ensures that all logrolling bundles, generated by t, are efficient.[45] These preference reversals define a partial order on X and condition (*ii*) requires that this partial order together with any connected subset of X form a join semilattice. We are now ready to provide a full characterization result.

Theorem 2. *Given a regular preference map* Λ*, there exists a mediation mechanism* f *satisfying strategy-proofness, efficiency, and individual rationality if and only if* Λ *satisfies quid pro quo and there is a partial order* $'?_t \in \Pi_\Lambda$ *such that* $f = f^{\succ_t}$.

Theorem 2 states that quid pro quo is both necessary and sufficient for the existence of strategy-proof, efficient, and individual rational mediation mechanisms, and any such mechanism must be a logrolling mechanism associated with a precedence order $'?_t$ which is induced by the preference map Λ.

A Practical Depiction of Quid Pro Quo

Definition 2 expresses quid pro quo property based on an order-theoretic semilattice structure. An equivalent and arguably more intuitive description uses a recursive and algorithmic process on the set of logrolling bundles, which we present through a simple example. This alternative structure may be practically useful since it provides hints to approximate the core principles of quid pro quo property and Theorem 2.

The essence of quid pro quo is that the preference domain (i.e., the preference map Λ) allows an "*elimination tournament*" of the form discussed below among the set of logrolling bundles, where there is always a winner of each matchup at each round. Furthermore, each round of this tournament represents the corresponding diagonal of the strategy-proof, efficient, and individual rational mediation mechanism to be constructed.

[45] Condition (*i.*2) is redundant when $|Y| = |X|$, and satisfied otherwise when working with standard continuous utility functions such as those in Example 2.

As an example, consider the mediation problem with three alternatives in each issue. The tournament always starts with all logrolling bundles ordered from b_1 to b_3 (see the left side of Figure 3), where $b_k = (x_k, y_{4-k})$.[46] In the first round of the tournament, each logrolling bundle matches up with its neighbors (i.e., both b_1 and b_3 match only with b_2). In the matchup between b_k and b_{k+1}, the "winner" is b_{k+1} if (and only if) negotiator 1 unambiguously ranks b_{k+1} over b_k. Here we say "*negotiator i unambiguously ranks bundle b over b*^{i}" if $b\ R_i\ b^i$ for all $R_i \in \Lambda(\theta_i)$ and all θ_i who deems both bundles acceptable. On the other hand, the winner of this matchup is b_k if (and only if) negotiator 2 unambiguously ranks b_k over b_{k+1}.[47] When both negotiators are able to compare these two bundles as required (i.e., negotiator 1 unambiguously ranks b_{k+1} over b_k and negotiator 2 unambiguously ranks b_k over b_{k+1}), then the winner can be any of these two bundles. In this case, the mediator (i.e., the partial order $'?_t$ that we create along the way) has the freedom to choose either one of these two bundles to proceed to the next round.

In our example, we suppose that the negotiators' preferences are such that negotiator 2 unambiguously ranks b_1 over b_2 and negotiator 1 unambiguously ranks b_3 over b_2. Therefore, b_1 and b_3 win over b_2 and move to the next round. In the second round, the winners of the first round (i.e., b_1 and b_3) match up (see the second raw on the left side of Figure 3). Once again, the winner will be b_3 (respectively b_1) if negotiator 1 (respectively 2) can unambiguously rank b_3 over b_1 (respectively b_1 over b_3).

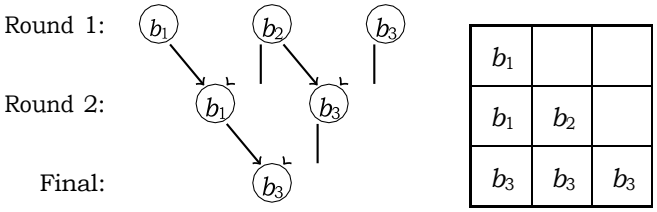


Figure 3: *An example for the elimination tournament and the matrix representation for the corresponding mediation rule*

If no negotiators can compare b_1 and b_3 as required, then the process fails. In this case, we go back to the previous round(s). If the mediator had the freedom to choose the winner of any matchups in the earlier rounds, then we replace the winner(s) of these matchups and reiterate the entire process. However, if the mediator had no freedom to choose the winner in earlier rounds, or if none of these reiterations yield a matchup in the second round with a winner, then the process fails. This means that the domain of preferences does not satisfy quid pro quo. Suppose, for the sake of the argument, bundles b_1 and b_3 are unambiguously ranked by both negotiators in the desired way. Then either bundle can be the winner of the second round. In the illustration above, we have chosen b_3 as the winner of the tournament. The matchup configurations in this entire tournament is in fact the join semilattice structure imposed by (*ii*) of Definition 2. Theorem 2 says that we can use this tournament structure in creating logrolling mechanisms that are efficient, individually rational and strategy-proof. The winners of each round fill up the corresponding diagonals. For the

[46]When $|X| = |Y|$, then order-reversing function t is unique. For cases where $|X| < |Y|$, the process may start with any such t. If the logrolling bundles in B^t fail to satisfy (*i*.2), then t should be replaced and the entire process should be repeated with the new logrolling bundles.

[47]These are the conditions implied by (*i*.1) of Definition 2.

tournament described above, the order of the logrolling bundles in the first round gives the placement order of these bundles (from the top corner to the bottom corner) along the first diagonal, the order in the second round gives the placement order along the second diagonal, and the last winner, b_3, fills up the bottom left entry of this matrix (which is the last diagonal). The constructed mechanism corresponds to the logrolling mechanism $f^{>-}_t$ with $'?_t$: b_3 b_1 b_2 where $t(x_k) = y_{4-k}$ for $k = 1, 2, 3$. Recall that both b_1 and b_3 were winners in the second round in our example, so the preference domain also admits a second logrolling mechanism $f^{>-}_t$ with $'?_t$: b_1 b_3 b_2.

Although our ordinal approach does not make any explicit assumptions about (or seek to elicit) negotiators' cardinal preferences, this certainly does not preclude the possibility that the negotiators are inherently endowed with such preferences. In fact, many standard utility functions are compatible with the quid pro quo condition. This is illustrated in Example 2 for the Cobb-Douglas and quasi-linear preferences when alternatives represent quantities.

Example 2 (Quid Pro Quo Under Standard Preferences): Suppose the negotiators are in dispute over dividing 10 units of good X and 6 units of good Y. Also suppose there are five possible ways of dividing good X where an alternative $x \in X = \{1, 3, 5, 7, 9\}$ denotes negotiator 1's share of good X.[48] Each negotiator's private bargaining range is determined by her least acceptable amount of good X. Symmetrically, an alternative $y \in Y = [0, 6]$ denotes negotiator 1's share of good Y. Therefore, when bundle (x, y) is chosen, negotiator 1 gets (x, y) and 2 gets $(10-x, 6-y)$. It is commonly known that negotiator i's consumption utility from a bundle with an acceptable amount of good X and Y is given by some function U_i (and, is otherwise zero when offered an unacceptable amount of good x outside her bargaining range) which may also depend on some privately known parameter(s). The private parameter in the utility function represents the uncertainty others are facing with regards to the negotiators' full fledged preferences over bundles as captured by the preference map Λ. Consider a linear order-reversing function $t(x) = \frac{11-x}{2}$ with which the mediator chooses alternatives from issue Y. This leads to one possible set of logrolling bundles where $B^t = \{(1,5), (3,4), (5,3), (7,2), (9,1)\}$.[49]

Cobb-Douglas: Suppose $U_i(x, y) = x^{a_i} y^{b_i}$ where $\frac{a_i}{b_i} \in [\frac{7}{12}, 1]$ for $i = 1, 2$; but the exact values of a_i and b_i are only privately known. Although negotiator 1 ceteris paribus prefers higher values of x (i.e., x^i θ_1 x when $x^i > x$), it can be verified that $(5, 3)$ R_1 $(7, 2)$ R_1 $(9, 1)$. This induces the partial order $'?_t$ such that 5 $'?_t$ 7 $'?_t$ 9. Similarly, although negotiator 2 ceteris paribus prefers lower values of x (getting more of good X), we have $(5, 3)$ R_2 $(3, 4)$ R_2 $(1, 5)$. This induces the partial order $'?_t$ such that 5 $'?_t$ 3 $'?_t$ 1. A logrolling mechanism associated with B^t and partial order $'?_t$ is strategy-proof. Figure 6 in Section 5 illustrates one such mechanism.

[48]While we have chosen this particular division possibility for a simple illustration with symmetric division options, it is also possible to choose $X = [0, 10]$ or some other discrete set. See the continuous analogue of our model in the Supplementary Appendix.

[49]When either issue is a continuum, there are infinitely many (possibly non-linear) order-reversing (i.e., strictly decreasing) functions and infinitely many possible sets of logrolling bundles with which the mediator can choose to form the basis of a logrolling mechanism.

Quasi-linear: Suppose $U_i(x, y) = x^{a_i} + y$ where $a_i \in (0, \frac{3}{5}]$ for $i = 1, 2$; but the exact value of a_i is only privately known. Although negotiator 1 ceteris paribus prefers higher values of x, she prefers $(x, t(x))$ over $(x', t(x'))$ for all $x, x' \in X$. Based solely on 1's preferences, this induces a complete order on X where $x \,'?_t^1\, x'$ when $x' > x$. Similarly, negotiator 2's preferences over bundles satisfies an analogous reversal. Based solely on 2's preferences, this induces a complete order on X where $x \,'?_t^2\, x'$ when $x > x'$. Consequently, any linear order on X satisfies Condition (i1) in Definition 2. Indeed, any logrolling mechanism associated with B^t and any well-defined partial order on X is strategy-proof under these preferences.

Remark: It is straightforward to generalize the above example to any well-behaved (e.g., continuous and monotonic) utility functions and arbitrary division possibilities. All that matters for the quid pro quo condition is how the curvature of the utility function (i.e., rate of substitution between the two issues) compares with the slope of the order-reversing (decreasing) t function that governs the set of logrolling bundles.[50] Consequently, for any given pair of differentiable and increasing utility functions, it is possible to choose an arbitrary division possibility (i.e., order-reversing function) so long as these slope comparisons have the appropriate direction, and vice versa. More generally, when division possibilities are governed by a linear t function as in Example 2, quid pro quo holds when preferences are convex. Also see the continuous analogue of our model in the Supplementary Appendix allowing for non-linear division possibilities.

Sketch of the Proof of Theorem 2

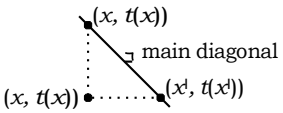
Consider the "if" part. The mediation mechanism $f^{>-t}$ satisfies individual rationality because it never suggests an unacceptable alternative. For efficiency, we consider a bundle $b = (x_b, t(x_b))$ that $f^{>-t}$ suggests at some type profile, corresponding to the lower half of the matrix. Suppose for a contradiction that another mutually acceptable bundle $a = (x_a, t(x_a)) \in B^t$ Pareto dominates b. Because $f^{>-t}$ suggests b, we must have $x_b \,'?_t\, x_a$. Moreover, since Λ satisfies quid pro quo, there must exist a negotiator i such that $x_a\, \theta_i\, x_b$; but $b\, R_i\, a$ for all consistent R_i, contradicting that a Pareto dominates b. If, however, $a \notin B^t$, then by condition (i.2) of Definition 2, there is no alternative $y \in Y$ that can be matched with x_a so that a Pareto dominates b. Hence, f must be efficient.

Regarding strategy-proofness of f, a profitable deviation is never possible, by the **BR** property, from or to a type profile in which $f^{>-t}$ suggests (o_x, y). So, consider a type profile where $f^{>-t}$ suggests b. Any deviation of, say, negotiator 1 to a less-accepting type to get a, which is located on the same column with b but on a lower row, is never profitable. This is true because (1) we have $x_b \,'?_t\, x_a$ since $f^{>-t}$ suggests b when both these bundles are mutually acceptable; (2) bundle a must appear above bundle b on a lower row on the main diagonal (due to the transitivity of $'?_t$), namely $x_a\, \theta_1\, x_b$; and thus (3) $b\, R_1\, a$ by quid pro quo and (1) above. A similar reasoning proves that negotiator 1 has no incentive to deviate to a more-accepting type. Hence, $f^{>-t}$ is strategy-proof.

Consider now the "only if" part. By Theorem 1, strategy-proofness, efficiency, and individual rationality of f imply an injective and order reversing function t and a partial

[50] For example, if the privately known parameters are outside the given interval in Example 2, then quid pro quo condition can be satisfied by choosing a flatter or a steeper t function.

order $\succeq$ such that $f = f^{\succeq}$. To prove $\succeq \in \Pi_{\Lambda}$, and so Λ satisfies quid pro quo, we show that $\succeq$ and t satisfy Definition 2. Condition (*i*.2) is simply implied by the efficiency of f. For condition (*i*.1) take any x, x^{i} with $x \succeq x^{i}$. By the construction of $\succeq$ in the proof of Theorem 1, we know that $x \succeq x^{i}$ implies that f must be suggesting a bundle with x at some type profile where both x and x^{i} are mutually acceptable. Assuming, w.l.o.g., that $x\ \theta_1\ x^{i}$, WARP requires that $f(\theta_1^{x^{i}}, \theta_2^{x}) = (x, t(x))$ (see the figure below). Then, it is easy to verify that strategy-proofness of f implies $(x, t(x))\ R_2\ (x^{i}, t(x^{i}))$, as required by condition (*i*.1).



Finally, the collection of sets $X_{j\ell}$ where $1 \le j \le \ell \le m$ constitutes the set of all connected subsets of X, and every doubleton $\{x, x^{i}\} \subset X_{j\ell}$ has a least upper bound in $X_{j\ell}$, which is $x^{*}_{X_{j\ell}}$. Thus, $(S, \succeq)$ is a semilattice for all connected subsets of X, as required by condition (*ii*).

4.3 A Visual Characterization of the Class of Logrolling mechanisms

To provide further insight into the logrolling mechanisms that are characterized by Theorems 1 and 2, we offer a geometric analysis of these mechanisms. We first take a mechanism $f = [f_{\ell,j}]_{(\ell,j)\in M^2}$ and introduce a couple of definitions to represent different rectangular and triangular regions of the matrix. In the following two definitions we slightly abuse notation and terminology in order to keep track of the entries contained in a rectangular/triangular region. Namely, we use $f_{\ell,j}$ to refer to entry (ℓ, j) of the matrix rather than the specific bundle that mechanism f assigns to that entry.

Definition 3. *Consider the entry $f_{k,k}$ for some $k \in M$ and an entry that lies (weakly) to its southwest, $f_{\ell,j}$ with $1 \le j \le k \le \ell \le m$. The* ***rectangle*** *induced by $f_{k,k}$ and $f_{\ell,j}$, denoted by $\square^{k}_{\ell,j}$, is the set of all entries in the rectangular region of the matrix (inclusively) enveloped between rows k and ℓ and columns k and j. Namely, $\square^{k}_{\ell,j} = \bigcup_{\substack{j\le s\le k \\ k\le t\le \ell}} \{f_{t,s}\}$.*

Definition 4. *The* ***triangle*** *induced by an entry $f_{\ell,j}$ with $1 \le j \le \ell \le m$, denoted by $\blacktriangle_{\ell,j}$, is the set of all entries in the triangular region of the matrix that is (inclusively) enveloped by the entry $f_{\ell,j}$, row ℓ, column j, and the main diagonal. Namely, $\blacktriangle_{\ell,j} = \bigcup_{j\le k\le \ell} \{f_{k,j}, f_{k,j+1}, \ldots, f_{k,k}\}$.*

A rectangle/triangle is merely a collection of entries of the matrix induced by mechanism f (i.e., sets of pairs of indexes). Note that an entry on the main diagonal is a special triangle (and also a special rectangle) that consists of a singleton entry. Furthermore, the entire main diagonal of the matrix and all the entries to its southwest constitute the largest possible

order n such that $f = f^{>}$. To prove $\in \mathrm{U}$, and so A satisfies quid pro quo, we show triangle $\mathsf{h}_{m,1}$. Given a triangle $\mathsf{h}_{x,j}$, its entries that lie on the main diagonal are said to be on the *hypotenuse* of $\mathsf{h}_{x,j}$. A partition of the lower half of the matrix is called a *rectangular*

(triangular) partition if and only if it is the union of disjoint rectangles (triangles).[51]

Theorem 3 (Visual Characterization). *The following statements are equivalent for the lower half of the mediation mechanism f, corresponding to type profiles in which a mutually acceptable alternative from the main issue exists:*

(i) *f is a logrolling mechanism.*

(ii) *The triangle* $\mathsf{h}_{m,1}$ *has a rectangular partition such that f assigns a unique bundle from the set of logrolling bundles* B^t *to each rectangle in this partition.*[52]

Part (*ii*) of Theorem 3 states that a logrolling mechanism f can be represented as the union of m disjoint rectangular regions. Each rectangle has a distinct corner entry on the main diagonal that contains the logrolling bundle that fills up the entire rectangle. Procedurally, these rectangles are obtained as follows. Given the precedence order on X, start with the logrolling bundle with the highest-precedence alternative (i.e., highest-precedence bundle). Starting from the entry of this bundle on the hypotenuse of the largest triangle, $\mathsf{h}_{m,1}$, let it fill up all the entries located to its southwest. This creates the first and largest rectangle $\square$, and leads to a triangular partition of $\mathsf{h}_{m,1} \setminus \square$. Next, pick any triangle from this partition and let the highest-precedence bundle on the hypotenuse of this triangle fill up all the entries that are located to its southwest. This leads to a second rectangle $\square^i$ as well as a unique triangular partition of $\mathsf{h}_{m,1} \setminus \{\square, \square^i\}$. The process can be iterated in this fashion until the entire triangle $\mathsf{h}_{m,1}$ is partitioned into m disjoint rectangles in m steps. Figure 4*a* provides an illustration of one such partitioning, where $b_k = (x_k, t(x_k))$ for $k = 1, \ldots, 9$. This process effectively traces the semilattice $(X, \succeq)$ in Figure 4*b*. Conversely, any such geometric set, namely any rectangular partition of $\mathsf{h}_{m,1}$, can be used to construct a precedence order and a corresponding logrolling mechanism.

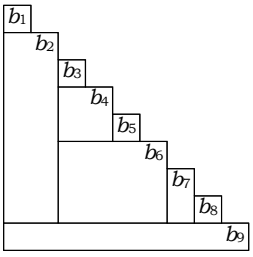


Figure 4*a*: *A rectangular partitioning of* $f^{\succ}$ *with m=9*

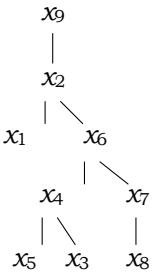


Figure 4*b*: *A semilattice* $(X, \succeq)$

4.4 A Practical Formulation of Logrolling Mechanisms

As briefly discussed in Section 1.1, dispute resolution protocols of some ODR platforms (e.g., SquareTrade) is based on generating a menu of recommendations from which negotiators are asked to make selections sequentially. In light of Theorem 3, the working principles

[51] Note that a rectangular partition consists of m disjoint rectangles. For example, $\{\square^k_{k,1}\}^m_{k=1}$ and $\{\square^k_{m,k}\}^m_{k=1}$ are two obvious rectangular partitions of $\mathsf{h}_{m,1}$. These two partitions correspond respectively to what we will later refer to as the negotiator 1- and negotiator 2-optimal mechanisms.

[52] More formally, for any $\square$ in the partition of $\mathsf{h}_{m,1}$ and any bundles $b, b' \in \square$, $b = b'$; but for any distinct pair $\square, \square'$ in the partition of $\mathsf{h}_{m,1}$, $(x, y) \in \square$ and $(x', y') \in \square'$ implies $x \neq x'$ and $y \neq y'$.

of the logrolling mechanisms generate a similar interpretation that is also reminiscent of the divide-and-choose mechanisms in fair division literature.

In particular, a logrolling mechanism can be thought to operate as a "*shortlisting mechanism*" in a decentralized fashion: One negotiator offers a shortlist of bundles as acceptable solutions for the dispute, the mediator communicates these options to the other negotiator who then chooses her favorite bundle from this list. To see this, observe that when negotiator 1 reports her type as $\theta^{x,\epsilon}$, it can be viewed as negotiator 1 forming a shortlist consisting of all the bundles on row £. When faced with the list of bundles negotiator 1 offers, negotiator 2 indeed picks the bundle $f_{£,j}$ since it is her favorite acceptable bundle on row £ by strategy-proofness. If the roles of the negotiators in this procedure were reversed, then the outcome would still be the same by symmetric arguments.[53]

For a more specific example, consider the logrolling mechanism depicted in Figure 4*a*. Suppose that negotiator 1 is of type $\theta_1^{x^3}$. Then we can think of her as proposing the shortlist $\{b_2, b_3, (o_x, y)\}$ to the other negotiator when she truthfully declares her type. The corresponding shortlists for other announcements as $\theta_1^{x^5}$ and $\theta_1^{x^7}$ are $\{b_2, b_4, b_5, (o_x, y)\}$ and $\{b_2, b_6, b_7, (o_x, y)\}$, respectively.

Under this interpretation, a logrolling mechanism specifies a set of shortlisted bundles that a negotiator can offer to the other party for each possible type she reports. By reporting a more-accepting type, the proposer may add new bundles or remove some from her shortlist. Theorem 3 implies that as negotiators declare more-accepting types, suggested shortlists must satisfy some kind of regularity in the sense that a previously removed bundle can never be added back to the shortlist. For the logrolling mechanism depicted in Figure 4*a*, for instance, if negotiator 1 switches from $\theta_1^{x^3}$ to $\theta_1^{x^5}$, she adds bundles b_4 and b_5 to the shortlist and removes b_3. If she switches from $\theta_1^{x^5}$ to $\theta_1^{x^7}$, then she adds b_6 and b_7 and removes b_4 and b_5 from the shortlist. Note for this logrolling mechanism that once bundles b_3, b_4 or b_5 are removed, they are never added back in.

5 Special members of the logrolling family

We next visit interesting members of the logrolling family. At the outset we assume that preference domain is such that all members of the family are strategy-proof, e.g., negotiators have quasi-linear preferences.[54] Three notable members of the family are worth pointing out. A **negotiator-optimal mechanism** represents a situation of extreme partiality to one side of the dispute and is constructed by using the precedence order implied by a negotiator's preferences over the logrolling bundles. Specifically, the negotiator 1-optimal mechanism takes

$$\succ^1: x_m \succ^1 x_{m-1} \succ^1 \dots \succ^1 x_1,$$

[53] One drawback of the divide-and-choose rule in the context of fair division is that its outcome depends on the order of agents. Divide-and-choose also violates strategy-proofness unlike the logrolling mechanism.

[54] This assumption renders a more meaningful comparison of the members possible. Specifically, we assume that quid pro quo is satisfied in the following strong sense. The preference map Λ admits an injective and order-reversing function $t : X \to Y$ such that for all i, $\theta_i \in \Theta_i$, $R_i \in \Lambda(\theta_i)$ and all $x, x' \in A(\theta_i)$ with $x' \succ_{\theta_i} x$, we have $(x, t(x)) \, R_i \, (x', t(x'))$. In this case, the negotiators' favorite logroling bundles are at the opposite corners of the diagonal.

whereas the negotiator 2-optimal mechanism takes

$$\succ^2: x_1 \succ^2 x_2 \succ^2 \ldots \succ^2 x_m.$$

In case of severe disagreement, i.e., when there is no mutually acceptable alternative in issue X, the corresponding designated bundle includes the favored negotiator's most-preferred alternative in issue Y. The two dual mechanisms are shown below for the case of $m = n = 5$.

	θ_2^{x1}	θ_2^{x2}	θ_2^{x3}	θ_2^{x4}	θ_2^{x5}
θ_1^{x1}	(x_1, y_5)	(o_X, y_1)	(o_X, y_1)	(o_X, y_1)	(o_X, y_1)
θ_1^{x2}	(x_2, y_4)	(x_2, y_4)	(o_X, y_1)	(o_X, y_1)	(o_X, y_1)
θ_1^{x3}	(x_3, y_3)	(x_3, y_3)	(x_3, y_3)	(o_X, y_1)	(o_X, y_1)
θ_1^{x4}	(x_4, y_2)	(x_4, y_2)	(x_4, y_2)	(x_4, y_2)	(o_X, y_1)
θ_1^{x5}	(x_5, y_1)	(x_5, y_1)	(x_5, y_1)	(x_5, y_1)	(x_5, y_1)

Figure 5a: *Negotiator 1-optimal mechanism*

	θ_2^{x1}	θ_2^{x2}	θ_2^{x3}	θ_2^{x4}	θ_2^{x5}
θ_1^{x1}	(x_1, y_5)	(o_X, y_5)	(o_X, y_5)	(o_X, y_5)	(o_X, y_5)
θ_1^{x2}	(x_1, y_5)	(x_2, y_4)	(o_X, y_5)	(o_X, y_5)	(o_X, y_5)
θ_1^{x3}	(x_1, y_5)	(x_2, y_4)	(x_3, y_3)	(o_X, y_5)	(o_X, y_5)
θ_1^{x4}	(x_1, y_5)	(x_2, y_4)	(x_3, y_3)	(x_4, y_2)	(o_X, y_5)
θ_1^{x5}	(x_1, y_5)	(x_2, y_4)	(x_3, y_3)	(x_4, y_2)	(x_5, y_1)

Figure 5b: *Negotiator 2-optimal mechanism*

A negotiator-optimal mechanism always chooses the corresponding negotiator's most-preferred bundle among the mutually acceptable logrolling bundles. The analogous shortlisting mechanism is rather simple: the favored negotiator's shortlist includes only two bundles, which are her favorite logrolling bundle and the designated disagreement outcome.[55] Clearly, these two polar members of the family of logrolling mechanisms are highly unattractive in practice.[56] Fortunately, there is a remarkable member of this family that treats negotiators symmetrically.

Impartiality entails focusing on a central element of the set of logrolling bundles as a compromise. It is then intuitive for the mediator to recommend a *median* logrolling bundle when it is mutually acceptable, or seek a bundle as close to it as possible when it is not. Within the family of logrolling mechanisms, this is achieved simply by assigning the highest precedence to a median logrolling bundle, and the next precedence to those bundles that are closest to the chosen median, and so on, and lowest precedence to the extremal logrolling bundles. Based on similar logic, when there is no mutually acceptable alternative in X, the designated bundle chosen by an impartial mediator should naturally include a median alternative in Y. This motivates the following type of mechanism, which we call a **constrained shortlisting (CS) mechanism**.

Definition 8. *Let $k \in \{\bar{k}, \underline{k}\}$ be the index of a median alternative, where $\bar{k} = \frac{m+1}{2}$ and $\underline{k} = \lfloor \frac{m+1}{2} \rfloor$. A mechanism is a constrained shortlisting mechanism, denoted $f^{CS} = [f_{\ell,j}]_{(\ell,j)\in M^2}$, if it is a logrolling mechanism that is associated with a precedence order $\succ$, where $x_k \succ x_{k-1} \succ \ldots \succ x_1$ and $x_k \succ x_{k+1} \succ \ldots \succ x_m$, and $f_{\ell,j}^{CS} = (o_X, y_k)$ whenever $\ell < j$.*

[55] Alternatively, the non-favored negotiator's shortlist includes all of her acceptable logrolling bundles and the designated disagreement outcome.

[56] Note that despite their polarity, these mechanisms are not dictatorial. Unlike a dictatorship, they remain individually rational and never get vetoed in equilibrium. Nevertheless, they hint at the possibility of the mediator having the power to tilt the balance in a dispute despite using a mechanism that meets our desiderata (i.e., efficiency, individual rationality, and strategy-proofness).

When the number of alternatives is odd, there is a unique constrained shortlisting mechanism When the number of alternatives is even, however, a constrained shortlisting mechanism prescribes one of four possible types of outcomes.[57] Figure 6 illustrates the constrained shortlisting mechanism for the case of $m = n = 5$.

When the number of alternatives is odd, the CS mechanism is a symmetric member of the logrolling mechanisms family.[58] In the lower half of the matrix, it acts as a negotiator-optimal mechanism whenever the median alternative in issue X is not mutually acceptable and recommends the median logrolling bundle whenever the set of mutually acceptable alternatives includes the median alternative. In other words, when both negotiators find at least half of the alternatives in X acceptable, the mechanism chooses the median logrolling bundle; and, when one negotiator finds at least half of the alternatives acceptable while the other finds less than half of the alternatives acceptable, the mechanism chooses the less-accepting negotiator's favorite logrolling bundle.

	θ_2^{x1}	θ_2^{x2}	θ_2^{x3}	θ_2^{x4}	θ_2^{x5}
θ_1^{x1}	(x_1, y_5)	(ox, y_3)	(ox, y_3)	(ox, y_3)	(ox, y_3)
θ_1^{x2}	(x_2, y_4)	(x_2, y_4)	(ox, y_3)	(ox, y_3)	(ox, y_3)
θ_1^{x3}	(x_3, y_3)	(x_3, y_3)	(x_3, y_3)	(ox, y_3)	(ox, y_3)
θ_1^{x4}	(x_3, y_3)	(x_3, y_3)	(x_3, y_3)	(x_4, y_2)	(ox, y_3)
θ_1^{x5}	(x_3, y_3)	(x_3, y_3)	(x_3, y_3)	(x_4, y_2)	(x_5, y_1)

Figure 6: *Constrained shortlisting mechanism*

In discrete resource allocation problems where agents are endowed with ordinal preference rankings, fairness properties (together with efficiency) have often proved difficult to attain in the absence of monetary transfers or a randomization device. It is nevertheless worthwhile to investigate whether it is possible for a member of the logrolling mechanisms family to achieve alternative fairness requirements beyond symmetry. We next formulate one such ordinal fairness notion as a normative requirement for our context.

Given the negotiators' preferences over alternatives (not including the outside option), let $r_i(z) \in M$ denote negotiator i's ranking of an acceptable alternative $z \in Z \in \{X, Y\}$. For a normalization, we re-assign ranks 1 through m to the chosen alternatives in Y and set the ranking of the outside option to be zero.[59] Given the logrolling mechanism $f = [f_{£,j}]_{(£,j)\in M^2}$, the *rank variance of the bundle* $f_{£,j}$ is defined as[60]

$$var(f_{£,j}) \equiv \sum_{i\in N} \left(r_i(f^X_{£j})\right)^2 + \left(r_i(f^Y_{£j})\right)^2 .$$

[57] In this case, the mechanism depends on whether $x_{\overline{k}}$ or $x_{\underline{k}}$ has the highest precedence and whether $y_{\overline{k}}$ or $y_{\underline{k}}$ is included in the designated disagreement bundle.

[58] When the number of alternatives is even, no logrolling mechanism is fully symmetric.

[59] This normalization is clearly not without loss, but simplifies the notation significantly as it treats issue Y as though it also has m alternatives. Nevertheless, the rank minimizing logrolling mechanism in the absence of this normalization is merely a "shifted" version of a CS mechanism where the magnitude of the shift depends on the order-reversing function t.

[60] This formulation assigns equal weights to both issues. One may also consider assigning different weights to different issues. Theorem 4 remains unchanged in that case due to the symmetric structure of the logrolling bundles under the normalization above.

Then, the **rank variance** of a mechanism f is the total sum of the rank variance of all possible outcomes of f, and defined as

$$Var(f) \equiv \sum_{\ell=1}^{m} \sum_{j=1}^{m} var(f_{\ell,j}).$$

Intuitively, the larger the differences between the two negotiators' rankings of the alternatives in a given bundle, the higher the rank variance of that bundle. For example, while never recommended by a logrolling mechanism, the bundles (x_1, y_1) and (x_m, y_m) have the highest rank variance. Despite making one negotiator as well off as possible, they make the opposite negotiator as worse off as possible. In this sense, the larger the rank variance of a mediation mechanism, the more skewed it is toward extremal bundles.

Theorem 4. *A mediation mechanism minimizes rank variance within the class of logrolling mechanisms if and only if it is a constrained shortlisting mechanism.*

6 Discussion and Extensions

In this section we provide a general discussion of our main model in light of the results obtained so far. To this end, first, we elaborate on some of our essential modeling assumptions, discuss the role they play in driving the positive results of our paper, and offer directions in which they can be extended to cases not covered in the main exposition. Second, drawing on our findings, we consider how one can go about formulating the mediation problem in a standard Bayesian setting such as that of Myerson and Sattertwaite (1983) [henceforth MS] and offer a reconciliation of the possibility results in our setup with the impossibility result in the MS setting.

6.1 Modeling conflicting preferences

We argue that diametrically opposed preferences in each issue is without loss of generality. When describing a dispute, using diametrically opposed preferences over alternatives is intuitive. However, it is conceivable that many other situations, where preferences are not necessarily diametrically opposed, could also depict a dispute. Consider, for example, a case where the set of available alternatives is $X = \{x_1, x_2, x_3, x_4, x_5\}$ and the negotiators' preferences are as follows:

$$\theta_1 : x_1\ x_2\ x_3\ x_4\ x_5$$
$$\theta_2 : x_3\ x_5\ x_4\ x_2\ x_1$$

These preferences are not diametrically opposed, but they are certainly conflicting to some extent as the agents cannot agree on their best alternative. Notice, however, that alternatives x_4 and x_5 are (Pareto) dominated by x_3. So, if selecting an efficient outcome by the mediation protocol is desired, then the presence of these two alternatives is irrelevant for the problem and can be eliminated from the preferences. Thus, this particular dispute problem can be transformed into a reduced problem where the only available alternatives are x_1, x_2, and x_3 and the negotiators' preferences over these three are diametrically opposed.

Proposition S.1. in the Supplementary Appendix shows that this observation generalizes to any (discrete) set of alternatives and any preference profile. A similar result, which we omit for brevity, also holds for two-person, multi-issue disputes whenever preferences over bundles satisfy monotonicity.

6.2 Symmetric treatment of the outside options

In this section we consider the case where the outside option in issue Y is also treated as each negotiator's private information. We let $\Theta_i = \Theta_i^X \times \Theta_i^Y$ denote the set of all **types** for negotiator i, and $\Theta = \Theta_1 \times \Theta_2$ be the set of all type profiles. Therefore, the mediation mechanism f maps Θ into $\overline{X} \times \overline{Y}$. We need to adjust the regularity assumption concerning the negotiators' preferences over bundles. Specifically, we need to modify the bargaining ranges condition since both issues can now potentially have unacceptable alternatives. The complete formalization and the proof of the next result is deferred to the Supplementary Appendix.

Proposition 1. *Under the symmetric treatment of the outside options, there is no mediation mechanism f that is efficient, individually rational, and strategy-proof.*

6.3 More than two issues or negotiators

Our two-issue model is without loss of generality. If there are more than two issues in the dispute, then we can regroup these issues under two types of categories depend- ing on whether an issue has certain or uncertain gains from mediation. In particular, let category-X be the collection of issues that exhibit uncertain gains from mediation (i.e., a negotiator's least acceptable alternative is her private information), and category-Y be the collection of issues that exhibit certain gains (i.e., it is common knowledge that efficient and mutually acceptable alternatives exist). Under this regrouping, each negotiator now faces a vector of alternatives for each category. The negotiators' preferences over these vectors (of alternatives) need not be diametrically opposed in general. However, as long as the negotiators' preferences are monotonic, by applying the transformation discussed in Section 6.1, we can eliminate all inefficient vectors. This brings us back to an environment analogous to our main model, in which preferences over vectors are diametrically opposed. When there are multiple parties involved in a dispute, as it would be the case for community/public disputes, we can similarly regroup them to be represented by either negotiator, effectively treating them as clones of the two negotiators. Nevertheless, there might be cases where negotiators' preferences are extremely disperse, and so grouping them into two "representative" agents may not be feasible. Such mediation environments are both practically and theoretically more complex than the one we study here and in need of further research.

6.4 Issue-wise voting in the direct mechanism with veto rights

In our main model, we assume that negotiators simultaneously and independently decide in the ratification stage whether to accept or veto the proposal. It does not matter whether voting is simultaneous or sequential. However, it is critical that the parties vote on the proposed bundle as a whole rather than voting on each issue separately. An alternative

consideration would be to allow the negotiators vote separately for each individual issue. In this case, revealing one's type truthfully in the announcement stage may no longer be an optimal strategy even if the mediation mechanism is a logrolling mechanism. Consider, for example, a strategy-proof negotiator-1 optimal mechanism when $m = n = 2$:

	M_2	L_2
L_1	(x_1, y_2)	(o_X, y_1)
M_1	(x_2, y_1)	(x_2, y_1)

Suppose negotiator 1 reports her type as L_1 and negotiator 2's true type is L_2. When negotiator 2 reports truthfully, the mechanism picks the disagreement bundle (o_X, y_1), and both o_X and y_1 would prevail in the ratification stage when voted individually. Suppose negotiator 2 instead reports M_2, in which case the mechanism would pick the logrolling bundle (x_1, y_2). In the ratification stage, negotiator 2 would veto the unacceptable alternative x_1, making the final outcome (o_X, y_2). Namely, negotiator 2 would gain by misreporting in the announcement stage. With similar logic, all logrolling mechanisms can be shown to be manipulable under issue-wise voting. Hence, there is no dominant strategy incentive compatible and efficient direct mechanism with veto rights under issue-wise voting.

The general impossibility of truthfully eliciting negotiators' private information under issue-wise voting underlines the importance of jointly resolving the two issues. In particular, bundling alternatives from different issues allows the negotiators to trade favors, which our analysis reveals to be manifested by the logrolling bundles. Consequently, to achieve dominant strategy incentives together with efficiency, it is paramount that the ratification stage only allows for voting on proposed bundles as a whole.

6.5 Reconciliation with the negative results in Bayesian settings

The influential work of MS is an important milestone in showing the difficulty of efficient trade in bargaining problems with asymmetric information. It is useful to discuss the underlying factors that are absent in the MS model, which may account for the possibility results in our model. Briefly, the mechanism design problem in MS concerns a bilateral trade between a buyer and a seller, who have private information about their valuations of a good. The mechanism has two components: the probability of trade, p, and the transfer, x, both of which are functions of the traders' reports. If no trade occurs, then $x = p = 0$ (the outside option), and so both traders receive zero utility. The utility functions are $U_b = v_b p - x$ for the buyer and $U_s = x - v_s p$ for the seller, where the valuations v_b, v_s are the traders' private information.

"Budget balancedness" is automatically satisfied in our setup, and so, "budget imbalance" is not the driving force for our possibility result. The buyer (seller) prefers lower (higher) transfers in MS and it is a priori uncertain whether a transfer leading to a mutually beneficial trade exists. Moreover, the quasi-linear utility functions in MS also satisfy the monotonicity and the quid pro quo assumptions. Despite all these similarities, the impossibility of MS is in agreement with our results (particularly the impossibilities we refer in Section 2 and Section 6.2) because the MS model translates as a single-issue mediation problem in our setup, where the transfer is the issue with uncertain gains. Efficiency in

MS implies that the probability of efficient trade is generically either 0 or 1, depending on whether or not the buyer's valuation is higher than the seller's valuation. This means that probability of trade cannot be considered as a second issue since we require the second issue to have at least as many alternatives as the main issue.

What is needed for a possibility is a new issue with a large set of efficient alternatives as in the case of issue Y in our model. To provide an illustration of the above points, in the following example we offer a simple adaptation of the MS setup in our model and demonstrate how one can overcome the impossibility by adding an extra issue:

Example 3 (Possibility in the augmented MS framework):

Suppose that the seller and the buyer now negotiate not only over the terms of trade but also over the division of a unit surplus. We refer to the latter as issue Y. The valuations of the good to the buyer and the seller are v_b and v_s, respectively. We assume that each negotiator knows her valuation and believes that the opponent's valuation is distributed over $[0, 1]$ with some probability distribution. The mediator privately solicits the traders' valuations and recommends a quadruple (p, x, y_s, y_b), where p denotes the probability of trade, x is the transfer, and y_s and y_b are respectively the seller's and the buyer's share of the unit surplus. The preferences of the two traders are as follows: $U_b = pv_b - x + u_b(y_b)$ and $U_s = x - pv_s + u_s(y_s)$. For simplicity, suppose that $u_b(y) = u_s(y) = y$ and each trader has only two types, $v_b, v_s \in \{0.2, 0.6\}$.

Efficiency implies that $p = 1$ if $v_b \geq v_s$, $p = 0$ if $v_s < v_b$, and $y_b + y_s = 1$. Individual rationality implies that the traders' utilities are nonnegative. Therefore, the following mechanism is strategy-proof, efficient, and individually rational:[61]

	$v_b = 0.6$		$v_b = 0.2$	
$v_s = 0.6$	$p = 1$ $x = 0.6$	$y_s = 0.3$ $y_b = 0.7$	*No trade*	$y_s = 0.5$ $y_b = 0.5$
$v_s = 0.2$	$p = 1$ $x = 0.4$	$y_s = 0.5$ $y_b = 0.5$	$p = 1$ $x = 0.2$	$y_s = 0.7$ $y_b = 0.3$

7 Related Literature

The law and economics literature on settlement negotiations under asymmetric information is extensive.[62] Our approach is fundamentally different from this literature both conceptually and methodologically. In a settlement negotiation, communications between parties revolve around evidence, rule of law, and witnesses, and when negotiations fail, trial is generally the next step. By contrast, we study what is referred as *facilitative mediation* in which the goal is not to determine who is right or who has a stronger case, but rather to explore mutually acceptable resolutions. In this type of mediations, mediators never invite

[61] The seller of type $v_s = 0.2$ has no incentive to mimic type $v_s = 0.6$. This is true because the seller's payoff under truth-telling (which is 0.7 regardless of the buyer's type) is higher than or equal to her deviation payoffs 0.7 (if the buyer is of type $v_b = 0.6$) and 0.5 (if the buyer is of type $v_b = 0.2$). Similarly, the seller of type $v_s = 0.6$ has no incentive to mimic type $v_s = 0.2$. Her payoff under truth-telling is either 0.3 (if the buyer is type $v_b = 0.6$) or 0.5 (if the buyer is type $v_b = 0.2$). However, her deviation payoffs are 0.3 regardless of the buyer's type. Symmetric arguments apply for the buyer.

[62] See, for example, Daughety and Reinganum (2017) and Wickelgren (2013) for two comprehensive accounts of this literature.

parties to present their evidences or cases or to allow parties to discuss their interpretation of the law. This solution-oriented approach is what makes facilitative mediation as the de facto dispute resolution method in e-commerce. To the best of our knowledge, we are not aware of any paper, in the economics, law, management, or information systems literature, that investigates the role of incentives in facilitative mediation.

From a modeling perspective, standard settlement negotiation models involve at least one party having private information about some aspects of the case. Parties' strengths determine the outcome of the trial and the value of the outside option for each side. As a direct implication of this modeling choice, settlement negotiation processes may reveal some information about parties' strengths, which would mean updated beliefs and expectations about outside options. A model where parties can influence other parties' beliefs, and so preferences, creates a highly adversarial environment. However, the whole point behind facilitative mediation is to prevent the formation of such environments. In our model, parties' preferences (i.e., acceptable alternatives) do not change with the opponent's private information. Finally, settlement negotiations are generally modeled through the lens of non-cooperative bargaining theory, whereas we model facilitative mediation as a mechanism design problem.

Our model is more comparable to multi-issue bargaining problems with exogenous outside options. Our modeling of separate and joint outside options is in line with how issues are addressed in political bargaining; see, e.g., Chen and Eraslan (2014, 2017) for similar interpretations to us. Mediation has been studied in the traditional bargaining literature with incomplete information, which is primarily based on a cardinal approach. A central question is whether private information prevents the bargainers from reaping all possible gains from trade. The mechanism design approach to this problem was pioneered by Myerson and Satterthwaite (1983), which shows that for a model with transferable utility there is no ex post efficient, individually rational, Bayesian incentive compatible, and budget balanced mechanism when there is uncertainty about whether gains are possible.[63] On the topic of mediation, specifically, there are very few papers, most of which model mediation as a settlement negotiation. For a model featuring a continuum of types, Bester and Warneryd (2006) show that asymmetric information about relative strengths as an outside option in a conflict may render agreement impossible even if there is no uncertainty about the agreement being efficient. In their model, conflict shrinks the pie and agreement on a peaceful settlement is always ex post efficient. Following Bester and Warneryd (2006), Hörner et al. (2015) compare the optimal mechanisms with two types of negotiators under arbitration, mediation, and unmediated communication. They show that there is no ex post efficient and Bayesian incentive compatible mechanism: the optimal mechanism is necessarily inefficient. Compte and Jehiel (2009) consider bargaining problem where outside options are private but correlated, and parties have a veto right. They show that inefficiencies are inevitable whatever the exact form of correlation, which resonates with the negative result in our benchmark model of single-issue mediation.

Obtaining a possibility result in our model hinges crucially on the availability of (at

[63]The MS impossibility crucially depends on types being independent. Subsequently, it was shown that efficient trade may be possible when types are correlated (e.g., Gresik (1991) and McAfee and Reny (1992).

least) a second issue. Linking multiple decisions/issues to overcome welfare and incentive constraints has been a useful tool in many economic applications such as bundling of goods by a monopolist (e.g., McAfee et al. 1989), agency problems (e.g., Maskin and Tirole 1990), and logrolling in voting (e.g., Wilson 1969). A common insight in these approaches is based on applying a law of large numbers theorem to ensure that truth telling incentives are restored in a sufficiently large market. In this vein, Jackson and Sonnenschein (2007) show that by linking different issues in many situations, including the bilateral bargaining setting of MS, it is possible to achieve outcomes that are approximately efficient in an approximately incentive compatible way as the number of issues goes to infinity.[64] In contrast with these approaches, we establish efficiency in dominant strategies with only two issues in an application where the number of potential issues is inherently limited.

With some caveats, a dispute resolution problem can also be interpreted as a type of fair division problem involving indivisible items. Logrolling mechanisms allow one negotiator to effectively reduce the set of possible outcomes to a shortlist, from which the other negotiator makes her favorite selection. In that sense, logrolling mechanisms are reminiscent of the well-known biblical rule of divide-and-choose, which has been extensively studied in fair cake-cutting problems. Two advantages of a logrolling mechanism relative to divide-and-choose is that it is strategy-proof (whenever preferences satisfy quid pro quo) and its outcome is independent of the ordering of the negotiators. More generally, the fair division literature almost exclusively focuses on fairness and efficiency issues due to inherent incompatibilities with strategy-proofness similar to those in the multi-unit assignment context; see, e.g., Brams and Taylor (1996).

Assignment problems have proved useful in achieving strategy-proofness and efficiency via non-dictatorial mechanisms in a number of applications. In this context, ordinal mechanisms are well known to achieve better incentive properties than their cardinal contenders in these problems.[65] In early work, Zhou (1990) showed that no cardinal mechanism is strategy-proof, efficient, and symmetric. By contrast, ordinal mechanisms such as the random priority, are well known to attain the three properties. In two-sided one-to-one and many-to-one matching problems, however, a stable mechanism can be strategy-proof only for one side of the market (see e.g., Roth and Sotomayor 1990).[66]

In assignment/matching problems, an agent's outside option is private consumption whereas in our model it creates an externality on the other negotiator, e.g., whenever either negotiator chooses to exercise her outside option by vetoing the proposal, the other negotiator is automatically compelled to also exercise her outside option. When outside options do not exist and the issues are discrete, our setting roughly resembles a type of multi-unit assignment problem (e.g., course allocation) in which only certain assignments

[64]Jackson et. al. (2020) derives a similar conclusion in a noncooperative bilateral bargaining game setting.

[65]For example, the most prominent cardinal mechanism in the context of unit-assignment problems (possibly allowing for stochastic assignments), the competitive equilibrium from equal incomes solution (Hylland and Zeckhauser 1979), is not strategy-proof. This difficulty of achieving strategy-proofness is generally attributed to the tension with efficiency since cardinal mechanisms achieve stronger welfare properties (e.g., maximization of utilitarian welfare) than ordinal mechanisms.

[66]Similar to the literature on linking decisions discussed below, a common method of circumventing these impossibilities is to resort to large market arguments by allowing for the number of participants and resources to grow. Such methods are obviously inapplicable in the context of mediation.

are feasible.[67] As discussed in Section 1.1, some of the existing point allocation-based ODR mechanisms are akin to course-bidding mechanisms that have been identified as deficient in this literature. Nonetheless, the multi-unit assignment setting provides little reason to remain optimistic for positive results. The literature contains a series of papers that show impossibility results. The main result of this literature is that the only strategy-proof and efficient mechanisms are serial dictatorships; e.g., see Pápai (2001), Klaus and Miyagawa (2002), and Ehlers and Klaus (2003).[68] Clearly, dictatorship mechanisms have little appeal in a dispute resolution situation.[69]

Absent outside options, our model also resembles a voting setting where a voting scheme aggregates individual preferences (Black 1948). This type of voting domains allows to overcome the Gibbard-Satterthwaite impossibility, and the famous median voter theorem states that the majority-rule voting system that selects the Condorcet winner (i.e., the outcome most preferred by the median voter) is strategy-proof; see Moulin (1980) for a classic generalization of this result. The constrained shortlisting mechanism can be viewed as similar to a Condorcet winner in the sense that it recommends the median logrolling bundle when the median is mutually acceptable for both negotiators and the closest logrolling bundle to it when it is not. Nevertheless, this connection is superficial as our model differs in several ways from a voting framework. In these voting models, there are several voters whose bliss point (peak value) is their private information, whereas in our model there are two agents (the negotiators) whose peaks in each issue are publicly known. What is private information here consists of two negotiators' outside options, which have no analogue in a voting model. Consequently, there is no clear way to adopt such voting schemes in our setup, as they would violate individual rationality. Moreover, the above analogy between the two types of models applies only when each issue is considered separately, since negotiators' underlying joint preferences over bundles in our two-issue model are not necessarily single-peaked.[70]

A novelty of our approach that distinguishes it from the literature on fair division, market design, and voting is that we do not ask agents to report their preferences. Instead, we maintain the view that a dispute is solvable so long as the underlying preference structure allows for it. This not only frees us from further complications related to the choice of a

[67]Suppose there are two agents, each of whom needs to be assigned two objects, one from each of two sets A and B, where an alternative in issue X (respectively Y) represents a specific pair of objects from set A (respectively B) that must be assigned simultaneously. Suppose, for example, set A contains three objects in the order of decreasing desirability, a, b, and c, where a and c are in unit supply and b has two copies. Then issue X can be viewed as consisting of the following object pairings $X = \{(a, c), (b, b), (c, a)\}$. That is, if one agent gets a, the other must get c, and b cannot be assigned together with any other object.

[68]Results continue to be negative even with stochastic mechanisms (Kojima, 2009). In the course allocation context, two notable contributions that identify non-dictatorship mechanisms are S¨onmez and Ünver (2010) and Budish (2011). The former paper argues for eliciting bids from students together with ordinal preferences over courses and then using a Gale-Shapley mechanism where bids are interpreted as course priorities. The mechanism is strategy-proof only if the bids are treated as exogenously given. The latter paper proposes an approximately efficient mechanism that is strategy-proof in a large market.

[69]Worse still, dictatorships violate individual rationality in our mode, i.e., such recommendations will be vetoed in equilibrium. A constrained dictatorship where one negotiator maximizes her welfare among the set of mutually acceptable outcomes would satisfy individual rationality, but such a mechanism is easily manipulable.

[70]An alternative view could be based on a multi-issue voting setting. However, in multidimensional voting models where people vote on several issues, a main conclusion is that strategy-proofness effectively requires each dimension to be treated separately in the sense that each dimension should admit its own generalized median voter schemes. Our strategy-proofness result, by contrast, depends critically on having more than one dimension and relies heavily on leveraging the exchangeability between the two issues.

suitable preference reporting language, but is also consistent with some of the ODR practices as well as the recommendation systems used in ecommerce.

Finally, with the hope of arriving at possibility results, there is a tradition of searching for strategy-proof mechanisms in restricted economic environments that make it possible to escape Arrow-Gibbard-Satterthwaite impossibilities. Well-known examples include VCG mechanisms (Vickrey 1961, Groves 1973, and Clarke 1971) for public goods and private assignment with transfers; the uniform rule (Sprumont 1991) for the distribution of a divisible private good under single-peaked preferences; generalized median-voters (Moulin 1980); proportional-budget exchange rules (Barberà and Jackson 1995) that allow for trading from a finite number of prespecified proportions (budget sets); deferred acceptance (Gale and Shapley 1962) and top trading cycles (Shapley and Scarf 1974, Abdülkadiroglu and Sönmez 2003) and hierarchical exchange and brokerage (Pápai 2001, Pycia and Ünver 2017). We also add to this literature by introducing and characterizing an entirely new class of strategy-proof and efficient mechanisms.

8 Conclusion

Mediation is a preferred alternative dispute resolution method thanks to the cost-effectiveness, speed, and convenience it affords to all parties involved. The need for structured and rigorous mediation protocols in practice has often been stressed by researchers and practitioners alike. Online dispute resolution platforms are often based on automation and rely on mechanized negotiation protocols. However, existing dispute resolution protocols fail to account for the incentives faced by disputants. Taking a foundational market design approach to this problem, we sought systematic mechanisms for delivering consistent, transparent, and objective recommendations while giving proper incentives to the disputants to be truthful. Without putting any restrictions on preferences, we considered mechanisms that have a simple preference reporting language; negotiators only report their bargaining ranges (i.e., least acceptable alternatives) in the main issue. It turns out that complementing the main issue with a second one—a piece of advice often voiced by pioneers in the field—is key to achieving strategy-proof, efficient, and individually rational mechanisms. Any such mechanism belongs to the family of logrolling mechanisms, which require that the mediator's recommendation must always be a logrolling bundle (a bundle that complements a more preferred alternative in one issue with a less preferred alternative from the other) when a mutual agreement is feasible. A sufficient and necessary condition for strategy-proofness is the quid pro quo property of preferences that necessitates the alternatives in the second issue to be interesting enough relative to those in the main issue. The constrained shortlisting mechanism is the central member within the characterized class and makes recommendations as close to the median logrolling bundle as possible.

Our approach can also be viewed as a novel attempt to marry the two distinct literatures of bargaining and assignment. Although the design of facilitative mediation protocols has not been previously considered in the former, this literature emphasizes the tensions due to private information and outside options in mechanism design with transferable utility. The latter literature offers blueprints for designing robust protocols in assignment problems that often arise in practice. The multiple-assignment nature of the problem at hand in our

study, however, is less than encouraging in light of the abundance of negative results in that literature. Our analysis confirms these challenges in that possibility results in our framework are also elusive unless the outside options in the two issues are treated asymmetrically. We argued that ordinal mechanisms coupled with strategy-proofness can help obtain detail-free and genuinely simple protocols for mediating disputes. Notwithstanding our emphasis on ordinality, the framework developed in this paper can accommodate both transferable and nontransferable utility settings since we do not directly elicit preferences.

While it would be premature to conclude that logrolling mechanisms are ready-to-use protocols for immediate practical applications, our theoretical analysis may help shed light on the fundamental forces at work when efficiency is sought together with robust incentives. An interesting open question is how to incorporate full preference elicitation from negotiators into the mechanism design problem. Further research is needed on this front since allowing negotiator types to also include preferences would readily give rise to a more sophisticated preference reporting language than ours as well as new incentive and welfare considerations. Although we leave this direction for future investigation, we contend that the class of mechanisms characterized here would constitute an ideal starting point for developing more sophisticated dispute resolution protocols.

9 APPENDIX

Proof of Theorem 1: Suppose that Λ is regular and the mediation mechanism f is strategy-proof, efficient, and individually rational.

The case where $R < j$: Individual rationality and regularity imply $f^X_{R,j} = o_X$. Then regularity and efficiency require $f_{R,j} = (o_X, y)$ for some $y \in Y$. By strategy-proofness and monotonicity, we must have $f_{R-1,j} = (o_X, y)$ for all $R - 1 < j$. Similarly, $f_{R,j+1} = (o_X, y)$ for all $R < j + 1$. Fixing j (and R) and applying the same argument for all remaining rows and columns yields $f_{R,j} = (o_X, y)$ whenever $R < j$.

The case where $R \geq j$:

Lemma 1 (WARP). *If $x, x' \in A(\theta) \cap A(\theta')$ /= Ø, x /= x' and $x = f^X_\theta$, then $f^X_{\theta'}$ /= x'.*

Proof. Let $\theta = (\theta_1, \theta_2)$ and $\theta' = (\theta'_1, \theta'_2)$ be two type profiles that correspond to the lower half of the matrix form of f (i.e., $A(\theta) \cap A(\theta')$ /= Ø). Suppose for a contradiction that there are two distinct alternatives $x, x' \in A(\theta) \cap A(\theta')$ such that $x = f^X_\theta$ and $f^X_{\theta'} = x'$. Suppose, without loss of generality, that θ and θ' correspond to different rows and columns (if they are on the same row or column, then we can just skip this step with bundle b). Start from the type profile that corresponds the higher row; namely the profile where negotiator 1's type is more accepting. Suppose, without loss of generality, that θ' is the higher row type profile. Let $b = f(\theta_1, \theta'_2)$ be the bundle that is on the same column with θ' and on the same row with θ. All three bundles, b, $f(\theta)$, and $f(\theta')$, are acceptable by both types of negotiator 1 because f is individually rational and θ'_1 is more accepting than type θ_1. Strategy-proofness implies that $b \, R_1 \, f(\theta')$ for all $R_1 \in \Lambda(\theta_1)$. This comparison is also true for all $R_1 \in \Lambda(\theta'_1)$ since preferences are consistent. Similarly, we must have $f(\theta') \, R_1 \, b$ for all $R_1 \in \Lambda(\theta'_1)$ since f is strategy-proof. The last two comparisons imply that $b = f(\theta')$ because preferences over bundles are antisymmetric. By repeating the symmetric arguments for negotiator 2 and recalling that $b = f(\theta')$ and both x, x' are acceptable by types θ_2 and θ'_2, we conclude that these two bundles (i.e., $f(\theta)$ and $f(\theta')$) must be the same, contradicting our presumption that x and x' are distinct alternatives. □

Lemma 2 (Existence of *t*). *There exists an injective order-reversing function* $t : X \to Y$ *such that* $f_{k,k} = (x_k, t(x_k))$ *for every* $k = 1, \ldots, m$.

Proof. Row and column k correspond to the preference profile $(\theta_1^{x_k}, \theta_2^{x_k})$ where the only mutually acceptable alternative in issue X is x_k. Therefore, for any $1 \le k \le m$, efficiency and individual rationality of f and regularity of preferences imply $f_{k,k}^X = x_k$ and $f_{k+1,k}^X \in \{x_k, x_{k+1}\}$ whenever $k \neq m$. Therefore, strategy-proofness of f, monotonicity of preferences, and WARP imply that $f_{k+1,k} \in \{f_{k,k}, f_{k+1,k+1}\}$.

Next, we claim that $f_{k+1,k+1}^Y \; \theta_1^Y \; f_{k,k}^Y$ for each $k = 1, \ldots, m-1$: If it is true, then we are done with the proof of Lemma 2 by setting $t(x_k) = f_{k,k}^Y$ for all k, including t being injective because θ_1^Y is transitive and irreflexive. To prove the last claim, take any k satisfying $1 \le k \le m-1$. If $f_{k+1,k} = f_{k+1,k+1}$, then strategy-proofness and monotonicity of preferences of negotiator 1 require that $f^Y \; \theta_1^Y \; f^Y_{k,k}$ because otherwise negotiator 1 would profitably deviate by declaring his type as $\theta_1^{x_k}$ rather than $\theta_1^{x_{k+1}}$ as she would be getting better alternative in issue X and better or the same alternative in issue Y. On the other hand, if $f_{k+1,k} = f_{k,k}$, then strategy-proofness and monotonicity of preferences of negotiator 2 require that $f^Y_{k,k} \; \theta_2^Y \; f^Y_{k+1,k+1}$, which implies $f^Y_{k+1,k+1} \; \theta_1^Y \; f^Y_{k,k}$ as the negotiators' preferences over the alternatives in issue X are diametrically opposed. This completes the proof. □

Therefore, a strategy-proof, efficient, and individually rational f implies an injective order-reversing function $t : X \to Y$ and a nonempty set of bundles $B^t = \{(x, t(x)) \mid x \in X\}$, which constitutes the set of bundles on the main (first) diagonal. For any $1 \le j \le R \le m$ let $B^t_{jR} = \{(x_k, t(x_k)) \in B^t \mid j \le k \le R\}$ denote the bundles on the main diagonal between row j and R.

Construction of ≻: Take any type profile $\theta = (\theta_1^{x_\ell}, \theta_2^{y_j})$ where $1 \le j \le R \le m$. We say $f^X_{\ell,j} \succ x$ whenever $x \in X_{j\ell}$. WARP implies that $\succ$ is antisymmetric and reflexive, but not necessarily complete.

Lemma 3. *The binary relation* $\succ$ *is transitive. That is, for any triple* $x, x', x'' \in X$ *where* $x \succ x'$ *and* $x' \succ x''$, *we have* $\neg x'' \succ x$. *Furthermore, for all* $1 \le j < R \le m$, $f_{\ell,j} = \left(x^*_{X_{j\ell}}, t\left(x^*_{X_{j\ell}}\right)\right) \in B^t_{j\ell}$ *where* $x^*_{X_{j\ell}} = \max_{X_{j\ell}} \succ$.

Proof. Suppose for a contradiction that $f_{\ell,j} \notin B^t_{j\ell}$. By efficiency and individual rationality $f^X_{\ell,j} \in \{x_j, x_{j+1}, \ldots, x_\ell\} = X_{j\ell}$. Let $f^X_{\ell,j} \neq x_k$ for some $j \le k \le R$. Lemma 2 shows that $f^X_{k,k} = x_k$, and thus by WARP we must have $f^X_{s,r} = x_k$ for all $k \le s \le R$ and $k \le r \le j$. Consider $f_{k,j}$: By strategy-proofness of f and monotonicity of the preferences, we must have $f_{k,j} = f_{k,k}$. Similar arguments imply $f_{\ell,j} = f_{k,j}$. Hence, $f_{\ell,j} = f_{k,k} \in B^t_{j\ell}$ and $f^Y_{\ell,j} = t(f^X_{\ell,j})$.

Now, suppose for a contradiction that there exists three distinct $x, x', x'' \in X$ such that $x \succ x'$, $x' \succ x''$, and $x'' \succ x$. Let a, b, and c in B^t denote $(x, t(x))$, $(x', t(x'))$, and $(x'', t(x''))$ respectively. Also suppose, without loss of generality, that a appears above bundle b and b appears above bundle c on the main diagonal. Similar to the arguments above, strategy-proofness of f, monotonicity of preferences and WARP imply that for some R, j, and k, $f_{\ell,j} = a$, $f_{k,j} = c$, and $f_{k,\ell} = b$ (see Figure 7). Therefore, f selects b at entry (k, R) while both x' and x'' are mutually acceptable, but selects c at entry (k, j) while these alternatives are still mutually acceptable, contradicting with WARP. Finally, by construction of $\succ$ we know that $f^X_{\ell,j} = x^*_{X_{j\ell}} \succ x$ for all $x \in X_{j\ell}$, which completes the

proof. □

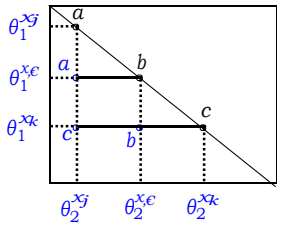


Figure 7

Proof of Theorem 2:

Proof of 'if': Suppose that a regular preference map Λ satisfies quid pro quo. By Definition 2 there exists an injective order-reversing function $t : X \to Y$ and a partial order $\succeq_t$ over X such that $\succeq_t \in \Pi_\Lambda$. Define the mediation mechanism $f^{>t}$ by using the partial order $\succeq_t$ as follows:

$$f^{>t} = \begin{cases} \left(x^*_{X_{j\ell}}, t\left(x^*_{X_{j\ell}}\right)\right), & \text{if } j \le R \\ (o_X, y), & \text{otherwise} \end{cases}$$

where $x^*_{X_{j\ell}} = \max_{X_{j\ell}} \succeq_t$ and $y \in Y$.

First note that $X_{j\ell}$ is a connected subset of X for all $1 \le j \le R \le m$, and $\succeq_t$ is a semilattice for all connected subsets of X. Thus, $\max_{X_{j\ell}} \succeq_t$ uniquely exists. Next, we prove that $f^{>t}$ is individually rational, efficient, and strategy-proof. The mechanism $f^{>t}$ never suggests an unacceptable alternative, and thus, it is individually rational by the regularity of preferences.

To show efficiency, first consider the type profile where both negotiators deem all alternatives acceptable in issue X, i.e., $(\theta^{xm}_1, \theta^{x1}_2)$. Let $f^{>t}$ propose a bundle $b = (x_b, t(x_b))$ from the set $B^t = \{(x, t(x)) \mid x \in X\}$ at that profile. If instead the negotiators receive another bundle from $B^t \backslash \{b\}$ at that profile, then one of the negotiators would certainly get worse off. Suppose for a contradiction that there is another bundle $(x_a, t(x_a)) = a \in B^t \backslash \{b\}$ that Pareto dominates b. Because $f^{>t}$ suggests b, we must have $x_b = \max_X \succeq_t$, and so $x_b \succeq_t x_a$. Moreover, because Λ satisfies quid pro quo there must exists a negotiator i where $x_a \, \theta_i \, x_b$ and $b \, R_i \, a$ for all admissible R_i, and the comparison is strict for some R_i as admissible preferences are consistent and bundles a and b are distinct. The last statement contradicts the presumption that a Pareto dominates b.

Again at that type profile, i.e., $(\theta^{xm}_1, \theta^{x1}_2)$, if the negotiators had a bundle with the outside option in issue X, rather than b, then both negotiators would be worse off because of the **BR** property. Finally, if the negotiators had any other bundle, say $c = (x_c, y)$ where $y \neq t(x_c)$, which is neither from the set B^t nor a bundle with the outside option in issue X, then one of the negotiators would certainly get worse off. To prove this point, suppose for a contradiction that the bundle c Pareto dominates b. Because $x_b = \max_X \succeq_t$, it must be the case that $x_b \succeq_t x_c$. Suppose, without loss of generality, that $x_c \, \theta_1 \, x_b$. Since Λ satisfies quid pro quo and $x_c \, \theta_1 \, x_b$, we must have $b \, R_1 \, (x_c, t(x_c))$ for all consistent R_1's. There are three exhaustive cases regarding the value of y and we consider all in turn:

First consider the case where $t(x_c) \, \theta^Y_1 \, y$. In this case, monotonicity implies that $(x_c, t(x_c)) \, R_1 \, (x_c, y) = c$ for all admissible R_1's, and thus by transitivity we have $b \, R_1 \, (x_c, t(x_c)) \, R_1 \, c$ for all admissible R_1, where the comparison is strict for some R_1 as admissible preferences are

consistent and bundles b and c are distinct. The last statement contradicts the presumption that bundle c Pareto dominates b. On the other hand, if $y\ \theta_1^Y\ t(x_b)$, then by monotonicity $b = (x_b, t(x_b))\ P_2\ (x_c, t(x_b))\ P_2\ (x_c, y) = c$ for all admissible R_2, contradicting the presumption that bundle c Pareto dominates b. Finally, if $t(x_b)\ \theta_1^Y\ y\ \theta_1^Y\ t(x_c)$, then the bundle (x_c, y) cannot Pareto dominate the bundle b because Λ satisfies quid pro quo, which proves our initial claim that b is not

Pareto dominated.

Thus, no other bundle makes one negotiator better off without hurting the other when both of the negotiators deem all alternatives acceptable. We can directly apply the same logic to all type profiles that the negotiators deem less alternatives acceptable. Finally, for those type profiles where there is no mutually acceptable alternative in issue X, in which case the mechanism suggests (o_X, y) for some $y \in Y$, any other bundle will include an alternative that is unacceptable in issue X by at least one of the negotiators who will veto the proposal. Thus, by regularity, at least one negotiator would be worse off if $f^{>t}$ had been proposing something other than (o_X, y). Hence, the mechanism $f^{>t}$ is efficient.

Next, we prove that the mechanism $f^{>t}$ is strategy-proof, but first establish some facts about the structure of this mechanism. If $a = f^{>t}_{\pounds,j}$ and $b = f^{>t}_{r,s}$ are two bundles (i.e., bundle a appears on row R and column j whereas bundle b appears on row r and column s), then we say bundle a appears above (below) bundle b whenever $R < r$ ($R > r$). Likewise, we say bundle a appears the right (left) of bundle b if $j > s$ ($j < s$).

Given the mediation mechanism $f^{>t}$ and a bundle a that appears on the main diagonal (i.e., $a = f^{>t}_{k,k}$ for some $k \in M$) define $V(a)$ to be the **value region of bundle** a, which is the submatrix of $[f^{>t}_{\pounds,j}]_{(\pounds,j)\in M^2}$ excluding all the rows lower than row k and all the columns higher than column k. Namely, $V(a) = [f^{>t}_{\pounds,j}]_{(\pounds,j)\in(M^k, M_k)}$ where $M^k = \{k, \ldots, m\}$ and $M_k = \{1, \ldots, k\}$. Furthermore, if bundle $b = f^{>t}_{r,r}$ appears on the main diagonal with $r \in M$ and $r > k$, then $V(a) \cap V(b) = [f^{>t}_{\pounds,j}]_{(\pounds,j)\in(M^r, M_k)}$ where $M^r = \{r, \ldots, m\}$. In Figure 8, the value region of bundle a is region *I* and *III*, the value region of bundle b, $V(b)$, is region *II* and *III*, and $V(a) \cap V(b)$ is region *III*.

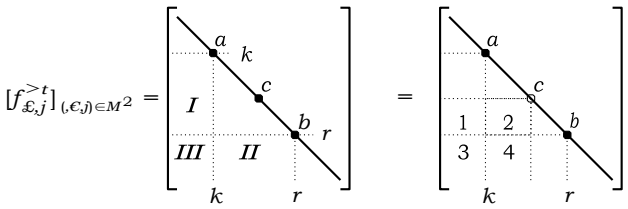


Figure 8

Lemma 4. *For the mediation mechanism $f^{>t}$ and for any two bundles $a, b \in B^t$,*

(i) *a never appears outside of its value region $V(a)$,*

(ii) *a and b both never appear in $V(a) \cap V(b)$, and*

(iii) *if both a and b appear on the same column (or row), where a is above b (or a is on the left of b), then on the main diagonal, bundle a appears above bundle b.*

Proof. Let $(x_a, t(x_a)) = a = f^{>t}_{k,k}$ and $(x_b, t(x_b)) = b = f^{>t}_{r,r}$ be two distinct bundles for some $k, r \in M$. The first claim follows directly from the construction of $f^{>t}$, the fact that t is one-to-one and that $x_a \notin X_{j\pounds}$ for any $j \le R < k$ and $k < j \le R$. Transitivity of $\succ_t$ implies the second claim but deserves a proof. Suppose first that a and b appear on the same column in region *III*, say column s, and a is located above bundle b on this column, namely a is on row r_a and b is on row r_b where $r \le r_a < r_b \le m$. Starting from column and row r (i.e., from bundle b) as we move from column r to column s along the row r, transitivity of $\succ_t$ and the fact that the set X_{jr} is getting larger as j increases from r to s imply that the first components of the bundles on the row r, which

includes the bundle $f_{r,s}^{>t}$, are either ranked higher than x_b with respect to $'\succ_t$ or equal to x_b. Now starting from column s and row r (i.e., the bundle $f_{r,s}^{>t}$) and move toward row r_a along column s. Transitivity of $'\succ_t$ and the fact that the set $X_{s\pounds}$ is getting larger as R increases from r to r_a imply

that the first component of the bundle on row r_a and column s (i.e., the bundle a) is ranked higher than x_b with respect to $\succ_t$. Namely, $x_a \succ_t x_b$ must hold.

Continue iterating from where we left off with the same logic. Starting from column s and row r_a (i.e., the bundle a) as we move from row r_a to r_b along the column s, first components of the bundles, including the bundle at row r_b (i.e., b) are either ranked above x_a or equal to x_a. Thus, we must have $x_b \succ_t x_a$, contradicting the fact that $\succ_t$ is antisymmetric and bundles a and b are distinct. If bundle b is above bundle a on column s, then we start the iteration from $f^t_{k,k} = a$.

Therefore, a and b cannot appear on the same column in region *III*. Symmetric arguments suffice to show that they cannot appear on the same row in region *III* either.

Therefore, suppose that a and b appear on different rows and columns. With similar arguments as above, if we start iteration from $f^t_{r,r} = b$ and go left on the same row and then go down to bundle a in region *III*, we conclude that $x_a \succ_t x_b$. However, when we start iteration from $f^t_{k,k} = a$ and move down the same column and then go left to bundle b in region *III*, we conclude that $x_b \succ_t x_a$, which yields the desired contradiction. Hence, either bundle a or b, whosever first component is ranked first with respect to $\succ_t$, may appear in region *III*, but not both.

The proof of condition (*iii*) uses (*ii*). Suppose for a contradiction that a and b appear on the same column s, where b is above a (i.e., $r_b < r_a$) and a appears above b on the main diagonal. In Figure 8, a and b can appear on the same column with $r_b < r_a$ only in region *III*, which contradicts what we just proved above. We can make symmetric arguments for rows as well. ∎

We are now ready to show that the mechanism $f^{>t} = [f^t_{\ell,j}]_{(\ell,j)\in M^2}$ is strategy-proof. Consider, without loss of generality, deviations of negotiator 1 only. If $R < j$, then $A(\theta_1^{x_\ell}, \theta_2^{x_j}) = \emptyset$. Negotiator 1 may receive a different bundle by deviating to a type that is represented by a higher (numbered) row, say $\theta_1^{x_k}$ where $k > R$. $A(\theta_2)$ is fixed because negotiator 2's type is fixed. Because the negotiators' preferences over issue X are diametrically opposed and $f^{>t}$ is individually rational, the alternative in issue X at type profile $(\theta_1^{x_k}, \theta_2)$ will be unacceptable for negotiator 1's true type, $\theta_1^{x_\ell}$. Thus, by the **BR** property, negotiator 1 has no profitable deviation from a type profile $(\theta_1^{x_\ell}, \theta_2^{x_j})$ with $R < j$.

On the other hand, if $R = j$, then negotiator 1 can deviate to (*i*) a lower row and receive (o_x, y), which is worse than $f^{>t}_{\ell,\ell} = (x_\ell, t(x_\ell))$ by **BR**, or (*ii*) a higher row and receive a bundle that suggests an unacceptable alternative in issue X. Thus, the **BR** property implies that negotiator 1 has no profitable deviation in that case either.

Finally, suppose that $j < R$. Let $c = (x_c, t(x_c)) \in B^t_{j\ell}$ denote the bundle negotiators get under truthful reporting. If negotiator 1 deviates to a row where $f^{>t}$ takes the value (o_x, y), then he clearly is worse off, by **BR** property. If he deviates to a lower numbered row and receives, say, bundle $a = (x_a, t(x_a)) \in B^t \backslash \{c\}$, then a appears above bundle c on the first diagonal, by the third condition of Lemma 4. In this case, it is true that $x_c \succ_t x_a$ because $f^{>t}$ suggests c at some type profile where both a and c are acceptable and $f^{>t}$ always selects the bundle with the best first component. Moreover, by the construction of $f^{>t}$ and the fact that a appears above bundle c on the first diagonal we have $x_a \, \theta_1 \, x_c$. Since Λ satisfies quid pro quo, we must have $c \, R_1 \, a$ for all admissible R_1. Thus, there is no profitable deviation for negotiator 1 by declaring a lower numbered row and getting a instead of c.

However, if negotiator 1 declares a higher numbered row and gets a different bundle $b \in B^t \backslash \{c\}$ (see in Figure 8), then by the third condition of Lemma 4 bundle c must be located on the first diagonal above bundle b. As it is clearly visible in Figure 8, Lemma 4 implies that negotiator 1's true preferences must give him the bundle c in region 1 or 2 and the deviation bundle b must be in region 3 or 4 because they cannot coexist in region 3 or 4. However, bundle b includes alternative x_r

from issue *X*, which is an unacceptable alternative for all types that lie above row *r*, including

negotiator 1's true type. Thus, by the **BR** property, negotiator 1 has no profitable deviation in that case either. Hence, $f^{>t}$ is strategy-proof.

Proof of 'only if': Now suppose that Λ is regular and there exists a mediation mechanism f that is strategy-proof, efficient, and individually rational. By Theorem 1 we know that there exists an injective order-reversing function $t: X \to Y$, a partial order $\succcurlyeq$ on X and $y \in Y$ such that

$$f = f^{\succcurlyeq} = \begin{cases} \left(x^*_{X_{j\ell}}, t\left(x^*_{X_{j\ell}}\right)\right), & \text{if } j \le R \\ (o_X, y), & \text{otherwise} \end{cases}$$

where $x^*_{X_{j\ell}} = \max_{X_{j\ell}} \succcurlyeq$. Then we need to prove that $\succcurlyeq \in \Pi_\Lambda$, and thus Λ satisfies quid pro quo.

To prove that $\succcurlyeq$ and t satisfy the first part of Definition 2, let $x_\ell, x_j \in X$ be two distinct alternatives for some j, $R \in M$ and $x_\ell \succcurlyeq x_j$. Suppose, without loss of generality, that $x_j \, \theta_1 \, x_\ell$, namely $j < R$. Recall the construction of $\succcurlyeq$ in the proof of Theorem 1: we define $x_\ell \succcurlyeq x_j$ if $f_{\ell,j} = (x_\ell, t(x_\ell))$. Strategy-proofness of f and consistency of preferences require that $f_{\ell,j} \, R_1 \, f_{j,j}$, or equivalently $(x_\ell, t(x_\ell)) \; R_1 \; (x_j, t(x_j))$ for all admissible $R_1 \in \Lambda(\theta_1)$ and $\theta_1 \in \Theta_1$ satisfying $x_j, x_\ell \in A(\theta_1)$, as required by part (*i*). To prove part (*ii*) suppose for a contradiction that there is some $y \in Y$ with $t(x_\ell) \; \underset{1}{\theta^Y} \; y \; \underset{1}{\theta^Y} \; t(x_j)$ such that (x_j, y) Pareto dominates $(x_\ell, t(x_\ell)) = f_{\ell,j}$. Because both of these bundles are acceptable at the profile $(\theta_1^{x_\ell}, \theta_2^{x_j})$, the existence of such bundle, i.e., (x_j, y), contradicts with the presumption that f is efficient.

We now prove that $\succcurlyeq$ and t satisfy the second part of Definition 2. First recall that all sets of the form $X_{j\ell}$ with $1 \le j \le R \le m$ designate all the connected subsets of X. By Theorem 1 we already know that every doubleton $\{x, x^1\} \subseteq X_{j\ell}$ has a least upper bound in $X_{j\ell}$, which is $x^*_{X_{j\ell}}$, and thus the poset $(S, \succcurlyeq)$ is a semilattice for all connected subset S of X. Hence, $\succcurlyeq \in \Pi_\Lambda$, and thus Λ satisfies quid pro quo. ■

References

[1] Ali, S. F.. (2018). Court mediation reform: Efficiency, confidence and perceptions of Justice. Edward Elgar Publishing.

[2] Abdülkadiroglu, A., and S¨onmez, T. (2003). School choice: A mechanism design approach. American Economic Review, 93(3), 729-747.

[3] Ausubel, L. M., Cramton, P., and Deneckere, R. J. (2002). Bargaining with incomplete information. Handbook of game theory with economic applications, 3, 1897-1945.

[4] Barber`a, S. (1977). The manipulation of social choice mechanisms that do not leave too much to chance. Econometrica 45:1573-1588.

[5] Barber`a, S., and Jackson, M. O. (1995). Strategy-proof exchange. Econometrica, 63(1): 51-87.

[6] Bellucci, E., and Zeleznikow, J. (2005). Developing Negotiation Decision Support Systems that support mediators: a case study of the Family Winner system. Artificial Intelligence and Law, 13(2), 233-271.

[7] Bester, H., and Warneryd, K. (2006). Conflict and the social contract. Scandinavian Journal of Economics, 108(2), 231-249.

[8] Black, D. (1948). On the rationale of group decision-making. Journal of Political Economy, 56(1), 23-34.

[9] Brams, S. J., and Taylor, A. D. (1996). Fair Division: From cake-cutting to dispute resolution. Cambridge University Press.

[10] Budish, E. (2011). The combinatorial assignment problem: Approximate competitive equilibrium from equal incomes. Journal of Political Economy, 119(6), 1061-1103.

[11] Budish, E., Cachon, G. P., Kessler, J. B., and Othman, A. (2017). Course match: A large-scale implementation of approximate competitive equilibrium from equal incomes for combinatorial allocation. Operations Research, 65(2), 314-336.

[12] Chen, Y. and Eraslan, H. (2014). Rhetoric in legislative bargaining with asymmetric information. Theoretical Economics, 9(2), pp.483-513.

[13] Chen, Y. and Eraslan, H. (2017). Dynamic agenda setting. American Economic Journal: Microeconomics, 9(2), pp.1-32.
[14] Clarke, E. H. (1971). Multipart pricing of public goods. Public choice, 11(1), 17-33.
[15] Compte, O., and Jehiel, P. (2009). Veto constraint in mechanism design: inefficiency with correlated types. American Economic Journal: Microeconomics, 1(1), 182-206.
[16] Damaska, M. (1975). Presentation of Evidence and Fact finding Precision, University of Pennsylvania Law Review, 1083-1106.
[17] Daughety, A. F., and Reinganum, J. F. (2017). Settlement and trial. The Oxford Handbook of Law and Economics, 3, 229-246.
[18] Ehlers, L., and Klaus, B. (2003). Coalitional strategy-proof and resource-monotonic solutions for multiple assignment problems. Social Choice and Welfare, 21(2), 265-280.
[19] Fisher, R. U., and Ury, W. (1981). Getting to Yes: Negotiating Agreement Without Giving In. A Perigee Book/Penguin Group.
[20] Gale, D., and Shapley, L. S. (1962). College admissions and the stability of marriage. The American Mathematical Monthly, 69(1), 9-15.
[21] Gresik, T. A. (1991). Ex ante incentive efficient trading mechanisms without the private valuation restriction. Journal of Economic Theory, 55(1), 41-63.
[22] Groves, T. (1973). Incentives in teams. Econometrica, 617-631.
[23] Habuka, H., and Rule, C. (2017). The promise and potential of online dispute resolution in Japan. International Journal of Online Dispute Resolution, 4, 74.
[24] Hadfield, G., K. (2000). The Price of Law: How the Market for Lawyers Distorts the Justice System. Michigan Law Review, 98(4), 953 - 1006.
[25] Hylland, A., and Zeckhauser, R. (1979). The efficient allocation of individuals to positions. Journal of Political Economy, 87(2), 293-314.
[26] H¨orner, J., Morelli, M., and Squintani, F. (2015). Mediation and peace. The Review of Economic Studies, 82(4), 1483-1501.
[27] Jackson, M.O. and Sonnenschein H.F. (2007): Overcoming Incentive Constraints by Linking Decisions. Econometrica, 75 (1), 241 - 258.
[28] Jackson, M. O., Sonnenschein, H., Xing, Y., Tombazos, C., and Al-Ubaydli, O. (2020). The efficiency of negotiations with uncertainty and multi-dimensional deals. Working Paper.
[29] Kagel, J. H., and Roth, A. E. (2016). The handbook of experimental economics (Vol. 2). Princeton University Press.
[30] Kelly, J.S. (1977). Strategy-proofness and social choice functions without single-valuedness. Econometrica 45: 439-446.
[31] Klaus, B., and Miyagawa, E. (2002). Strategy-proofness, solidarity, and consistency for multiple assignment problems. International Journal of Game Theory, 30(3), 421-435.
[32] Kojima, F., (2009). Random assignment of multiple indivisible objects. Mathematical Social Sciences, 57(1), pp.134-142.
[33] Krishna, A., and Ünver, M. U. (2008). Research note—improving the efficiency of course bidding at business schools: Field and laboratory studies. Marketing Science, 27(2), 262-282.
[34] LaFree, G., and Rack, C. (1996). The Effects of Participants' Ethnicity and Gender on Monetary Outcomes in Mediated and Adjudicated Civil Cases, Law and Society Review, 30 (4): 767-798.
[35] Li, S. (2017). Obviously strategy-proof mechanisms. American Economic Review, 107(11), 3257-87.
[36] Lodder, A., and Thiessen, E. (2003). The role of artificial intelligence in online dispute resolution. In Workshop on online dispute resolution at the international conference on artificial intelligence and law, Edinburgh, UK.
[37] Malhotra, D., and Bazerman, M. H. (2008). Negotiation genius: How to overcome obstacles and achieve brilliant results at the bargaining table and beyond. Bantam.
[38] Maskin, E., and Tirole, J. (1990). The principal-agent relationship with an informed principal: The case of private values. Econometrica, 379-409.
[39] McAfee, R. P., and Reny, P. J. (1992). Correlated information and mechanism design. Econometrica, 395-421.
[40] McAfee, R. P., McMillan, J., and Whinston, M. D. (1989). Multiproduct monopoly, commodity bundling, and correlation of values. The Quarterly Journal of Economics, 104(2), 371-383.
[41] Milgrom, P. (2011). Critical issues in the practice of market design. Economic Inquiry, 49(2), 311-320.

[42] Moulin, H. (1980). On strategy-proofness and single peakedness. Public Choice, 35(4), 437-455.
[43] Myerson, R. B., and Satterthwaite, M. A. (1983). Efficient mechanisms for bilateral trading. Journal of Economic Theory, 29(2), 265-281.
[44] P´apai, S. (2001). Strategyproof and nonbossy multiple assignments. Journal of Public Economic Theory, 3(3), 257-271.
[45] Pycia, M., and Troyan, P. (2021). A theory of simplicity in games and mechanism design. University of Zurich, Department of Economics, Working Paper, (393).
[46] Pycia, M., and Ünver, M. U. (2017). Incentive compatible allocation and exchange of discrete resources. Theoretical Economics, 12(1), 287-329.
[47] Pycia, M., and Ünver, M. U. (2020). Arrovian efficiency and auditability in the allocation of discrete resources. CEPR Discussion Paper Series, (DP15377).
[48] Roth, A. and Sotomayor, M. (1990). Two-sided Matching: A Study in Game-theoretic Modeling and Analysis. Econometric Society Monographs, Cambridge University Press.
[49] Rubinstein, A. (2012). Lecture notes in microeconomic theory: the economic agent. Princeton University Press.
[50] Rule, C. (2014). Technology and the future of dispute resolution. Dispute Resolution Magazine, 21, 4.
[51] Shapley, L., and Scarf, H. (1974). On cores and indivisibility. Journal of Mathematical Economics, 1(1), 23-37.
[52] S¨onmez, T. and Ünver, M.U., (2010). Course bidding at business schools. International Economic Review, 51(1), pp.99-123.
[53] Sprumont, Y. (1991). The division problem with single-peaked preferences: a characterization of the uniform allocation rule. Econometrica, 509-519.
[54] Thiessen, E. M., and Loucks, D. P. (1992). Computer Assisted Negotiation of Multi-objective Water Resources Conflicts 1. JAWRA Journal of the American Water Resources Association, 28(1), 163-177.
[55] Thiessen, E. M., Loucks, D. P., and Stedinger, J. R. (1998). Computer-assisted negotiations of water resources conflicts. Group Decision and Negotiation, 7(2), 109-129.
[56] Thiessen, E. M., Miniato, P., and Hiebert, B. (2012). ODR and eNegotiation (Chapter 16): Online dispute resolution: theory and practice: a treatise on technology and dispute resolution. Eleven International Pub..
[57] Thomson, W. (2016). Fair allocation, in The Oxford Handbook of Well-Being and Public Policy, ed. by M. D. Adler and M. Fleurbaey, Oxford University Press.
[58] Tyler, T. R., and Huo, Y. J. (2002). Russell Sage Foundation series on trust. Trust in the law: Encouraging public cooperation with the police and courts. New York, NY, US: Russell Sage Foundation.
[59] Vickrey, W. (1961). Counterspeculation, auctions, and competitive sealed tenders. The Journal of Finance, 16(1), 8-37.
[60] Zhou, L. (1990). On a conjecture by Gale about one-sided matching problems. Journal of Economic Theory, 52(1), 123-135.
[61] Wahab, M. S. A., Katsh, M. E., Rainey, D. (2012). Online dispute resolution: theory and practice: a treatise on technology and dispute resolution. Eleven International Pub..
[62] Wickelgren, A. L. (2013). Law and economics of settlement. In Research Handbook on the Economics of Torts. Edward Elgar Publishing.
[63] Wilson, R. (1969). An axiomatic model of logrolling. The American Economic Review, 59(3), 331-341.

THE NEWSLETTER FOR FINRA NEUTRALS

Financial Industry Regulatory Authority

Volume 3 – 2017

The Neutral Corner

What's Inside

Office of Dispute Resolution and FINRA News 5

Mediation Update 12

Questions and Answers 13

Arbitrator Disclosure Reminder 15

Mission Statement

We publish *The Neutral Corner* to provide arbitrators and mediators with current updates on important rules and procedures within securities dispute resolution. FINRA's dedicated neutrals better serve parties and other participants in the FINRA forum by taking advantage of this valuable learning tool.

Subpoenas and Orders of Appearance and Production

*By Barry Temkin and Kate DiGeronimo**

Introduction

Two commonly used third-party discovery mechanisms available to parties in FINRA arbitrations are the subpoena and the order of production. While the functional purpose of these tools is the same and the procedure to obtain them is similar, they derive their power from different rules. Their utility depends upon the relationship between FINRA and the third party from whom discovery is sought. Understanding the differences is crucial. Using the wrong device may increase costs and lead to a procedural quagmire. This article addresses the differences between arbitrator-issued subpoenas and orders of production, and explains the circumstances in which a party should use each device.

Orders of Production Under Rules 12513 and 13513

The order of production is unique to FINRA arbitrations. Authority for an arbitrator's ability to issue an order of production is found in Rule 12513 of the Code of Arbitration Procedure for Customer Disputes (Customer Code) and Rule 13513 of the Code of Arbitration Procedure for Industry Disputes (Industry Code). An order of production is the discovery mechanism that a party uses to obtain relevant testimony and documents from nonparty FINRA associated persons and firms. FINRA has jurisdiction over those individuals and entities and has the power to compel associated persons and employees of firms to testify or produce documents in arbitrations before FINRA.

An associated person or firm served with an order of production must comply at risk of incurring sanctions or disciplinary action. There are no geographical limitations to the arbitrator's authority to compel an associated person or a firm to provide documents or testimony. However, the requesting party must reimburse the responding nonparty for the reasonable costs of the appearance or production unless the panel directs otherwise.

next page ▶

We Want to Hear From You

The Neutral Corner strives to provide useful and timely information to FINRA arbitrators as they serve in our forum. To ensure we are responsive to what you want to see in this publication, we invite you to share your suggestions and comments. Please feel free to suggest training topics and ways we can improve this publication. Please submit your suggestions to Neutral Management. We look forward to hearing from you.

Although an order of production serves the same functional purpose as a subpoena, it cannot be applied to a non-registrant. The arbitrator's power to issue the order is derived solely from FINRA's authority over the persons and entities it regulates. FINRA is unable to enforce an order of production against an unaffiliated third party, and courts will not enforce an order of production because it is not a judicial order or subpoena.

FINRA Rules 12513 and 13513 govern the "Authority of Panel to Direct Appearances of Associated Person Witnesses and Production of Documents Without Subpoenas." According to Rules 12513 and 13513, a party requesting the order of production must file a motion with FINRA requesting an order directing "the appearance of any employee or associated person of a member of FINRA or the production of any documents in the possession or control of such persons or members." The motion must include a draft order of production for the arbitrator's signature, and be served upon all parties. The other parties to the arbitration are given 10 days to file an opposition to the request, and then the moving party is given five days to file its reply. If the arbitrator(s) decides to issue the order of production, FINRA will transmit the signed order of production to the moving party to serve on the third party. The recipient of the order of production is then given 10 days to file its own objections to the order of production.

Subpoenas Under Rules 12512 and 13512

Unlike orders of production, subpoenas are not unique to FINRA arbitration. They are a common mechanism for third-party discovery used throughout U.S. courts and arbitration. A subpoena is a judicial order that directs a nonparty to provide discovery in a legal proceeding. Although the law governing the validity and enforcement of subpoenas issued by arbitration panels is far from settled and beyond the scope of this article, there are federal and state statutes that may authorize courts to enforce a subpoena issued by a FINRA arbitrator to a third party.

For example, New York Civil Practice Law and Rules Section 7505 permits New York courts to enforce arbitrator-issued subpoenas directing a nonparty to testify and produce documents at the final hearing of an arbitration. Likewise, the Federal Arbitration Act provides federal courts with the authority to enforce some subpoenas issued by arbitration panels, though what kind of subpoena and to what extent it will be enforced is

subject to the laws of the particular jurisdiction in which the arbitration is venued and the third party resides. These laws often contain geographical limitations on the authority to compel compliance from a third party and require the requesting party to reimburse the nonparty for the costs of complying with the subpoena.

FINRA provides parties with a procedure to obtain a subpoena from the arbitration panel, which is similar to that of obtaining an order of production. The party requesting the subpoena must make its request in the form of a motion to the panel, which should include a draft subpoena. The motion must be served upon all parties, who are then given 10 days to oppose the request, which is followed by a five-day period for the moving party to file a reply. If the arbitrator issues the subpoena, FINRA will transmit the signed subpoena to the moving party to serve on the nonparty in accordance with the rules for service of subpoenas in the applicable jurisdiction. FINRA provides the nonparty 10 days to object to the subpoena, although the nonparty may also choose to file a motion to quash the subpoena in court. If the nonparty ignores the subpoena, the moving party can seek to have the subpoena enforced in a court. FINRA rules provide that the party requesting the subpoena must pay the nonparty for the reasonable costs of complying with the subpoena, unless the panel directs otherwise.

Practical Considerations When Seeking Non-party Discovery

Parties in FINRA arbitration who seek discovery from a third party should first consider whether that third party is subject to FINRA's jurisdiction. If the third party is an associated person or firm, parties should seek discovery using an order of production under Rules 12513 or 13513. Under those circumstances, FINRA has the ability to enforce compliance with the order of production through its regulatory powers, obviating any need for judicial intervention to secure compliance. Although it is possible to obtain a subpoena directed at an associated person or firm, FINRA rules explicitly direct parties and arbitrators to use an order of production unless there are unusual circumstances dictating the need for a subpoena.

If the third party is not subject to FINRA's jurisdiction then the only procedural option available is to move the panel to issue a subpoena under Rule 12512 or 13512. Prior to requesting a subpoena, the party should ascertain whether it will be able to obtain court enforcement of the arbitrator-issued subpoena. As mentioned, the law regarding enforceability of arbitrator-issued subpoenas varies among jurisdictions. For example, although the federal courts of the Sixth and Eighth Circuits interpret the Federal Arbitration Act as authorizing courts to enforce arbitrator-issued subpoenas directing the production of documents prior to a final hearing, the federal courts of the Fourth Circuit will enforce such subpoenas only if the requesting party can demonstrate a "special need" for the discovery, while the courts of the Second and Third Circuits will not enforce arbitrator-issued subpoenas for prehearing document production. State law may also provide a basis for enforcing subpoenas issued by an arbitration panel, as is the case in New York and Ohio where there are state statutes authorizing some forms of arbitrator-issued subpoenas. However, every state has its own rules governing the enforceability of arbitrator-issued subpoenas.

Conclusion

Whenever possible, parties should use an order of production to obtain discovery from a third party because it is the easiest and most cost effective way to do so. When a party cannot avail itself of an order of production, it should proceed with caution and consider the practicalities of enforcement prior to requesting an arbitrator-issued subpoena. There may be less costly, non-judicial means available to the party to obtain the sought-after information such as determining whether another document or documents can provide the same information, or whether an associated person or firm has the same information. If a party requests a subpoena from the panel, it should be careful to make its request pursuant to the correct FINRA rule to ensure proper judicial enforcement, and also consult the law of the local jurisdiction to ascertain the enforceability of an arbitration subpoena.

**Barry Temkin is a partner at Mound Cotton Wollan & Greengrass, a FINRA arbitrator and an adjunct professor of law at Fordham University School of Law. Kate DiGeronimo is an associate at Mound Cotton Wollan & Greengrass and a graduate of Fordham University School of Law.*

Award Information Sheet

Arbitrators should use the most current version of the Award Information Sheet when preparing an award at the end of a hearing. This ensures that arbitrators provide all required information to FINRA to be included in the award. The most updated version is always available on our website. Arbitrators should contact their case administrator with any questions about completing the Award Information Sheet.

Office of Dispute Resolution and FINRA News

Case Filings and Trends

Arbitration case filings from January through August 2017 reflect a nine percent decrease compared to cases filed during the same eight-month period in 2016 (from 2,507 cases in 2016 to 2,286 cases in 2017). Customer-initiated claims decreased by 14 percent through August 2017, as compared to the same time period in 2016.

Expanded Statistics

To increase forum transparency, FINRA updated its website to include archives of the last five years of year-end arbitration and mediation statistics. Website visitors can now access year-end statistics for 2012 – 2016 on FINRA's statistics page. FINRA will keep these figures updated so that the last five years of statistics are always available online.

Notice on Expanded Expungement Guidance

FINRA has updated the Notice to Arbitrators and Parties on Expanded Expungement Guidance regarding requests for expungement prior to the conclusion of an underlying arbitration. A broker may not file a request for expungement of customer dispute information arising from an underlying customer arbitration until the underlying customer arbitration has concluded. To ensure that the underlying customer arbitration is resolved before any subsequent request to expunge customer dispute information is considered, the Director will deny the forum as to the second expungement-only case.

Accommodations for Hearings Scheduled in Puerto Rico

FINRA Office of Dispute Resolution is administratively staying all cases venued in Puerto Rico **until October 20, 2017**. This includes canceling all hearings, conference calls and deadlines scheduled during this time. FINRA will begin the process of rescheduling any impacted hearings and prehearings as soon as reasonably practicable, once the stay is lifted.

Notwithstanding the foregoing, if parties mutually agree otherwise, they should communicate that agreement to FINRA at their earliest convenience.

Cases not venued in Puerto Rico may also be affected by the events in Puerto Rico. For example, parties, witnesses or records necessary to a case may be located in Puerto Rico and may be unavailable. In such an instance, the parties may agree to stay the case. If such an agreement is reached, the parties should notify FINRA in writing at their earliest convenience. FINRA will then alert the panel in the affected case of the agreed upon stay.

FINRA will continue to monitor the situation in Puerto Rico and will make any necessary adjustments to the foregoing as conditions warrant.

ADTRAV: FINRA's New Travel Service

When traveling to a hearing location more than 75 miles from their primary address, arbitrators now have the option to book airfare and hotel accommodations through ADTRAV—FINRA's corporate travel provider. Arranging travel through ADTRAV offers benefits for FINRA and arbitrators alike:

- Airline tickets can be billed directly to FINRA, reducing out-of-pocket expenses for which arbitrators will need to seek reimbursement.
- FINRA can prepay hotel room fees and taxes at the designated hotel, further reducing the amount of out-of-pocket expenses charged to an arbitrator's personal card. (A personal credit card is required at check-in to cover all other items, such as meals and incidentals.)
- ADTRAV can track travel, notify an arbitrator of changes or delays and revise itineraries if needed.
- ADTRAV provides a dedicated toll-free number for all FINRA-related travel needs.
- Agents can book travel with an arbitrator's preferred carriers.
- Arbitrators may still earn airline/rail reward points.
- A 24-hour emergency call service is available.

Learn more about this new option, and how to contact ADTRAV, in a new video, Using ADTRAV for Travel. The page also includes frequently asked questions and Guidelines for Arbitrator Reimbursement.

DR Portal Enhancements

New Online Portal Oath of Arbitrator and Arbitrator Disclosure Checklist

Arbitrators can now submit the Oath of Arbitrator and Arbitrator Disclosure Checklist to FINRA directly through the DR Portal. By doing so, all Portal-registered parties and arbitrators on the case will receive a copy of the Oath and Disclosure Checklist electronically via the Portal. Additionally:

- the new Oath and Disclosure Checklist are broken down by section (*e.g.,* subject matter disclosures, personal disclosures), providing a quick overview;
- arbitrators can save a draft and return to it later;
- the system alerts arbitrators if information is missing before submitting the Oath and Disclosure Checklist; and
- a copy of the Oath and Disclosure Checklist is saved in the Portal for review.

Arbitrators can submit an electronic Oath and Disclosure Checklist using the Portal by going to the Drafts & Submissions tab of the case and selecting "Oath of Arbitrator" as the submission type. Arbitrators with questions about using the new Portal Oath and Disclosure Checklist can contact FINRA staff for assistance at (800) 700-7065.

Last Affirmation Date on Arbitrator Disclosure Report

FINRA enhanced arbitrator disclosure reports by publishing the date that arbitrators last affirmed the accuracy of their disclosure reports. The affirmation date appears prominently at the top of the disclosure report that parties review when selecting arbitrators. Parties may consider the last affirmation date as a factor when they choose arbitrators, so it is important for arbitrators to regularly review their disclosures on the DR Portal.

Arbitrators can affirm the accuracy of their disclosures in two ways:

- submitting an update through the DR Portal; or
- submitting an Oath of Arbitrator when assigned to a case.

Even if there are no changes, arbitrators can affirm the information and update their affirmation date by submitting an update through the DR Portal. If arbitrators send new information to FINRA outside of those two methods (*e.g.,* email, fax, telephone), the update will not trigger a new affirmation date.

New Password Requirement

As part of the enhancements, password requirements have changed. Strengthening the requirements provides a more secure portal and helps FINRA better protect arbitrator information.

New requirements and features:

- Auto Unlock—accounts will lock after five incorrect password attempts within 24 hours. Accounts will now be automatically unlocked after a waiting period of one hour. Accounts can be unlocked sooner if users contact the FINRA Call Center (301-590-6500).
- Length—character minimum is now 10 characters, up from eight characters. The maximum character length is 32.
- Special Characters—all special characters are now acceptable. Previously, "&," spaces, "*" and "%" were prohibited.
- Common Words—to prevent the use of guessable passwords, some common words are now prohibited.
- Reusing passwords—the past 10 passwords cannot be reused, up from seven passwords.

Requirements that remain the same

- Password complexity—remains the same, requiring at least one:
  - lower case character;
  - upper case character; and
  - special or numeric character (*i.e.,* non-alphabetic).
- Password expiration—passwords expire after one year and must be reset.
- Current security question lockout—accounts will lock after five incorrect attempts to answer security challenge questions. The lockout will remain in effect until users contact the FINRA Call Center (301-590-6500).

Portal Reminder

We strongly encourage arbitrators and mediators to register with the DR Portal. Portal benefits include:

- viewing and updating profile information;
- viewing and printing the disclosure report;
- accessing information about assigned cases, including upcoming hearings and payment information;
- scheduling hearings;
- viewing case documents;
- filing case documents like the new electronic Oath and Checklist;
- reviewing list selection statistics to see how often an arbitrator's name has appeared on arbitrator ranking lists sent to parties and how often an arbitrator has been ranked or struck on those lists; and
- updating the last affirmation date.

FINRA encourages all arbitrators to register. Portal registration will be noted on the arbitrator disclosure report that parties review when selecting arbitrators. Registering in the portal is more important than ever. In April 2017, use of the portal became mandatory for all parties (except for *pro se* investors).

Demographic Survey

In October, we will once again conduct a demographic survey of the neutral roster. As in previous years, the survey will be administered by a third-party consultant, Alight (formerly part of Aon Hewitt). Participation in the survey is voluntary and all responses will be confidential.

FINRA has embarked on a campaign to recruit individuals from varied backgrounds to serve as arbitrators. The data received from this annual survey helps us track our progress in enhancing the diversity of the roster and helps to inform future recruitment events. We are not attempting to assess the quality of the roster or rulings or awards made by arbitrators.

The results of the 2015 and 2016 demographic surveys are now published on our website. Thank you to those who participated in the survey.

Please look out for an email from Alight in October with instructions to complete the survey.

Ninth Annual Securities Dispute Resolution Triathlon

The Ninth Annual Securities Dispute Resolution Triathlon (DR Triathlon) will take place October 14-15, 2017, at the St. John's University School of Law, Manhattan Campus. The DR Triathlon provides student teams from participating law schools an opportunity to demonstrate their advocacy skills in negotiation, mediation and arbitration of a securities dispute. FINRA invites local FINRA neutrals to serve as judges, mediators and arbitrators. Note that all FINRA arbitrators and mediators are eligible to serve as judges in any round. Judges for the negotiation and mediation rounds observe students and score their performances. We use only experienced mediators to mediate during that round of the competition. For the arbitration round, the three arbitrators will also submit scores as judges. Please complete the participation form on FINRA's website to be considered to serve as a judge or neutral for the competition.

SEC Approvals

Expedited List Selection in Arbitration

The Securities and Exchange Commission (SEC) approved a proposed change to amend Rules 12402 and 12403 of the Customer Code and Rule 13403 of the Industry Code to provide that the Director of FINRA's Office of Dispute Resolution will send the list or lists generated by the Neutral List Selection System to all parties at the same time, within approximately 30 days after the last answer is due. The lists will be sent within this time, regardless of the parties' agreement to extend any answer due date.

The amendments became effective for cases filed on or after on September 18, 2017. Please view *Regulatory Notice 17-25* for more information.

Amendments to the Non-Public Arbitrator Definition

The SEC approved a rule change to revise the non-public arbitrator definition. Specifically, the proposal amended Rule 12100 of the Customer Code and Rule 13100 of the Industry Code, to define a non-public arbitrator as someone who is otherwise qualified to serve as an arbitrator, and is disqualified from service as a public arbitrator under the Codes.

The amendments will become effective October 9, 2017. Arbitrators who are currently ineligible because they no longer qualify as a public arbitrator under the previous definition may contact FINRA if they are interested in becoming active again on the roster. Please view SR-FINRA-2017-025 for more information.

Rulemaking Items Discussed at the FINRA Board of Governors July 2017 Meeting

Unpaid Arbitration Awards

At its July meeting, FINRA's Board of Governors authorized FINRA to publish a *Regulatory Notice* soliciting comment on proposed amendments to FINRA's Membership Application Program rules to provide FINRA staff with rule-based authority to presumptively deny a new membership application if the applicant or its associated persons are subject to pending arbitration claims.

In addition, the proposed amendments would require a member firm to seek a materiality consultation with FINRA if the member is not otherwise required to file a continuing membership application and the member is seeking to effect a business expansion or asset transfer and the member or an associated person has a substantial level of pending arbitration claims, an unpaid arbitration award or an unpaid settlement related to an arbitration. The proposal would provide that the safe harbor in IM-1011-1 for business expansions would not be available for any member under these circumstances. FINRA staff would review the submission and determine whether the member is required to file a continuing membership application in accordance with Rule 1017.

Mediation Update

Mediation Statistics



From January through August 2017, parties initiated 424 mediation cases, an increase of five percent for the same period in 2016. FINRA also closed 499 cases during this time. Approximately 83 percent of these cases concluded with successful settlements.

Mediation Settlement Month

October is Mediation Settlement Month. FINRA invites all active mediators on the roster to participate in this event to help promote mediation. During this annual event, mediators reduce their rates to encourage parties to explore FINRA's mediation program. At the same time, parties who are familiar with FINRA's mediation services may be encouraged to try new mediators on our roster.

Discontinuation of Mediator Annual Fee

We remind FINRA mediators that the Office of Dispute Resolution discontinued the annual $200 fee requirement. This is a good opportunity for mediators, who are unavailable because of non-payment, to become active again. Interested mediators should send an email to *mediate@finra.org*.

Mediation Program for Small Arbitration Claims

The telephonic mediation program remains available to parties in active arbitration cases with claims of $50,000 or less.

The program offers free or low cost mediation (depending on the claim amount) with a FINRA mediator. It provides parties, many who find it difficult to obtain legal representation due to their claim size, an informal process to resolve their dispute. Parties and mediators report satisfaction with the process, and the settlement rate for cases in the program has averaged 80 percent, which is consistent with the settlement rate for all cases over the lifetime of FINRA's Mediation Program.

Questions and Answers

Independent Research

Question: Are arbitrators permitted to conduct independent research?

Answer: No. Arbitrators should not conduct independent factual investigations or research when serving on a case. If arbitrators are in doubt about an issue, legal or otherwise, they should request briefs from the parties. If cases are cited in a party's motion or brief, and the arbitrators wish to read the full court opinions, arbitrators should ask the parties to provide copies. Generally, arbitrators should review only those materials presented by the parties.

Jurisdiction Over Terminated Members and Associated Persons

Question: Does FINRA have jurisdiction over terminated members and associated persons in arbitration cases?

Answer: Yes. Terminated members and associated persons are subject to FINRA's arbitration jurisdiction regardless of the number of years since the termination of their FINRA registration or membership. This is in contrast to the two-year jurisdictional limit for terminated members and associated persons in FINRA's disciplinary proceedings.

However, terminated members are prohibited from enforcing predispute arbitration agreements with its customers to arbitrate at FINRA, unless the customers agree in writing to do so after the claim has arisen. Therefore, a claimant may, but is not required to, arbitrate the claim involving a terminated member or associated person in FINRA's arbitration forum. *See* Rule 12202 of the Customer Code. If the customer elects to proceed in arbitration, FINRA retains jurisdiction over such terminated member.

Rules 12100 and 13100 provide definitions of a "member" and a "person associated with a member."

- **Member:** For purposes of the Code, the term "member" means any broker or dealer admitted to membership in FINRA, whether or not the membership has been terminated or cancelled; and any broker or

dealer admitted to membership in a self-regulatory organization that, with FINRA consent, has required its members to arbitrate pursuant to the Code and/or to be treated as members of FINRA for purposes of the Code, whether or not the membership has been terminated or cancelled.

- **Person Associated With a Member:** For purposes of the Code, a person formerly associated with a member is a person associated with a member.

Arbitrator Disclosure Reminder



As a reminder, arbitrators should review their disclosure reports regularly to ensure that all information is accurate and current. Even if arbitrators are not currently assigned to cases, their disclosure reports may be sent to parties in their hearing locations during arbitrator selection. Parties should have the most current and complete information about an arbitrator to make an informed decision when selecting arbitrators. Arbitrators should log into the DR Portal to update their disclosure reports.

In September, FINRA enhanced arbitrator disclosure reports by publishing the date arbitrators last affirmed the accuracy of their disclosure reports. Arbitrators can affirm the accuracy of their disclosure reports and refresh the affirmation date by submitting an update through the DR Portal.

The affirmation date appears prominently at the top of the disclosure report that parties review during the arbitrator selection process. Parties may consider the last affirmation date as a factor when choosing arbitrators. Therefore, arbitrators are encouraged to review and affirm regularly the accuracy of their disclosure reports using the DR Portal. Even if there are no changes, arbitrators can affirm the information and update the affirmation date on their disclosure reports by submitting an update through the DR Portal.

Directory

Richard W. Berry
Executive Vice President and Director of Dispute Resolution

Kenneth L. Andrichik
Senior Vice President – Chief Counsel and Director of Mediation and Strategy

Todd Saltzman
Vice President
Case Administration, Operations and Neutral Management

James Schroder
Associate Vice President
DR Product Management

Katherine M. Bayer
Regional Director
Northeast Region

Carolann Gemski
Regional Director
Midwest Region

Laura D. McNamire
Regional Director
West Region

Manly Ray
Regional Director
Southeast Region

Jisook Lee
Associate Director of Neutral Management and Editor of *The Neutral Corner*

FINRA Dispute Resolution Offices

Northeast Region
FINRA Dispute Resolution
One Liberty Plaza, 27th Floor
165 Broadway
New York, NY 10006
Phone: (212) 858-4200
Fax: (301) 527-4873
neprocessingcenter@finra.org

West Region
FINRA Dispute Resolution
300 S. Grand Avenue, Suite 1700
Los Angeles, CA 90071
Phone: (213) 613-2680
Fax: (301) 527-4766
westernprocessingcenter@finra.org

Southeast Region
FINRA Dispute Resolution
Boca Center Tower I
5200 Town Center Circle, Suite 200
Boca Raton, FL 33486
Phone: (561) 416-0277
Fax: (301) 527-4868
fl-main@finra.org

Midwest Region
FINRA Dispute Resolution
55 West Monroe Street, Suite 2600
Chicago, IL 60603-1002
Phone: (312) 899-4440
Fax: (312) 236-9239
midwestprocessingcenter@finra.org

Editorial Board

Bola Aguda	Northeast Region
David Carey	Case Administration
William Cassidy	Southeast Region
Christina Gates	West Region
Allison Phillips	Mediation
Elizabeth Muldoon	Midwest Region

© Volume 3 – 2017 FINRA.
All rights reserved.

FINRA is a registered trademark of Financial Industry Regulatory Authority. MediaSource is a service mark of FINRA.

The Neutral Corner is published by FINRA Dispute Resolution in conjunction with FINRA Corporate Communications. Send all correspondence to Jisook Lee, Associate Director of Neutral Management and Editor of *The Neutral Corner*:

FINRA Dispute Resolution
One Liberty Plaza
165 Broadway, 27th Floor
New York, NY 10006

Or call (212) 858-4400.

No part of this publication may be copied, photocopied or duplicated in any form or by any means without prior written consent from FINRA. Unauthorized copying of this publication is a violation of the federal copyright law.

17_0294.1—09/17



Investor protection. Market integrity.

FINRA
One Liberty Plaza
165 Broadway
New York, NY 10006

www.finra.org
© 2017 FINRA. All rights reserved.
FINRA and other trademarks of the
Financial Industry Regulatory Authority, Inc.
may not be used without permission.
17_0294.1–09/17

INSURANCE COVERAGE BASICS FOR THE SECURITIES ARBITRATION ATTORNEY

Jeff Sonn [1]

Knowledge of insurance law is important when suing brokers other than the largest self-insured wirehouses, because many of them carry liability insurance for wrongful acts. All securities lawyers should acquire at least a baseline knowledge of insurance coverage law in their state.[2] Many broker-dealers carry Errors and Omissions (E & O) insurance that are designed to provide insurance coverage for some claims that are typically brought in a securities arbitration action.[3] This article is designed for the securities arbitration practitioner to understand the basics of insurance coverage, and issues common to broker dealer policies that may provide coverage to securities arbitration claims. The article will cover some of the basic issues, such as notice of claims to carriers, insurance disclosure laws, claims made versus occurrence policies, reservations of rights letters, related acts exclusions, pleadings, policy limits, policy limits demands, and assignment of bad faith rights.

I. Timely Notices to Carriers. As an "insured," a broker-dealer or financial advisor must timely[4] give a notice to the insurance carrier ("the insurer") of the circumstances that reasonably could be expected give rise to a claim, and should do so prior to the end of the policy year in which the policyholder learns of those circumstances. The duty to provide a notice to the insurer is necessary under most types of E&O (errors and omissions) and D&O (directors and officers) insurance.

If the insured fails to provide a timely notice to the insurer, that can be used as a basis to deny any duty to defend and a denial of coverage. See e.g., Sparacino v. Pawtucket Mut. Ins. Co., 50 F.3d 141, 143 (2d Cir.1995)("Under New York law, compliance with a notice-of-occurrence

---

[1] . Jeffrey Sonn is the managing shareholder of Sonn Law Group P.A. in Aventura, Florida and has practiced securities litigation since 1988. Mr. Sonn was named as a LawDragon 500 Leading Plaintiff Financial Lawyers. The views expressed in this article are his own.

[2] . Insurance law as it affects securities arbitration claims varies from state to state. Many states have procedures that are not in the mainstream around the country. The securities arbitration securities practitioner is cautioned to carefully review his or her state's insurance statutes to review the important distinctions that may exist in their own state.

[3] . A study by the North American State Securities Administrators (NASSA) revealed that 77% of the broker dealers carried errors and omissions insurance and were generally small firms (1-150 advisors) or medium firms (151-499 advisors). See https://www.nasaa.org/wp-content/uploads/2019/12/2019-BD-EO-Survey-Report-Formatted-FINAL.pdf

[4] . "[F]inding the point at which discovery occurred is difficult, given the inherently fact-driven nature of the inquiry." Resol. Tr. Corp. v. Fid. & Deposit Co. of Md., 205 F.3d 615, 632 (3d Cir. 2000). Thus, it "may be extremely difficult ... to determine on summary judgment when the insured discovered a loss caused by employee dishonesty." Id. "The well-established rule is that the Insured under a blanket employee's fidelity bond is not bound to give notice 'until [it] [has] acquired knowledge of some specific fraudulent or dishonest act which might involve the [Insurer] in liability for the misconduct.' " Fed. Deposit Ins. Corp. v. Lott, 460 F.2d 82, 87 (5th Cir. 1972). Notice is not required where "the insured merely suspects or has reason to suspect wrongdoing." Id. (citing Am. Sur. Co. v. Pauly, 170 U.S. 133, 144 (1898)).

provision in an insurance policy is a condition precedent to an insurer's liability under the policy.");[5] Aseff v. Catlin Specialty Ins. Co., 115 F. Supp. 3d 1364, 1369 (S.D. Fla. 2015) (quoting Ideal Mut. Ins. Co. v. Waldrep, 400 So. 2d 782, 785 (Fla. 3d DCA 1981)); Lehrfield v. Liberty Mut. Fire Ins. Co., 396 F. Supp. 3d 1178, 1182 (S.D. Fla. 2019); Plantation Pipe Line Co. v. Stonewall Ins. Co., 335 Ga. App. 302, 310 (2), 780 S.E.2d 501 (2015); Harleysville Worcester Insurance Company v. High Tech Construction, Inc. 568 F.Supp.3d 152 (DRI 2021); TRT Development Company, Inc. v. ACE American Insurance Company 566 F.Supp.3d 118 (DNH 2021).

Yet, some states hold that a denial of coverage based on the failure to give timely notice will not be sustained unless the insurer shows that it suffered substantial prejudice. See e.g. Clemmer v. Hartford Insurance Co. 22 Cal.3d 865, 881-883 (1972); Billington v. Interinsurance Exchange 71 Cal.2d 728, 737-738 (1969); James Constr. Grp., LLC v. Westlake Chem. Corp., No. 20-0079, 2022 WL 1594955, (Tx, May 20, 2022); Gregory v. Safeco Insurance Company of America, 514 P.3d 971, (Co., Apr. 21, 2022); Cas. Indem. Exch. Ins. Co. v. Liberty Nat'l Fire Ins. Co., 902 F.Supp. 1235, 1239 (D.Mont.1995); Mutual of Enumclaw Ins. Co. v. USF Ins. Co., 164 Wash.2d 411, 417, 191 P.3d 866 (2008); Berkley National Insurance Company v. XTO Energy, Inc. 556 F.Supp.3d 981 (DND 2021); Depositors Insurance Company v. NEU Construction Services, Inc. 305 F.Supp.3d 1011 (EDMO 2018)(insured properly denied coverage in arbitration case for failing to give timely notice).

The Eleventh Circuit said that "the purpose of policy provisions requiring prompt notice 'is to enable the insurer to evaluate its rights and liabilities, to afford it an opportunity to make a timely investigation, and to prevent fraud and imposition upon it.' " PDQ Coolidge Formad, LLC v. Landmark Am. Ins. Co., 566 F. App'x 845, 847 (11th Cir. 2014) (quoting Laster v. U.S. Fid. & Guar. Co., 293 So. 2d 83, 86 (Fla. 3d DCA 1974));[6] See also Harleysville Worcester Insurance Company v. High Tech Construction, Inc. 568 F.Supp.3d 152 (DRI 2021).

---

[5] Failure to timely provide notice may support a denial of coverage. Great Canal Realty Corp. v. Seneca Ins. Co., Inc., 5 N.Y.3d 742, 743, 800 N.Y.S.2d 521, 522, 522, 833 N.E.2d 1196 (2005) (holding that an insured's failure to satisfy the notice requirement constitutes "a failure to comply with a condition precedent which, as a matter of law, vitiates the contract."); accord Lobosco v. Best Buy, Inc., 80 A.D.3d 728, 731, 915 N.Y.S.2d 305, 308–09 (2d Dep't 2011). If the insured has no excuse, even a relatively short delay may be deemed unreasonable. Cambridge Realty Co., LLC v. St. Paul Fire & Marine Ins. Co., 421 Fed.Appx. 52, 57 (2d Cir.2011) (court held a 3 month delay was unreasonable); see also U.S. Underwriter's Ins. Co. v. Ziering, No. 06–CV1130, 2009 WL 238562, at *6 (E.D.N.Y. Feb. 2, 2009) (collecting cases).

[6] . "The question of whether an insured's untimely reporting of loss is sufficient to result in the denial of recovery under the policy implicates a two-step analysis." Yacht Club on the Intracoastal Condo. Ass'n, Inc. v. Lexington Ins. Co., 599 F. App'x 875, 879 (11th Cir. 2015) (quoting LoBello v. State Farm Fla. Ins. Co., 152 So. 3d 595, 599 (Fla. 2d DCA 2014)). In step one, the Court must determine "whether the insured provided timely notice." Id. In step two, "if notice was untimely, prejudice to the insurer is presumed, but that presumption may be rebutted." Id. See eg Audalus v. Scottsdale Ins. Co., No. 20-62559, slip op. at 7 (S.D. Fla. Sept. 8, 2021) ("[R]eporting [a] loss two years after [a] hurricane does not—as a matter of law—constitute prompt notice [where] Plaintiffs were aware of the hurricane and repaired the property before reporting the loss."); PDQ Coolidge Formad, LLC, 566 F. App'x at 849 (six-month delay is not prompt as a matter of law); Waldrep, 400 So. 2d at 786 (six weeks); Deese v. Hartford Acc. & Indem. Co., 205 So. 2d 328, 329 (Fla. 1st DCA 1967) (four weeks); Morton v. Indemnity Ins. Co., 137 So. 2d 618, 620 (Fla. 2d DCA 1962) (6.5 months); see also Yacht Club, 599 F. App'x at 882 ("Moreover, [insured] undertook certain repairs before filing a claim with [insurer]. [Insurer] was prejudiced by not being able to investigate prior to those repairs and by not participating in the repair of those damages.").; Alina Montenegro Happy Dreams Learning Ctr. v. Nautilus Ins. Co., No. 20-24323, 2021 WL 4991099, at

Sometimes, insureds may have a valid excuse to not provide a timely notice of a claim. Under New York law there may be a valid excuse such as where the insured has a good faith belief of nonliability. See Great Canal Realty Corp., 5 N.Y.3d at 743, 800 N.Y.S.2d at 522, 833 N.E.2d.[7]

A policyholder generally will give a "notice of circumstances that reasonably could be expected give rise to a claim" prior to the end of the policy year in which the policyholder learns of those circumstances. This practice is necessary under most types of D&O (directors and officers) and E&O (errors and omissions) policies.

It is particularly important that the insured give timely notice. The securities arbitration practitioner is cautioned to make sure that the Respondent broker dealer or financial advisor timely gave notice to the insurer so that insurance coverage is triggered. This author is aware of arbitration cases that yielded awards, but the claimants were unable to collect because the insured broker-dealer failed to timely give the insurer notice. Therefore, it is recommended that the Claimant's attorney send a copy of the statement of claim to the insurance company as soon as the name of the insurance carrier is disclosed. In addition, Claimant's counsel should also consider asking the insurance defense attorney to confirm in writing that the insurance carrier is on notice.

The consequences of the failure to give timely notice cannot be understated. In Wm. C. Vick Const. Co. v. Pennsylvania Nat. Mut. Cas. Ins. Co. 52 F Supp 69 (EDNC 1999), insurance coverage was denied in an arbitration because, although the insured had good faith belief of a timely notice being given to his insurance agent, the insurance company never learned of the claim until after the arbitration award was upheld by the Superior Court and the delay prejudiced the insurer's ability to protect its interests.

Securities arbitration practitioners are thus cautioned to obtain confirmation that the insurer is on notice of the claim and has a copy of the statement of claim, or the practitioner should email a copy of the statement of claim to the "claims office" email address of the insurer and obtain a copy of a letter or email acknowledging the claim. Most insurers publish their claims notification phone number, address or email on their website. See, e.g. https://www.chubb.com/us-en/business-insurance/securities-broker-dealer-professional-liability-policy.html.

II. Insurance Disclosure Laws. In a Financial Regulatory Authority (FINRA) arbitration, there is no rule or mandatory Discovery Guide disclosure of insurance information. Yet in Federal Court, the early disclosure of liability insurance coverage has been a routine part of federal cases since at least 1970, as mandated by the Federal Rules of Civil Procedure.[8] Under Fed. R. Civ. Proc. 26(a)(1)(iv), a party to a civil action must produce to other parties at the outset of the litigation "any insurance agreement under which an insurance business may be liable to satisfy all or part of a possible judgment in the action or to indemnify or reimburse for payments made to satisfy the judgment." The advisory committee notes reflects that details concerning insurance coverage

*4 (S.D. Fla. Oct. 7, 2021)("[p]rompt notice is not excused because an insured might not be aware of the full extent of damage or that damage would exceed the deductible.")

[7] . See also St. James Mech., Inc. v. Royal & Sunalliance, 44 A.D.3d 1030, 1031, 845 N.Y.S.2d 83, 85 (2d Dep't 2007); Sec. Mut. Ins. Co. of N.Y. v. Acker–Fitzsimons Corp., 31 N.Y.2d 436, 441, 340 N.Y.S.2d 902, 293 N.E.2d 76 (1972)). In New York, the burden of proof of a valid excuse is on the insured, not the insurer, to show the reasonableness of the excuse. Courduff's Oakwood Rd. Gardens & Landscaping Co., Inc. v. Merchants Mut. Ins. Co., 84 A.D.3d 717, 718, 922 N.Y.S.2d 212, 214 (2d Dep't 2011).

[8] . See Federal Rule of Civil Procedure 26(a)(1)(A)(iv).

represent “basic information that is needed in most cases to prepare for trial or make an informed decision about settlement.”[9] The committee notes state in relevant part:

> “Disclosure of insurance coverage will enable counsel for both sides to make the same realistic appraisal of the case, so that settlement and litigation strategy are based on knowledge and not speculation. It will conduce to settlement and avoid protracted litigation in some cases, though in others it may have an opposite effect. The amendment is limited to insurance coverage, which should be distinguished from any other facts concerning defendant's financial status (1) because insurance is an asset created specifically to satisfy the claim; (2) because the insurance company ordinarily controls the litigation; (3) because information about coverage is available only from defendant or his insurer; and (4) because disclosure does not involve a significant invasion of privacy.”

The rationale for early disclosure of insurance information supports the important public policy consideration of judicial economy, where early disclosure of insurance information permits an early assessment of a Respondent or defendant’s ability or inability to pay a settlement or a possible judgment. That same rationale supports early disclosure not only in FINRA arbitration, but other arbitration forums like AAA[10] and JAMS[11]. FINRA, AAA and JAMS could help save the parties time and money if they mandated the early disclosure of insurance information, in the same manner as has worked for decades in the federal courts.

FINRA's Dispute Resolution Task Force reviewed the FINRA Discovery Guide and recommended that insurance information should be disclosed to claimants in FINRA proceedings, finding it would be beneficial.[12] would be beneficial to customers in arbitration proceedings. The recommendation was to amend the Discovery Guide to add a requirement in the Firm/Associated Persons List to require the production of insurance policies “that may be applicable to a claimant's claims.”[13] FINRA then issued Notice to Members 18-22 and asked for comments to a new proposed rule to require certain insurance disclosures in arbitration.[14] Comments were received, but the amendment to the Discovery Guide was never enacted, probably due to the opposition of most industry participants.[15]

---

[9] See Federal Rule of Civil Procedure 26(a)(1)(A)(iv), Notes of Advisory Committee on Rules—1970 Amendment.

[10] .American Arbitration Association

[11] Judicial Arbitration and Mediation Services

[12] . https://www.finra.org/rules-guidance/notices/18-22

[13] . Id.

[14] See FINRA Notice to Members 18-22.

[15] Nearly 80 comments were published, and most of them supported the proposed rule. Yet, the comments from the industry were all negative. The Securities Industry Financial Marketing Association, the marketing mouthpiece for the financial services industry, said that ““The marginal, if any, benefit to claimants of discovering all possible insurance coverages would be far outweighed by the substantial costs to well-capitalized firms of reviewing and producing such documents, engaging in discovery disputes, and suffering potential prejudice in the arbitration proceeding as a result. Regardless, and in addition, it would be inappropriate for FINRA to impose a new regulatory obligation that gives customer

Even though the routine disclosure of insurance policy information was well established by the Federal Courts decades ago, only some states have laws require disclosure of insurance policy information to the Plaintiff/Claimant in state court cases or in arbitration. For example, under New York law[16] defendants[17] must disclose, within 90 days of filing an answer to a complaint:

- Complete copies of all potentially applicable primary, umbrella and excess policies (unless the party to whom the disclosure must be made agrees in writing to accept a declaration page) insofar as such documents relate to the claim being litigated;
- The total limits of the applicable policies and the amounts still available under the insurance policy to satisfy, or reimburse for, the judgment, taking into account any erosion or other offsets; and
- The name and e-mail address for persons responsible for adjusting the claim.

Likewise, under Florida law[18], a defendant's insurer , within 30 days of receiving a written request, must provide a statement under oath to disclose:

- The name of the insurer.
- The name of each insured.
- The limits of the liability coverage.
- A statement of any policy or coverage defense which such insurer reasonably believes is available to such insurer at the time of filing such statement.
- A copy of the policy.

Also, in Florida, upon written request, the insured (Respondent) must disclose the name and coverage of each known insurer to the claimant and forward the request for information to all affected insurers. Thereafter the insurance company is supposed to supply the statutorily required information to the claimant within 30 days of receipt of such request. Georgia likewise requires disclosure of insurance information within 30 days of a demand. Unlike Florida, Georgia does not require disclosure or delivery of the full policy.[19]

---

claimants the sole and unfettered discretion to impose an unnecessary discovery burden on well-capitalized firms."

[16] . Comprehensive Insurance Disclosure Act; CPLR 3101(f). The Act applies to cases filed on or after February 24, 2022.

[17] . New York insurance disclosure laws also apply to third-party defendants, counter-claim defendants, or cross-claim defendants.

[18] . See Florida Statute 627.4137, Disclosure of certain information required.

[19] See Georgia Statute 33-3-28. Request by claimant for information as to name of insurer, name of each insured, and limits of coverage (a) (1) Every insurer providing liability or casualty insurance coverage in this state and which is or may be liable to pay all or a part of any claim shall provide, within 60 days of receiving a written request from the claimant, a statement, under oath, of a corporate officer or the insurer's claims manager stating with regard to each known policy of insurance issued by it, including excess or umbrella insurance, the name of the insurer, the name of each insured, and the limits of coverage. Such insurer may provide a copy of the declaration page of each such policy in lieu of providing such information. The claimant's request shall set forth under oath the specific nature of the claim asserted and shall be mailed to the insurer by certified mail or statutory overnight delivery.

Other states, like Massachusetts, also require disclosure of insurance information within 30 days of a demand.[20] Unlike Florida, Massachusetts provides for a penalty of $500 for noncompliance. Maine has a similar penalty of $500 for failing to timely provide disclosure of insurance information.[21]

California, in the other hand, treats insurance policy information as confidential.[22] Yet, insurance carriers in California generally have a duty to settle claims within policy limits when liability is clear to avoid a bad faith claim.[23] In other states, like California, there is no express statutory duty to disclosure insurance information upon written request. States such as Alabama, Arizona, Delaware, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Michigan, Mississippi, Missouri, Montana, Nebraska, New Hampshire, New Mexico, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Dakota, Tennessee, Texas, Washington, Wisconsin, and Wyoming lack statutory disclosure laws.[24]

Thus, in states without statutory insurance disclosure laws, the best practice for the securities arbitration or litigation practitioner is to ask the Respondent's counsel in writing to reveal the policy limits so that the parties can try to resolve the case in good faith within limits.[25] If the insurance defense attorney refuses to provide the policy information, a claimant's attorney should ask in writing for the name of the Respondent's insurance coverage counsel or to speak with Respondent's representative in charge of insurance coverage issues, since the insurance defense attorney is almost always conflicted out of providing insurance coverage advice to the

[20] . Section 112C: Disclosure of coverage limits to claimants; penalty- Section 112C. Any insurer doing business in the commonwealth shall reveal to an injured party making claim against an insured, the amount of the limits of said insured's liability coverage, upon receiving a request in writing for such information from the injured party or his attorney. A reply shall be made within thirty days of receiving such request. Any insurer who fails to comply with the provisions of this section shall be liable to pay to the claimant the sum of five hundred dollars plus reasonable attorneys' fees and expenses incurred in obtaining the coverage information provided for herein.

[21] . See Maine Statute 24-A M.R.S. § 2164-E requires insurers to respond to written requests for liability coverage limits within 60 days of receipt. The law also imposes a penalty of $500 and reasonable attorney's fees and expenses.

[22] . See Griffin v. State Farm Mutual Auto Ins. Co. 230 Cal.App.3d 59, 65-68 (1991)(policy limits are confidential and should not be disclosed without the insured's consent.); See also California Statute 791.13 -Disclosure of personal or privileged information about individual- "An insurance institution, agent, or insurance-support organization shall not disclose any personal or privileged information about an individual collected or received in connection with an insurance transaction unless….".

[23] See Boicourt v. Amex Ins. Co. 78 Cal.App.4th 1390, 1392 (2000). In Boicourt, the court held that that a bad faith claim may arise when an insurer neglects to seek the insured's consent to disclose the insurance policy limits, because a failure to request consent hurts the chances of the case being settled within policy limits.

[24] . See Pre-Suit Disclosure of Liability Policy Limits in Third-Party Claims, Matthiesen, Wickert, & Lehrer SC, June 1, 2022 at https://www.mwl-law.com/wp-content/uploads/2020/03/PRESUIT-DISCLOSURE-OF-LIABILITY-POLICY-LIMITS-IN-THIRD-PARTY-CLAIMS.pdf

[25] . Claimant lawyers should be cautioned that states with statutory disclosure laws sometimes limit them to automobile insurance claims. See eg N.J.S.A. § 39:6A-13.2; Vt. Stat. Ann. tit. 23, § 941(g).

Respondent. A smart insurance company will ask their insured for consent to disclose the policy limits in the interest of settling the case and avoiding a verdict in excess of policy limits.[26]

III. Claims Made Polices vs Occurrence Policies. Liability insurance is generally sold in two principal ways: either as a "claims made" or as an "occurrence" policy. See eg 7 Couch on Insurance § 102:22 (3d ed.). Occurrence policies are designed to cover claims that are tied to events that take place within the defined policy period, even if the claim is presented after the defined policy period. In contrast, a claims-made policy was designed to cover claims actually made during the pending policy year then in effect, and not after the policy period lapsed. In this author's experience, most broker dealer policies are of the claims-made variety. See eg Acosta v. Potts, 2017 WL 4418579 (S.D. Ohio Oct. 5, 2017). Such a policy "conditions coverage on the insured reporting the claim within a specified period." Restatement of the Law of Liability Insurance § 35 cmt. c.

Thus, the distinction between a Respondent owning a "claims made" policy versus an "occurrence" policy is an important one because the insured and insurer must determine which policy is subject to the claim and will pay for the defense of the claim and provide insurance coverage in the event liability is found. Normally, when a claim is filed, the insurance carrier will treat the claim as triggering a duty to defend the insured in effect at the time of the claim. But sometimes, there may be a prior policy (an occurrence policy) that covered prior bad conduct. More importantly, if the insured broker-dealer was aware of the conduct that could give rise the claim before the "claims made" policy period started, then the insurer will not have to cover the claim. The exclusion of coverage for claims where the insured knew or should have known of a claim before the policy period can be avoided sometimes, where the claimants attorney makes his or her best effort to confirm that the carrier is on timely notice of the claim.

In general, claims-made policies are less expensive than occurrence policies, largely because the insurer may " 'close its books' on a policy upon expiration of the policy period and not be exposed to coverage at a later date which exists under most occurrence policies. See Fin. Indus. Corp. v. XL Specialty Ins. Co., 285 S.W.3d 877 (Tex.2009). Claims-made policies actually reduce the insurance company's obligation to create cash reserves or pay for reinsurance for unknown, future claims because at the end of the policy defined period, the insurer no longer retains any exposure to claims or liabilities. See Restatement of the Law of Liability Insurance § 35 cmt. c. ("A claim-reporting condition that sets an outside limit on the date by which all claims under a policy must be reported allows the insurer to have a date certain on which it can reduce its [incurred but not reported] reserves on that policy to zero.").

IV. Reservation of Rights Letters. Reservation of rights letters are meant to inform the insured of possible coverage and/or policy defenses, and to preserve the insurance company's right to assert defenses.[27] "A typical reservation of rights letter does most, if not all, of the following: (1) identifies the policy at issue; (2) quotes, or at least refers to, the relevant policy provisions and identify any terms, conditions, or exclusions which may bar coverage; (3) refers to specific, relevant allegations in the complaint; (4) identifies which claims may not be covered; (5) explains

[26] . See fn 13, supra.

[27] See eg Portal Pipe Line Co. v. Stonewall Ins. Co., 845 P.2d 746, 749–750 (Mont.1993) (indicating that reservation of rights letters under Montana Statute § 33–18–201(14) must "inform the insured of all policy defenses [the insurer] intends to rely upon").

in detail the basis for the insurer's coverage position; (6) sets forth the proposed arrangement for providing a defense and, depending on the law of the jurisdiction, advises the insured of its right to independent defense counsel; (7) advises the insured of any actual or potential conflicts of interest between the insurer and the insured; (8) reserves the right to withdraw from the defense; (9) contains a general reservation of rights, including the right to assert other defenses the insurer may subsequently learn to exist during further investigation; and (10) uses the words "reservation of rights."" Western Heritage Ins. Co. v. Love, 24 F. Supp. 3d 866, 877–878 (W.D. Mo. 2014), citing, 1 Leo Martinez, Marc S. Mayerson & Douglas R. Richmond, New Appleman Insurance Law Practice Guide § 11.11[2][b] (2012); 14 Steven Plitt, Daniel Maldonado, Joshua D. Rogers & Jordan R. Plitt, Couch on Insurance § 202:47 (3d ed.2013).[28]

In some jurisdictions, a reservation of rights letter may permit the insurer to withdraw from the defense of the case when there is no for coverage under the policy. See e.g. American Eagle Ins. Co. v. Nettleton, 932 S.W.2d 169, 174 (Tex.App.—El Paso 1996, writ denied).[29] "The purpose of the reservation of rights letter is to permit the insurer to provide a defense for its insured while it investigates questionable coverage issues." J.E.M. v. Fidelity & Casualty Co., 928 S.W.2d 668, 673 (Tex.App.—Houston [1st Dist.] 1996)

Some states, such as California, have statutes that mandate when a potential conflict of interest arises between the insured and the insurance company, the insured must be informed of the right to their own, independent coverage counsel, unless their insured waives the right to independent counsel.[30]. See also, Mut. Serv. Cas. Ins. Co. v. Luetmer, 474 N.W.2d 365, 368-69 (Minn. Ct. App. 1991)(when an insurer has a conflict of interest with its insured, the insured has a right to select independent counsel).

When a reservation of rights or other issues create a potential conflict of interest, insurers in many states are required to notify the insured of the potential conflict and offer to provide the insured with independent counsel, paid for by the insurer. See e.g. California Civil Code 2860. The potential conflicts of interest are varied. "Some of the circumstances that may create a conflict of interest requiring the insurer to provide independent counsel include: (1) where the insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by the insurer's retained counsel [citations]; (2) where the insurer insures both the plaintiff and the defendant [citation]; (3) where the insurer has filed suit against the insured, whether or not the suit is related to the lawsuit the insurer is obligated to defend [citation]; (4) where the insurer pursues settlement in excess of policy limits without the insured's consent and leaving the insured exposed to claims by third parties [citation]; and (5) any other situation where an attorney who represents the interests of both the insurer and the insured finds that his or her 'representation of the one is rendered less effective by reason of his [or her] representation of the other.' " See Simonyan v. Nationwide Ins. Co. of America 78 Cal.App.5th 889, 896 (2022), citing James 3 Corp. V. Truck Ins. Exchange, 91 Cal. App. 4th 1093, 1100 (2001).The insured is not obligated to accept the offer of independent counsel. In some states, the insured is entitled to select the

[28] See generally, Harleysville Lake States Ins. Co. v. Granite Ridge Builders, Inc., 2008 WL 4935974, at 5–6 (N.D. Ind. Nov. 17, 2008); Canal Ins. Co. v. Flores, 524 F. Supp. 2d 828, 834 (W.D. Tex. 2007); All Am. Ins. Co. v. Broeren Russo Constr., Inc., 112 F. Supp. 2d 723, 729–730 (C.D. Ill. 2000). See also, 14 Couch on Ins. § 202:47: Sufficiency of Reservation of Rights (3d ed.).

[29] . "Once a defense is taken under a valid reservation of rights, the insurer may withdraw the defense when it becomes clear that there is no coverage under the applicable policy." Id.

[30] California Civil Code 2860 (a); See Fed. Ins. Co. v. MBL, Inc., 219 Cal. App. 4th 29, 41, 160 Cal.Rptr.3d 910 (2013) (citing Cumis Ins. Society, Inc., 162 Cal. App. 3d at 364, 208 Cal.Rptr. 494).

independent counsel, but in some states the insurer retains this right. See e.g., National Hockey League v. TIG Insurance Company, 172 N.Y.S.3d 342 (2022); L.A. Terminals, Inc. v. United National Insurance Company, 2022 WL 2209362 (C.D.CA 2022)(insured selects counsel); Am. Motorists Ins. Co. v. Trane Co., 544 F.Supp. 669, 673 (W.D.Wis.1982) (stating that where a conflict does exist, "the insurer must either provide an independent attorney to represent the insured or pay the costs incurred by the insured in hiring counsel of the insured's own choice"), aff'd, 718 F.2d 842 (7th Cir.1983); All–Star Ins. Corp. v. Steel Bar, Inc., 324 F.Supp. 160, 165 (N.D.Ind.1971) (insured has right to select counsel); Fireman's Fund Ins. Co. v. Waste Management of Wisconsin, Inc., 777 F.2d 366, 368–69 (7th Cir.1985) (under Wisconsin law, insured was permitted to select counsel "subject to the approval and at the expense of" the insurer); .

Although a reservation of rights protects an insurer's interests, it also can alert the insured to the fact that some of the claims may not be covered. In that vein the ROR letter allows the insured, and the claimants, to consider availability of coverage issues during settlement negotiations and other decisions prior to a final hearing. The ROR permits allows all parties appropriate action to protect their interests regarding possibly uninsured claims.

As one can easily see, a reservation of rights letter often presents serious issues that both the broker-dealer (the insured) and claimants must consider before and during any settlement negotiation. As such, this author suggests that FINRA amend its proposal to amend the Discovery Guide to require the disclosure of any and all reservation of rights letters, in addition to insurance policies.[31] Further, it would be helpful for FINRA to caution its members to obtain their own private coverage counsel when faced with reservation of rights letters and coverage issues, because this author has seen financial advisors and broker dealers caught off-guard, right before trial or during a mediation, when they are first told there is not enough coverage for the claim and they have to contribute to pay any settlement. This failure of proper disclosure often causes problems that could have been avoided had insurance coverage and reservation of rights letters been disclosed at the beginning of the case, and not the end following an award.

V. Related Acts Exclusions. In securities arbitration, it is not unusual for a wide spread product failure to generate scores of arbitration claims for practitioners. When these multitudes of claims are filed, they likely will cause an insurance company to reserve rights or deny policy coverage under its exclusion for "related acts" or "interrelated acts." "Interrelated wrongful acts" in one policy means: "Wrongful Acts which are the same related, or continuous; or Wrongful Acts which arise from the same, related, or common nexus of facts. Claims can allege Interrelated wrongful acts regardless of whether such Claims involve the same or different claimants, Insureds, or legal causes of action." National Union Fire Ins. Co. v. Ambassador Group, Inc., 691 F.Supp. 618, 623 (E.D.N.Y.1988), quoting Specimen Policy Forms For Lawyers Professional Liability Coverage in New York, Practicing Law Institute: Litigation and Administrative Course Handbook Series 580, at 516 (1998)). In a more recently issued broker-dealer policy, the insurance company defined related acts as "I. Interrelated Wrongful Acts means all Wrongful Acts that have as a common nexus any fact, circumstance, situation, event, transaction, cause or series of related facts, circumstances, situations, events, transactions or causes." See Ace Advantage Securities Broker Dealer Professional Liability Insurance Policy, appended hereto as Appendix A page 3, section I.

A related acts or interrelated wrongful act clause is meant to limit the scope of available coverage by often treating related claims as a "single" claim. In the Ace policy, Appendix A, the Ace

[31] . See FINRA NTM 18-22.

insurance company limits coverage for related acts to the limits for a "single" claim as follows: "All Claims arising out of the same Wrongful Act and all Interrelated Wrongful Acts of the Insureds shall be deemed to be one Claim, and such Claim shall be deemed to be first made on the date the earliest of such Claims is first made, regardless of whether such date is before or during the Policy Period. ***All Loss resulting from a single Claim shall be deemed a single Loss***." Appendix A, page 9 at section VII. [italics and bold added]. Similarly, in an XL Specialty Insurance policy that covered a registered investment advisor, "Interrelated Wrongful Acts were defined as "Wrongful Acts which are based on, arising out of, directly or indirectly resulting from, in consequence of, or in any way involving any of the same or related or series of related facts, circumstances, situations, transactions or events." See Morden v. XL Specialty Insurance, 903 F. 3d 1145 (10th Cir. 2018).

In Brecek & Young Advisors, Inc. v. Lloyds of London Syndicate 2003, 715 F.3d 1231, 1238 (10th Cir. 2013), the policy defined interrelated wrongful acts to include those "connected by reason of any common fact, circumstance, situation, transaction, casualty, event, decision or policy or one or more series of facts, circumstances, situations, transactions, casualties, events, decisions or policies." The Court in Brecek found that the wrongful acts from three separate arbitration cases were "interrelated" "because of several common facts: the same alleged culprits, roughly the same time period ("from the late 1990s to the mid-2000s"), and similar alleged fraud—selling "unsuitable investment products including various types of annuities" and churning or flipping investment accounts." Morden, infra. The Court noted that minor variations in the arbitration cases "were inconsequential." Morden, infra; See also Brecek at 1238–39; see also Kilcher v. Cont'l Cas. Co., 747 F.3d 983, 990 (8th Cir. 2014) (court found that variations in the specifics of the fraud perpetuated against various clients were immaterial "micro-distinguishing" factors, particularly in light of the victims' allegations of similarity); Am. Med. Security Inc. v. Executive Risk Specialty Ins. Co., 393 F. Supp. 2d 693, 707 (E.D. Wisc. 2005) (finding 39 lawsuits were "clearly 'related' " because they were based on the insured's underwriting practices and business decision to market and sell certain policies as group health insurance).

In Continental Casualty Co. v. Wendt, 205 F.3d 1258 (11th Cir.), rehear'g denied, April 19, 2000, the appellate court affirmed the findings of the trial court, per curiam affirmed. In Continental Casualty, a financial advisor named Bernard Wendt sold promissory notes to investors for an issuer named K.D. Trinh, and further provided legal services relating to the transactions. Wendt and Thomas P. Hall(the lawyer who suggested that Wendt sell K.D. Trinh promissory notes), were both sued in two separate cases. Wendt filed a third party lawsuit against Hall. Then, Hall's insurance carrier filed a declaratory relief action seeking to deny coverage for the third party complaint. The policy language at issue provided, "Any claim or claims arising out of the same or related wrongful acts, shall be considered first made during the policy term in which the earliest claim arising out of such wrongful acts was made." Continental, 205 F3d at 1260[appendix]. The policy did not define the word "related." To reach its conclusion, the Court said in part: "The words "relate" or "related" are commonly understood terms in everyday usage. They are defined in the dictionary as meaning a "logical or causal connection between" two events. See Webster's Third New International Dictionary (1981). There is no ambiguity unless one is created through the device of simply ignoring one half of the definition." Continental, 205 F3d at 1263[appendix].

The Defendants in Continental argued that Hall's [the lawyer] conduct was a series of disconnect acts, in that he " (1) appeared at seminar where he held himself out as an attorney knowledgeable in securities law; (2) represented at the seminars as to the legality of K.D. Trinh loans; (3) vouched for the legality of the notes to clients to whom he had a fiduciary duty; (4) took loans of money from his employees, drafting brochures for use by promoters, and various other illegal and unethical activities all performed with the aim of supporting investment in K.D. Trinh loans."

Continental, 205 F3d at 1263[appendix]. But, the Court rejected the idea of "disconnected acts," finding that "Hall engaged in a series of actions all of which were intended to encourage investment in K.D. Trinh.." Id. The court held that the first lawsuit (by the investors) and the third party complaint (financial advisor vs lawyer) were "related" for the purposes of the insurance policies. Id. at 1263.[32] The Third, Seventh, Eighth and Eleventh Circuits all use the same or a close variation of the "logical or casual connection" test. See Northrop Grumman Corp. v. Axis Reinsurance Co., 809 F. App'x 80 (3d Cir. 2020); Gregory v. Home Ins. Co., 876 F.2d 602, 606 (7th Cir. 1989). Kilcher vs. Continental Cas Co, 747 F3d 983(8th Cir 2014)(Related acts found where insured investment advisor offered unsuitable investments to her customer was logically connected to churning, where she had a pattern of offering advice to purchase inappropriate annuities while simultaneously liquidating similarly inappropriate annuities, and as such was within the meaning of "Interrelated Wrongful Acts" defined in insurance policy; claims were "logically connected by reason of any common fact, circumstance, situation, transaction or event," since customer continued to present same opportunity to advisor of investor who trusted her to act in his best interest and advisor also engaged in same method or modus operandi.) Cont'l Cas. Co. v. Wendt, 205 F.3d 1258, 1262–63 (11th Cir. 2000) (per curiam); See also, In re DBSI, Inc., No. 08–12687 PJW, 2011 WL 3022177, at *4 (Bankr.D.Del. July 22, 2011)Courts in other jurisdictions have held that "[c]laims may be related even if they allege different types of causes of action and arise from different acts" where there is "a 'single course of conduct' that serves as the basis for the various causes of action.").

Note that the Continental Court was not looking at any facts showing a sale of various products or a different product strategy, made by different financial advisors, to unrelated investors.[33] In Financial Management Advisors LLC vs. American Intern. Specialty Lines Ins. Co. , 506 F3d 922 (9th Cir. 2007), the court was faced with unrelated investors who both sued Kenneth Malamed, a financial advisor, for providing poor financial advice. One family of investors, the Sitricks, complained that "(1) that Malamed made certain misrepresentations in order to dissuade the

[32] . Florida Courts focus on and compare the allegations to determine if claims are related. Health First, Inc. v. Capitol Specialty Ins. Corp., 230 F. Supp. 3d 1285, 1299 (M.D. Fla. 2017), aff'd, 747 F. App'x 744 (11th Cir. 2018). "This approach does not require exact factual overlap, or even identical legal causes of action, but rather focuses simply on whether the claims are logically linked by a 'sufficient factual nexus.' " Cap. Growth Fin. LLC v. Quanta Specialty Lines Ins. Co., No. 07-80908-CIV, 2008 WL 2949492, at *4 (S.D. Fla. July 30, 2008).

[33] .Kilcher v. Cont'l Cas. Co., 747 F.3d 983, 989–90 (8th Cir. 2014) (acts done to different victims were unambiguously "logically ... connected," as defined in the insurance policy, where each victim shared common characteristics such that he or she "presented the same opportunity" to the perpetrator). See also Gregory v. Home Ins. Co., 876 F.2d 602, 606 (7th Cir. 1989) (finding that the various claims of class members against a brokerage for a failed investment package designed to offer certain tax benefits were related to the cross-claim of the brokerage against the attorney who had drafted the documents such that the policy's single claim limit applied); Liberty Ins. Underwriters, Inc. v. Davies Lemmis Raphaely Law Corp., 162 F. Supp. 3d 1068, 1078-79 (C.D. Cal. 2016) (finding that several separate lawsuits against a law firm, each alleging false representations as to sales of properties, constituted a "single claim" under a policy provision governing "related" claims because the lawsuits arose out of a "single course of conduct" reflecting a fraudulent scheme); Barr v. Colo. Ins. Guar. Ass'n, 926 P.2d 102, 104-05 (Colo. App. 1995) (finding claims against officers and directors of grocery cooperative for damages relating to a failed loan constituted a single claim under policy providing "Losses arising out of the same Wrongful Act by one or more of the Directors and/or Officers ... shall be considered a single Loss"); cf. Lexington Ins. Co. v. Lexington Healthcare Grp., Inc., 311 Conn. 29, 39-40, 84 A.3d 1167, 1174 (2014) (finding multiple claims by nursing home residents injured by a fire not to be "related" under policy providing that "[a]ll claims arising from continuous, related, or repeated medical incidents shall be treated as arising out of one medical incident" and noting that "each individual claimant was differently situated").

Sitricks from liquidating their equity investments; and (2) that Malamed misrepresented the risk inherent in several Collateral Bond Obligation funds (CBOs)1 managed by FMA in order to induce the Sitricks to invest in those funds." Id at 924. Investor Steiman, on the other hand, invested in a Collateralized Bond Obligation fund, known as the CBO II fund, on Malamed's advice. When that fund declined, Steinman sued Malamed claiming that he had misrepresented the riskiness of CBO II and, had also made investments in a tranche of the fund different from and riskier than the tranche he had agreed to buy. Id. So Steinman alleged a breach of an agreement in addition to being misled. Id.

The district court granted summary judgment for the insurance company. But the appellate Court reversed, finding that,

> The Sitricks and Steinman were ***unrelated investors, with unique investment objectives.*** They were ***advised at separate meetings on separate dates, according to their unique financial positions***. Indeed, ***the investment packages*** ultimately ***recommended*** to and chosen by each client ***were different***—the Sitricks invested in several CBO funds as well as various equities, while Steinman invested only in CBO II. More importantly, ***some of the Wrongful Acts alleged by the two clients were different***. The district court focused solely on the allegations in the Sitrick and Steinman complaints relating to the investment vehicle common to both investors—CBO II. ***Even with respect to CBO II, the Sitricks and Steinman allege different wrongful conduct*** by Malamed and FMA. The Sitricks based their CBO claims largely on Malamed's ***failure to disclose*** certain significant information, including: (1) that FMA failed to maintain sufficient liability *926 insurance; (2) that FMA had been stripped of its management duties with respect to the first CBO it managed; and (3) that Malamed and FMA stood to earn substantial fees on the CBO investments. ***Steinman's claim, by contrast, relies heavily on affirmative misrepresentations in written materials*** prepared by Prudential, the underwriter for the CBOs, ***and in a commitment letter confirming that Steinman's investment would be placed in a low risk, "senior" tranche of CBO II when in fact it was placed in a more junior, higher-risk tranche***. The Sitricks' claims were not based on written materials.

Financial Management Advisors LLC vs. American Intern. Specialty Lines Ins. Co. , 506 F3d 922, 925 (9th Cir. 2007).

The 9th Circuit's focus on the "unique financial positions" (aka their suitability profile") of the different clients and on the fact that they did not buy the same exact products and made different claims regarding the financial advisor's conduct appears to the key to the Court's findings that they claims were not related. Its analyses was bolster by rejecting the insurance carrier's citation to both Gregory v. Home Insurance Co., 876 F.2d 602 (7th Cir.1989) and Continental Casualty Co. v. Wendt, 205 F.3d 1258 (11th Cir.2000), where the insured attorney was accused of committing a single wrong—where the lawyers gave the same advice to several parties to promote a single investment. But in Financial Management Advisors, infra, the court noted that there were different claims involving different investing vehicles. Id. Importantly, the 9th Circuit noted in dicta that "[w]e do not believe the term "related" was intended to bar recovery whenever two parties are advised to invest in the same fund. Nor are the Sitrick and Steinman Claims logically related simply because both claimants blamed the same financial advisor." Id at 926.

After Financial Management Advisors was decided, the Central District of California, in Liberty Insurance Underwriters v. Davies Lemmis Raphaela Law Corporation cited to Financial Management Advisors, but distinguished it in finding that a series of claims against a law firm were related, because "the present case involves allegations of similar or identical acts of wrongdoing which were part of a general course of conduct aimed at the same goal of inducing investors to participate in transactions related to section 1031 like-kind exchanges." Liberty Insurance Underwriters, Inc. v. Davies Lemmis Raphaely Law Corp., 162 F. Supp. 3d 1068, 1078 (C.D. Cal. 2016)(finding that multiple claims are "sufficiently related where the underlying actions are in service of a single plan" or "goal").

In another case, an insurance carrier sought to use the related acts clause to limit its liability. See Landmark American Insurance Company vs. Shurwest LLC, 2020 WL 5434550 (DAZ 2020). There, financial advisors sold the same product, called Future Income Payments, aka FIP. FIP offered to sell structured cash flow products (a return of 6.5-8% by buying, at a discount, a pensioner's future monthly pension payments). The cash flow received from those future payments were then used to fund life insurance premiums for life insurance policies sold by financial and insurance advisors. FIP was later revealed to be a Ponzi Scheme. See https://www.justice.gov/usao-sc/pr/federal-grand-jury-returns-indictment-300-million-nationwide-investment-fraud-and-ponzi.

In Landmark, infra, Shurwest, the broker dealer, fought the insurance company's attempt to limit coverage under a related acts clause because it alleged there were a multitude of unique wrongful acts, unique claims, different financial advisors and other employees involved. In Landmark, Melanie Shulze-Miller, Shurwest's National Sales Director, had here request to sell FIP products rejected. Id. Yet, in a wrongful act of operating an illegal outside business activity, Shulze-Miller formed a separate corporation, MJSM Financial LLC ("MJSM"), so that she could become a FIP referrer. Id. Shurwest claimed it had no knowledge of Shulze-Miller's OBA and that she was using a separate email account for her FIP business. ID, Schulz-Miller, without authorization, also used Shurwest employees under her supervision to perform clerical tasks for her separate company, MJSJ, in furtherance of FIP business. Id. Yet, Shurwest argued it did not receive compensation for FIP sales.[34] Id. When FIP stopped paying customers, numerous claims were filed against Shurwest. Id. After being sued, Schulze-Miller tendered here defense to Landmark, claiming that "Shurwest knew FIP was a source of funding life insurance policies sold by Shurwest for which Shurwest received a commission." Id.

Landmark defended Shurwest under a reservation of rights, while alleging that "because all eleven claims arise from [FIP] a "single negligent act, error or omission, or a series of related acts, errors or omissions," they should be treated as a single claim under the Policy." Id. Shurwest disagreed with Landmark, claiming that the eleven lawsuits "concern: (1) dozens of individual plaintiffs; (2) seven groups of financial advisors, each of whom owed a separate fiduciary duty to their client(s); and (3) multiple, discrete acts by Schulze-Miller…Shurwest emphasizes that Schulze-Miller allegedly engaged in activities ranging from direct representations concerning FIP, to training financial advisors to promote FIP, to providing back-office support for FIP." Id. Shurwest further argued that it was "therefore "untenable" for Landmark to argue…"that dozens of individual grievances that resulted in dozens of alleged particularized injuries stem from 'one proximate uninterrupted, and continuing cause which resulted in all of the injuries and damages.' " Id.

[34] . Shurwest did, however, receive commissions from at least one advisor's sale of a life insurance policy through Minn. Life, which was funded that through the FIP income stream. See Shurwest v. Howard, 2021 WL 1050046 (DKY 2021).

(quoting Ariz. Prop. & Cas. Ins. Guar. Fund v. Helme ("Arizona Property"), 735 P.2d 451, 456 (Ariz. 1987)).)

The Court agreed with Shurwest, finding in part that,

> The fundamental question, then, is whether the eleven lawsuits arise from "a single negligent act, error or omission or a series of related negligent acts, errors or omissions," in other words: whether the lawsuits arise out of a single occurrence or multiple occurrences. Arizona Property suggests the latter. Arizona Property holds that it is the number of causative acts, rather than the number of injuries produced, on which the interpretation of "per occurrence" turns. See 735 P.2d at 457–58. In the instant matter, there are certainly multiple injuries. But there are also multiple causative acts—allegedly performed by Schulze-Miller as a representative of Shurwest—that triggered the eleven lawsuits. Critically, the eleven lawsuits name the claimants' individual financial advisors with whom Schulze-Miller consulted at different times, in different locations, while performing different roles and/or functions.

See Landmark American Insurance Company vs. Shurwest LLC, 2020 WL 5434550 (DAZ 2020).

The Court in Landmark reviewed the facts and allegations made in five of the investors suits. The Court concluded that "the allegations in these five suits make it quite clear that far more than a "single negligent act, error or omission or a series of related negligent acts, errors or omissions" precipitated these eleven lawsuits." Id. The Court pointed out that "Schulze-Miller's marketing and promotion of FIP's structured cash flow products was not a one-time timeshare sales pitch delivered to a room of fifty passive participants. Far from it. The allegations, particularly those detailing Schulze-Miller's individual conduct, span dozens of claimants who worked with unconnected advisors at different times across multiple states." Id.

> The Court in Landmark, in dicta, also found that
>
> > the acts, errors, and omissions at issue here are personalized, targeted, and manifold. For the eleven lawsuits to be related or part of the same series of omissions, there would have to be some indication that the acts alleged in one lawsuit "caused" the other. Cf. Arizona Prop., 735 P.2d at 458 ("[E]ven though there have been multiple causative acts, there will be a single 'occurrence' if the acts are causally related to each other as well as to the final result."). There is no such indication here. The South Carolina Plaintiffs' allegation that Schulze-Miller deliberately consulted with Storer about the kinds of clients that best fit the investment profile for FIP's product is unrelated to the Metzner's allegation that Schulze-Miller paid in-person visits to Swerdlow. (S.C. Pls.' Compl. ¶¶ 6–7; Metzner Compl. ¶ 18, 31.) Metzner's allegation is similarly unrelated to Kim's allegation that Schulze-Miller made specific representations about FIP's licensing and registration status in the state of California. (See Kim Draft Compl. ¶¶ 19–21.)

Landmark American Insurance Company vs. Shurwest LLC, 2020 WL 5434550 (DAZ 2020).

The Landmark Court then rejected Landmark's claim that all claims were related because they all arose from "the same cause" and "common scheme," to market and promote FIP products. Id. The Court found that the to be related, the wrongful acts alleged had to be "related to each other." Id. So for example, that Shulze-Miller consulted with an advisor about the kinds of clients that

best fit the investment profile for FIP's products, was unrelated to an allegation that Shulze-Miller paid personal visits to another financial advisor, and was also unrelated to allegations of representations made by Schulze-Miller about licensing and registration status of FIP in California. Id.

At the end of the day, policy language matters. Some policies may define a "related act" as any that has "a nexus with any fact or circumstance" and include claims brought by different claimants. See e.g. Associated Industries vs. Brad Williams 2018 WL 230877 (SDMS 2018). Other policies, such as in Financial Management Advisors, infra, simply exclude coverage for claims "arising out of the facts alleged, or arising out of the same or related Wrongful Acts alleged or contained." See Financial Management Advisors LLC vs. American Intern. Specialty Lines Ins. Co. , 506 F3d 922, 924 (9th Cir. 2007). Still other policies, such as the Ace Advantage policy appended to this article, state that related acts are those that have "a common nexus any fact, circumstance, situation, event, transaction, cause or series of related facts, circumstances, situations, events, transactions or causes." See Appendix A. In a 2015 form policy, another insurer opted to draft very particularized language:

"Interrelated Wrongful Act(s)" means Wrongful Acts which are the same, related or continuous, or Wrongful Acts which arise from the same, related or common nexus of facts regardless of whether such Claims involve the same or different claimants, Insureds or legal causes of action. Further, and without limiting the aforementioned, the following Claims shall automatically be deemed to allege Interrelated Wrongful Acts:

1. Claims in connection with securities of any entity (or affiliated entities) which become(s) the subject of any
bankruptcy, insolvency, receivership, liquidation or reorganization proceeding; or
2. Claims in connection with securities purchased in connection with an offering (or series of offerings) of
securities issued by the same entity or affiliated entities; or
3. Multiple Selling Away Claims alleging the sale, attempted sale, or servicing of any of the same unapproved products.

See Appendix B, Securities Shield, Securities Broker-Dealer Professional Liability Policy at pg. 6, ¶3(h).

And, in another policy, which tracks the "logical or casually connected" definition used by many courts, its states in part that ""Related Wrongful Acts" means all Wrongful Acts that are logically or causally connected by any fact, circumstance, situation, event, transaction, cause or series of related facts, circumstances, situations, events, transactions or causes." See Professional First – Life Agent Broker-Dealer Professional Liability Policy at Appendix C. So, the narrower the definition of "related," the more an insured has an opportunity to rebut the exclusion or limitations imposed by "related acts." See eg, Dormitory Authority of New York v. Continental Cas. Co., 756 F.3d 166, 170 (2d Cir. 2014) (defining "related claims" as "aris[ing] ...out of a single wrongful act or related wrongful acts," and finding claims were unrelated where the facts showed different design teams, claims that manifested themselves at different times and resulted in different types of damage requiring different solutions); Fed. Deposit Ins. Corp. v. Mmahat, 907 F.2d 546, 553-54 (5th Cir. 1990) ("related acts" defined as "acts which are logically or causally connected," and that "a single motive does not make a single act" where "discrete acts of malpractice resulted in discrete losses"); Eureka Fed. Sav. and Loan Ass'n v. Am. Cas. Co. of Reading, Pa., 873 F.2d 229, 235 (9th Cir. 1989)(policy's related acts exclusion did not bar coverage of claims; the existence of an aggressive loan policy was insufficient in and of itself to transform disparate acts

and omissions made by five directors in issuing loans to over 200 unrelated borrowers into a single loss); Scott v. Am. Nat. Fire Ins. Co., Inc., 216 F. Supp. 2d 689, 693-95 (N.D. Ohio 2002) (claims were unrelated because the attorney "owed a separate duty" to each investor and the investors' rights were independent from the corporation's rights)

VI. Pleadings. Sometimes the actions of the financial advisor are so egregious, a securities practitioner wants to paint the advisor like a criminal in the statement of claim. However, a careful practitioner will avoid solely painting the advisor's misconduct as criminal, or using the strongest possible or inflammatory language, as that may trigger exclusions in the insurance policy. There is usually some basis to plead that the financial advisor or the brokerage firm was negligent. In most cases, there may be a basis to plead that the broker dealer failed to properly supervise the advisor, and so a negligent supervision case in an egregious case is one of the easiest routes to obtaining insurance coverage for the client. Further, there should be some acts or elements of negligence or breach of fiduciary duty that exist in most cases, for which there should be insurance coverage, so a careful practitioner will plead those acts and describe them as negligent or a breach of a fiduciary duty. Also, there may be elements of impairment, such as drug or alcohol use, which may be plead to turn an apparent act of intentional misconduct into a non-intentional act that could be covered. See eg. Jacobs v. Fire Ins. Exch 36 Cal.App.4th 1258, 1269 . (1995) (if insured was legally insane, actions cannot be deemed "willful"); J.C. Penney Cas. Ins. Co. v. M.K. 52 Cal.3d 1009, 1019, 278 Cal.Rptr. 64, 804 P.2d 689(1991(evidence insured lacked sufficient mental capacity to control his own conduct admissible to show that there could be no "voluntary act" of any kind.) As a result, the customer's case for negligence may trigger insurance coverage, though there are elements of intentional wrongdoing.

The easiest way for an insurance company to deny coverage is where the claims asserted in the statement of claim are solely based on intentional or deliberate acts, or the acts alleged in the pleadings are those that were simply outside of the scope of coverage purchased by the defendant. One should expect that the broker dealer policy will have some sort of exclusion of coverage for a wrongful act arising from intentional or deliberate acts, such as fraud or dishonesty. See, Westport Resources Investment Services v. Chubb Custom Ins. Co., 20-3 WL 22966305 (SDNY 2003)(the Chubb policy excludes coverage for claims "brought about or contributed to" by "any knowing, intentional, fraudulent, or dishonest Wrongful Act by an Insured...."); Imperato v. Navigators Insurance Company, 777 Fed. Appx 341 (11th Cir. 2019)("Imperato's insurance policy with Navigators expressly excluded coverage for indemnification and for legal counsel where a director or officer is adjudicated of "deliberately fraudulent or criminal acts.").[35]

[35] , A related issue is whether the intentional acts of one will bar coverage all other co-insureds. See e.g. Allstate, 693 F.Supp. at 889 ("Since [the policy] excludes coverage for harm resulting from the intentional or criminal 'acts of an insured person,' the insurance policy excludes coverage to any other insureds ... for liability arising from the harm which is directly attributable to the intentional or criminal act."); Allstate Ins. Co. v. Stamp, 134 N.H. 59, 588 A.2d 363, 365 (N.H.1991) ("We find that Allstate's use of the indefinite article 'an,' rather than the definite 'the,' before 'insured' is a clear reference to any insured who commits an intentional act resulting in damages, regardless of whether or not he is the particular insured seeking coverage."); Farmers Ins. Co. of Washington v. Hembree, 54 Wash.App. 195, 773 P.2d 105, 108 (Wash.Ct.App.1989) ("Here, the exclusion is not restricted to intentional acts of the particular insured sought to be held liable, but broadly excludes coverage for all intentionally caused injury or damage by an insured, which includes anyone insured under the policy."); Travelers Ins. Co. v. Blanchard, 431 So.2d 913, 915 (La.Ct.App.1983) ("[T]he exclusion is not restricted to intentional acts of the particular insured sought to be held liable, but broadly excludes coverage for all intentionally caused injury or damage by an insured person."). But other courts may interpret severability clauses to provide coverage for co-insureds who did not commit intentional or deliberate wrongdoing. See eg Northwestern National Insurance

For example, in the Ace Advantage Securities Broker Dealer policy, appended hereto as Appendix A, it states in part: “The Insurer shall not be liable for Loss on account of any Claim made: D. alleging, based upon, arising out of, or attributable to: 1. any deliberately criminal or deliberately fraudulent act, error or omission, or any willful violation of any law of the United States or Canada, or state, province, territory, county, political division or municipality thereof, or any rules or regulations promulgated thereunder, in fact committed by an Insured; or, 2. an Insured gaining in fact any profit, remuneration or financial advantage to which such Insured was not legally entitled, including any actual or alleged commingling of funds or accounts.” See Appendix A page 5, IV Exclusions, Sec. D;

Usually, a criminal conviction is a sufficient basis to deny coverage for dishonesty or criminal acts. See e.g., Pacific Ins. Co. v. General Dev. Corp., 28 F.3d 1093, 1096 (11th Cir.1994) ; U.S. v. Weissman, No. 1997 WL 334966, at 9–13 (S.D.N.Y. June 16, 1997); Fidelity and Deposit Co. of Maryland v. Jernagan, 1987 WL 49657, at 1 (N.D.FL 1987); Chubb Custom Ins. Co. v. Triumph Capital Group, Inc., 2007 WL 799906, at 3 (Mass.Super.Ct. Feb. 9, 2007).

With that in mind, the best practice for the securities practitioner is to focus on the wrongful acts and causes of action that are typically covered, such as negligence, negligent supervision, and breach of fiduciary duty (the unintentional type). But, a breach of contract claim is typically not covered. See eg Baylor Heating & Air Conditioning, Inc. v. Federated Mut. Ins. Co., 987 F.2d 415, 419-20 (7th Cir.1993). In Baylor, the court found that “Baylor's liability to the pension fund is contractual. Although at the time Baylor refused to make fund payments it did not believe it had any contractual obligation to do so, these beliefs do not change the contractual nature of the obligation. The Fund was awarded amounts owed pursuant to the collective bargaining agreement, not damages for negligence, and these payments are not covered by Baylor's policy.” Id. Similarly, in Cincinnati Ins. Co. v. Metropolitan Properties, 806 F.2d 1541, 1543 (11th Cir.1986), the court held that damages that resulted from a breach of contract are not covered by a policy that covered negligent errors. Id. The Eleventh Circuit found that the word “negligent” had to be given its legal meaning and was not the same as one guilty of “carelessness or slack.” Id. at 1544. So even if the insured’s actions that were linked to the breach were seen as careless, those acts are covered by the policy. Id. at 1543. Similarly, the Eighth Circuit also rejected coverage for breach of contract in First S. Ins. Co. v. Jim Lynch Ent., Inc., 932 F.2d 717 (8th Cir.1991).

Still another legal claim that is often not covered is a state or federal securities violation. See eg ACE Advantage Securities Broker-Dealer Professional Liability Insurance Policy, Appendix A, Exclusions, Section IV.D(1)(coverage is excluded for “any willful violation of any law of the United States or Canada, or state, province, territory, county, political division or municipality thereof, or any rules or regulations promulgated thereunder, in fact committed by an Insured”). For example, in this day and age, it is not unusual to find insurance agents, who lack a securities license, selling unregistered securities. It is common for insurance carriers, in those types of cases, to simply deny coverage because the policy was designed to cover claim relating to the insurance business, and not the sale or offering of securities. American Automobile Insurance Company vs. Mayfield, 287 F Supp 1 (ND Tx 2003).

Company v. Nemetz, 135 Wis.2d 245, 400 N.W.2d 33 (1986), (wife afforded coverage as innocent insured even though husband started the fire--“We conclude that this contract is ambiguous because the severability clause creates a reasonable expectation that each insured's interests are separately covered, while the exclusion clause attempts to exclude coverage for both caused by the act of only one.”).

And in other cases, coverage is simply denied because the policy excludes coverage for the sale of unregistered securities. See . See e.g. See Bill Saoud v. Everest Indemnity Insurance Company 564 F Supp 597 (EDMI 2021). In the Saoud case, Bill Saoud, a self-titled financial advisor who lacked any securities licenses, sold 9 month "memorandum of indebtedness" (aka promissory notes) issued by 1Global. Saoud v. Everest Indemnity Insurance Company 564 F Supp 597 (EDMI 2021). 1 Global loaned money to small businesses, and "swept" those businesses daily credit card receivables to repay the loans. Id. 1 Global was, in actuality, selling unregistered securities and the principal of the company misused, for personal benefit, tens of millions of dollars. Id. 1 Global needed new investors to pay old investors due to the misuse of investor money. Id. When 1 Global declared bankruptcy, Saoud was sued, but his insurer, Everest, denied coverage, because the notes were "unregistered securities," for which Everest said was excluded from coverage under a clause that said in part: ""[Everest] shall not be liable to pay any Loss resulting from any Claim against an Insured ... [b]ased upon, attributable to, or arising out of the use of or investment in any security that is not registered with the Securities and Exchange Commission." Id. The district court found that the 9 month notes were not excluded from the SEC Act of 1934 as short term paper, deemed the notes to be unregistered securities, and granted summary judgement for the Everest, the insurer. Id., *affirmed,* Saoud v. Everest Indemnity Insurance Company 2022 WL 2758274 (6th Cir. 2022).

Again, policy language matters, and some have broader exclusion language than others and can yield different results in coverage. Compare, Great American Fidelity Insurance Company v. Stout Risius Ross, Inc. 438 F.Supp.3d 779 (EDMI 2020("This Policy does not apply to any Claim ... based on or arising out of actual or alleged violation of ... (1) The Employee Retirement Income Security Act of 1974; (2) The Securities Act of 1933"- arising out of is a cause-and-affect relationship; and claims for negligent misrepresentation and fraud do not arise out of the statutory violation) with Isroff v. Federal Insurance Co., 25 F.3d 1048, 1994 WL 253027 (6th Cir. June 8, 1994) and Bendis v. Federal Insurance Co., 958 F.2d 960, 961 (10th Cir. 1991)(Isroff and Bendis courts excluded coverage because of policy language that stated "where all or part of such claim is directly or indirectly, based on, attributable to, arising out of, resulting from or in any manner related to any actual or alleged violation" of securities laws. See 1994 WL 253027, at 1; 958 F.2d at 961.

Query whether some securities act violations may be covered in those states where the scienter element to prove a statutory violation is based on one of negligence. See. Eg In re Harris, 3 F3d 1339 (11th Cir 2021); Gochnauer v. A.G. Edwards & Sons, Inc., 810 F.2d 1042, 1046 (11th Cir. 1987) (citing Merrill Lynch, Pierce, Fenner and Smith v. Byrne, 320 So.2d 436, 440 (Fla. 3d DCA 1975)).

In insurance coverage disputes, though the pleadings are just the starting point for insurers to determine if they will provide a defense, ultimately, the insured has the duty to prove coverage, the insurer has the duty to prove exclusions from coverage and the insured then has the burden to prove exceptions from coverage. See Great Lakes Insurance vs. Wave Cruiser, 36 F4th (11th Cir 2022)(burden to prove exception to exclusion on insured); AMCO Insurance Company v. Van Laningham & Associates, PLLC 2022 WL 2813041(EDNC 2022)(insured bears the burden to prove coverage); Century Sur. Co. v. Hardscape Constr. Specialties, Inc., 578 F.3d 262, 265 (5th Cir. 2009)(insured has the burden to prove coverage, the insurer has burden to prove exclusions, and the insured has the burden to prove exceptions to coverage exclusions.);Barnes v. American Intern. Life Assur. Co. of NY, 681 FSupp 513 (SDNY 2010)(insured's burden to prove loss is covered by the policy); Fajardo Shopping Ctr., S.E. v. Sun Alliance Ins. Co. of Puerto Rico, Inc., 999 F.Supp. 213, 224 (D.P.R.1998) aff'd, 167 F.3d 1 (1st Cir.1999);(burden to prove exclusion's applicability on insurer); Spirtas Co. v. Fed. Ins. Co., 481 F.Supp.2d 993, 997

(E.D.Mo.2007)(Under Missouri law, burden in insurer to prove that an exclusion applies); Capitol Indem. Corp. v. 1405 Assocs., Inc., 340 F.3d 547, 550 (8th Cir.2003) (same); Charles Beseler Co. v. O'Gorman & Young, Inc., 188 N.J. 542, 911 A.2d 47, 49 (2006) (same, per curia;). Ironshore Specialty Ins. v. Callister, Nebeker & McCullough, P.C., 2017 WL 6550678, at *5 (D. Utah Dec. 21, 2017) (After an insurer meets its burden that an exclusion applies, the insured must prove an exception to the exclusion); Williams v. SIF Consultants of Louisiana, Inc., 133 So.3d 707, 712 (La.App. 3 Cir.,2014)(burden to prove loss comes within an exclusion is on the insurer.); Neal-Pettit v. Lahman, 125 Ohio St.3d 327, 928 N.E.2d 421, 424 (2010) (citing Cont'l Ins. Co. v. Louis Marx & Co., 64 Ohio St.2d 399, 415 N.E.2d 315, 317 (1980))("insurer—not the insured—bears the burden to prove that the exclusion "specifically applies.")

VII. <u>Policy Limits.</u> Most policy limits on a declaration's page of the policy will show two numbers. The first number is normally the maximum dollar amount for damages or expenses paid for a single incident or occurrence. The second number is normally the "aggregate" or the total dollar amount the policy will pay during a policy term, no matter the number of incidents or occurrences. In a typical "claims made" policy for a broker dealer, designed to last one year, the limits are for all claims brought to the carrier during that year. In an occurrence policy, the policy covers a particular time period, and the claim could be made outside of that time period and still be covered. This is why occurrence policies are more expensive than claims made policies, because the extend the period within which a claim may be made. Some broker dealers may only carry a $1 million/$2 million policy, meaning that the total the insurance company will pay out to all customers in that year is $2 million, so it is important for the securities practitioner to try to learn the total number and value of all claims, and to know the financials of the broker dealer, which can be found by examining the "Focus Report" (aka Form x-17a-5) filed annually with the SEC.[36]. FOCUS Reports contain the basic financial and operational reporting required of those brokers or dealers, each of whom must meet a minimum net capital requirement as set for by Rule 15c3-1.[37]

One of the significant issues that securities practitioners will experience is where the insurer invokes the "related acts" clause to limit all claims to just the single policy limit, and not the "aggregate" policy limit. Therefore, the securities practitioner must be prepared to argue why the related acts limitation does not apply. This practitioner successfully sued an insurance company to obtain the aggregate policy limits in a settlement from an insurance company after a broker dealer closed their doors and the insurance carrier claimed that all benefits had been fully paid.

In multiple customer cases that are in excess of policy limits, an insurer may choose to settle with less than all claimants until the policy is exhausted, and some states permit this practice, so long as it is not done in bad faith. See In re September 11 Property Damage Litigation, 2011 WL 1331847, at *6 (2nd Cir. April 11, 2011) (quoting Allstate Ins. Co. v. Russell, 788 N.Y.S.2d 401, 402 (N.Y. App. Div. 2004)). "An insurer may…'settle with less than all of the claimants under a particular policy even if such settlement exhausts the policy proceeds.' " Id. (quoting STV Grp., Inc. v. Am. Cont'l Props., Inc., 650 N.Y.S.2d 204, 205 (N.Y. App. Div. 1996)). "Such settlements are not 'voluntary' or 'additional insurance,' but rather 'reduc[e] the liability remaining under the policy.' " Id. (quoting Duprey v. Security Mut. Cas. Co., 256 N.Y.S.2d 987, 989 (N.Y. App. Div. 1965)). "[U]nder New York State law, an insurer has discretion to settle whenever and with whomever it chooses, provided it does not act in bad faith." Id. (citing Allstate, 788 N.Y.S. at 402)."

[36] https://www.sec.gov/files/formx-17a-5_3.pdf

[37] https://www.finra.org/sites/default/files/SEA.Rule_.15c3-1.Interpretations.pdf

In Texas Farmers Ins. Co. v. Soriano, 881 S.W.2d 312 (Tex. 1994), the Texas Supreme Court held in Soriano that "when faced with a settlement demand arising out of multiple claims and inadequate proceeds, an insurer may enter into a reasonable settlement with one of the several claimants even though such settlement exhausts or diminishes the proceeds available to satisfy other claims." 881 S.W.2d at 315; See also, Miller v. Ga. Interlocal Risk Mgmt. Agency, 232 Ga.App. 231, 501 S.E.2d 589 (1998)(" a liability insurer may, in good faith and without notification to others, settle part of multiple claims against its insured even though such settlements deplete or exhaust the policy limits so that remaining claimants have no recourse against the insurer."); DeMarco v. Travelers Insurance Company, 26 A.3d 585 (R.I. 2011)[38], Castoreno vs. Western Indem Co Inc. 515 P2d 789 (KS 1973).

Similarly, in Florida, "where multiple claims arise out of one accident, the liability insurer has the right to enter reasonable settlements with some of those claimants, regardless of whether the settlements deplete or even exhaust the policy limits to the extent that one or more claimants are left without recourse against the insurance company." Farinas v. Fla. Farm Bureau Gen. Ins. Co., 850 So. 2d 555, 560 (Fla. 4th DCA 2003) (quotation omitted). An insurer even has the right "to settle certain claims to the exclusions of others, provided this decision [was] reasonable and in keeping with its good faith duty." Id. at 561. But the duty of good faith still requires that an insurer "fully investigate all claims arising from a multiple claim accident," and "minimize the magnitude of possible excess judgments against the insured by reasoned claim settlement." Gen. Sec. Nat'l Ins. Co. v. Marsh, 303 F. Supp. 2d 1321, 1325 & n.17 (M.D. Fla. 2004) (citing Florida cases).

VIII. Policy Limit Demands. A useful tool in the securities practitioner's arsenal is the policy limit demand letter. If sent timely and well crafted, a policy limit demand letter can force an insurer to closely examine the case and force a settlement, lest the insurer open itself up to a bad faith claim. Needless to say, the practitioner should get the client's consent to make the demand, and make it clear that the demand for policy limits may be for less than the full value of the case. But, in situations where there are multiple claims and a policy that is declining, a well-executed policy limits demand may be better than waiting until all the policy limits have been exhausted on other claims.

Before making the demand, a smart lawyer will reach out to find out how much coverage is left on the policy, as many policy limits decline dollar for dollar due to payment of attorneys fees and expenses. The carrier will require consent from the insured, and a smart defense lawyer and a smart insurer will not open themselves to liability by counseling his client to refuse consent. Indeed, in Boicourt v. Amex Ins. Co. 78 Cal.App.4th 1390, 1392(2000) the court held it can be bad faith to neglect to seek the insured's consent to disclose the limit since a failure to do so inhibits the chances of the case settling within the policy limit.

The law generally obligates insurance companies to use good faith to investigate and settle claims, especially where liability is clear and the amount of the judgment is "likely" to exceed the policy limits declared in the policy. See generally, Haddick v. Valor Ins., 198 Ill.2d 409, 261 Ill.Dec.

[38] "W]hen an insurer is faced with multiple claimants with claims that in the aggregate exceed the policy limits, the insurer has a fiduciary duty to engage in timely and meaningful settlement negotiations in a purposeful attempt to bring about settlement of as many claims as is possible, such that the insurer *614 will thereby relieve its insured of as much of the insured's potential liability as is reasonably possible given the policy limits and the surrounding circumstances."

329, 763 N.E.2d 299, 303 (2001)(Insurer has a duty to settle in good faith);[39] Huitron v. Kaye, 2022 WL 36519472022 (UT 2022)(same); Schlusselberg v. New York Central Mutual Fire Insurance Company, 206 A.D.3d 682 (NY Sup Ct 2022)(same); State ex rel. Kilroy Was Here, LLC v. Moriarty, 633 S.W.3d 406 (EDMO 2021)(same); Hedayati v. Interinsurance Exchange of the Automobile Club 67 Cal.App.5th 833(Cal 4th Dist. 2021)(same); GEICO Indemnity Company v. Whiteside, 311 Ga. 346 (GA 2021)(same); State Farm Mutual Automobile Insurance Company v. Goddard, 484 P.3d 765 (CO 2021)(same): Gruber v. Estate of Marshall, 59 Kan.App.2d 297 (KS 2021)(same); Hiland Partners Holdings, LLC v. National Union Fire Insurance Company of Pittsburgh, PA, 475 P.3d 869 (KS 2020); Chiulli v. Liberty Mutual Insurance, Inc. 97 Mass.App.Ct. 248 (MA 2020)(insured's liability is not clear if there is a legitimate difference of opinion on the extend of liability or a good faith disagreement over amount of damages); Rawan v. Continental Casualty Company, 483 Mass. 654 (MA 2019)(duty of good faith efforts to investigate); Mutual of Enumclaw Insurance Company v. Myong Suk Day Court of Appeals of Washington, 197 Wash.App. 753 (WA 2017)(insurer has "enhanced obligation of fairness" toward insured beyond contractual good faith); Kelly v. State Farm Fire & Cas. Co. 169 So.3d 328 (LA 2015)(insurer can be liable for bad faith even without settlement offer or for misrepresenting facts unrelated to coverage).

Therefor, the best practice for the practitioner in writing a policy limits demand letter is to write it in such a fashion to convince the carrier that 1) there is a clear case of liability on at least some of the claims; 2) that the likely damages will exceed the policy limits; 3) that the demand offers a full and final release of all claims; 4) that there are no third parties needed to approve the settlement; 5) set a reasonable deadline for acceptance of the claim; 6) that the demand, if not accepted, will not be repeated; 7) that you will not contact the carrier to remind it of the upcoming deadline to accept the demand; 8) make sure the letter is addressed correctly and arrives; 9) remind the carrier of its obligation to notify the insured of the demand before accepting or rejecting it; and finally 10) as the carrier to contact you immediately if for any reason that the insurer cannot accept the demand by the deadline because of any missing crucial information. [40] See also, 14 Couch, Insurance § 203:15, at 203–25 (3d ed.2008)(" "An insurer has a duty ... to respond to settlement offers within policy limits by the deadline prescribed in the offer ... provided that the time allotted for acceptance is reasonable. What constitutes a reasonable time depends upon the circumstances of the particular case. Whether an insurer has acted in bad faith by failing to settle a claim within the time limits unilaterally imposed by a plaintiff is a question for the finder of fact.").

If the insurance company fails to settle the case in good faith, where there is a clear case of liability and the claim exceeds the policy limits, then the insurer can be exposed to pay all damages awarded against its insured. See e.g. Gore v. Arbella Mutual Insurance Company, 932 NE 2d 837 (MA 2010)Carrier waited five months to respond to a 30 day demand letter to claim it was looking at other claims in the same incident; since liability was clear and damages exceeded limits carrier was found to have acted in bad faith and the full damages as set forth in the settlement agreement with the insured would be awarded); Truck Insurance Exchange v. Prairie Framing, LLC, 162 S.W.3d 64, 94 (Mo.App.2005)("An insurer that assumes control of the right to settle claims against its insured may become liable in excess of the policy limits if it fails to exercise good faith in considering an offer to compromise the claim for an amount within the policy limits.");

[39] . See also Cramer v. Insurance Exchange Agency, 174 Ill.2d 513, 526, 221 Ill.Dec. 473, 675 N.E.2d 897 (1996) (failure of insurer to act in good faith to settle claim exposes carrier to liability for the full amount of a judgment regardless of policy limits);

[40] . See generally, https://www.plaintiffmagazine.com/recent-issues/item/the-letter-perfect-policy-limit-demand-letter

Johnson v. Hardware Mutual Casualty Company, 109 Vt. 481, 1 A.2d 817, 821–22 (Vt.1938))("bad faith on the part of the insurer would be the intentional disregard of the financial interest of the insured in the hope of escaping the responsibility imposed upon it by its policy." Boling v. New Amsterdam Casualty Company, 173 Okla. 160, 46 P.2d 916, 919 (Okla.1935))(("[An] insurer must act honestly to effectually indemnify and save the insured harmless as it has contracted to do—to the extent, if necessary, that it must make whatever payment and settlement an honest judgment and discretion dictate, within the limits of the policy[.]' ")

IX. Assignment of Bad Faith Rights. Assuming that the insurance carrier has rejected or failed to respond to the demand letter, and, upon winning an arbitration award that cannot be paid by the respondent or its carrier, the securities arbitration practitioner may decide to enter into a post award assignment of bad faith rights. Or, in another scenario, if the carrier has refused to defend the respondent, the carrier has provided a defense under a reservation of rights, and the respondent likewise is likely unable to pay an award, a pre-award assignment of bad faith rights agreement can be reached.

According to one court, "[the weight of authority favors the assignment of an insured's right of recovery against the insurer for the wrongful refusal to settle a claim within the policy limits." Glenn v. Fleming, 27 Kan. 29 (KS 1990)[41], citing, DiMarzo v. American Mutual Ins. Co., 389 Mass. 85, 93 n. 8, 449 N.E.2d 1189 (1983) ("overwhelming weight" of authority, according to the Massachusetts Supreme Court), Kagele v. Aetna Life, 40 Wash.App. 194, 197, 698 P.2d 90 (1985), Annot., 12 A.L.R.3d 1158; Jerry, Understanding Insurance Law § 25G[d], p. 125 (1987), Shernoff, Gage & Levine, Insurance Bad Faith Litigation § 3.06[1] p. 3–33 (Matthew Bender 1990), and Wall, Litigation and Prevention of Insurer Bad Faith § 7.02, pp. 245–46 (1985). "The arguments for permitting assignments of bad faith and negligent defense actions are: (1) Breach of contract actions are not personal to the insured; (2) the insured is prevented from filing bankruptcy when faced with an excess judgment; (3) the injured plaintiff is compensated; (4) settlements between the injured plaintiff and the insured are fostered; (5) the injured plaintiff is allowed to sue the insurer directly, thus simplifying the process; and (6) the possibility of collusion between the injured plaintiff and the insured is not increased." See Glenn V. Fleming 799 P2d at 90, citing 12 ALR 3d at 1159-60.

The best practice is to engage the services of a mediator, and conduct the mediation in good faith.[42] The parties can stipulate that the mediator should determine the value of the claim, and the parties then settle based on the finding by the mediator. That stipulation for settlement reached in mediation is then sent to the arbitrators to enter an award on the mediated settlement.

Or, alternatively, the parties can proceed to the final hearing and have the arbitrators make the award after an adversarial hearing. Either way, the goal is for the parties to avoid an award that has any taint of collusion. See e.g. Romstadt vs. Allstate, 844 FSupp 361 (NDOH 1994)(bad faith claim based on assignment of benefits was collusive where the parties simply stipulated to a final

[41] "[a] nonjury verdict judgment may be enforced against an insurer contingent upon proving bad faith or negligence in a refusal to settle. The assignment/covenant not to sue may be utilized if the judgment is reasonable in amount and entered into in good faith." Id. at 93. Further, "an insured's breach of contract claim for bad faith or negligent refusal to settle may be assigned." Id. at 91.

[42] "In Alabama, when an insurer has a right to defend its insured, receives notice of settlement negotiations, and refuses to participate, the insurer waives the right to assert the no-action clause in a later suit to determine coverage." Twin City Fire Insurance Co. v. Ohio Casualty Insurance Co., 480 F.3d 1254, 1258 (11th Cir. 2007).

judgment; there must be a "recovery" to trigger the duty to indemnify). "Because a covenant judgment presents the potential for fraud or collusion between the settling parties, the settlement is subject to a reasonableness hearing in superior court pursuant to RCW 4.22.060(1)." See Wood v. Milionis Construction Inc. 492 P3d 813 (WA 2021); Wood v. Milionis Construction Inc. 42 P3d 813 (WA 2021)(covenant not to sue raises the issue of collusion).

In Water's Edge Homeowners Assoc. v. Water's Edge Associates, the court found a stipulated judgment was unreasonable because, "1) counsel for the plaintiff contacted the defendants without notice to the insurance-appointed defense counsel and recommended the defendants obtain independent counsel, (2) the parties realigned their interests by stipulating that [the defendants] could recover their $215,000 contribution if the [plaintiff] prevailed in its malpractice and bad faith case [against the insurer], and (3) neither of the defendants "had any reason to care what dollar amount they agreed to, so long as they could sell it to the trial court as reasonable."" Water's Edge Homeowners Ass'n v. Water's Edge Associates216 P.3d 1110 (WA 2009), quoted by Wood v. Milionis Construction Inc. 42 P3d 813 (WA 2021). The Water's Edge case is fair guidance on what not to do in these situations.

The practitioner is cautioned that some policies will contain a "non-assignment" clause prohibiting the assignment of the policy to anyone without the insured's consent. But, states while it appears that some states will enforce a "pre-loss" ban on assignments, they will disregard the non-assignability clause in "post-loss" situations. This principle is best stated by Bentley v. Standard Fire Insurance Co., 40 W.Va. 729, 23 S.E. 584 (1895): "Where a policy of insurance provides that it shall be void if assigned without the insurer's consent, the clause applies to assignment before loss of the claim for damages in case of loss." See also Smith v. Buege, 387 SE 2d 109 (WV 1989). Other courts, have found that even if there is a policy clause banning "post-loss" assignments, they will still permit a claim for bad faith to proceed, "where the insurer beaches a duty to the insured and the assignment is of the cause of action to recover damages for that breach." Negri v. Nationwide Mut. Ins Co 2011 WL 041214 (WV 2011), citing, See Henkel Corp. v. Hartford Accident and Indemnity Co., 29 Cal.4th 934 (2003).

There is no perfect form of an assignment of bad faith rights. First, the practitioner must check his state insurance laws and local law to review any specific limitations or requirements to meet within the assignment. Second, the practitioner must make every effort to ensure that the arbitration award is not tainted by any collusion or fraud. Third, the assignment should include a "reasonable cooperation clause" so that the insured will make themselves available for deposition or trial and to "tell the truth." Fourth, the agreement generally will recite consideration that the claimant will not execute on the judgment upon the personal assets of the respondent. Fifth, the assignment will contain the "covenant not to sue" and not a release. A covenant not to execute coupled with an assignment and settlement agreement, is not a release permitting the insurer to escape its obligation. See Kagele v. Aetna Life & Casualty, 40 Wash.App. 194,198 (1985), cited by Logg v. Tig Insurance Company, 2011 WL 2718092 (WDWA 2022). Other courts likewise have found that a covenant not to execute does not equate to a release or excuse liability, but a full release does. See Genesis Ins. Co. v. Crowley, 495 F. Supp. 2d 1110, 1120 (D. Colo. 2007) ("I agree with those courts that have considered similar language and concluded that where, as here, a covenant not to execute is not accompanied by a release of liability, amounts awarded under a consent judgment remain a legal obligation.") (emphasis added) (collecting cases); In re Feature Realty Litig., 634 F. Supp. 2d 1163, 1168 (E.D. Wash. 2007) ("The vast majority of Courts follow the rule that the insured remains 'legally obligated to pay' because a covenant not to execute coupled with an assignment and settlement agreement is a contract and 'not a release permitting the insurer to escape its obligation.' ") (quoting Kagele v. Aetna Life & Cas. Co., 40 Wash. App. 194, 198, 698 P.2d 90 (1985)); Clock v. Larson, 564 N.W. 2d 436, 436–38 (Iowa 1997) ("[W]hen there is a

full release[,] there is no further liability owed by the insurance company to its insured, and therefore the insured has no right to recover against the insurance company which can be assigned to the injured party."); State Farm Mut. Auto. Ins. Co. v. Paynter, 122 Ariz. 198, 593 P.2d 948, 953 (1979) (holding that a covenant not to execute is not a release from liability, however, if it were to find otherwise, the court would "wholly undermine the purpose of such agreements[.]"); Cf. Red Giant Oil Co. v. Lawlor, 528 N.W.2d 524, 531 (Iowa 1995) (holding that a covenant not to execute is not a release); but see Gray v. Grain Dealers Mut. Ins. Co., 871 F.2d 1128, 1133 (D.C. Cir. 1989).

So, in drafting, it is important NOT to give a full release to the respondent, and only provide a covenant not to sue or execute on the judgment. Sixth, it is important to express that the respondent was represented by counsel, and that the there are no verbal agreements outside of the assignment. After obtaining the assignment, the claimant can then obtain the arbitration award, confirm it to a judgment and then proceed to file a new lawsuit in court for bad faith against the insurance company.[43]

[43] . Bad faith litigation is a complicated area of law, and is outside the scope of this article.



☐ **Westchester Surplus Lines Insurance Company**
☐ **Illinois Union Insurance Company**
☐ **INA Surplus Insurance Company**

ACE Advantage Securities Broker-Dealer Professional Liability Insurance Policy

In consideration of the payment of premium, in reliance upon the **Application**, and subject to the Declarations and the terms and conditions of this **Policy**, the **Insureds** and the **Insurer** agree as follows:

I. INSURING AGREEMENTS

A. **Insured Broker-Dealer** Liability

The **Insurer** shall pay on behalf of the **Insured Broker-Dealer** all **Loss** which the **Insured Broker-Dealer** becomes legally obligated to pay by reason of any **Claim** first made against the **Insured Broker-Dealer** during the **Policy Period**, or, if elected, the **Extended Reporting Period**, and reports to the **Insurer** pursuant to the terms of this **Policy**, for any **Wrongful Acts** taking place after the **Retroactive Date** but prior to the end of the **Policy Period**:

1. in rendering or failing to render **Professional Services** by the **Insured Broker-Dealer**; or,
2. in failing to supervise an **Insured Registered Representative** in the rendering or failing to render **Professional Services** by such **Insured Registered Representative**.

B. **Insured Registered Representative** Liability

The **Insurer** shall pay on behalf of the **Insured Registered Representative** all **Loss** which the **Insured Registered Representative** becomes legally obligated to pay by reason of any **Claim** first made against the **Insured Registered Representative** during the **Policy Period**, or, if elected, the **Extended Reporting Period**, and reports to the **Insurer** pursuant to the terms of this **Policy**, for any **Wrongful Acts** taking place after the **Retroactive Date** but prior to the end of the **Policy Period**.

C. **Cost of Corrections Expenses**

The **Insurer** shall pay on behalf of the **Insureds** all **Cost of Corrections Expenses** which the **Insured** incurs by reason of a **Cost of Corrections Claim** during the **Policy Period**, and reports to the **Insurer** pursuant to the terms of this **Policy**, to correct any **Wrongful Act** of the **Insureds** taking place during the **Policy Period**. It is a condition precedent to coverage under this Insuring Agreement C that:

1. if not corrected, such **Wrongful Act** would have resulted in a **Claim** (as defined in Section III, Definitions, subsection B, **Claim**, paragraphs 1 or 2) for which such **Insured** would be liable and which, in the absence of any correction, would be covered under this **Policy**;
2. the **Wrongful Act** arises solely out of such **Insured's** failure to follow the directions of a customer or client in connection with the investment of the assets of such customer or client, resulting in either: (i) the erroneous execution and/or settlement of a transaction; or, (ii) the alleged failure to execute a transaction; and,
3. coverage as is afforded under this Insuring Agreement C is specifically excess over any other indemnification or valid insurance available from any source and shall only drop down and be primary insurance in the event of exhaustion of such other insurance due to **Loss** paid hereunder.

II. DEFENSE, INVESTIGATION AND SETTLEMENT

A. The **Insurer** shall have the right and duty to defend any **Claim** covered by this **Policy**, even if the allegations in the **Claim** are groundless, false or fraudulent. The **Insurer's** duty to defend, and obligation to settle or pay, shall cease upon exhaustion of the applicable Limit of Liability under this **Policy** as set forth in Item 3 of the Declarations. **Defense Costs** under this **Policy** shall be part of, and not in addition to, the applicable Limit of Liability.

APPENDIX A

B. The **Insurer** shall have the right to make any investigation it deems necessary with respect to any **Claim** under this **Policy** and to assign defense counsel as it deems appropriate. The **Insurer** shall have the right to make, with the written consent of the **Insured**, which shall not be unreasonably withheld, any settlement of a **Claim** under this **Policy**. If the **Insured** refuses to consent to any settlement recommended by the **Insurer** and deemed acceptable to the claimant, the **Insurer** may then withdraw from the defense of the **Claim** by tendering control of the defense to the **Insured**, and the **Insured** shall thereafter at its own expense negotiate or defend such **Claim** independently of the **Insurer**, and the **Insurer's** liability shall not exceed the amount of damages for which the **Claim** could have been settled if such recommendation was consented to, plus **Defense Costs** incurred by the **Insurer**, and **Defense Costs** incurred by the **Insured** with the **Insurer's** prior written consent, up to the date of such refusal.

C. The **Insured** agrees not to settle or offer to settle any **Claim**, incur any **Defense Costs** or otherwise assume any obligation or admit any liability with respect to any **Claim** without the **Insurer's** prior written consent. The **Insurer** shall not be liable for any settlement, **Defense Costs**, assumed obligation or admission to which it has not consented.

D. The **Insured** agrees to provide the **Insurer** and defense counsel with all information, assistance and cooperation which the **Insurer** or defense counsel reasonably requests, and agrees that in the event of a **Claim**, the **Insured** will do nothing that shall prejudice the **Insurer's** position or its potential or actual rights of recovery. The **Insurer** may make any investigation it deems necessary.

III. DEFINITIONS

When used in this **Policy**:

A. **Application** means all applications, including any attachments thereto, and all other information and materials submitted therewith or incorporated therein by or on behalf of the **Insureds** to the **Insurer** in connection with the **Insurer** underwriting this **Policy** or any policy of which this **Policy** is a direct or indirect renewal or replacement or which it succeeds in time. **Application** also includes any public documents filed by the **Insured Broker-Dealer** with any federal, state, local or foreign regulatory body or self-regulatory body, including but not limited to the Securities and Exchange Commission and the Financial Industry Regulatory Authority. All such applications, attachments, information and materials are deemed attached to and incorporated into this **Policy**.

B. **Claim** means:

1. a written demand for monetary damages or non-monetary or injunctive relief;

2. a civil, mediation or arbitration proceeding for monetary damages or non-monetary or injunctive relief, commenced by service of a complaint or similar pleading; or,

3. a **Cost of Corrections Claim**.

C. **Cost of Corrections Claim** means a written report submitted by the **Insured** to the **Insurer** seeking the payment of **Cost of Corrections Expenses** to correct: (i) the erroneous execution and/or settlement of a transaction; or, (ii) the alleged failure to execute a transaction.

D. **Cost of Corrections Expenses** means reasonable and necessary costs, charges, fees and expenses incurred by the **Insured** in correcting: (i) the erroneous execution and/or settlement of a transaction; or, (ii) the alleged failure to execute a transaction. **Cost of Corrections Expenses** do not include wages, salaries, fees or other compensation of natural person **Insureds** or employees of entity **Insureds**.

E. **Defense Costs** means reasonable and necessary costs, charges, fees and expenses incurred by any **Insured** in defending **Claims** and the premium for appeal, attachment or similar bonds arising out of covered judgments, but with no obligation to furnish such bonds. **Defense Costs** do not include wages, salaries, fees or other compensation of natural person **Insureds** or employees of entity **Insureds**.

F. **Insured** means, collectively or singly:

1. an **Insured Broker-Dealer**; and
2. an **Insured Registered Representative**.

G. **Insured Broker-Dealer** means:

1. the **Named Insured**, any **Subsidiary**, and any **Insured Broker-Dealer** added by endorsement; and
2. any past, present or future director, officer, partner or employee of an entity set forth in paragraph 1 immediately above.

However, **Insured Broker-Dealer** does not include an **Insured Registered Representative**.

H. **Insured Registered Representative** means:

1. any natural person who was, on or before the inception date of the **Policy**, a duly licensed and registered representative or registered principal of the **Insured Broker-Dealer** in good standing with the Financial Industry Regulatory Authority, and who, for compensation, engages in the business of rendering **Professional Services** on behalf of the **Insured Broker-Dealer**;
2. subject to Section II, Definitions, subsection Q, **Subsidiary**, any natural person who becomes after the inception date of this **Policy**, a duly licensed and registered representative or registered principal of the **Insured Broker-Dealer** in good standing with the Financial Industry Regulatory Authority, and who, for compensation, engages in the business of rendering **Professional Services** on behalf of the **Insured Broker-Dealer**; or,
3. any corporation, partnership, or other business entity which engages in the conduct of **Professional Services** and which is either owned or controlled by an **Insured Registered Representative** as defined in paragraphs 1 or 2 immediately above, or in which an **Insured Registered Representative** as defined in paragraphs 1 or 2 immediately above, is an employee, and which is not an **Insured Broker-Dealer**. The coverage granted pursuant to this paragraph 3 shall only apply to the vicarious liability arising out of a **Wrongful Act** by an **Insured Registered Representative** as defined in paragraphs 1 or 2 immediately above, in rendering or failing to render **Professional Services**, and no coverage shall be provided for any **Wrongful Act** of an **Insured Registered Representative** as defined in this paragraph 3.

I. **Interrelated Wrongful Acts** means all **Wrongful Acts** that have as a common nexus any fact, circumstance, situation, event, transaction, cause or series of related facts, circumstances, situations, events, transactions or causes.

J. **Loss** means the damages, judgments, any award of pre-judgment and post-judgment interest, settlements and **Defense Costs** which the **Insureds** become legally obligated to pay on account of any **Claim** first made against any **Insured** during the **Policy Period**, or, if elected, the **Extended Reporting Period**, for **Wrongful Acts** to which this **Policy** applies. **Loss** does not include:

1. any amount for which the **Insured** is not financially liable or which is without legal recourse to an **Insured** or for which the **Insured** is absolved from payment;
2. taxes, fines or penalties;
3. any amount incurred by any **Insured** in a proceeding or investigation that is not at that time a **Claim**, even if such amount also benefits the defense of a **Claim** and even if such proceeding or investigation subsequently gives rise to a **Claim**;
4. fees, commissions, charges, or other compensation, including compensation paid to or claimed by an **Insured** for **Professional Services**;
5. matters uninsurable under the laws pursuant to which this **Policy** is construed; and,

6. the cost of any remedial, preventive or other non-monetary relief, including without limitation, any costs associated with compliance with any relief of any kind or nature imposed by any judgment, settlement, or governmental authority.

Loss includes punitive and exemplary damages and the multiplied portion of any multiple damage award, to the extent such damages are insurable under the internal laws of the applicable jurisdiction that most favors coverage for such damages.

Loss also means the **Cost of Corrections Expenses** incurred on account of any **Cost of Corrections Claim** during the **Policy Period** by the **Insured**.

K. **Named Insured** means the organization named in Item 1 of the Declarations.

L. **Policy** means, collectively, the Declarations, the **Application**, this policy form and any endorsements attached hereto.

M. **Policy Period** means the period of time specified in Item 2 of the Declarations of this **Policy**, subject to prior termination in accordance with Section XIII, Termination of the **Policy**.

N. **Professional Services** means the following services performed by an **Insured** for or on behalf of a customer or client of the **Insured Broker-Dealer** pursuant to a written agreement between the **Insured Broker-Dealer** and the customer or client for consideration inuring to the benefit of the **Insured**:

1. the purchase or sale of securities, annuities, life insurance, and/ or accident and health insurance; and,

2. brokerage services for individual retirement accounts, Keogh retirement plans and employee benefit plans (other than multiple employer or multi-employee welfare arrangements),

provided that such services:

a. have been approved by the **Insured Broker-Dealer** to be performed by such **Insured**;

b. (i) are performed by such **Insured** in connection with the purchase or sale of securities which have been approved by the **Insured Broker-Dealer** to be transacted through such **Insured**; or, (ii) performed by an **Insured Registered Representative** in connection with the purchase or sale of insurance and annuity products so long as such products have been disclosed by the **Insured Registered Representative** to the **Insured Broker-Dealer** as an outside business activity and such products have been approved by the **Insured Broker-Dealer**. Notwithstanding anything in this definition to the contrary, and solely with respect to (b)(ii) immediately above, such services performed by the **Insured Registered Representative** shall not be required to be performed for or on behalf of a customer or client of the **Insured Broker-Dealer**; and,

c. are performed by an **Insured** that has obtained all licenses required by the **Insured Broker-Dealer**, applicable law, and/or applicable regulation.

Professional Services do not include:

a. services performed as a **Registered Investment Advisor**, unless such coverage is specifically added to this **Policy** by endorsement; or,

b. advice relating to personal risk management or taxes, or the preparation of financial plans, personal financial statements or tax returns.

O. **Registered Investment Advisor** means a natural person or entity registered as an Investment Advisor with the Securities and Exchange Commission and/or an applicable state securities regulatory department, who provides investment advice and/or management services to customers for a fixed fee, hourly fee or fee based on a percentage of assets managed.

P. **Retroactive Date** means the date stated in Item 6 of the Declarations.

Q. **Subsidiary** means any entity, in which the **Named Insured**:

1. owns interests representing more than 50% of the voting, appointment or designation power for the selection of a majority of the board of directors if such entity is a corporation, the management

committee members if such entity is a joint venture or partnership, or the members of the management board if such entity is a limited liability company; or,

2. has the right, pursuant to written contract or the by-laws, charter, operating agreement or similar documents of a company, to elect, appoint or designate a majority of the board of directors if such entity is a corporation, the management committee members if such entity is a joint venture or partnership, or the members of the management board if such entity is a limited liability company,

on or before the inception date of the **Policy**, either directly or indirectly, in any combination, by one or more other **Subsidiaries**.

If, during the **Policy Period**, the **Named Insured** acquires voting securities in another organization or creates another organization which as a result of such acquisition or creation becomes a **Subsidiary**, or acquires any organization by merger into or consolidation with the **Named Insured**, then, subject to the terms and conditions of this **Policy** including the following paragraphs of this definition, such organization and its directors, officers, partners or employees shall be covered under this **Policy** but only with respect to **Claims** for **Wrongful Acts** taking place after such acquisition or creation, unless the **Insurer** agrees to provide coverage by endorsement for **Wrongful Acts** taking place prior to such acquisition or creation.

If the total number of registered representatives registered and/or associated with such acquired or created organization, as reflected in documentation and information that the **Insurer** reasonably requests, exceeds 20% of the total number of registered representatives registered and/or associated with the **Named Insured** at the inception of the **Policy Period**, coverage shall be provided for such acquired or created organization for a period of 30 days after the effective date of such acquisition or creation, or until the end of the **Policy Period**, whichever is earlier, so long as the **Named Insured** gives written notice of such acquisition or creation to the **Insurer** prior to the end of the **Policy Period**. Coverage otherwise afforded under this paragraph for such acquired or created organization and its directors, officers, partners or employees shall terminate 30 days after the effective date of such acquisition or creation, or at the end of the **Policy Period**, whichever is earlier, unless the **Named Insured** agrees to and pays any additional premium required by the **Insurer**, and agrees to any additional terms and conditions of this **Policy** as required by the **Insurer**.

R. **Wrongful Act** means any actual or alleged act, error, omission, misstatement, misleading statement, neglect, or breach of duty by an **Insured** in connection with the rendering of or failure to render **Professional Services**.

The foregoing definitions shall apply equally to the singular and plural forms of the respective words.

IV. EXCLUSIONS

The **Insurer** shall not be liable for **Loss** on account of any **Claim** made:

A. alleging, based upon, arising out of, or attributable to any **Wrongful Act**, fact, or circumstance which has been the subject of any written notice given under any other policy of which this **Policy** is a renewal or replacement.

B. alleging, based upon, arising out of, or attributable to any **Wrongful Act** first occurring before the applicable **Retroactive Date**, even when the **Wrongful Act** continued after such **Retroactive Date**.

C. for bodily injury, discrimination, sickness, disease or death of any person, or for damage to or destruction of any tangible property, including loss of use thereof, or for injury from a violation of a person's right of privacy.

D. alleging, based upon, arising out of, or attributable to:

1. any deliberately criminal or deliberately fraudulent act, error or omission, or any willful violation of any law of the United States or Canada, or state, province, territory, county, political division or municipality thereof, or any rules or regulations promulgated thereunder, in fact committed by an **Insured**; or,

2. an **Insured** gaining in fact any profit, remuneration or financial advantage to which such **Insured** was not legally entitled, including any actual or alleged commingling of funds or accounts.

E. brought by, on behalf of, or in the right of any **Insured**, the successors or assigns of any **Insured**, or

any trustee in bankruptcy; or by or on behalf of any subsidiary, affiliate, parent company, enterprise, trust or other entity that is operated or managed or owned, directly or indirectly, in whole or in part, by any **Insured**, or for which any **Insured** is a trustee, fiduciary, partner, principal, director, member of the board of managers or management board, officer or similar executive thereof; provided, however, that this exclusion shall not apply to any such **Claim** brought by, on behalf of, or in the right of any such person or entity in their capacity as a customer or client of the **Insured Broker-Dealer**.

F. for the actual or alleged breach of any oral, written or implied contract or agreement; provided, however, that this exclusion shall not apply: (i) if and to the extent that liability would have attached to the **Insureds** in the absence of such contract or agreement; or, (ii) to that portion of any **Claim** alleging negligence by the **Insureds**.

G. alleging, based upon, arising out of, or attributable to the rendering or failing to render **Professional Services** by the **Insured** as an actuary, accountant, tax preparer, attorney, real estate agent, real estate broker, property and/or casualty insurance agent, third party claims administrator, trustee, escrow agent, notary public or mortgage banker or broker.

H. brought by or on behalf of any clearing agency or brokerage firm, or based upon, arising out of, or attributable to any function of an **Insured** as a clearing agent.

I. alleging, based upon, arising out of, or attributable to any activities related to the exercise of discretionary authority with regard to the management or disposition of assets, whether for individuals, groups, employee benefit plans, or other entities of any legal form or character.

J. alleging, based upon, arising out of, or attributable to the insolvency, receivership, bankruptcy, conservatorship, liquidation or inability or refusal to pay of any broker or dealer in securities or commodities, clearing agency, bank or banking firm, or any insurance or reinsurance entity or any **Insured**; provided, however, that this exclusion shall not apply to: (i) **Wrongful Acts** solely in connection with any **Insured's** investment on behalf of the claimant in any stock of any foregoing entity other than an **Insured** or affiliate of the **Insured**; and, (ii) to an insurance entity which at the time the **Professional Service** which is the subject of the **Claim** was rendered, had a financial strength rating, as established by A.M. Best, of A- or better.

K. brought or maintained in any capacity by or on behalf of any governmental or quasi-governmental official, agency or self-regulatory organization, including without limitation the Securities and Exchange Commission, the Financial Industry Regulatory Authority, the Securities Investor Protection Corporation, or any state or federal securities or insurance commission, agency or official; provided, however, that this exclusion shall not apply to any **Claim** by such official, agency or organization in its capacity as a direct client of an **Insured**.

L. alleging, based upon, arising out of, or attributable to investment products partially or totally owned or controlled by any **Insured**, or to securities for which the **Insured** acts as a market maker.

M. alleging, based upon, arising out of, or attributable to the management, operation, condition or activities of any pension, profit sharing, health and welfare or other employee benefit plan or trust sponsored by the **Insured** or any entity owned or controlled by the **Insured** or in which the **Insured** is a participant, trustee or named fiduciary, as defined under Employee Retirement Income Security Act of 1974, as amended, or any other state, local or foreign employee benefit law; provided, however, that this exclusion shall only apply to an alleged or actual **Wrongful Act** in connection with a pension, profit sharing, or other employee benefit plan or trust established or maintained for the purpose of providing benefits to employees, principals, directors, officer, managers, or members of the board of managers or management board of entity **Insureds**.

N. alleging, based upon, arising out of, or attributable to the sale, attempted sale, or servicing of:

1. commodities, commodity future contracts, any type of option contract or derivative; provided, however, that this paragraph 1 shall not apply to protective puts and covered calls;

2. any collectible, including, but not limited to, stamps, art, sports or other cards, jewelry, coins, antiques or any other tangible personal property;

3. any equity securities priced under $5.00 at the time of the alleged **Wrongful Act** giving rise to such **Claim**, but this exclusion shall not apply if such securities are listed on the New York Stock

Exchange or the NASDAQ;

4. any security in any market outside the United States of America and its territories and possessions and Canada;

5. annuities used in connection with any structured settlement;

6. corporate owned life insurance or any other types of policies where the purchaser of the life product does not have a direct interest in the beneficiary under the life policy;

7. limited partnerships or real estate investment trusts not offered to an investor on a public exchange, unless such investor is an "accredited investor" as defined in Section 2(15) of the Securities Act of 1933; in no event, however, shall there be any coverage under this **Policy** for any **Claim** alleging, based upon, arising out of or attributable to any transaction involving the use of, or investment in, hedge funds of any kind; or,

8. viatical settlements, life settlements, reverse mortgages or similar transactions in which the present value of a conditional contract is exchanged or sold.

O. for **Wrongful Acts** in connection with an **Insured** giving advice, or performing services with respect to, any aspect of investment banking, including but not limited to, underwriting, syndicating or promoting any security or partnership interest in connection with any actual, alleged or threatened merger, acquisition, divestiture, tender offer, proxy contest, leveraged buy-out, public offering, going private transaction, reorganization, restructuring, recapitalization, spin-off, primary or secondary offering of securities whether public or private, dissolution or sale of all or substantially all of the assets or stock of a business entity, or effort to raise or furnish capital or financing for any enterprise or entity, or any acquisition or sale of securities by the **Insured** for its own account, or any activity by an **Insured** as a specialist or market maker for any securities, or any disclosure requirements in connection with any of the foregoing, including, but not limited to the rendering of advice or recommendations, or the rendering of a written opinion in connection with any of the foregoing.

P. alleging, based upon, arising out of or attributable to use by an **Insured** of, or an **Insured's** disclosure to another person of, or actual or alleged participating after the fact by an **Insured** in the use of non-public information in a manner prohibited by the laws of the United States, including without limitation Section 10(b) or 20(A) of the Securities Exchange Act of 1934 (as amended) and Rule 10b-5 thereunder, or the laws of any state, commonwealth, territory or subdivision thereof, or the laws of any other jurisdiction, or any rules or regulations promulgated under any of the foregoing.

Q. alleging, based upon, arising out of, or attributable to any mechanical or electronic failure, breakdown or malfunction of machines or systems, including hardware and software.

R. alleging, based upon, arising out of, or attributable to any **Asset Backed Security**, including but not limited to, the issuance, trade, underwriting, servicing, distribution, sale, offer to sell, purchase, or offer to purchase any **Asset Backed Security**. For the purpose of this exclusion, **Asset Backed Security** means any security based on, backed by, or collateralized by the cash flow of any pool of assets or revenues. **Asset Backed Securities** include, but are not limited to, collateralized receivable securities, mortgage-backed securities, and collateralized mortgage obligations.

S. alleging, based upon, arising out of, or attributable to the **Insured's** actual or alleged oral or written representations, promises, or guarantees regarding the performance or value, either past, present, or future, of any investment product.

T. alleging, based upon, arising out of, or attributable to, directly or indirectly, tenant in common exchanges, including but not limited to, 1031 tenant in common exchanges, any actual or attempted investment in, sale of, or servicing of, an interest in a security, partnership, real estate investment trust, product or other vehicle backed in any way by a tenant in common exchange, or the rendering or failure to render **Professional Services** in connection with a tenant in common exchange.

U. alleging, based upon, arising out of, or attributable to any activities of, or services provided by, an **Insured Registered Representative**, which is not a **Professional Service** rendered on behalf of the **Insured Broker-Dealer**, including, but not limited to, **Claims** against the **Insured Broker-Dealer** and/or the **Insured Registered Representative** arising out of or in any way relating to the "outside business activities" of, or "selling away" (as generally defined in (NASD) Notices to Members No. 01-

79) by an **Insured Registered Representative**.

V. with respect to Section I, Insuring Agreements, subsection C, **Cost of Corrections Expenses**, alleging, based upon, arising out of, or attributable to any **Wrongful Act** in the wire or electronic transfer of funds.

W. with respect to Section I, Insuring Agreements, subsection C, **Cost of Corrections Expenses**, for any **Wrongful Act** for which the **Insured** would not be liable pursuant to any contractual provision defining the scope of the **Insured's** liability or providing protection from liability including, without limitation, any applicable exculpatory provision.

X. with respect to Section I, Insuring Agreements, subsection C, **Cost of Corrections Expenses**, for any diminution in value of the money, securities, property or any other item of value.

Y. with respect to Section I, Insuring Agreements, subsection C, **Cost of Corrections Expenses**, alleging, based upon, arising out of, or attributable to the physical loss of money, securities or other property in the custody or control of such **Insured**.

V. SEVERABILITY OF EXCLUSIONS

For the purpose of determining the applicability of Section IV, Exclusions, subsection D, the **Wrongful Act** of any **Insured** shall not be imputed to other natural person **Insureds**.

VI. EXTENDED REPORTING PERIOD

A. If the **Insurer** or the **Named Insured** terminates or does not renew this **Policy** (other than for failure to pay a premium when due), the **Named Insured** shall have the right, upon payment of the additional premium set forth in Item 7.B. of the Declarations, to a continuation of the coverage granted by this **Policy** for an extended reporting period of one year following the effective date of such termination or nonrenewal ("**Extended Reporting Period**"), but only with respect to **Claims** first made during the **Extended Reporting Period** and arising from **Wrongful Acts** taking place prior to the effective date of such termination or nonrenewal. This right to continue coverage shall lapse unless the **Named Insured** gives written notice of such election and pays the **Extended Reporting Period** premium to the **Insurer** within 30 days following the effective date of termination or nonrenewal. A change in policy terms, conditions, exclusions and/or premiums shall not be considered a nonrenewal for purposes of triggering the right to the **Extended Reporting Period**.

B. The **Extended Reporting Period** is not cancelable and the entire premium for such **Extended Reporting Period** shall be deemed fully earned and non-refundable upon payment.

C. The Limit of Liability applicable to the **Extended Reporting Period**, if elected, shall be part of and not in addition to the applicable Limit of Liability shown in the Declarations for the immediately preceding **Policy Period**. The purchase of the **Extended Reporting Period** shall not increase or reinstate the applicable Limit of Liability, which shall be the maximum liability of the **Insurer** for such **Policy Period** and **Extended Reporting Period**, combined.

D. The **Extended Reporting Period** shall not apply to Section I, Insuring Agreements, subsection C, **Cost of Corrections Expenses**.

VII. REGISTERED REPRESENTATIVES

The **Insureds** acknowledge that the premium charged by the **Insurer** for this **Policy** is based, in part, upon the number of registered representatives registered, affiliated and/or associated with the **Insured Broker-Dealer** at the time the **Application** was submitted to the **Insurer**, and at the time of each renewal, if any, and that the premium set forth in Item 7 of the Declarations is a minimum premium that is not refundable in the event that the number of registered representatives decreases during the term of this **Policy** or any renewal hereof.

VIII. LIMIT OF LIABILITY AND RETENTION

A. All **Claims** arising out of the same **Wrongful Act** and all **Interrelated Wrongful Acts** of the **Insureds** shall be deemed to be one **Claim**, and such **Claim** shall be deemed to be first made on the date the earliest of such **Claims** is first made, regardless of whether such date is before or during the **Policy Period**. All **Loss** resulting from a single **Claim** shall be deemed a single **Loss**.

B. The Aggregate Limit of Liability stated in Item 3.A of the Declarations shall be the maximum aggregate limit of liability of the **Insurer** resulting from all **Claims** first made during the **Policy Period**.

C. Subject to the Aggregate Limit of Liability stated in Item 3.A of the Declarations, the maximum liability of the **Insurer** for all **Claims** under any one Insuring Agreement shall be the applicable Insuring Agreement Limit of Liability stated in Item 3.B, C or D of the Declarations.

D. Subject to the Aggregate Limit of Liability stated in Item 3.A of the Declarations and the applicable Insuring Agreement Limit of Liability stated in Item 3.B, C or D of the Declarations, the maximum liability of the **Insurer** for each **Claim** under an Insuring Agreement shall be the Per **Claim** Limit of Liability stated in Item 3.E, F or G of the Declarations.

E. **Defense Costs** and **Cost of Corrections Expenses** shall be part of and not in addition to the applicable Limit of Liability shown in the Declarations, and **Defense Costs** and **Cost of Corrections Expenses** shall reduce such applicable Limit of Liability. If the Limit of Liability is exhausted by payment of **Loss**, the obligations of the **Insurer** under this **Policy** shall be completely fulfilled and extinguished.

F. Except as otherwise provided in this section, the liability of the **Insurer** shall apply only to that part of **Loss** which is excess of the applicable Retention amount shown in Item 5 of the Declarations. Such **Retention** shall be borne uninsured by the **Insureds** and at their own risk. If different parts of a single **Claim** are subject to different applicable Retentions, the applicable Retentions will be applied separately to each part of such **Loss**, but the sum of such Retentions shall not exceed the largest applicable Retention.

IX. NOTICE

A. The **Insureds** shall, as a condition precedent to their rights under the **Policy**, give to the **Insurer** written notice of any **Claim**, other than a **Cost of Corrections Claim**, made against the **Insureds** as soon as practicable after the general counsel or risk manager, or equivalent positions, first learn of the **Claim**, but in no event later than: (i) the termination of the **Policy Period**, or, if elected, the **Extended Reporting Period**; or (ii) with respect to any **Claim** first made during the last 30 days of the **Policy Period**, or, if elected, the **Extended Reporting Period**, 30 days after termination of the **Policy Period**, or, if elected, **Extended Reporting Period**.

B. If during the **Policy Period,** or, if elected, the **Extended Reporting Period**, the **Insureds** first become aware of facts or circumstances which may reasonably give rise to a future **Claim** covered under this **Policy**, and if the **Insureds** give written notice to the **Insurer** during the **Policy Period**, or, if elected, the **Extended Reporting Period**, of the identity of the potential claimants; a description of the anticipated **Wrongful Act** allegations; the identity of the **Insureds** allegedly involved; the circumstances by which the **Insureds** first became aware of the facts or circumstances; the consequences which have resulted or may result; and the nature of the potential monetary damages and non-monetary relief, then any **Claim** which arises out of such **Wrongful Act** shall be deemed to have been first made at the time such written notice was received by the **Insurer**. No coverage is provided for fees, expenses and other costs incurred prior to the time such **Wrongful Act** results in a **Claim**.

C. All notices under any provision of this **Policy** shall be in writing and given by prepaid express courier, certified mail, fax or e-mail properly addressed to the appropriate party. Notice to the **Insureds** may be given to the **Named Insured** at the address shown in Item 1 of the Declarations. Notice to the **Insurer** of any **Claim, Cost of Corrections Claim**, or **Wrongful Act** shall be given to the **Insurer** at the address in Item 5.a. of the Declarations. All other notices to the **Insurer** under this **Policy** shall be given to the **Insurer** at the address in Item 5.b. of the Declarations. Notice given as described above

shall be deemed to be received and effective upon actual receipt thereof by the addressee or one day following the date such notice is sent, whichever is earlier.

D. The **Insureds** shall, as a condition precedent to their rights under this **Policy**, give to the **Insurer** a written report of a **Cost of Corrections Claim** no later than 48 hours after the discovery of the **Wrongful Act** requiring the **Cost of Corrections Expenses**. Such written report shall include a sworn proof of loss setting forth all the circumstances of the **Cost of Corrections Claim** and explaining why the **Insured** believes coverage is applicable. At the request of the **Insurer**, the **Insureds** shall make their directors, trustees, officers and employees available for interview by the **Insurer** in connection with the **Cost of Corrections Claim** and to provide the **Insurer** with all information, assistance and cooperation which the **Insurer** reasonably requests. No **Cost of Corrections Expenses** shall be incurred prior to the **Insurer's** written consent.

X. OTHER INSURANCE

If any **Loss** covered under this **Policy** is covered under any other valid and collectible insurance, then this **Policy** shall cover the **Loss**, subject to its terms and conditions, only to the extent that the amount of the **Loss** is in excess of the amount of such other insurance whether such other insurance is stated to be primary, contributory, excess, contingent or otherwise, unless such other insurance is written only as specific excess insurance over the Limits of Liability provided by this **Policy**.

XI. MATERIAL CHANGES IN CONDITIONS

A. If, during the **Policy Period**, any of the following events occurs:

1. the acquisition of the **Named Insured**, or of all or substantially all of its assets, by another entity, or the merger or consolidation of the **Named Insured** into or with another entity such that the **Named Insured** is not the surviving entity; or

2. the obtaining by any person, entity or affiliated group of persons or entities of the right to elect, appoint or designate at least 50% of the directors or equivalent positions of the **Named Insured**;

then coverage under this **Policy** will continue in full force and effect until termination of this **Policy**, but only with respect to **Claims** for covered **Wrongful Acts** taking place before such event. Coverage under this **Policy** will cease as of the effective date of such event with respect to **Claims** for **Wrongful Acts** taking place after such event. This **Policy** may not be canceled after the effective time of the event, and the entire premium for this **Policy** shall be deemed earned as of such time.

B. If before or during the **Policy Period** an organization ceases to be a **Subsidiary**, coverage with respect to the **Subsidiary** and its natural person **Insureds** shall continue until termination of this **Policy**. Such coverage continuation shall apply only with respect to **Claims** for **Wrongful Acts** taking place prior to the date such organization ceased to be a **Subsidiary**.

C. If before or during the **Policy Period** an **Insured Registered Representative** ceases to be an **Insured Registered Representative**, coverage with respect to the **Insured Registered Representative** shall continue until termination of this **Policy**. Such coverage continuation shall apply only with respect to **Claims** for **Wrongful Acts** taking place prior to the date such **Insured Registered Representative** ceased to be an **Insured Registered Representative**.

XII. REPRESENTATIONS

A. The **Insureds** represent and acknowledge that the statements contained in the **Application** are true and accurate and are the basis of this **Policy**, are to be considered as incorporated into and constituting a part of this **Policy**, and shall be deemed material to the acceptance of this risk or the hazard assumed by the **Insurer** under this **Policy**. It is understood and agreed that this **Policy** is issued in reliance upon the truth of such representations.

B. In the event the **Application**, including materials submitted or required to be submitted therewith, contains any misrepresentation or omission made with the intent to deceive or which materially affects either the acceptance of the risk or the hazard assumed by the **Insurer** under this **Policy**, this **Policy** shall be void ab initio as to:

1. any natural person **Insured** who knew the facts misrepresented or the omissions, whether or not such natural person **Insured** knew of the **Application** or this **Policy**. For purposes of this paragraph 1, the knowledge of a natural person **Insured** shall not be imputed to any other natural person **Insured**; and,

2. with respect to an entity **Insured**, any entity **Insured** if the chief executive officer, chief financial officer, or an equivalent position of the **Named Insured** knew the facts misrepresented or the omissions, whether or not such chief executive officer, chief financial officer, or equivalent position knew of the **Application** or this **Policy**. For purposes of this paragraph 2, the knowledge of only the chief executive officer, chief financial officer, or equivalent position of the **Named Insured** shall be imputed to the entity **Insureds**.

XIII. TERMINATION OF POLICY

A. This **Policy** shall terminate at the earliest of the following times:

1. the effective date of termination specified in a prior written notice by the **Named Insured** to the **Insurer**;

2. 15 days after receipt by the **Named Insured** of a written notice of termination from the **Insurer** for failure to pay a premium when due, unless the premium is paid within such 15 day period;

3. upon expiration of the **Policy Period** as set forth in Item 2 of the Declarations; or

4. at such other time as may be agreed upon by the **Insurer** and the **Named Insured**.

B. If this **Policy** is terminated by the **Named Insured**, the **Insurer** shall refund the unearned premium computed at the customary short rate. If this **Policy** is terminated by the **Insurer**, the **Insurer** shall refund the unearned premium computed pro rata. Payment or tender of any unearned premium by the **Insurer** shall not be a condition precedent to the effectiveness of such termination, but such payment shall be made as soon as practicable.

XIV. TERRITORY AND VALUATION

A. All premiums, limits, retentions, **Loss** and other amounts under this **Policy** are expressed and payable in the currency of the United States of America. If judgment is rendered, settlement is denominated or another element of **Loss** under this **Policy** is stated in a currency other than United States of America dollars, payment under this **Policy** shall be made in United States of America dollars at the applicable rate of exchange as published in *The Wall Street Journal* as of the date the final judgment is reached, the amount of the settlement is agreed upon or the other element of **Loss** is due, respectively, or if not published on such date, the next date of publication of *The Wall Street Journal*.

B. This **Policy** only applies to **Claims** which are brought in the United States of America, its territories or possessions or Canada, alleging **Wrongful Acts** anywhere in the world.

XV. SUBROGATION

In the event of any payment under this **Policy**, the **Insurer** shall be subrogated to the extent of such payment to all the rights of recovery of the **Insureds**. The **Insureds** shall execute all papers required and shall do everything necessary to secure and preserve such rights, including the execution of such documents necessary to enable the **Insurer** effectively to bring suit or otherwise pursue subrogation rights in the name of the **Insureds**.

XVI. ACTION AGAINST THE INSURER

Except as provided in Section XXI, Alternative Dispute Resolution, no action shall lie against the **Insurer**. No person or organization shall have any right under this **Policy** to join the **Insurer** as a party to any action against any **Insured** to determine the liability of the **Insured** nor shall the **Insurer** be impleaded by any **Insured** or its legal representatives.

XVII. BANKRUPTCY

Bankruptcy or insolvency of any **Insured** or of the estate of any natural person **Insured** shall not relieve the **Insurer** of its obligations nor deprive the **Insurer** of its rights or defenses under this **Policy**.

XVIII. AUTHORIZATION CLAUSE

By acceptance of this **Policy**, the **Named Insured** agrees to act on behalf of all **Insureds** with respect to the giving and receiving of notice of **Claim** or **Loss** or termination, the payment of premiums and the receiving of any return premiums that may become due under this **Policy**, the agreement to and acceptance of endorsements, and the giving or receiving of any notice provided for in this **Policy**, and the **Insureds** agree that the **Named Insured** shall so act on their behalf.

XIX. ESTATES, LEGAL REPRESENTATIVES AND SPOUSES

The estates, heirs, legal representatives, assigns, spouses of natural person **Insureds**, and any natural person qualifying as a domestic partner of a natural person **Insured** under the provisions of any applicable federal, state or local law or under the provisions of any formal program established by an entity **Insured**, shall be considered **Insureds** under this **Policy**; but coverage is afforded to such estates, heirs, legal representatives, assigns, spouses and domestic partners only for a **Claim** arising solely out of their status as such and, in the case of a spouse or domestic partner, where the **Claim** seeks damages from marital community property, jointly held property or property transferred from the natural person **Insured** to the spouse or domestic partner. No coverage is provided for any **Wrongful Act** of an estate, heir, legal representative, assign, spouse or domestic partner. All of the terms and conditions of this **Policy** including, without limitation, the Retention applicable to **Loss** incurred by natural person **Insureds** shown in the Declarations, shall also apply to **Loss** incurred by such estates, heirs, legal representatives, assigns, spouses or domestic partners.

XX. ALTERATION, ASSIGNMENT AND HEADINGS

No change in, modification of, or assignment of interest under this **Policy** shall be effective except when made by a written endorsement to this **Policy** which is signed by an authorized representative of the **Insurer**. The titles and headings to the various parts, sections, subsections and endorsements of the **Policy** are included solely for ease of reference and do not in any way limit, expand or otherwise affect the provisions of such parts, sections, subsections or endorsements.

XXI. ALTERNATIVE DISPUTE RESOLUTION

The **Insureds** and the **Insurer** shall submit any dispute or controversy arising out of or relating to this **Policy** or the breach, termination or invalidity thereof to the alternative dispute resolution ("ADR") process described in this section.

Either an **Insured** or the **Insurer** may elect the type of ADR process discussed below; provided, however, that the **Insured** shall have the right to reject the choice by the **Insurer** of the type of ADR process at any time prior to its commencement, in which case the choice by the **Insured** of ADR process shall control.

There shall be two choices of ADR process: (1) non-binding mediation administered by any mediation facility to which the **Insurer** and the **Insured** mutually agree, in which the **Insured** and the **Insurer** shall try in good faith to settle the dispute by mediation in accordance with the then-prevailing commercial mediation rules of the mediation facility; or (2) non-binding arbitration submitted to any arbitration facility to which the **Insured** and the **Insurer** mutually agree, in which the arbitration panel shall consist of three disinterested individuals. In either mediation or arbitration, the mediator or arbitrators shall have knowledge of the legal, industry, or insurance issues relevant to the matters in dispute. In the event of arbitration, the decision of the arbitrators shall be provided to both parties, and the award of the arbitrators shall not include attorneys' fees or other costs. In the event of either mediation or arbitration, either party shall have the right to commence a judicial proceeding; provided, however, that no such judicial proceeding shall be commenced until the conclusion of the arbitration, or in the event of mediation, at least 60 days after the date the mediation shall be deemed concluded or terminated. In all events, each party shall share equally the expenses of the ADR process.

Either ADR process may be commenced in New York, New York or in the state indicated in Item 1 of the

Declarations as the principal address of the **Named Insured**. The **Named Insured** shall act on behalf of each and every **Insured** in connection with any ADR process under this section.



SECURITIES BROKER-DEALER PROFESSIONAL LIABILITY

ORIGINAL

APPENDIX B

DECLARATIONS PAGE

THIS IS A CLAIMS MADE AND REPORTED POLICY. SUBJECT TO ALL PROVISIONS (INCLUDING ENDORSEMENTS), THIS POLICY APPLIES ONLY TO ANY CLAIM FIRST MADE AGAINST THE INSURED DURING THE POLICY PERIOD OR DISCOVERY PERIOD (IF APPLICABLE) PROVIDED SUCH CLAIM IS REPORTED IN ACCORDANCE WITH NOTIFICATION PROVISION OF EACH COVERAGE SECTION. AMOUNTS INCURRED AS DEFENSE COSTS SHALL REDUCE AND MAY EXHAUST THE LIMIT OF LIABILITY AND ARE SUBJECT TO THE RETENTIONS.

These Declarations along with the completed and signed Application and the Policy with endorsements shall constitute the contract between the **Insureds** and Underwriters.

Previous Policy No.: N/A

Authority Ref. No.:

Policy No.:

Item 1. **Broker/Dealer**:
Address:

Item 2. **Policy Period**: From:
To:
Both days at 12.01 a.m. Local Standard Time at the address shown in Item 1.

Item 3. **Limits of Liability**:

☒ Insuring Agreement A – Broker/Dealer Professional Liability
Limit of Liability: USD each **Claim** and in the aggregate

☒ Insuring Agreement B – Registered Representative Professional Liability
Limit of Liability: USD each **Claim** and in the aggregate

☒ Insuring Agreement C – Registered Investment Advisor Professional Liability
Limit of Liability: USD each **Loss** and in the aggregate

☐ Nonstandard Coverages

- ☐ 1. Selling Away: USD each **Claim** and in the aggregate
- ☐ 2. Investment Banking: USD each **Claim** and in the aggregate
- ☐ 3. Alternate Investments: USD each **Claim** and in the aggregate
- ☐ 4. Penny Stocks: USD each **Claim** and in the aggregate

If the box before any Insuring Agreement or Nonstandard Coverage above is not checked, no Coverage is provided under the Policy for such Insuring Agreement or Nonstandard Coverage.

Overall Policy Aggregate Limit of Liability: USD applicable to Insuring Agreements A, B and C and any Nonstandard Coverages, if purchased, as indicated above.

Item 4. New York **Registered Representative** Coverage:
Limit of Liability for each New York **Registered Representative:** USD each **Claim** and in the aggregate
Number of New York **Registered Representatives**:

Item 5. **Retentions**:

☒ Insuring Agreement A – Broker/Dealer: USD each and every **Claim**

☒ Insuring Agreement B – Registered Representative: USD each and every **Claim**

☒ Insuring Agreement C – Registered Investment Advisor: USD each and every **Claim**

☒ Non-Standard Coverages:

- ☐ 1. Selling Away: USD each **Claim** and in the aggregate
- ☐ 2. Investment Banking: USD each **Claim** and in the aggregate
- ☐ 3. Alternate Investments: USD each **Claim** and in the aggregate
- ☐ 4. Penny Stocks: USD each **Claim** and in the aggregate

ORIGINAL

Item 6. Retroactive Date: (a)
(b) Continuity of **Retroactive Date** for Registered Representative as per Section 3. (Q) 2. Included: Yes ☐ No ☐ *

**If "No" is checked, then Continuity of Retroactive Date as per Section 3.(Q)2. is not provided.*

Item 7. Premium: USD (100%) in full for period hereon
USD Surplus Lines Taxes and Fees
USD Stamping Fee

Item 8. Notice of **Loss** to:
Kaufman Dolowich & Voluck LLP
Attn: Stefan Dandelles, Managing Partner
55 E. Monroe Street, Suite 2950
Chicago, IL 60603
312.646.6742 (Direct) / 312.646.6744 (Main)
312.896.9403 (Fax) / Email: sdandelles@kdvlaw.com

Item 9. Notice of Election of Discovery to:
Integro Insurance Brokers Limited
Attn: Mark Hogsden
100 Leadenhall Street
London EC3A 3BP
Telephone: +44(0)207444 6145
Email: mark.hogsden@integrogroup.com

Item 10. Service of Suit:
Kaufman Dolowich & Voluck LLP
55 E. Monroe Street, Suite 2950
Chicago, IL 60603

Item 11. Choice of Law:

Item 12. Discovery Period: % of the total Policy Premium for a period of 12 months
% of the total Policy Premium for a period of 24 months

Item 13. Forms and Endorsements attached hereto:
1.
2.
3.
4.

ORIGINAL

SEVERAL LIABILITY NOTICE

The subscribing insurers' obligations under contracts of insurance to which they subscribe are several and not joint and are limited solely to the extent of their individual subscriptions. The subscribing insurers are not responsible for the subscription of any co-subscribing insurer who for any reason does not satisfy all or part of its obligations.
08/94 LSW1001 (Insurance)

This evidences that insurance has been Underwritten by certain underwriters at Lloyd's as listed:

This certificate is not valid until signed by an authorized signatory.

This contract is subject to US state surplus lines requirements. It is the responsibility of the surplus lines broker to affix a surplus lines notice to the contract document before it is provided to the insured. In the event that the surplus lines notice is not affixed to the contract document the insured should contact the surplus lines broker.

ORIGINAL

SECURITIES BROKER/DEALER'S PROFESSIONAL LIABILITY INSURANCE

In consideration of the payment of the premium, and in reliance upon the statements made to the Insurer in the application attached hereto and made a part hereof, and its attachments and the material incorporated therein, and subject to the Limit of Liability and all other terms and conditions contained herein, Underwriters at Lloyds, hereinafter called the "Insurer", agrees as follows:

1. INSURING AGREEMENTS

A. BROKER/DEALER PROFESSIONAL LIABILITY INSURANCE (INCLUDING FAILURE TO SUPERVISE)

This policy shall pay on behalf of the **Broker/Dealer Loss** arising from a **Claim** first made against the **Broker/Dealer** during the **Policy Period** or the Discovery Period (if applicable) and reported in writing to the Insurer pursuant to the terms of this policy for any actual or alleged **Wrongful Act** committed by the **Broker/Dealer**:

1. in the rendering or failure to render **Professional Services** by the **Broker/Dealer**; or
2. in **Failing to Supervise** a **Registered Representative** in the rendering or failure to render **Professional Services** by such **Registered Representative** on the behalf of the **Broker/Dealer**
3. in **Failing to Supervise** a **Registered Representative** in connection with **Selling Away** by such **Registered Representative**.

B. REGISTERED REPRESENTATIVE PROFESSIONAL LIABILITY INSURANCE

This policy shall pay on behalf of a **Registered Representative Loss** arising from a **Claim** first made against the **Registered Representative** during the **Policy Period** or the Discovery Period (if applicable) and reported in writing to the Insurer pursuant to the terms of this policy for any actual or alleged **Wrongful Act** committed by the **Registered Representative** in the rendering or failure to render **Professional Services** on behalf of the **Broker/Dealer** or any other covered entity.

C. REGISTERED INVESTMENT ADVISOR PROFESSIONAL LIABILITY INSURANCE

This policy shall pay on behalf of a **Registered Representative** acting in his/her capacity as a **Registered Investment Advisor Loss** arising from a **Claim** first made against the **Registered Representative** during the **Policy Period** or the Discovery Period (if applicable) and reported in writing to the Insurer pursuant to the terms of this policy for any actual or alleged **Wrongful Act** committed by the **Registered Representative** in the rendering or failure to render **Professional Services**

2. DEFENSE, INVESTIGATION AND SETTLEMENT (INCLUDED IN THE LIMITS OF LIABILITY)

A. Defense

The Insurer shall have the right and duty to defend, subject to and as part of the Limits of Liability, any **Claim** made against an **Insured** during the **Policy Period** or Discovery Period (if applicable) and reported in writing to the Insurer pursuant to the terms of this policy for any actual or alleged **Wrongful Act** for which coverage is afforded by this policy, even if any of the allegations of the **Claim** are groundless, false or fraudulent.

B. Investigation and Settlement

The Insurer shall have the right to make any investigation it deems necessary with respect to any **Claim** or notice of circumstances under this policy. The Insurer shall have the right to make any settlement of a **Claim** under this policy it deems expedient.

In the event the **Insured(s)** refuse to consent to a settlement opportunity, then Underwriters' liability for all **Loss** including **Defense Costs** on account of such **Claim** shall not exceed the total sum of:

(a) the amount for which Underwriters could have settled such **Claim**, plus **Defense Costs** incurred up to the date of the **Insured's** refusal to consent to such settlement; and

(b) twenty percent (20%) of any **Loss**, including **Defense Costs**, in excess of the amount referenced in paragraph (a) above, incurred in connection with such **Claim**. The remaining eighty percent (80%) of any **Loss**, including **Defense Costs**, in excess of the amount referenced in paragraph (a) above will be borne uninsured and at the **Insured's** own risk;

In all events, the Insurer shall not be obligated to settle any **Claim**, pay any **Loss** or undertake or continue defense of any **Claim** after the applicable Limit of Liability has been exhausted by settlement of **Claim(s)** or payment of **Loss**. In each such case, the Insurer shall have the right to withdraw from the further defense of the **Claim** by tendering control of the defense to the **Insured(s)**.

The **Insured**(s) shall not admit liability for or settle any **Claim** or incur any **Defense Costs** without the Insurer's prior written consent. The **Insured**(s) shall give the Insurer and defense counsel full cooperation and such information as the Insurer and defense counsel reasonably request; including upon the Insurer's request, assisting in making

ORIGINAL

settlements in the conduct of **Claims**, attending hearings, trials, arbitrations, mediations, and assisting in securing and giving evidence and obtaining the attendance of witnesses.

If all **Insured** defendants are able to dispose of all **Claims** which are subject to one Retention amount, for an amount not exceeding the Retention amount (inclusive of **Defense Costs**), then the Insurer's consent to such disposition shall not be required for such **Claims**.

3. DEFINITIONS

(a) "**Alternative Investments"** shall include hedge funds, funds of hedge funds, Real Estate Investment Trusts (REITs), Delaware Statutory Trusts (DSTs), Tenant-in-Common Interests (TICs), limited partnerships, direct participation programs (DPPs), limited liability company interests, other pooled investment vehicles, structured investment products, 1031 exchanges, collateralized mortgage obligations (CMOs), real estate interests (excluding primary residence), or any like investment generally accepted in the securities industry as alternative.

(b) "**Approved Activity**" means a service or activity performed by the **Registered Representative** including in his capacity as a **Registered Investment Advisor** on behalf of the **Broker/Dealer** which:

(1) has been approved by the **Broker/Dealer** to be performed by the **Registered Representative**, and is

(2) in connection with the purchase or sale of a specific security, annuity or insurance product which has been approved by the **Broker/Dealer** to be transacted through the **Registered Representative**, and for which

(3) the **Registered Representative** has obtained all licenses required by the **Broker/Dealer** or applicable law or regulation

(c) "**Broker/Dealer**" means the **Broker/Dealer** designated in Item 1 of the Declarations and any **Subsidiary** thereof.

(d) "**Claim**" means the following brought by an **Insured**'s customer or client in such capacity:

(1) a written demand for monetary relief; or

(2) a civil or arbitration proceeding for monetary or non-monetary relief

which is commenced by:

(i) service of a complaint or similar pleading; or

(ii) receipt or filing of an arbitration demand or statement of claim.

(e) "**Defense Costs**" means reasonable and necessary fees, costs and expenses consented to by the Insurer (including premiums for any appeal bond, attachment bond or similar bond, but without any obligation to apply for or furnish any such bond) resulting solely from the investigation, adjustment, defense and appeal of a **Claim** against an **Insured**(s), but excluding salaries of any **Insured**.

(f) "**Failing to Supervise**" means the failure to create, implement, enact or enforce any applicable supervisory procedures required by law, common or statutory, regulation, governmental authority or regulation authority or self-regulatory authority, including but not limited to the procedures established by the Financial Industry Regulatory Authority ("FINRA") outlined in Section 3000 of the FINRA Rules, and any amendments thereto.

(g) "**Insured**" means:

(1) a **Broker/Dealer** and/or a **Registered Representative** including any former **Registered Representative** if listed on Schedule A attached to this policy

(2) any past, present or future director, officer, partner or employee (other than a **Registered Representative**) of the **Broker/Dealer**,

(3) any present or future **Registered Representative** of the **Broker/Dealer**.

(4) an administrative, clerical or secretarial employee of a **Registered Representative** identified in Definition (o), or an entity identified in Definition (p), solely in his or her capacity as such, provided that:

(a) the administrative, clerical or secretarial employee is engaged solely in the **Professional Services** of such **Registered Representative**;

(b) receives no commission income based on employment with the **Registered Representative**; and

(c) has no other insurance applicable to a **Claim**

(5) heirs or executors of a **Registered Representative**.

(h) "**Interrelated Wrongful Act(s)**" means **Wrongful Act**s which are the same, related or continuous, or **Wrongful Act**s which arise from the same, related or common nexus of facts regardless of whether such **Claims** involve the same or different claimants, **Insureds** or legal causes of action. Further, and without limiting the aforementioned, the following **Claims** shall automatically be deemed to allege **Interrelated Wrongful Acts**:

ORIGINAL

1. **Claims** in connection with securities of any entity (or affiliated entities) which become(s) the subject of any bankruptcy, insolvency, receivership, liquidation or reorganization proceeding; or

2. **Claims** in connection with securities purchased in connection with an offering (or series of offerings) of securities issued by the same entity or affiliated entities; or

3. Multiple **Selling Away Claims** alleging the sale, attempted sale, or servicing of any of the same unapproved products.

(i) "**Investment Banking Activity**" means, but is not limited to, the underwriting, syndicating or promotion of any security or partnership interest in connection with any of the following: any actual, alleged or threatened merger, acquisition, divestiture, tender offer, proxy contest, leveraged buy-out, going private transaction, reorganization (voluntary or involuntary), capital restructuring, recapitalization, spin-offs, primary or secondary offerings of securities (regardless of whether the offering is a public offering or private placement), dissolution or sale of all or substantially all of the assets or stock of a business entity, or effort to raise or furnish capital or financing for any enterprise or entity, or any acquisition or sale of securities by the **Broker/Dealer** for its own account, or any activity by any **Insured** as a specialist or market maker (including the failure to make a market) for any securities, or any disclosure requirements in connection with any of the foregoing. **Investment Banking Activity** also includes the rendering of advice or recommendations or the rendering of a written opinion in connection with any of the foregoing.

(k) "**Loss**" means damages, judgments, settlements and **Defense Costs**; however, **Loss** shall not include:

(1) salaries of any **Insured**;

(2) the cost of complying with any settlement for or award of non-monetary relief;

(3) civil or criminal fines or penalties imposed by law, punitive or exemplary damages, the multiplied portion of multiplied damages, taxes, any amounts for which the **Insureds** are not financially liable or which are without legal recourse to the **Insureds**, or matters which may be deemed uninsurable under the law pursuant to which this policy shall be construed; notwithstanding the foregoing, **Loss** shall include awards of punitive or exemplary damages (where insurable by law) in an amount not greater than the amount of the compensatory damages award; and

(4) the return of fees, commissions, or other compensation for any **Professional Services** rendered or required to be rendered by the **Insured** or that portion of any settlement or award in an amount equal to such fees, commissions, or other compensation.

(l) "**Policy Period**" means the period from the inception date of this policy shown in Item 2 of the Declarations to the earlier of the expiration date shown in Item 2 of the Declarations or the effective date of cancellation of this policy.

(m) "**Professional Services**" means the following services if rendered in connection with an **Approved Activity** (except with respect to **Selling Away Claims** if covered pursuant to Item 3 of the Declarations) for or on the behalf of a customer or client of the **Broker/Dealer** pursuant to a written agreement between the **Broker/Dealer** and the customer or client:

(1) purchase or sale of **Securities**, including investment companies;

(2) purchase or sale of annuities, variable annuities;

(3) purchase or sale of commodities, futures contracts, forwards contracts or any type of option or futures contract, or any similar investment or investment product; or

(4) purchase or sale of life or accident and health insurance,

(5) providing brokerage services for individual retirement accounts (IRA's), Keogh retirement plans and employee benefit plans (other than multiple employer or multi employee welfare arrangements),

(6) services performed as a **Registered Investment Advisor** or advice provided to a client in accordance with the Investment Advisors Act 1940, as amended concerning Securities and products provided that such Securities and products are approved and authorized by the **Broker/Dealer**, but only if coverage under Insuring Agreement C is provided by this policy.

and in connection with or incidental to any of the foregoing 6 activities:

(7) providing financial planning advice including without limitation any of the following activities in conjunction therewith: the preparation of a financial plan or personal financial statements, the giving of advice relating to personal risk management, insurance, savings, investments, retirement planning or taxes.

If elected per the Declarations, "**Professional Services**" shall also mean "**Investment Banking Activity**".

(n) "**Registered Investment Advisor**" means an investment advisor and/or an investment advisor representative registered with the Securities and Exchange Commission; or a state securities agency in the U.S.A.; or a securities agency of the District of Columbia.

ORIGINAL

(o) "**Registered Representative**" means an individual who is registered with the Financial Industry Regulatory Authority, including a registered principal, and whose business is conducted on behalf of the **Broker/Dealer** or any other covered entity pursuant to a valid written contract in force at the time a **Claim** is first made.

In addition, **Registered Representative** shall include a **Registered Representative Company.**

For purposes of coverage identified in Item 4 of the Declarations, **Registered Representative** shall also include a **Registered Representative** who is domiciled and/or maintains a principal place of business in the State of New York.

(p) "**Registered Representative Company"** means any corporation, partnership or other business entity which engages in the conduct of **Professional Services** and which is either owned or controlled by a **Registered Representative** or in which a **Registered Representative** is an employee and then only with respect to those operations of the business entity related to **Professional Services** provided by the **Registered Representative**.

(q) "**Retroactive Date**" means:

1. as to the **Broker/Dealer**, the date stated in Item 6(a) of the Declarations;

2. as to a **Registered Representative**, or a Retired or Disabled Representative, the date stated in Item 6(a) of the Declarations or if indicated as included in Item 6(b) of the Declarations, the first date on which the **Registered Representative** had insurance coverage for errors and omissions under a securities broker-dealer professional liability insurance policy provided that such **Registered Representative** continuously renewed and maintained such insurance in effect thereafter up to the date that the **Registered Representative** became an **Insured** under this Policy.

(r) "**Securities"** means:

1. stocks, bonds and other investments, as defined by the Securities Act of 1933,the Securities Exchange Act of 1934, the Investment Company Act of 1940 or the Investment Advisors Act of 1940, and any amendments thereto, other than variable life insurance, universal life insurance, whole life insurance, variable annuities, flexible annuities, scheduled premium mutual funds.

2. In the event **Alternative Investment** coverage is elected as per Item 3 of the Declarations, **Securities** shall include **Alternative Investments** which are on the insured **Broker/Dealer's** approved product list. Additionally, it is agreed and understood that in the event a **Claim** arises out of **Alternative Investments** that have been approved, authorized and distributed through the **Broker/Dealer**, the **Broker/Dealer** must provide the Insurer proof that the **Broker/Dealer** had conducted a comprehensive due diligence of the **Alternative Investment** at issue prior to adding it to the approved product list and prior to the sale of such **Alternative Investment** at issue in such **Claim**.

(s) "**Selling Away"** means a **Registered Representative's** purchase, sale, attempted sale, solicitation, or servicing of **Securities**, **Alternative Investments**, or life insurance products that are not approved or authorized by the **Named Insured**, including, but not limited to, participating, in any manner, in a private securities transaction (as that term is used in NASD Rule 3040) except in accordance with the requirements of NASD Rule 3040.

Selling Away Claim means any **Claim** based on or arising out of **Selling Away**.

(t) "**Subsidiary**" means:

(1) a corporation of which the **Broker/Dealer** owns on or before the inception of the **Policy Period** more than 50% of the issued and outstanding voting stock either directly, or indirectly through one or more of its subsidiaries;

(2) a corporation created or acquired during the **Policy Period** if the number of **Registered Representatives** of such other corporation total less than 10% of the total number of **Registered Representatives** of the **Broker/Dealer** as of inception date of this policy. However, as a condition hereto, the **Broker/Dealer** shall provide the Insurer with full particulars of the new entity within 30 days of creation or acquisition or before the end of the **Policy Period,** whichever comes first;

(3) a corporation created, or acquired during the **Policy Period** (other than a corporation described in paragraph (2) above) but only upon the condition that within 30 days of its becoming a **Subsidiary**, the **Broker/Dealer** shall have provided the Insurer with full particulars of the new **Subsidiary** and agreed to any additional premium and/or amendment of the provisions of this policy required by the Insurer relating to such new **Subsidiary**. Further, coverage as shall be afforded to the new **Subsidiary** is conditioned upon the **Broker/Dealer** paying when due any additional premium required by the Insurer relating to such new **Subsidiary**.

A **Broker/Dealer** creates or acquires a **Subsidiary** when the **Broker/Dealer** owns more than 50% of the issued and outstanding voting stock, either directly or indirectly through one or more of its Subsidiaries. A corporation ceases to be a **Subsidiary** when the **Broker/Dealer** ceases to own more than 50% of the issued and outstanding voting stock, either directly or indirectly through one or more of its Subsidiaries.

ORIGINAL

In all events, coverage as is afforded with respect to a **Claim** made against a **Subsidiary** or any director, officer, employee or **Registered Representative** thereof shall only apply for **Wrongful Act**s committed or allegedly committed after the effective time that such **Subsidiary** became a **Subsidiary** and prior to the time that such **Subsidiary** ceased to be a **Subsidiary**.

(u) "**Wrongful Act**" means any negligent act, error or omission by the **Broker/Dealer**, any director, officer, partner or employee thereof, or by any **Registered Representative** thereof and solely in their respective capacities as such.

4. EXTENSIONS

Subject otherwise to the terms hereof, this policy shall cover **Loss** arising from a **Claim** made against the estates, legal heirs, or legal representatives of any deceased individual **Insured**, and the legal representatives of such individual **Insured** in the event of incompetency, insolvency or bankruptcy, who were individual **Insured** at the time the **Wrongful Acts** upon which such **Claims** are based were committed.

Subject otherwise to the terms hereof, this policy shall cover **Loss** arising from a **Claim** made against the lawful spouse or domestic partner (whether such status is derived by reason of statutory law, common law or otherwise of any applicable jurisdiction in the world) of an individual **Insured** for a **Claim** arising solely out of his or her status as the spouse or domestic partner of an individual **Insured**, including a **Claim** that seeks damages recoverable from marital community property, property jointly held by the individual **Insured** and the spouse or domestic partner, or property transferred from the individual **Insured** to the spouse or domestic partner ; provided, however, that this extension shall not afford coverage for any **Claim** for any actual or alleged **Wrongful Act**s of the spouse or domestic partner , but shall apply only to **Claims** arising out of any actual or alleged **Wrongful Act**s of an individual **Insured**, subject to the policy's terms, conditions and exclusions.

5. EXCLUSIONS

The Insurer shall not be liable for **Loss** in connection with any **Claim** made against an **Insured**:

a) alleging, arising out of, based upon or attributable to the gaining in fact any profit or advantage to which the **Insured** was not legally entitled, including but not limited to any actual or alleged commingling of funds or accounts, as determined by a final adjudication in the underlying action or in a separate action or proceeding;

b) alleging, arising out of, based upon or attributable to the committing in fact of: any criminal or deliberately fraudulent act, or any wilful violation of any law of the United States or Canada, or any state, territory, county, political division or municipality thereof, or any rules or regulations promulgated thereunder, as determined by a final adjudication in the underlying action or in a separate action or proceeding;

c) for bodily injury, sickness, disease, death or emotional distress of any person, or damage to or destruction of any tangible property, including the **Loss** of use thereof, or for injury from libel or slander or defamation or disparagement, or for injury from a violation of a person's right of privacy.

d) alleging, arising out of, based upon or attributable to any bankruptcy, insolvency, conservatorship, receivership or liquidation of, or suspension of payment or refusal to pay by any broker or dealer in securities or commodities, clearing agency, or any bank or banking firm, or any insurance or reinsurance entity or any **Insured**; provided, however, this exclusion will not apply to **Wrongful Act**s solely in connection with any **Insured**'s investment on the behalf of the **claim**ant in the stock of any of the foregoing entities;

e) alleging, arising out of, based upon or attributable to any **Wrongful Act** occurring prior to the inception date of the first Securities **Broker/Dealer**'s Errors And Omissions policy or Securities Brokers Professional Liability Insurance policy issued to the **Broker/Dealer** designated in Item 1 of the Declarations by the Insurer and continuously renewed and maintained in effect thereafter to the inception date of this policy, if on or before such date any **Insured** knew or could have reasonably foreseen that such **Wrongful Act** could lead to a **Claim**, or alleging, arising out of, based upon or attributable to any subsequent Interrelated **Wrongful Act**;

f) alleging, arising out of, based upon or attributable to any **Wrongful Act** occurring prior to the **Retroactive Date** stated in Item 6 of the Declarations or arising out of any subsequent **Interrelated Wrongful Act**;

g) alleging, arising out of, based upon or attributable to any: (i) employee benefit plan or trust sponsored by any **Insured** or sponsored by any business enterprise that is operated or managed or owned, directly or indirectly, in whole or in part, by any **Insured**; or (ii) any plan in which an **Insured** is a participant or is a named fiduciary; or arising out of, based upon or attributable to any services performed by any **Insured** acting in fact as a trustee, administrator or fiduciary under the Employee Retirement Income Security Act of 1974, or amendments thereto, or any similar federal or state statutory law or any regulation or order issued pursuant thereto.

However, this exclusion will not apply to services performed (i) as a 'fiduciary adviser' as defined under sections 601 of the Pension Protection Act of 2006; (ii) as a functional fiduciary commonly defined or described in Section 3(21) of ERISA when performing covered service and solely arising out of rendering investment advice for a fee or other compensation; (iii) as a fiduciary as an investment manager defined or described in Section 3(38) of ERISA when performing a covered service; or (iv) related 'securities' or insurance purchases or sales by an **Insured** within the normal scope of retirement or benefit planning services performed by a "financial services professional".

ORIGINAL

h) brought by or on behalf of any **Insured**, or the successors or assigns of any **Insured**; or by or on behalf or any enterprise, trust or other entity that is operated or managed or owned, directly or indirectly, in whole or in part, by any **Insured**; or for which any **Insured** is a trustee, fiduciary, director or officer thereof;

i) alleging, arising out of, based upon or attributable to, in whole or in part, any **Investment Banking Activity** by an **Insured**, including but not limited to any disclosure requirements in connection with the foregoing; provided, however, that this exclusion shall not apply to **Claims** arising out of the sale by an **Insured** to a particular client or customer of any open-ended investment company or variable annuity which alleges that a client or customer of the **Broker/Dealer** was unsuitable for and wrongfully placed into such investment company or variable annuity. This exclusion shall not apply if Investment Banking coverage is elected per Item 3 of the Declarations.

j) alleging, arising out of, based upon or attributable to the facts alleged, or arising out of the same or Interrelated **Wrongful Acts** alleged or contained in any **Claim** which has been reported, or in any circumstances of which notice has been given, under any policy of which this policy is a renewal or replacement or which it may succeed in time;

k) brought by or on behalf of any clearing agency, or alleging, arising out of, based upon or attributable to any function of any **Insured** as a clearing agency;

l) alleging, arising out of, based upon or attributable to any: use by any **Insured** of, or aiding or abetting by any **Insured** in the use of, or participating after the fact by any **Insured** in the use of, non-public information in a manner prohibited by the laws of the United States, including, but not limited to, the Insider Trading and Securities Fraud Endorsement Act of 1988 (as amended), Section 10(b) of the Securities Exchange Act of 1934 (as amended) and Rule 10b-5 thereunder, any state, commonwealth, territory or subdivision thereof, or the laws of any other jurisdiction, or any rules or regulations promulgated under any of the foregoing;

m) alleging, arising out of, based upon or attributable to the purchase or sale of (or failure to purchase or sell) any of the following, or any advice in connection therewith:

   i. any collectible, including but not limited to stamps, art, cards, jewelry, antiques or any other tangible personal property; or

   ii. any equity security priced under USD5.00 at the time that the **Wrongful Act** triggering such **Claim** arose; however, this exclusion shall not apply if the security is:

      (i) registered or authorized, or approved for registration or authorization upon notice of issuance, on a national securities exchange; or

      (ii) issued by an investment company registered under the Investment Company Act of 1940 (as amended); or

   Provision m) 2) shall not apply if Penny Stock coverage is elected as per Item 3 of the Declarations.

   3) annuities used in connection with any structured settlement; or

   4) any security in any market outside of the United States of America and its territories and possessions and Canada.

n) alleging, arising out of, based upon or attributable to any mechanical or electronic failure, breakdown or malfunction of machines or systems;

o) brought by or on behalf of, or instigated or continued with the solicitation, assistance, participation or intervention of, any State or Federal regulatory or administrative agency or bureau or any other governmental, quasi-governmental or self-regulatory entity ("Governmental Entity"), whether directly or indirectly, and whether brought in its capacity as trustee, liquidator, or assignee of the **Broker/Dealer**, or in any other capacity and whether brought in its own name or in the name of any other entity; however, this exclusion shall not apply to any **Claim** brought solely in such Governmental Entity's capacity as a customer or client of the **Broker/Dealer** and instigated and continued totally independent of, and totally without the solicitation of, or assistance of, or active participation of, or intervention of, any **Insured**.

p) alleging, arising out of, based upon or attributable to rendering of or failure to render any of the following services or activities:

   1) actuarial,

   2) accounting,

   3) legal,

   4) real estate agent or broker, or

   5) tax preparation or appearing before the Internal Revenue Service as an enrolled agent;

q) for any actual or alleged **Wrongful Act** in rendering or failure to render **Professional Services** to any securities **Broker/Dealer**; however this exclusion shall not apply if the **Professional Service** is solely the purchase or sale of securities to such **Broker/Dealer** for its own account;

ORIGINAL

r) alleging, arising out of, based upon or attributable to any activity of, or service provided by a **Registered Representative,** other than a covered **Professional Service**, including but not limited to **Selling Away**. This exclusion shall not apply to coverage provided under Insuring Agreement A.3, if elected, as per Item 3B of the Declarations.

s) alleging, arising out of, based upon or attributable to an **Insured** exercising discretionary authority or control with regard to management or disposition of assets; however, this exclusion shall not apply to **Registered Investment Advisors** or any **Insured**'s purchase or sale of no-load investment company or variable annuities in which there is no initial or contingent sales charge or commission;

t) alleging, arising out of, based upon or attributable to, or in any way involving, directly or indirectly, the formation, operation, administration or management by an **Insured**, in part or in whole, of any entity other than the **Broker/Dealer** including but not limited to general partnerships, including but not limited to **Claims** arising out of an **Insured** acting as a general partner of any limited partnership and/or managing general partner of any general partnership;

u) alleging, arising out of, based upon or attributable to any liability assumed by the **Insured** under any indemnification contract or agreement, either oral or in writing; however, this exclusion does not apply to liability that would exist in the absence of such contract or agreement;

v) alleging, arising out of, based upon or attributable to employment or work place practices, including **Claims** arising under worker compensation laws or **Claims** in respect of alleged discrimination, harassment or inappropriate employment conduct of any sort.;

w) alleging, arising out of, based upon or attributable to any third party **Claim** for the reimbursement of fees, commissions, costs or other charges paid or payable to the **Insured** or any third party **Claim** based upon allegations against the **Insured** of excessive fees, commissions, costs or other charges.

x) arising out of, based upon or in consequence of, directly or indirectly resulting from or in any way involving a qualified intermediary's or other similar party's conversion, defalcation, misuse or embezzlement of monies, funds or other assets held for the purpose of a 1031 exchange or TIC, regardless of whether any **Insured** was a participant in such conduct or had notice or knowledge of same.

The foregoing shall only apply in the event coverage was extended under this Policy to sales and servicing of 1031 exchanges and TICs by way of the election of **Alternative Investments** coverage as per Item 3 of the Declarations.

y) in connection with any **Claim** for any intentional, "Corporate or Business Policy".

"Corporate or Business Policy" shall mean any policy which has been approved, condoned or endorsed by two or more of the **Broker/Dealer's** Management and which financially disadvantages all of the **Insured's** clients or any group or class of the **Insured's** clients.

The **Broker/Dealer**'**s** Management shall be deemed to be the **Broker/Dealer's** executive level officers, including but not limited to the CEO, President, COO, CCO, CFO and General Counsel.

z) alleging, arising out of, based upon, or attributable to depreciation (or failure to appreciate) in value of any investments, including but not limited to securities, leased products, commodities, currencies, options and futures transactions as to which the Assured has expressly or implicitly made a guarantee, representation or warranty as to the performance of such investments;

6. LIMITS OF LIABILITY

A. The Limits of Liability stated in Item 3 of the Declarations as "each **Claim**" is the limit of the Insurer's liability for all **Loss** arising out of all **Claims** alleging the same **Wrongful Act** or **Interrelated Wrongful Act**. This "each **Claim**" limit shall be part of and not in addition to the "aggregate" limit set forth in Item 3 of the Declarations as well as the "Overall Policy Aggregate" limit set forth in Item 3 of the Declarations, as described below.

B. The Limits of Liability stated in Item 3 of the Declarations as "aggregate " is the total limit of the Insurer's liability for all **Loss** arising out of all **Claims** first made against the **Insureds** during the **Policy Period** and the Discovery Period (if applicable) and reported to the Insurer in accordance with the terms herein. This "aggregate" limit shall be part of and not in addition to the "Overall Policy Aggregate" limit set forth in Item 3 of the Declarations, as described below.

C. The Overall Policy Aggregate Limit of Liability stated in Item 3 of the Declarations is the aggregate total limit of the Insurer's liability for **Loss** arising out of all **Claims** first made against the **Insureds** during the **Policy Period** and the Discovery Period (if applicable) and reported to the Insurer in accordance with the terms herein under this policy.

D. More than one **Claim** involving the same **Wrongful Act** or **Interrelated Wrongful Acts**, regardless of the causes of action plead or the number or identity of claimants involved, shall be deemed to constitute a single **Claim**, and shall be deemed to have been made at the earliest of the following times, regardless of whether such date is before or during the **Policy Period**:

1. the time at which the earliest **Claim** involving the same **Wrongful Act** or **Interrelated Wrongful Acts** is first made; or

2. the time at which the **Claim** involving the same **Wrongful Act** or **Interrelated Wrongful Acts** shall be deemed to have been made pursuant to subsection 8(c) below.

ORIGINAL

E. The Limit of Liability for the Discovery Period shall be part of, and not in addition to, the applicable Limit of Liability for the **Policy Period**. Further, a **Claim** which is made subsequent to the **Policy Period** or the Discovery Period (if applicable) which pursuant to Clause 8(b) or 8(c) is considered made during the **Policy Period** or the Discovery Period (if applicable) shall also be subject to the aggregate Limit of Liability stated in Item 3 of the Declarations.

F. Solely with respect to coverage afforded under this Policy for **Selling Away Claims**, subject to the Insurer's maximum "each **Claim**" Limit of Liability shown in Item 3 of the Declarations, the "each **Claim**" limit set forth in Item 3 of the Declarations shall be the maximum per **Claim** limit for each **Selling Away Claim**. Subject to the Insurer's "aggregate" limit shown in Item 3 of the Declarations, the "aggregate" limit set forth in Item 3 of the Declarations shall be the maximum aggregated Limit of Liability for all **Loss** under the Policy in connection with **Selling Away Claims**, regardless of the number of **Selling Away Claims** made against the **Insureds**. This is a sublimit of liability which further reduces, and in no way increases, the "each **Claim**" or "aggregate" Limit of Liability of this Policy as stated in the Declarations.

G. In the event of the total erosion of the Overall Policy Aggregate Limit of Liability stated in Item 3 of the Declarations, the Limit of Liability for a **Registered Representative** domiciled or with a principal place of business in New York as stated in Item 4 of the Declarations shall be made available to each such New York **Registered Representative**.

The total limit of liability available to any one New York **Registered Representative** following the total erosion of the Overall Policy Aggregate Limit of Liability in Item 3C of the Declarations will be the "aggregate" Limit of Liability as stated in Item 4 of the Declarations for each such New York **Registered Representative**.

The "each **Claim**" and "aggregate" Limit of Liability set forth in Item 4 of the Declarations is only available to the number of New York **Registered Representatives** as identified in Item 4 of the Declarations.

H. **Defense Costs** are not payable by the Insurer in addition to the Limit of Liability**. Defense Costs** are part of **Loss** and as such are subject to the applicable Limit of Liability.

7. RETENTION

The Insurer shall only be liable for the amount of **Loss** arising from a **Claim** which is in excess of the applicable Retention Amount stated in Item 5 of the Declarations, such Retention Amount to be borne by the **Insureds** and shall remain uninsured with regard to all **Loss** arising from any **Claim**.

The Retention stated in Item 5 of the Declarations as the "Broker/Dealer Retention" shall apply to **Claims** for which coverage is provided under Insuring Agreement A of this policy.

The Retention stated in Item 5 of the Declarations as the "Registered Representative Retention" shall apply to **Claims** for which coverage is provided under Insuring Agreement B of this policy except for those **Claims** described immediately below.

The Retention stated in Item 5 of the Declarations as the "Registered Investment Advisor Retention" shall apply to **Claims** for which coverage is provided under Insuring Agreement C of this policy except for those **Claims** described immediately below.

The Retention stated in Item 5 of the Declarations as the "**Selling Away Claim** Retention" shall apply to **Selling Away Claims** for which coverage is provided, but only when 50% or more of the alleged damages (excluding any punitive or exemplary amounts) arise from **Selling Away**.

In the event of a **Claim** (or **Claims** alleging **Interrelated Wrongful Acts**) for which more than one retention amount set forth in Item 5 of the Declarations is applicable, then the highest applicable single Retention Amount shall apply.

8. NOTICE/CLAIM REPORTING PROVISIONS

Notice hereunder shall be given in writing to the persons and/or entities shown under Item 8 of the Declarations Page. If mailed, the date of mailing shall constitute the date that such notice was given and proof of mailing shall be sufficient proof of notice.

(a) The **Broker/Dealer** or the **Insured** shall, as a condition precedent to the obligations of the Insurer under this policy, give written notice to the Insurer of a **Claim** made against an **Insured** as soon as practicable after the general counsel, chief compliance officer or risk manager (or functional equivalent) of the **Broker/Dealer** first becomes aware of such **Claim** but in no event later than 30 days after the Policy Period or Discovery Period (if purchased).

(b) If written notice of a **Claim** has been given to the Insurer pursuant to Clause 8 (a) above, then a **Claim** which is subsequently made against the **Insureds** and reported to the Insurer alleging, arising out of, based upon or attributable to the facts alleged in the **Claim** for which such notice has been given, or alleging any **Wrongful Act** which is the same as or related to any **Wrongful Act** alleged in the **Claim** of which such notice has been given, shall be considered made at the time such notice was given.

(c) If during the **Policy Period** or during the Discovery Period (if applicable) the **Broker/Dealer** or the **Insureds** shall become aware of any circumstances which may reasonably be expected to give rise to a **Claim** being made against the **Insureds** and shall give written notice to the Insurer of the circumstances and the reasons for anticipating such a **Claim**, with full particulars as to dates, persons and entities involved, then a **Claim** which is subsequently made against the **Insureds** and reported to the Insurer alleging, arising out of, based upon or attributable to such circumstances or alleging any **Wrongful Act** which is the same as or related to any **Wrongful Act** alleged or contained in such circumstances, shall be considered made at the time such notice of such circumstances was given.

ORIGINAL

9. PROTECTION FOR INNOCENT INSURED

Whenever coverage under this policy would be excluded under Exclusion a) or b) because an **Insured** committed a criminal or deliberately fraudulent act; or wilfully violated the law or gained a profit or advantage to which the **Insured** was not legally entitled, the coverage otherwise afforded under this policy to a natural person **Insured** will continue to apply to each such **Insured** who did not personally commit or personally participate in committing such criminal or deliberately fraudulent act; did not wilfully violate the law or gain a profit or advantage; and did not personally acquiesce in or remain passive after having personal knowledge or becoming aware of one or more such acts, wilful violation or improper gain as set forth in Exclusions a) and b).

10. DISCOVERY CLAUSE

A. If this Policy is not renewed by the **Broker/Dealer** or by the Insurer, or if this Policy is cancelled for any reason other than non-payment of premium in whole or in part, then the **Broker/Dealer** shall have the right, upon payment of the additional premium set forth in Item 12 of the Declarations for this Policy, to an extension of the coverage granted by this Policy for a period of either one (1) year or two (2) years with respect to any **Claim** first made during the period of time set forth in Item 12 of the Declarations after the Policy expiration date, but only with respect to any **Wrongful Act** committed before such date. This period shall be referred to as the Discovery Period.

As a condition precedent to the right to purchase the Discovery Period in A. above, the total premium for this Policy must have been paid in full. The right to purchase the Discovery Period shall terminated unless written notice together with full payment of the premium for the Discovery Period is received by the Insurer within 30 days after the Policy expiration date. If such notice and premium payment is not so given to the Insurer, there shall be no right to purchase the Discovery Period.

B. In the event of a Transaction, as set forth in Clause 12., the **Broker/Dealer** shall have the right to request a Discovery Period (with respect to **Wrongful Acts** occurring prior to the effective date of the Transaction) for a period of up to 6 years. Insurer shall offer such Discovery Period pursuant to such terms, conditions and additional premium as Insurer may reasonably decide. The **Broker/Dealer** shall make an election with respect to the Discovery Period no later than 10 days after the date of such Transaction. The right to a Discovery Period in the event of a Transaction shall not otherwise exist except as indicated in this paragraph.

As a condition precedent to the right to purchase the Discovery Period in B. above, the total premium for this Policy must have been paid. The right to purchase the Discovery Period shall terminate unless full payment of the premium for the Discovery Period is received by the Insurer within 30 days after the Transaction or election of Discovery Period, whichever is later. If such notice and premium payment is not so received by the Insurer, there shall be no right to purchase the Discovery Period.

C. The additional premium for the Discovery Period shall be fully earned at the inception of the Discovery Period. The Discovery Period is not cancelable. This clause and the rights contained herein shall not apply to any cancellation resulting from non-payment of premium.

D. The offer by the Insurer of renewal terms, conditions, Limits of Liability and/or premiums different from those of the expiring policy shall not constitute a refusal to renew.

E. The exercise of the Discovery Period shall not in any way increase the Limit of Liability of the Insurer.

11. CANCELLATION CLAUSE

This Policy is non-cancellable by the Insurer except for non–payment of premium, when the Insurer may cancel this Policy by mailing to the **Broker/Dealer** written notice stating when, not less than 45 days thereafter, such cancellation shall be effective. If payment is not received within the forty five (45) day period, then this Policy will be cancelled *ab initio*, meaning coverage is null and void from inception. The mailing of such notice shall be sufficient notice and the effective date of cancellation stated in the notice shall become the end of the **Policy Period**. Delivery of such written notice by the Insurer shall be equivalent to mailing. If the foregoing notice period is in conflict with any governing law or regulation, then such period shall be amended to afford the minimum notice period permitted thereunder.

This policy may be cancelled by the **Broker/Dealer** first named in Item 1 of the Declarations at any time only by mailing written prior notice to the Insurer stating when thereafter such cancellation shall be effective, or by surrender of this policy to the Insurer or its authorized agent.

If this policy shall be cancelled by the **Broker/Dealer**, the Insurer shall retain the customary short rate proportion of the premium hereron.

Payment or tender of any unearned premium by the Insurer shall not be a condition precedent to the effectiveness of cancellation, but such payment shall be made as soon as practicable. If the period of limitation relating to the giving of notice is prohibited or made void by any law controlling the construction thereof, such period shall be deemed to be amended so as to be equal to the minimum period of limitation permitted by such law.

ORIGINAL

12. CHANGE IN CONTROL OF BROKER/DEALER

If during the **Policy Period**:

a. the **Broker/Dealer** shall consolidate with or merge into, or sell all or substantially all of its assets to any other person or entity or group of persons and/or entities acting in concert; or

b. any person or entity or group of persons and/or entities acting in concert shall acquire an amount of the outstanding securities representing more than 50% of the voting power for the election of directors of the **Broker/Dealer**, or acquires the voting rights of such an amount of such securities;

(either of the above events herein referred to as the "Transaction")

then, this policy shall continue in full force and effect as to **Wrongful Acts** occurring prior to the effective time of the Transaction, but there shall be no coverage afforded by any provision of this policy for any actual or alleged **Wrongful Act** occurring after the effective time of the Transaction. This policy may not be canceled after the effective time of the Transaction and the entire premium for this policy shall be deemed earned as of such time. The **Broker/Dealer** shall also have the right to an offer by the Insurer of a Discovery Period described in Clause 9 of the policy.

The **Broker/Dealer** shall give the Insurer written notice of the Transaction as soon as practicable, but not later than 30 days after the effective date of the Transaction.

13. SUBROGATION

In the event of any payment under this policy, the Insurer shall be subrogated to the extent of such payment to all the **Broker/Dealer's** and the **Insureds'** rights of recovery thereof, and the **Broker/Dealer** and the **Insured**s shall execute all papers required and shall do everything that may be necessary to secure such rights including the execution of such documents necessary to enable the Insurer effectively to bring suit in the name of the **Broker/Dealer** and/or the **Insureds**. In no event, however, shall the Insurer exercise its rights to subrogation against an **Insured** under this policy unless such **Insured** has been convicted of a criminal act, or been judicially determined to have committed a deliberate fraudulent act, or obtained any profit or advantage to which such **Insured** was not legally entitled, or arising out of an act other than a covered **Professional Service** or **Broker/Dealer** service by such other **Insured**.

14. OTHER INSURANCE

Such insurance as is provided by this policy shall apply only as excess over any other valid and collectible insurance.

15. NOTICE AND AUTHORITY

It is agreed that the **Broker/Dealer** first named in Item 1 of the Declarations shall act on behalf of **Insureds** with respect to the giving of notice of **Claim** or giving and receiving notice of cancellation, the payment of premiums and the receiving of any return premiums that may become due under this policy, the receipt and acceptance of any endorsements issued to form a part of this policy and the exercising or declining to exercise any right to a Discovery Period. Notice to any agent or knowledge possessed by any agent or any other person shall not effect a waiver or a change in any part of this policy or stop the Insurer from asserting any right under the terms of this policy; nor shall the terms of this policy be waived or changed except by endorsement issued to form a part of this policy and signed by an authorized representative of the Insurer.

16. TERRITORY

This policy applies to **Claims** which are brought anywhere in the World.

17. ASSIGNMENT

This policy and any and all rights hereunder are not assignable without the written consent of the Insurer.

18. ALTERNATIVE DISPUTE RESOLUTION PROCESS

It is hereby understood and agreed that all disputes or differences which may arise under or in connection with this policy, whether arising before or after termination of this policy, including any determination of the amount of **Loss**, shall be subject to the alternative dispute resolution process ("ADR") set forth in this clause.

Either the Insurer or the **Insured**(s) may elect the type of ADR discussed below; provided, however, that the **Insureds** shall have the right to reject the Insurer's choice of ADR at any time prior to its commencement, in which case the **Insureds**' choice of ADR shall control.

The Insurer and **Insured**(s) agree that there shall be two choices of ADR: (1) non-binding mediation administered by the America Arbitration Association, in which the Insurer and **Insureds** shall try in good faith to settle the dispute by mediation under or in accordance with its then-prevailing Commercial Mediation Rules; or (2) arbitration submitted to the America Arbitration Association under or in accordance with its then-prevailing commercial arbitration rules, in which the arbitration panel shall be composed of three disinterested individuals. In either mediation or arbitration, the mediator(s) or arbitrators shall have knowledge of the legal, corporate management, or insurance issues relevant to the matters in dispute. The mediator(s) or arbitrators shall also give due consideration to the general principles of the law of the state where the **Broker/Dealer** is incorporated in the construction or interpretation of the provisions of this policy; provided, however, that the terms, conditions, provisions and exclusions of this policy are to be construed in an even-handed fashion in the manner most consistent with the relevant terms, conditions, provisions or exclusions of the policy. In the event of arbitration, the decision of the arbitrators shall

ORIGINAL

be final and binding and provided to both parties, and the arbitrators' award shall not include attorney's fees or other costs. In the event of mediation, either party shall have the right to commence a judicial proceeding; provided, however, that no such judicial proceeding shall be commenced until the mediation shall have been terminated and at least 120 days shall have elapsed from the date of the termination of the mediation. In all events, each party shall share equally the expenses of the ADR.

Either choice of ADR may be commenced in either New York, New York; Atlanta, Georgia; Chicago, Illinois; Denver, Colorado; or in the state indicated in Item 1 of the Declarations as the mailing address for the **Broker/Dealer**. The **Broker/Dealer** shall act on behalf of all **Insureds** in deciding to proceed with ADR under this clause.

19. ACTION AGAINST INSURER

Except as provided in Clause 18 of this policy, no action shall lie against the Insurer unless, as a condition precedent thereto, there shall have been full compliance with all of the terms of this policy, nor until the amount of the **Insureds**' obligation to pay shall have been finally determined either by judgment against the **Insureds** after actual trial or by written agreement of the **Insureds**, the claimant and the Insurer.

Any person or organization or the legal representative thereof who has secured such judgment or written agreement shall thereafter be entitled to recover under this policy to the extent of the insurance afforded by this policy. No person or organization shall have any right under this policy to join the Insurer as a party to any action against the **Insureds** or the **Broker/Dealer** to determine the **Insureds**' liability, nor shall the Insurer be impleaded by the **Insureds** or the **Broker/Dealer** or their legal representatives. Bankruptcy or insolvency of the **Broker/Dealer** or the **Insureds** or of their estates shall not relieve the Insurer of any of its obligations hereunder.

20. HEADINGS

The descriptions in the headings of this policy are solely for convenience, and form no part of the terms and conditions of coverage.

21. SERVICE OF SUIT CLAUSE (U.S.A.)

This Clause is not intended to conflict with or override the parties' obligated to arbitrate their disputes in accordance with Clause 18.

It is agreed that in the event of the failure of the Insurers hereon to pay any amount claimed to be due hereunder, the Insurers hereon, at the request of the **Insured**, will submit to the jurisdiction of a Court of competent jurisdiction within the United States. Nothing in this Clause constitutes or should be understood to constitute a waiver of Insurers' rights to commence an action in any Court of competent jurisdiction in the United States, to remove an action to a United States District Court, or to seek a transfer of a case to another Court as permitted by the laws of the United States or of any State in the United States.

It is further agreed that service of process in such suit may be made upon the firm shown under Item 10 of the Declarations and that in any suit instituted against any one of them upon this contract, Insurers will abide by the final decision of such Court or of any Appellate Court in the event of an appeal.

The firm shown under Item 10 of the Declarations is directed to accept service of process on behalf of Insurers in any such suit and/or upon the request of the **Insured** to give a written undertaking to the **Insured** (or Reinsured) that they will enter a general appearance upon Insurers' behalf in the event such a suit shall be instituted.

Further, pursuant to any statute of any state, territory or district of the United States which makes provision therefore Insurers hereon hereby designate the Superintendent, Commissioner or Director of Insurance or other officer specified for that purpose in the statute, or his successor or successors in office, as their true and lawful attorney upon whom may be served any lawful process in any action, suit or proceeding instituted by or on behalf of the **Insured** or any beneficiary hereunder arising out of this contract of insurance, and hereby designate the above-named as the person to whom the said officer is authorized to mail such process or a true copy thereof.

22. CHOICE OF LAW

This insurance shall be governed by and construed in accordance with the law of the state designated in Item 11 of the Declarations. Each party agrees to submit to the exclusive jurisdiction of any competent court within the United States of America.

23. MANDATORY LLOYD'S EXCLUSIONS

A. NUCLEAR INCIDENT EXCLUSION CLAUSE-LIABILITY-DIRECT (BROAD) (U.S.A.)

This Policy does not apply:

I. Under any Liability Coverage, to injury, sickness, disease, death or destruction:

(a) with respect to which an **Insured** under the Policy is also an **Insured** under a nuclear energy liability policy issued by Nuclear Energy Liability Insurance Association, Mutual Atomic Energy Liability Underwriters or Nuclear Insurance Association of Canada, or would be an **Insured** under any such policy but for its termination upon exhaustion of its limit of liability; or

ORIGINAL

(b) resulting from the hazardous properties of nuclear material and with respect to which (1) any person or organization is required to maintain financial protection pursuant to the Atomic Energy Act of 1954, or any law amendatory thereof, or (2) the **Insured** is, or had this Policy not been issued would be, entitled to indemnity from the United States of America, or any agency thereof, under any agreement entered into by the United States of America, or any agency thereof, with any person or organization.

II. Under any Medical Payments Coverage, or under any Supplementary Payments Provision relating to immediate medical or surgical relief, to expenses incurred with respect to bodily injury, sickness, disease or death resulting from the hazardous properties of nuclear material and arising out of the operation of a nuclear facility by any person or organization.

III. Under any Liability Coverage, to injury, sickness, disease, death or destruction resulting from the hazardous properties of nuclear material, if:

(a) the nuclear material (1) is at any nuclear facility owned by, or operated by or on behalf of, an **Insured** or (2) has been discharged or dispersed therefrom;

(b) the nuclear material is contained in spent fuel or waste at any time possessed, handled, used, processed, stored, transported or disposed of by or on behalf of an **Insured**; or

(c) the injury, sickness, disease, death or destruction arises out of the furnishing by an **Insured** of services, materials, parts or equipment in connection with the planning, construction, maintenance, operation or use of any nuclear facility, but if such facility is located within the United States of America, its territories or possessions or Canada, this exclusion (c) applies only to injury to or destruction of property at such nuclear facility.

IV. As used in herein:

"hazardous properties" include radioactive, toxic or explosive properties; "nuclear material" means source material, special nuclear material or by-product material; "source material", "special nuclear material", and "by-product material" have the meanings given them in the Atomic Energy Act 1954 or in any law amendatory thereof; "spent fuel" means any fuel element or fuel component, solid or liquid, which has been used or exposed to radiation in a nuclear reactor; "waste" means any waste material (1) containing by-product material and (2) resulting from the operation by any person or organization of any nuclear facility included within the definition of nuclear facility under paragraph (a) or (b) thereof; "nuclear facility" means:

(a) any nuclear reactor,

(b) any equipment or device designed or used for (1) separating the isotopes of uranium or plutonium, (2) processing or utilizing spent fuel, or (3) handling, processing or packaging waste,

(c) any equipment or device used for the processing, fabricating or alloying of special nuclear material if at any time the total amount of such material in the custody of the **Insured** at the premises where such equipment or device is located consists of or contains more than 25 grams of plutonium or uranium 233 or any combination thereof, or more than 250 grams of uranium 235,

(d) any structure, basin, excavation, premises or place prepared or used for the storage or disposal of waste,

and includes the site on which any of the foregoing is located, all operations conducted on such site and all premises used for such operations; "nuclear reactor" means any apparatus designed or used to sustain nuclear fission in a self-supporting chain reaction or to contain a critical mass of fissionable material. With respect to injury to or destruction of property, the word "injury" or "destruction" includes all forms of radioactive contamination of property.

It is understood and agreed that, except as specifically provided in the foregoing to the contrary, this clause is subject to the terms, exclusions, conditions and limitations of the Policy to which it is attached.

* NOTE: As respects policies which afford liability coverages and other forms of coverage in addition, the words underlined should be amended to designate the liability coverage to which this clause is to apply.

B. RADIOACTIVE CONTAMINATION EXCLUSION CLAUSE-LIABILITY-DIRECT (U.S.A.)

In relation to liability arising outside the U.S.A., its Territories or Possessions, Puerto Rico or the Canal Zone, this Policy does not cover any liability of whatsoever nature directly or indirectly caused by or contributed to by or arising from ionising radiations or contamination by radioactivity from any nuclear fuel or from any nuclear waste from the combustion of nuclear fuel.

ORIGINAL

C. WAR AND TERRORISM EXCLUSION

Notwithstanding any provision to the contrary within this insurance or any endorsement thereto it is agreed that this insurance excludes **Loss**, damage, cost or expense of whatsoever nature directly or indirectly caused by, resulting from or in connection with any of the following regardless of any other cause or event contributing concurrently or in any other sequence to the **Loss**:

1. war, invasion, acts of foreign enemies, hostilities or warlike operations (whether war be declared or not), civil war, rebellion, revolution, insurrection, civil commotion assuming the proportions of or amounting to an uprising, military or usurped power; or

2. any act of terrorism.

   For the purpose of this exclusion, an act of terrorism means an act, including but not limited to the use of force or violence and/or the threat thereof, of any person or group(s) of persons, whether acting alone or on behalf of or in connection with any organization(s) or government(s), committed for political, religious, ideological or similar purposes including the intention to influence any government and/or to put the public, or any section of the public, in fear.

This exclusion also excludes **Loss**, damage, cost or expense of whatsoever nature directly or indirectly caused by, resulting from or in connection with any action taken in controlling, preventing, suppressing or in any way relating to 1 and/or 2 above.

If the Insurers allege that by reason of this exclusion, any **Loss**, damage, cost or expense is not covered by this insurance, the burden of proving the contrary shall be upon the **Insured**.

In the event any portion of this provision is found to be invalid or unenforceable, the remainder shall remain in full force and effect.

D. SANCTION LIMITATION AND EXCLUSION CLAUSE

No (re)insurer shall be deemed to provide cover and no (re)insurer shall be liable to pay any claim or provide any benefit hereunder to the extent that the provision of such cover, payment of such claim or provision of such benefit would expose that (re)insurer to any sanction, prohibition or restriction under United Nations resolutions or the trade or economic sanctions, laws or regulations of the European Union, United Kingdom or United States of America.

ORIGINAL

Professional First™ – Life Agent Broker-Dealer Professional Liability Policy

In consideration of the payment of the premium, and in reliance upon the representations made in the **Application**, and subject to all terms, conditions and limitations of this policy, the **Insureds' Representative**, **Insureds** and **Insurer** agree as follows:

SECTION I INSURING AGREEMENTS

A. Agent – Registered Representative – Registered Investment Adviser

The **Insurer** shall pay **Loss** on behalf of any **Agent**, **Registered Representative** or **Registered Investment Adviser** as a result of a **Claim**:

1. first made against such **Insured** during the **Policy Period** for a **Wrongful Act** of such **Insured** occurring on or after the **Prior Acts Date** and prior to the end of the **Policy Period**; and
2. reported to the **Insurer** as required by this policy.

B. Sponsor Broker-Dealer

The **Insurer** shall pay **Loss** on behalf of a **Sponsor Broker-Dealer** as a result of a **Claim**:

1. first made against such **Insured** during the **Policy Period** for a **Wrongful Act** taking place on or after the **Prior Acts Date** and prior to the end of the **Policy Period**; and
2. reported to the **Insurer** as required by this policy.

C. Sponsor Company Vicarious Liability

The **Insurer** shall pay **Loss** on behalf of a **Sponsor Company** as a result of a **Claim** first made against such **Insured** during the **Policy Period** for a **Wrongful Act**:

1. committed by an **Agent**;
2. taking place on or after the applicable **Prior Acts Date** for such **Agent** and prior to the end of the **Policy Period**; and
3. reported to the **Insurer** as required by this policy.

This **Insuring Agreement C.** shall not apply to any **Claim** that contains any allegation of a **Wrongful Act** or other wrongdoing of the **Sponsor Company**, including, but not limited to, bad faith or the negligent hiring, training, management or supervision of such **Agent** who committed or was alleged to have committed a **Wrongful Act**.

SECTION II CONDITIONS

Coverage provided under **Section I Insuring Agreements** applies only if, prior to the inception date of this policy, or that of the first policy issued and continuously renewed by the **Insurer** of which this policy is a renewal, no **Insured** knew or could have reasonably foreseen that such **Wrongful Act** did or might likely give rise to a **Claim**.

SECTION III DEFINITIONS

1. "**Accredited Investor**" means an investor meeting the requirements of the Securities and Exchange Commission at the time of the occurrence of the first **Wrongful Act** giving rise to the **Claim**.

SPECIMEN

2. "**Administration of Employee Benefit Plans**" means with respect to employee benefit plans: **(a)** counseling of employees, participants or beneficiaries of such plans; **(b)** preparing, distributing, or filing required notices, including, without limitation, COBRA notices; **(c)** handling records; or **(d)** carrying out the enrollment, termination or cancellation of employees, participants or beneficiaries of such plans. **Administration of Employee Benefit Plans** shall not include third-party claims administration.

3. "**Agent**" means any:

a. natural person who at the time of the actual or alleged **Wrongful Act** had the necessary federal, state and regulatory license(s) to perform the **Professional Services** set forth in the **Claim**, and who:

i. maintains(ed) an agent contract with the **Sponsor Company**; and

ii. enrolled for coverage under this policy, and whose enrollment is on file with the **Policyholder**, **Insureds' Representative** or the broker identified in **Item 12.** of the Declarations, and is memorialized by a **Certificate**; or

b. corporation, partnership, or other business entity for which there is no other valid and collectible insurance, which is owned or controlled by the **Agent** described in subparagraph **a.** above; provided, however, that the extension set forth in this subparagraph **b.** shall apply solely with respect to the vicarious liability of such corporation, partnership, or other business entity resulting from a **Wrongful Act** of an **Agent**; or

c. natural person who at the time of the actual or alleged **Wrongful Act** was an administrative, secretarial or clerical employee of the **Agent** described in subparagraph **a.** above and who:

i. was solely performing administrative, secretarial or clerical services on behalf of the **Agent**; and

ii. received no fees, commissions, or charges pursuant to such **Professional Services** set forth in the **Claim**;

but only with respect to **Claims** alleging **Wrongful Acts** of an **Agent** described in subparagraph **a.** above, where such **Claim** is also made and continuously maintained against such **Agent**.

4. "**Application**" means the application submitted to the **Insurer** for this policy together with any written materials attached thereto or submitted to the **Insurer** in connection with the underwriting of this policy and the application(s) for all previous policies of which this policy is a direct or indirect renewal or replacement.

5. "**Broker-Dealer**" means any 'broker' or 'dealer' as such terms respectively are defined in the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, or the Investment Advisers Act of 1940, each as amended.

6. "**Certificate**" means an ACORD or other document provided by the broker identified in **Item 12.** of the Declarations that memorializes enrollment for cover under this policy, the endorsements provided, the Limit of Liability elected and the applicable Retention amounts. All natural persons and entities included as an **Agent**, or a **Registered Representative** or **Registered Investment Adviser**, under this policy by virtue of any **Certificate** shall share the same **Prior Acts Date**, Limit(s) of Liability and Retention of the **Agent**, **Registered Representative** or **Registered Investment Adviser** specifically named on the **Certificate**.

SPECIMEN

7. "**Claim**" means:

a. a written demand for monetary relief, including a request to toll any statute of limitations, or to engage in arbitration or mediation, which shall be deemed first made upon receipt by the **Insured** of such demand; or

b. a civil proceeding for monetary relief, which shall be deemed first made upon the service of a complaint or similar pleading upon the **Insured**.

8. "**Client**" means any natural person or entity that **Professional Services** are rendered to by an **Insured**. **Client** shall not include any insurance company, fraternal benefit society, insurance agent, general agent, registered representative, registered investment adviser, or **Broker-Dealer**, including any of the foregoing that may qualify as an **Insured** under this policy.

9. "**Corporate Registered Investment Adviser**" means a corporation registered as an Investment Adviser under the Investment Advisers Act of 1940, as amended.

10. "**Defense Costs**" means reasonable and necessary fees, costs and expenses incurred by, or at the direction of the **Insurer**, in the defense or appeal of any **Claim**, including the costs of an appeal bond, attachment bond or similar bond, but does not include the obligation to apply for or furnish such bonds.

Defense Costs shall not include: **(a)** any salaries, wages, overhead, benefits, benefit expenses or internal charges associated with any **Insured** or the **Insurer**; or **(b)** any fees, costs or expenses incurred by any **Insured** prior to the time that the **Claim** is noticed to the **Insurer.**

11. "**Due Diligence Services**" means an independent investigation to determine the: **(a)** accuracy of representations made by an issuer of securities; or **(b)** advisability of securities recommended in connection with the sale, attempted sale, or servicing of securities approved by the **Sponsor Broker-Dealer**.

12. "Enforcement Authority" means any governmental, regulatory or self-regulatory authority; including, but not limited to, the Securities and Exchange Commission, the Financial Industry Regulatory Authority or the Department of Labor.

13. "**Financial Planning Services**" means the provision of financial or investment advice regarding covered **Professional Services** to a **Client** based upon an analysis of such **Client's** individual needs, financial circumstances and objectives.

14. "**Former Registered Representative**" means any natural person who does not qualify as a **Registered Representative** under this policy, but was registered with the Financial Industry Regulatory Authority as a registered representative or registered principal, was contracted with the **Sponsor Broker-Dealer** and was an 'insured' under any professional liability policy issued to or for the benefit of the **Sponsor Broker-Dealer** for which this policy is a renewal, replacement or succeeds in time.

15. "**Insured**" means any:

a. Agent;

b. Registered Representative or **Registered Investment Adviser**;

c. Sponsor Broker-Dealer; or

d. Sponsor Company.

Insured shall not include the **Policyholder** or the **Insureds' Representative**.

16. "**Insureds' Representative**" means the purchasing group entity identified at **Item 3.** of the Declarations.

SPECIMEN

17. "**Insurer**" means the insurance company identified at **Item 4.** of the Declarations.

18. "**Investment Advisory Services**" means advisory services provided pursuant to the Investment Advisers Act of 1940, as amended, by a **Registered Investment Adviser**, but in all cases solely with respect to securities approved by the **Sponsor Broker-Dealer**, and then only if, prior to providing such services, the **Registered Investment Adviser** gave written notice to the **Sponsor Broker-Dealer** of the intent to provide such services and received written approval from the **Sponsor Broker-Dealer** to conduct such services.

19. "**Life Insurance Company**" means any entity that files its annual and/or quarterly statements as Life, Accident, and Health Company with the National Association of Insurance Commissioners (NAIC).

20. "**Loss**" means those amounts any **Insured** is legally obligated to pay as a result of a **Claim**, including, but not limited to:

a. compensatory damages;

b. settlements and judgments, including costs and fees awarded pursuant to a covered judgment and pre-judgment and post-judgment interest on that portion of a covered judgment; and

c. Defense Costs.

Loss (other than **Defense Costs**) shall not include any of the following:

i. taxes, fines or penalties imposed against an **Insured**;

ii. any amount for which an **Insured** is legally absolved from payment;

iii. costs incurred by an **Insured** to comply with any order for non-monetary relief (including injunctive relief) or with any agreement to provide such relief;

iv. any amount which constitutes disgorgement, restitution, rescission, the return of fees, commissions, charges or other compensation, including, without limitation, the structure of fees or excessive fees, paid to an **Insured**, provided, however, this shall not apply to surrender charges;

v. punitive or exemplary damages or the amount of any multiplied damage award which is in excess of the damage award so multiplied; or

vi. any amount not insurable under the law pursuant to which this policy shall be construed.

21. "**Management Control**" means:

a. owning an interest in an entity representing more than fifty percent (50%) of the power to manage or control said entity, including the power to elect, appoint or designate a majority of the board of directors or equivalent executives of such entity; or

b. having the right with respect to an entity (including a limited liability company or joint venture), to elect, appoint or designate a majority of the board of directors or equivalent executives of such entity, pursuant to written contract, by-laws, charter, operating agreement or similar documents.

22. "**Policy Period**" means the period from the inception date to the expiration date of this policy as set forth in **Item 5.** of the Declarations (subject to its earlier cancellation in accordance with **Section XIV Cancellation**).

23. "**Policyholder**" means the entity identified at **Item 1.** of the Declarations.

24. "**Pollutants**" means, but is not limited to, any substance located anywhere in the world exhibiting any hazardous characteristics as defined by, or identified on, any list of hazardous substances issued by, the United States Environmental Protection Agency or any state, county, municipality or locality

SPECIMEN

counterpart thereof, including, but not limited to, nuclear material or nuclear waste. Such substances shall include, without limitation, solids, liquids, gaseous, biological, radiological or thermal irritants, contaminants or smoke, vapor, dust, fibers, mold, spores, fungi, germs, soot, fumes, acids, alkalis, chemicals or waste materials and any other air emission, odor, waste water, oil or oil products, infectious or medical waste, asbestos or asbestos products and any noise.

25. "Prior Acts Date" means:

a. with respect to an **Agent**, the inception date of the first claims-made professional liability policy issued to or for the benefit of such **Agent**, which has been continuously maintained and in force without interruption up to the inception of this policy, and written documentation evidencing such continuously maintained insurance must be provided to the **Insurer** with any notice of a **Claim** under this policy;

b. with respect to a **Registered Representative** or **Registered Investment Adviser**, the most recent date such **Registered Representative** or **Registered Investment Adviser** contracted with the **Sponsor Broker-Dealer**; or

c. with respect to a **Sponsor Broker-Dealer**, the date set forth in **Item 10.** of the Declarations for each such **Sponsor Broker-Dealer**.

26. "**Private Placement**" means an offering of unregistered securities regulated by the Securities and Exchange Commission, as promulgated under Regulation D of the Securities Act of 1933, as amended, and meets all rules and conditions set forth under Regulation D.

27. "**Professional Services**" means:

a. with respect to an **Agent** or a **Registered Representative** or **Registered Investment Adviser**, the following services provided to a **Client**:

i. the sale, attempted sale, or servicing of:

1. life insurance, accident and health insurance, managed health care organization contracts, disability income insurance, fixed annuities, equity indexed annuities and 24-hour care coverage (as defined by statutory law); or

2. KEOGH retirement plans, employee benefit plans, individual retirement accounts or arrangements; or

3. variable annuities, variable life insurance or mutual funds that are registered with the Securities and Exchange Commission, if required, through a **Broker-Dealer**; or

4. securities approved by the **Sponsor Broker-Dealer**; or

ii. the **Administration of Employee Benefit Plans**; or

iii. **Investment Advisory Services**; or

iv. solely in connection with the services described in subparagraphs **i.** through **iii.** above:

1. **Financial Planning Services**, including when an additional fee is not charged; or

2. the use of any internet marketing, including social media, to achieve the marketing and communication goals of an **Insured's** business; or

v. as a fiduciary adviser, as defined in the Pension Protection Act of 2006, as amended, or as described in Section 3(21) (A)(ii) of the Employee Retirement Income Security Act of 1974, as amended, and any rules promulgated thereunder, respectively; or

vi. as a notary public; or

SPECIMEN

vii. solely in connection with the services described above in this subparagraph a., the supervision, management and training of:

1. an **Agent** by a general agent, who is also an **Insured** under this policy; or

2. a **Registered Representative** or **Registered Investment Adviser** by a registered principal, who is also an **Insured** under this policy; or

b. with respect to the **Sponsor Broker-Dealer**: **(i) Investment Advisory Services**; **(ii) Supervisory Services**; or **(iii) Due Diligence Services**; but in all cases only to the extent any such services described in **(i)** through **(iii)** of this subparagraph **b.** are provided by the **Sponsor Broker-Dealer** in the course and scope of such **Insured's** business as a **Broker-Dealer**.

28. "**Registered Investment Adviser**" means any natural person **Registered Representative**, or any corporation, partnership or other business entity owned or controlled by such natural person **Registered Representative**, but solely with respect to **Investment Advisory Services** provided in such **Registered Representative's** capacity as an Investment Adviser registered under the Investment Advisers Act of 1940, as amended.

29. "**Registered Representative**" means any:

a. natural person who, at the time of the actual or alleged **Wrongful Act**, had the necessary federal, state and regulatory license(s) to perform the **Professional Services** set forth in the **Claim**, and who:

i. is registered with the Financial Industry Regulatory Authority as a registered representative or registered principal, and who is contracted with the **Sponsor Broker-Dealer**; and

ii. enrolled for coverage under this policy, and whose enrollment is on file with the **Policyholder**, **Insureds' Representative** or the broker identified in **Item 12.** of the Declarations, and is memorialized by a **Certificate**; or

b. corporation, partnership or other business entity for which there is no other valid and collectible insurance, which is owned or controlled by the **Registered Representative** described in subparagraph **a.** above; provided, however, that the extension set forth in this subparagraph **b.** shall apply solely with respect to the vicarious liability of such corporation, partnership or other business resulting from a **Wrongful Act** by such **Registered Representative** described in subparagraph **a.** above; or

c. natural person who at the time of the actual or alleged **Wrongful Act** was an administrative, secretarial or clerical employee of the **Registered Representative** described in subparagraph **a.** above and who:

i. was solely performing administrative, secretarial or clerical services on behalf of the **Registered Representative**; and

ii. received no fees, commissions, or charges pursuant to such **Professional Services** set forth in the **Claim**;

but only with respect to **Claims** alleging **Wrongful Acts** of a **Registered Representative** described in subparagraph **a.** above, where such **Claim** is also made and continuously maintained against such **Registered Representative**.

30. "**Related Wrongful Acts**" means all **Wrongful Acts** that are logically or causally connected by any fact, circumstance, situation, event, transaction, cause or series of related facts, circumstances, situations, events, transactions or causes.

SPECIMEN

31. "**Sponsor Broker-Dealer**" means the entity(ies) specified in **Item 2.B.** of the Declarations, and any **Corporate Registered Investment Adviser** thereof.

32. "**Sponsor Company**" means the entity(ies) specified in **Item 2.A.** of the Declarations.

33. "**Supervisory Services"** means services relating to the **Sponsor Broker-Dealer's** ensuring or failing to ensure that performance of **Professional Services** by an **Agent** or a **Registered Representative**, **Former Registered Representative** or **Registered Investment Adviser**, is or was in compliance with the procedures and duties established by any **Enforcement Authority**.

34. "**Wrongful Act**" means any actual or alleged negligent act, error, or omission committed by an **Insured** in the rendering of or failure to render **Professional Services**.

SECTION IV EXCLUSIONS

This policy shall not apply to any **Claim**:

A. Conduct

based upon, arising out of, or relating to any:

i. criminal, intentional, dishonest, malicious, fraudulent or knowing act, error or omission, or any willful violation of any statute, rule or law by an **Insured**; or

ii. **Insured** gaining any profit, financial or non-financial advantage or remuneration that such **Insured** is not legally entitled to receive;

provided, however, this exclusion shall only apply if a final adjudication adverse to such **Insured** in any underlying proceeding establishes that such conduct occurred or profit, advantage or remuneration was gained.

B. Prior Notice

based upon, arising out of, or relating to any **Wrongful Act**, fact, circumstance or situation which has been the subject of any written notice given before the inception of the **Policy Period** under any professional liability policy, provided the insurer of such policy does not reject such notice as invalid.

C. Pending and Prior Litigation

based upon, arising out of, or relating to essentially the same facts, circumstances, situations, transactions or events underlying or alleged in any litigation, any administrative or regulatory proceeding, any investigation, any arbitration, or any alternative dispute resolution proceeding against the **Insured**, that was pending on or prior to the inception date of this policy.

D. Prior Wrongful Acts

based upon, arising out of, or relating to any **Wrongful Acts** of a **Broker-Dealer** occurring or allegedly occurring before the date the **Insured** had **Management Control** of such **Broker-Dealer**, including any **Wrongful Acts** occurring or allegedly occurring on or after such date that are **Related Wrongful Acts** thereto.

E. Bodily Injury/Property Damage

for any actual or alleged:

i. bodily injury, mental anguish, emotional distress, sickness, disease, or death of any person; or

ii. damage to or destruction of any tangible property, including the loss of use thereof.

SPECIMEN

F. Employment Practices

based upon, arising out of, or relating to any actual or alleged:

i. employment-related act, omission, error, misstatement, misleading statement, neglect or breach of duty; or

ii. harassment of or discrimination against anyone.

G. Antitrust/Unfair Competition

based upon, arising out of, or relating to any actual or alleged:

i. antitrust violations, including, without limitation, any violation of the Sherman Antitrust Act, the Clayton Act, the Robinson-Patman Act, each of the foregoing as amended, or any similar federal, state, local or foreign statutory, common or regulatory law; or

ii. violation of any federal, state, local or foreign statutory, common or regulatory law with respect to business competition, unfair trade practices or tortious interference in another's contractual or business relationships.

H. Confidential/Personally Identifiable Information

based upon, arising out of, or relating to any actual or alleged misuse of (including but not limited to for purposes of sale or replacement of insurance coverage) or failure to protect any confidential information or personally identifiable information by or on behalf of an **Insured**, including, but not limited to, trade secrets, personal customer information, customer lists, a customer's personally identifiable financial or medical information and intellectual property.

I. Insider Trading

based upon, arising out of, or relating to any actual or alleged violation of the Insider Trading and Securities Fraud Enforcement Act of 1988, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, any similar federal, state, local or foreign laws or statutes, or any rules or regulations promulgated under any of the foregoing, as amended.

J. Clearing Agency Services

based upon, arising out of, or relating to, an **Insured's** performance of or failure to perform services for or on behalf of a clearing agency or arising out of any function of any **Insured** as a clearing agency.

K. Professional Services for Specified Persons/Entities

based upon, arising out of, or relating to **Professional Services** performed for or on behalf of any:

i. past or present **Insured**;

ii. entity in which an **Insured** has or had, directly or indirectly: (a) the right to manage or operate; or (b) a 10% or more equity ownership at the time of such **Professional Services**, including any entity under **Management Control** of an **Insured**, directly or indirectly;

iii. entity that has or had, directly or indirectly: **(a)** the right to manage or operate; or **(b)** a 10% or more equity ownership in an **Insured** at the time of such **Professional Services**, including any entity that has **Management Control** of an **Insured**;

iv. parent, spouse, domestic partner, household member, or child of an **Insured**; or

v. Broker-Dealer, other than one which buys, sells or trades in securities exclusively as a principal for its own account.

SPECIMEN

L. Enforcement Authority

brought or maintained by or on behalf of an **Enforcement Authority**; provided, however, this exclusion shall not apply to any **Claim** by an official of such **Enforcement Authority** if such natural person is bringing the **Claim** in his or her capacity as a **Client** of an **Insured** and not as an official of such agency or organization.

M. Contractual Liability

based upon, arising out of, or relating to:

i. an **Insured's** alleged liability under any oral or written contract or agreement, including, but not limited to, express warranties or guarantees; or

ii. the liability of others an **Insured** assumes under any oral or written contract or agreement;

provided, however, this exclusion shall not apply to an **Insured's** liability that exists in the absence of such contract or agreement.

N. Representation/Guarantee

based upon, arising out of, or relating to any representations or guarantees made by the **Insured** with respect to interest rates or fluctuations in interest rates, the market value or performance of any investment or insurance product, or future premium payments; provided, however, this exclusion shall not apply to future value or similar projections when they include an appropriate written disclaimer.

O. Commingling

based upon, arising out of, or relating to any actual or alleged commingling, theft, or use of the funds of any **Client** or prospective client.

P. Insolvency

based upon, arising out of, or relating to the insolvency, receivership, conservatorship, liquidation, bankruptcy, or inability or refusal to pay of any natural person, entity, benefit plan, trust or investment vehicle, insurance or reinsurance entity, managed health care organization, risk retention group or captive (or any self-insurance plan or trust by whatsoever name), or limited partnership, in which the **Insured** has placed business or obtained insurance coverage, or placed or recommended the placement of the funds of a **Client**; however, notwithstanding the foregoing, the **Insurer** shall have the right and duty to defend the **Insured** in any **Claim** alleging any of the foregoing acts described above, provided the **Claim** arises from the **Insured's** placement of coverage with an admitted insurance company with an A.M. Best rating of "A-" or better at the time of placement.

Q. Employee Benefit Plans/Fiduciary Services

based upon, arising out of, or relating to the responsibilities, obligations or duties imposed pursuant to the Employee Retirement Income Security Act of 1974, as amended, or any similar federal, state, local or foreign statutory law or common law with respect to:

i. any plans, programs and trusts, **(1)** established or maintained in whole or in part for the benefit of employees of the **Insured**; **(2)** sponsored by the **Insured**; **(3)** in which the **Insured** is a participant, trustee or named fiduciary, as defined in the Employee Retirement Income Security Act of 1974, as amended**,** or any similar federal, state, local or foreign statutory law or common law; or

SPECIMEN

ii. any fiduciary services as defined in Section 3(38) of the Employee Retirement Income Security Act of 1974, as amended, or any similar federal, state, local or foreign statutory law or common law.

R. Discretionary Authority

based upon, arising out of, or relating to any actual or alleged activities in connection with discretionary authority exercised by or on behalf of an **Insured** with regard to **Client** assets; provided, however, this exclusion shall not apply to the activities of the **Insured** when exercising discretionary authority as a **Registered Investment Adviser**.

S. Mechanical Failure/ War/Pollutants

based upon, arising out of, or relating to any:

i. mechanical or electronic failure, breakdown or malfunction of machines or systems;

ii. war, invasion, acts of foreign enemies, hostilities (whether war is declared or not), civil war, rebellion, revolution, insurrection, military or usurped power, or confiscation, nationalization, requisition, or destruction of, or damage to, property by or under the order of any government, public or local authority; or

iii. actual or alleged or threatened discharge, release, escape, seepage, migration or dispersal of any **Pollutants**, or any request, demand, order, direction, or statutory or regulatory requirement that any **Insured** or others test for, monitor, remove, contain, treat, detoxify, neutralize, clean up, or in any way respond to or assess the effects of such **Pollutants**.

T. Investment Banking Activities

based upon or arising out of any actual or alleged liability involving any advice or service relating to or in connection with any aspect of corporate mergers, acquisitions, securities offerings, restructuring, divestitures, market making (including the failure to make a market) for any securities, specialization in securities, or investment banking; provided, however, this exclusion shall not apply to any **Claim** related solely to conduct by the **Insured** that is detrimentally relied upon by **Clients** and does not arise from facts or circumstances affecting the offering generally including actual or alleged misrepresentations or omissions in the formal written offering materials, registration statements, offering memoranda and circulars.

U. Unlicensed Entity

based upon, arising out of, or relating to the placement of a **Client's** coverage or funds directly or indirectly with any organization, entity, or vehicle of any kind, nature or structure which is not licensed to do business in the state or jurisdiction with authority to regulate such business; provided, however, this exclusion shall not apply to any **Claim** arising from or contributed to by the placement of a **Client's** coverage or funds directly or indirectly with such organization, entity or vehicle which is an eligible surplus lines insurer in the state or jurisdiction with authority to regulate such business.

V. Other Activities

based upon, arising out of, or relating to any actual or alleged performance of or failure to perform services by or on behalf of an **Insured** as an actuary, accountant, attorney, property or casualty agent, real estate agent, or third-party administrator, including providing tax or legal advice, unless such tax or legal advice is an incidental part of the **Professional Services** being rendered by a natural person **Insured**.

SPECIMEN

W. Unsolicited Communications

based upon, arising out of, or relating to any actual or alleged violation of any federal, state or local anti-spam statute, ordinance or other regulation that addresses, prohibits, or limits the printing, dissemination, disposal, collecting, recording, sending, transmitting, communicating or distribution of material or information, including any statute or regulation prohibiting the dissemination of unsolicited communications, including, but not limited to, the CAN-SPAM Act of 2003 or Telephone Consumer Protection Act of 1991, both as amended.

X. Prohibited Products

based upon, arising out of, or relating to the actual or alleged recommendation, purchase, sale, attempted sale, or servicing, including any advice in connection therewith, of any:

i. proprietary fund or investment products in which an **Insured** has any ownership interest;

ii. coverage, alleged coverage or plan placed with any form of Multiple Employer Welfare Arrangement as defined by the Employee Retirement Income Security Act of 1974, as amended, or any employee benefit plan involving self-funding in whole or in part, by any employer, union, or employment related entity;

iii. product or service, which at the time of the **Wrongful Act** was not approved by the Sponsor **Broker-Dealer**;

iv. commodities, futures contract, forwards contract or any type of options contract, or any similar investment or investment product, except: **(1)** as part of a mutual fund; or **(2)** covered call or covered put options;

v. promissory note;

vi. security in any market outside of the United States of America, or its territories or possessions;

vii. viatical settlements, viatical insurance benefits, viatical investment pools or any security backed by viatical settlements;

viii. structured settlements, structured notes, principal protected notes, reverse convertible notes, life settlements, reverse mortgages, or similar transactions in which the present value of a conditional contract is exchanged or sold;

ix. Stranger Originated Life Insurance (STOLI) or Speculator Initiated Life Insurance (SPIN LIFE) or any similar transactions;

x. issuer callable certificates of deposit or equipment sale-lease-buy-back transactions of any kind;

xi. multiple or leveraged exchange traded funds or notes, multiple inverse exchange traded funds or notes, unit investment trusts, or auction rate securities;

xii. life insurance policy in which the premium was paid for, in whole or in part, by or through any premium finance mechanism or any premium finance company;

xiii. income stream from an annuity, disability policy or a pension plan, including, but not limited to, Voyager Financial Group products, military pension plans, retirement pension plans, or disability benefits;

xiv. plans created under Sections 412 or 419 of the Internal Revenue Code or insurance or annuities sold as part of or to be used in conjunction with or to fund any plan created under Sections 412 or 419 of the Internal Revenue Code;

SPECIMEN

xv. security that is not registered with the Securities and Exchange Commission, unless the security is exempt from registration with the Securities and Exchange Commission and is approved by the **Sponsor Broker-Dealer**;

xvi. hedge fund, regardless of whether it is registered with the Securities and Exchange Commission;

xvii. limited partnership or **Private Placement**, unless it is: **(a)** compliant with all applicable Blue Sky laws; **(b)** sold only to **Accredited Investors**; and **(c)** not otherwise excluded by another provision of this policy;

xviii. public or private non-traded real estate investment trust (REIT), unless: **(a)** the **Claim** is by an **Accredited Investor**; **(b)** the REIT investment(s) for the **Client** met the applicable **Sponsor Broker-Dealer**, state and federal concentration guidelines at the time of the **Wrongful Act**; **(c)** the underlying property is not illiquid, insolvent, bankrupt or in receivership or foreclosure; and **(d)** the **Claim** is not otherwise excluded by any other provision of this policy;

xix. Tenants in Common (TIC/1031 Exchange), unless: **(a)** the **Claim** is by an **Accredited Investor**; **(b)** the TIC investment(s) for the **Client** met the applicable **Sponsor Broker-Dealer**, state and federal concentration guidelines at the time of the **Wrongful Act**; **(c)** the underlying property is not illiquid, insolvent, bankrupt or in receivership or foreclosure; and **(d)** the **Claim** is not otherwise excluded by any other provision of this policy; or

xx. security priced at or below $5.00 per share at the time of the **Wrongful Act** triggering such **Claim**; provided, however, this exclusion shall not apply if the security is: **(a)** registered or approved for registration upon notice of issuance on a national securities exchange; **(b)** authorized or approved for authorization upon notice of issuance for quotation in the NASDAQ National Market System or the NASDAQ SmallCap Market; or **(c)** issued by an investment company registered under the Investment Company Act of 1940, as amended.

SECTION V POLICY LIMITS

A. The maximum liability of the **Insurer** for all **Loss** under this policy arising from all **Claims** combined shall be the Policy Aggregate stated in **Item 6.** of the Declarations. The Policy Aggregate applies regardless of the number of **Claims**, **Insureds**, **Wrongful Acts** or **Related Wrongful Acts**.

B. The applicable each **Claim** Limit of Liability stated in **Item 7.** of the Declarations, or by endorsement to this policy, is the maximum limit of the **Insurer's** liability for all **Loss** for each **Claim** against the **Insured** under this policy, and such amount shall be part of, and not in addition to, the applicable aggregate Limit of Liability stated **Item 7.** of the Declarations. Both the each **Claim** and aggregate Limits of Liability shall be part of, and not in addition to, the Policy Aggregate stated in **Item 6.** of the Declarations. Coverage for **Loss** under **Insuring Agreement C.**, shall be subject to the each **Claim** and the aggregate Limit of Liability stated on the **Certificate** of the **Agent** who committed, or was alleged to have committed, a **Wrongful Act**, and shall in no way serve to reinstate or increase any such limit of liability.

C. In the event of a **Claim** involving more than one **Insured**, the highest applicable each **Claim** Limit of Liability to any one such **Insured** shall be the maximum amount the **Insurer** shall be liable to pay on behalf of all **Insureds** involved in such **Claim**, and any subsequent **Claim** made against any **Insured** involving the same **Wrongful Act** or **Related Wrongful Acts** to such **Claim**.

D. **Defense Costs** shall be part of, and not in addition to, the applicable Limits of Liability stated in **Item 7.** of the Declarations and the Policy Aggregate stated in **Item 6.** of the Declarations. Such **Defense Costs** shall reduce the applicable Limit of Liability and Policy Aggregate.

SPECIMEN

SECTION VI RETENTION

A. The applicable Retention as set forth in **Item 8.** of the Declarations shall apply to **Loss** resulting from each **Claim**.

B. The **Insurer's** liability with respect to covered **Loss** resulting from each **Claim** shall be excess of the applicable Retention as set forth in **Item 8.** of the Declarations. The applicable Retention shall be borne by the **Insured** under this policy, and shall apply to all covered **Loss**.

C. Each **Agent**, **Registered Representative** and **Registered Investment Adviser** is responsible for their pro rata share of the applicable Retention amount when more than one such **Insured** is named in a **Claim**, provided, however, that the Retention amount stated in **Item 8.B.** of the Declarations shall apply if a **Sponsor Broker-Dealer** is also named in such **Claim,** and such amount shall be paid by the **Sponsor Broker-Dealer**.

SECTION VII RELATED CLAIMS

More than one **Claim** against one or more **Insured** involving the same **Wrongful Act** or **Related Wrongful Acts**, shall be considered a single **Claim**, and only one Retention shall be applicable to such single **Claim**. In the event such single **Claim** triggers more than one Retention, the highest Retention shall apply.

All such **Claims** constituting a single **Claim**, shall be deemed to have been first made on the earlier of the following dates: **(A)** the earliest date on which any such **Claim** was first made; or **(B)** the earliest date on which any such **Wrongful Act** or **Related Wrongful Acts** was reported under this policy or any other policy providing similar coverage, regardless whether such date is before or during the **Policy Period**. In no event shall a single lawsuit or proceeding constitute more than one **Claim** subject to more than one Retention.

SECTION VIII DEFENSE AND SETTLEMENT

A. Defense

i. The **Insurer** shall have the right and duty to defend a **Claim** alleging a **Wrongful Act** even if the **Claim** is groundless, false or fraudulent.

ii. The **Insurer** shall have the right to select and instruct defense counsel.

iii. The **Insurer's** right and duty to defend and pay on the **Insured's** behalf ends when the applicable Limit of Liability stated in **Item 7.** of the Declarations or the Policy Aggregate stated in **Item 6.** the Declarations has been exhausted, whichever occurs first.

iv. The **Insured** shall not incur any **Defense Costs** without the prior written consent of the **Insurer**.

B. Settlement

The **Insured** shall not admit liability, offer to settle, or agree to any settlement in connection with any **Claim** without the express prior written consent of the **Insurer**, which consent shall not be unreasonably withheld or delayed. The **Insurer** shall not be liable under this policy for **Loss** incurred as a result of any such admission, offer or agreement to which the **Insurer** did not so consent. Notwithstanding the foregoing, the **Insureds** may settle all **Claims** subject to a single Retention without the **Insurer's** prior written consent if the settlement amount plus **Defense Costs** for all such **Claims** do not exceed the applicable Retention stated in **Item 8.** of the Declarations.

If any **Insured** refuses to consent to a settlement recommended by the **Insurer** within the applicable Limit of Liability stated in the Declarations of this policy, the **Insurer's** liability under this policy will be reduced to the amount for which the **Claim** could have been settled, plus all **Defense Costs**

SPECIMEN

incurred up to the time the **Insurer** made its recommendation, the total of which is not to exceed the applicable Limit of Liability stated in the Declarations of this policy.

SECTION IX ASSISTANCE AND COOPERATION OF THE INSUREDS

Each **Insured** shall cooperate with the **Insurer**, and provide to the **Insurer** all information which the **Insurer** reasonably requests, without charge to the **Insurer**, including, but not limited to, attending hearings, depositions and trials and assistance in effecting settlements, securing and giving evidence, obtaining the attendance of witnesses and conducting the defense of any **Claim** covered by this policy. The **Insured(s)** shall do nothing that may prejudice the **Insurer's** position.

SECTION X NOTICE

A. Notice of Claim

The **Insureds** shall, as a condition precedent to their rights under this policy, give the **Insurer** written notice of any **Claim** made during the **Policy Period**. Notice provided pursuant to this section shall be given as soon as practicable after the **Insured** first learns of such **Claim**, but in no event later than the end of the **Policy Period**.

B. Notice of Potential Claims

During the **Policy Period**, the **Insureds** may give written notice to the **Insurer** of circumstances that may reasonably be expected to give rise to a **Claim**. Notice shall set forth:

- **i.** a description of the specific **Wrongful Act** which forms the basis of the potential **Claim**;
- **ii.** the reasons for anticipating such a **Claim**;
- **iii.** full particulars as to dates, the insurance and/or investment products recommended, sold or serviced, and the **Clients** and **Insureds** potentially involved;
- **iv.** the facts and events by which the **Insureds** first became aware of the circumstances;
- **v.** the consequences which have resulted or may result; and
- **vi.** the nature of the potential monetary damages and non-monetary relief.

Any **Claim** which is subsequently made against such **Insured** alleging, arising out of, based upon or attributable to such circumstances, shall be considered made at the time notice of such circumstances was first given to the **Insurer**.

Notice of any such subsequent **Claim** shall be given to the **Insurer** as soon as practicable after the **Insured** first learns of such **Claim**. No coverage shall be provided under this policy for fees, costs, expenses or other **Loss** incurred as a result of such circumstances prior to the time such subsequent **Claim** is actually made and notice of same is provided to the **Insurer**.

C. Addresses for Notices

Except as otherwise provided in this policy, all notices under any provision of this policy shall be in writing and given by email, prepaid express courier or certified mail properly addressed to the appropriate party. Notice to the **Insureds** may be given to the **Policyholder** at the address shown in **Item 1.** of the Declarations, or the **Insureds' Representative** at the address shown in **Item 3.** of the Declarations in accordance with **Section XXVI Authorization**. Notice to the **Insurer** shall be given to the respective address shown in **Item 9**. of the Declarations. If notice is given as described above, it shall be deemed to be received and effective upon the date of transmittal, subject to proof of transmittal.

SPECIMEN

SECTION XI COVERAGE IMPLICATIONS OF MERGERS, ACQUISITIONS AND SALES OF THE POLICYHOLDER, SPONSOR COMPANY OR SPONSOR BROKER-DEALER

A. Merger or Acquisition of the Policyholder

If during the **Policy Period** any of the following events occur:

i. the **Policyholder**: **(a)** sells all or substantially all of its assets to any other person or entity or affiliated group of persons or entities; or **(b)** merges or consolidates with another entity such that the **Policyholder** is not the surviving entity; or

ii. any person, entity or affiliated group of persons or entities acquires **Management Control** of the **Policyholder**;

(each a "transaction") then coverage under this policy shall continue until expiration of the **Policy Period**, but only for **Wrongful Acts** taking place prior to the effective date of such transaction. This policy may not be cancelled after the effective date of the transaction and the entire premium for this policy shall be deemed earned as of such date.

B. Addition of a Sponsor Company or a Sponsor Broker-Dealer

i. Except as set forth in subparagraph ii. below, if during the **Policy Period** a **Sponsor Company** or a **Sponsor Broker-Dealer** creates, or acquires direct or indirect **Management Control** of any **Life Insurance Company** or **Broker-Dealer**, then such entity shall be an **Insured**, but only with respect to **Wrongful Acts** occurring or allegedly occurring after such entity is created or acquired.

ii. If during the **Policy Period** a **Sponsor Company** or **Sponsor Broker-Dealer** creates, or acquires direct or indirect **Management Control** of a **Life Insurance Company** or a **Broker-Dealer**, and the total number of **Agents** and **Registered Representatives** of the acquired entity is greater than 10% of the consolidated number of **Agents** and **Registered Representatives** enrolled for coverage under this policy as of the date of such creation or acquisition, then coverage under this policy for such entity as set forth in subparagraph **i.** above, shall cease 30 days after such entity was created or acquired, unless:

a. the **Policyholder** within such 30 days provides the **Insurer** with written notice of such creation or acquisition;

b. the **Policyholder** and the **Insurer** agree on any revisions to the policy either party may require; and

c. the **Policyholder** pays any additional premium required by the **Insurer** as a result of the addition of the new **Sponsor Company** or **Sponsor Broker-Dealer**;

and then only with respect to **Wrongful Acts** occurring or allegedly occurring after such entity is created or acquired.

C. Cessation of a Sponsor Company or a Sponsor Broker-Dealer

If during the **Policy Period** a **Sponsor Company** or a **Sponsor Broker-Dealer** ceases to be under the direct or indirect **Management Control** of the **Policyholder**, then coverage for such entity under this policy shall only be available, subject to all other terms and conditions of this policy, for any **Wrongful Act** occurring or allegedly occurring prior to the date such entity ceased to be under direct or indirect **Management Control**.

SPECIMEN

Section XII Other Insurance and Subrogation

A. Other Insurance

All amounts payable under this policy will be specifically excess of, and will not contribute with, any other valid and collectible insurance, unless such other insurance is specifically excess of this Policy; provided this Policy shall apply on a primary basis with respect to any personal umbrella liability insurance policy purchased by an **Agent**, **Registered Representative** or **Registered Investment Adviser**. This policy will not be subject to the terms of any other insurance policy.

B. Subrogation

In the event of any payment under this policy, the **Insurer** shall be subrogated to all of the **Insureds'** rights of recovery, and each and every **Insured** shall execute all papers required and shall do everything that may be necessary to secure such rights, including the execution of such documents as may be necessary to enable the **Insurer** to effectively bring suit in the name of such **Insured**. The **Insurer** assumes no duty to seek a recovery of any amounts paid under this policy.

SECTION XIII EXTENDED REPORTING PERIODS

A. Automatic and Optional Extended Reporting Periods

i. In the event the **Insurer** shall cancel or refuse to renew this policy, the **Policyholder** shall have the right following the effective date of such cancellation or non-renewal to a period of 60 days ("Automatic Extended Reporting Period") in which to give written notice to the **Insurer** of **Claims** first made against the **Sponsor Company** or **Sponsor Broker-Dealer** during the Automatic Extended Reporting Period for any **Wrongful Act** occurring prior to the end of the **Policy Period** and otherwise covered under this policy. The Automatic Extended Reporting Period shall not apply where an Optional Extended Reporting Period has been purchased as set forth in subparagraph **ii.** below, or to **Claims** that are covered under any subsequent insurance that applies to such **Claims**, whether purchased by the **Insured** or others for the **Insured's** benefit.

ii. In the event the **Insurer** refuses to renew this policy or the **Policyholder** cancels or non-renews this policy, the **Policyholder** shall have the right to elect an extension of the coverage provided by this policy for the time period and subject to the additional premium set forth in **Item 11.** of the Declarations ("Optional Extended Reporting Period") in which to give written notice to the **Insurer** of any **Claims** first made against the **Sponsor Company** or **Sponsor Broker-Dealer** during the Optional Extended Reporting Period for any **Wrongful Acts** occurring prior to the end of the **Policy Period** and otherwise covered by the terms of this policy.

As a condition precedent to the right to purchase the Optional Extended Reporting Period, the total premium for this policy must have been paid and a written request to elect the Extended Reporting Period, together with payment of the additional premium for the Extended Reporting Period, must be provided to the **Insurer** no later than 60 days following the effective date of such non-renewal or cancellation. The premium paid for the Extended Reporting Period is deemed nonrefundable at the inception of the Extended Reporting Period.

B. Extended Reporting Period for Agents, Registered Representatives and Registered Investment Advisers

i. In the event: **(a)** this policy is not renewed or is cancelled by the **Policyholder**; **(b)** an **Agent** is terminated by a **Sponsor Company** (other than for disciplinary reasons) or retires or becomes disabled or deceased during the **Policy Period**; or **(c)** a **Registered Representative** or **Registered Investment Adviser** is terminated by a **Sponsor Broker-Dealer** (other than for disciplinary reasons) or retires or becomes disabled or deceased during the **Policy Period**; then each **Agent**, **Registered Representative** or **Registered Investment Adviser** shall have the right following the effective date

SPECIMEN

of such cancellation or non-renewal, or termination, retirement, disability or death, to a period of one year ("Extended Reporting Period") in which to give written notice to the **Insurer** of **Claims** first made against such **Insured** during the Extended Reporting Period for any **Wrongful Act** occurring prior to such effective date and otherwise covered under this policy.

ii. In the event any **Agent**, **Registered Representative** or **Registered Investment Adviser** is terminated by a **Sponsor Company** or a **Sponsor Broker-Dealer** during the **Policy Period** for disciplinary reasons, such **Agent**, **Registered Representative** or **Registered Investment Adviser** shall have a period of 90 days following the effective date of such termination ("Extended Reporting Period") in which to give written notice to the **Insurer** of **Claims** first made against such **Insured** during the Extended Reporting Period for any **Wrongful Act** occurring prior to such effective date and otherwise covered under this policy.

iii. The Extended Reporting Periods described above shall expire at such time that subsequent professional liability insurance is purchased by others for the **Insured's** benefit, or the **Insured** independently enrolls for or purchases professional liability insurance, and, in each case, regardless of whether coverage is available for such **Claim** under said other insurance.

C. The Extended Reporting Periods described in this **Section XIII** shall not in any way increase the applicable Limit(s) of Liability stated in **Item 7.**, or the Policy Aggregate stated in **Item 6.**, of the Declarations, or in any endorsement. For purposes of the Limit of Liability and Policy Aggregate, the Extended Reporting Period is considered to be part of, and not in addition to, the **Policy Period**.

SECTION XIV CANCELLATION

A. This policy may be cancelled by the **Insureds' Representative** at any time by prior written notice to the **Insurer** stating the effective time of such cancellation. Upon cancellation, the **Insurer** shall be entitled to retain the short rate proportion of the premium calculated from the effective date of such cancellation.

B. This policy may be cancelled by the **Insurer** by written notice to the **Insureds' Representative** at the address shown in **Item 3.** of the Declarations stating the reason for such cancellation. Such cancellation shall be effective on the date specified in the written notice of cancellation given by the **Insurer**, provided such date is at least 90 days after the date such notice is given, or 10 days in the event of cancellation for non-payment of premium. If the premium due is paid in full by an **Insured** prior to such effective date, the **Insurer's** notice of cancellation shall be ineffective.

SECTION XV DISPUTE RESOLUTION PROCESS

The **Insurer** and the **Policyholder** shall attempt in good faith to resolve any dispute arising out of or relating to this policy on behalf of all **Insureds** promptly by negotiation between executives with authority to settle such dispute. If any dispute cannot be resolved through negotiation, the parties agree that they will submit the dispute to non-binding mediation. The parties will use best efforts to agree on the terms of any such mediation process, but if they do not agree within 30 days of either party requesting mediation, the dispute will be submitted to JAMS for mediation. Each party will bear their own costs, regardless of the mediation process used. If the dispute is not settled at mediation, no party may commence an action against any other party until at least 30 days after the final mediation session.

SECTION XVI ACTION AGAINST THE INSURER

A. No action shall lie against the **Insurer** unless, as a condition precedent thereto, there shall have been full compliance by all **Insureds** with all the terms of this policy.

SPECIMEN

B. No person or organization shall have any right under this policy to join the **Insurer** as a party to any **Claim** against an **Insured**, nor shall the **Insurer** be impleaded by any **Insured** or their legal representative in any such **Claim**.

SECTION XVII SPOUSES, DOMESTIC PARTNERS, ESTATES AND LEGAL REPRESENTATIVES

A. The coverage provided by this policy shall also apply to an **Insured's** lawful spouse or domestic partner under applicable law or the provisions of any formal program established by the **Sponsor Company** or **Sponsor Broker-Dealer**, but only for a **Claim** arising out of any actual or alleged **Wrongful Acts** of such **Insured**.

B. The coverage provided by this policy also shall apply to the estates, heirs, legal representatives or assigns of any natural person **Insured** in the event of their death, incapacity or bankruptcy, but only for **Claims** arising out of any actual or alleged **Wrongful Acts** of such **Insured.**

SECTION XVIII ASSIGNMENT

This policy and any and all rights hereunder are not assignable without the prior written consent of the **Insurer**, which consent shall be in the sole and absolute discretion of the **Insurer**.

SECTION XIX CONFORMITY TO STATUTE

Any terms of this policy which are in conflict with the terms of any applicable laws are hereby amended to conform to such laws.

SECTION XX TERRITORY

Where permissible by law, coverage shall apply to **Claims** made and **Wrongful Acts** committed anywhere in the world. Coverage shall not apply to any **Insured** that maintains a primary place of business, or has a **Certificate** provided or maintained by the **Policyholder**, **Insureds' Representative** or the broker identified in **Item 12.** of the Declarations bearing an address outside of the United States of America.

SECTION XXI COMPLIANCE WITH APPLICABLE TRADE AND ECONOMIC SANCTION LAWS

The **Insurer** shall not be deemed to provide cover under this policy and the **Insurer** shall not be liable to pay any claim or provide any benefit hereunder to the extent that the provision of such cover, payment of such claim or provision of such benefit would expose the **Insurer** to any sanction, prohibition or restriction under United Nations resolutions or the trade or economic sanctions, laws or regulations of the European Union, United Kingdom or United States of America.

SECTION XXII CURRENCY

All premiums, limits, retentions, **Loss** and other amounts under this policy are and shall be expressed and payable in the currency of the United States. If any covered **Loss**, including judgments or settlements, is expressed in, calculated on or otherwise based upon any other currency, payment of such **Loss**, whether in such other currency or U.S. dollars, shall be made at the rate of exchange published in *The Wall Street Journal* on the date the **Insurer's** obligation to pay such **Loss** is established (or, if not published on that date, on the date of next publication).

SECTION XXIII BANKRUPTCY

Bankruptcy or insolvency of any **Insured** shall not relieve the **Insurer** of any of its obligations under this policy. In such event, the **Insureds** hereby waive and release any automatic stay or injunction in such

SPECIMEN

proceeding which may apply to this policy or its proceeds, and agree not to oppose or object to any efforts by the **Insurer** or any **Insureds** to obtain relief from any such stay or injunction.

SECTION XXIV HEADINGS

The descriptions in the headings of this policy form no part of the terms and conditions of the coverage under this policy.

SECTION XXV ENTIRE AGREEMENT

By acceptance of this policy, all **Insureds** and the **Insurer** agree that this policy (including the Declarations and **Application**) and any written endorsements attached hereto constitute the entire agreement between the parties. The terms, conditions and limitations of this policy can be waived or changed only by written endorsement hereto.

SECTION XXVI AUTHORIZATION, REPRESENTATIONS AND REQUIREMENTS

A. By acceptance of this policy, the **Policyholder** shall act on behalf of all **Insureds** with respect to electing any dispute resolution process, giving notice of **Claim** and exercising, or declining to exercise, any optional extended reporting period; and the **Insureds** agree that the **Policyholder** shall act on their behalf. Each and every **Insured** covenants that the **Insureds' Representative** shall be their sole agent for purposes of giving and receiving all notices relating to cancellation, nonrenewal, conditional renewal, the payment of premiums and the receipt of any return premiums that may become due under this policy, and the agreement to and acceptance of endorsements.

B. The **Insureds' Representative** represents that it is a properly formed purchasing group, that on and as of the inception date of this policy it is registered and compliant, in all states where an **Insured** is located, and that each such registration and compliance, shall be current for the entirety of the **Policy Period**.

C. The **Policyholder** and the **Insureds' Representative** agree to provide the **Insurer**, upon request, a schedule including the name of each **Agent**, **Registered Representative** and/or **Registered Investment Adviser** for whom a **Certificate** has been provided or maintained, along with the complete address of such **Insured's** primary place of business and Limit of Liability option selected.

SPECIMEN

WHAT EVERY ATTORNEY SHOULD KNOW ABOUT TECHNOLOGY IN PRACTICE

Nicole Iannarone*

INTRODUCTION

To say that the legal profession is rooted in tradition would be an understatement. Legal education adopted its primary teaching method, the case method, early in the last century. As one legal ethics scholar describes it: "Lawyers historically have been reluctant to embrace new inventions, resisting the newfangled invention of the telephone as undignified, looking skeptically at mechanical devices like typewriters, and even avoiding taking elevators."[1] The legal profession has, however, undoubtedly entered an age where lawyers who ignore technology are putting their practices and their clients at risk.

The American Bar Association's Commission on Ethics 20/20 aimed to revise lawyer ethics rules in light of technological changes.[2] After years of study, in 2012, the group made several recommended changes to the ABA Model Rules of Professional Conduct to address technology's impact on law practice.[3] The changes, years in the making, give very little specific and practical information on the steps lawyers must take to ensure technological competence, instead recognizing that technology simply changes too quickly to specifically describe how lawyers should interact with specific technologies.[4]

Thus, the most significant change ultimately adopted in the ABA Model Rules of Professional Conduct as a result of Ethics 20/20 was a change to a comment following ABA Model Rule 1.1, Competence, adding language informing lawyers that they must understand and keep up to date on technology. The revised Comment 8 describes the duty of competence and how lawyers are to ensure compliance with it as follows:

---

* Associate Clinical Professor and Director, Investor Advocacy Clinic, Georgia State University College of Law.

[1] Catherine J. Lanctot, *Becoming a Competent 21st Century Legal Ethics Professor: Everything You Always Wanted to Know About Technology (But Were Afraid to Ask)*, 2015 Prof. Law. 75, 76 (2015).

[2] American Bar Association, *ABA Commission on Ethics 20/20,* available at https://www.americanbar.org/content/dam/aba/administrative/ethics_2020/20120508_ethics_20_20_final_hod_introdution_and_overview_report.pdf.

[3] *See* American Bar Association, August 2012 Amendments to ABA Model Rules of Professional Conduct, available at http://www.americanbar.org/content/dam/aba/administrative/ethics_2020/20120808_house_action_compilation_redline_105a-f.authcheckdam.pdf.

[4] Agnieszka McPeak, *Social Media Snooping and Its Ethical Bounds*, 46 Ariz. St. L.J. 845, 858 (2014) ("it may be that no precise framework of legal ethics rules can effectively address specific scenarios surrounding new technology like social media, as technological advances move more quickly than any rule-making process.").

> To maintain the requisite knowledge and skill, a lawyer should keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology, engage in continuing study and education and comply with all continuing legal education requirements to which the lawyer is subject.[5]

Similarly, confidentiality is vital to the client-attorney relationship – we want clients to be forthright with their lawyers. Without full information, lawyers cannot fulfill their duty of competence. Moreover, lawyers cannot be competent if they do not protect confidentiality and understand the risks of our technological world. Confidentiality covers all information the lawyer gains while working with a client, whether the lawyer receives it directly from a client or not.[6] Under such a broad definition, a significant amount of material is confidential. Due to the sensitivity of information that we lawyers receive to simply do our jobs, we also owe our clients a duty to take steps to protect all of their information. Though our jobs are to practice law, the practice of law increasingly means more than just being up to speed on the latest court cases and rules. In today's world, lawyers also need to understand the technology-related risks to their clients' confidential information.

While lawyers would probably prefer more specific information on what they should do to implement their competence and confidentiality obligations, perhaps the ethics rules are not the right place to talk about specific steps that lawyers should take. Technologies change on a seemingly daily basis, making it difficult to describe what we should do tomorrow, let alone a year from now. Although it would be too burdensome to require lawyers to adhere to a standard requiring them to become technological experts working every day to outsmart the criminal element, that does not mean that lawyers can't do anything. This essay will explore common questions concerning technology and its impact on law practice.

I. THE ETHICAL DUTY OF TECHNOLOGICAL COMPETENCE BEYOND THE ABA

The American Bar Association's Model Rules of Professional Conduct are just that: a model set of ethics rules for licensing jurisdictions to consider when evaluating the ethical rules that will govern the actions of lawyers within their jurisdiction.[7] Though they serve as a guide for regulators in licensing jurisdictions, each lawyer must look to the ethics rules in the jurisdiction(s) where she is licensed to determine the relevant standards.

Not all states have adopted the ABA's technological competence comment. In the seven years since the ABA added "the benefits and risks associated with relevant technology"[8] to its comment

---

[5] MODEL RULES OF PROF'L CONDUCT r.1.1 cmt. 8.

[6] *See* MODEL RULES OF PROF'L CONDUCT r. 1.6.

[7] *See* American Bar Association, *Model Rules of Professional Conduct*, available at http://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct.html ("The ABA *Model Rules of Professional Conduct* were adopted by the ABA House of Delegates in 1983. They serve as models for the ethics rules of most states."). *See also* Agnieszka McPeak, *Social Media Snooping and Its Ethical Bounds*, 46 Ariz. St. L.J. 845, 851 (2014) ("Most states base their codes on a version of the ABA's model ethics rules, with state-specific variation in some instances.").

describing the bounds of the duty of competence, more than half of the states have taken their own steps to adopt technology as a specifically enumerated component of competence.[9] Lawyers in Arizona, Arkansas, Colorado, Connecticut, Delaware, Florida, Idaho, Illinois,[10] Iowa, Kansas,[11] Kentucky, Massachusetts, Minnesota, Missouri, Nebraska, New Hampshire, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, Tennessee, Utah, Virginia, Washington, West Virginia, Wisconsin, and Wyoming are all required to understand how relevant technology impacts their practices.[12] Florida has taken the recent step of requiring, starting January 1, 2017, that in every CLE cycle, its members receive three hours of technology CLE training.[13]

Lawyers in states that have not yet adopted Comment 8 concerning technological competence are not exempt from the duty. The drafters of the change noted that the comment merely provides additional information explaining the parameters of a duty already part of the competence rule. Thus, all lawyers should assume that technological competence is one of the duties they owe their clients as part of the broader duty of competence.

II. CLOUD COMPUTING

You may have your head up in the clouds if you have not heard the buzz surrounding cloud computing.[14] As clients pressure firms to decrease costs and increase accessibility of data, more

---

[8] MODEL RULES OF PROF'L CONDUCT r. 1.1 cmt. 8.

[9] Robert Ambrogi, *31 States Have Adopted Ethical Duty of Technology Competence*, Law Sites, available at http://www.lawsitesblog.com/2015/03/11-states-have-adopted-ethical-duty-of-technology-competence.html (collecting state ethical requirements concerning technological competence).

[10] Daniel A. Cotter, *The Use of Technology by Lawyers and the Rules of Professional Conduct*, CBA Rec., at 30, 31 (Sept. 2016) ("On October 15, 2015, the Illinois Supreme Court amended Rule 1.6(e) of the Illinois Rules of Professional Conduct ("RPC") to require that lawyers make reasonable efforts to prevent unauthorized access to client data, and imposing an affirmative duty on lawyers to understand the relevant technology.").

[11] M. H. Hoeflich & Frank Siler, *New Technologies and Lawyer Competence*, J. Kan. B. Ass'n, July/August 2016, at 38, 39 ("To codify the technology aspect of maintaining competence, in March of 2014 the Kansas Supreme Court adopted a modification to the Competence rule's Comments. Comment [8] now states 'To maintain the requisite knowledge and skill, a lawyer should keep abreast of changes in the law and its practice, **including the benefits and risks associated with relevant technology…**') (emphasis in original).

[12] Robert Ambrogi, *31 States Have Adopted Ethical Duty of Technology Competence*, Law Sites, available at http://www.lawsitesblog.com/2015/03/11-states-have-adopted-ethical-duty-of-technology-competence.html.

[13] *See*, Victor Li, *Florida Supreme Court Approves Mandatory Tech CLE Classes for Lawyers,* ABA Journal (Sept. 30, 2016), available at http://www.abajournal.com/news/article/florida_supreme_court_approves_mandatory_tech_cles_for_lawyers.

[14] "Cloud computing, broadly defined, is a category of software and services delivered over the Internet rather than installed locally on a user's computer." American Bar Association, *Cloud Computing for Lawyers*,

and more lawyers are beginning to embrace the technology. Cloud computing technology is not without its risks. The Federal Trade Commission has received complaints concerning inadequate security in the cloud. Even more disconcerting is the FBI's warning to law firms that they were "being specifically targeted by hackers who have designs of accessing the firms' databases."[15] These threats underscore the main ethical concern in cloud computing: confidentiality.

Recognizing the confidentiality concern, the American Bar Association Ethics 20/20 Commission's working group on the "Implications of New Technologies" proposed a series of changes to the Model Rules that were ultimately adopted.[16] The first, discussed in the introduction, added a comment to the competence rule, making explicit that lawyers must understand "the benefits and risks associated with relevant technology."[17]

In addition, the Model Rules require lawyers to make "reasonable efforts" to ensure that client information is not inadvertently disclosed or that it is not improperly accessed.[18] While such "reasonable efforts" are not specifically described, a new Comment 18 describes certain "[f]actors to be considered in determining the reasonableness of the lawyer's efforts."[19] Clients may require lawyers to go further or, with informed consent, "forgo security measures that would otherwise be required."[20] Specifically unaddressed by Model Rule 1.1 are two important points that lawyers should consider: (1) duties to protect information and maintain privacy that arise from other laws and (2) notification requirements arising from other sources of law when an unauthorized breach or other data loss occurs.[21]

Numerous state bar associations have issued ethical opinions on cloud computing, each permitting its use when reasonable care is exercised.[22] As defined by these jurisdictions,

---

available at https://www.americanbar.org/groups/departments_offices/legal_technology_resources/resources/cloud_computing/ (Mar. 1, 2016).

[15] *See also* Jennifer Smith, *Client Secrets at Risk as Hackers Target Law Firms*, WALL ST. J. LAW BLOG, June 24, 2012, http://blogs.wsj.com/law/2012/06/25/dont-click-on-that-link-client-secrets-at-risk-as-hackers-target-law-firms/.

[16] Catherine S. Reach, Rachel Packer, & Paul Bateman, *Ethical Challenges on the Horizon: Confidentiality, Competence and Cloud Computing*, ABA Section of Litigation Section Annual Conference (April 2013).

[17] MODEL RULES OF PROF'L CONDUCT r. 1.1 cmt. 8.

[18] MODEL RULES OF PROF'L CONDUCT r. 1.6(c).

[19] MODEL RULES OF PROF'L CONDUCT r. 1.6 cmt. 18 (these factors "include, but are not limited to, the sensitivity of the information, the likelihood of disclosure if additional safeguards are not employed, the cost of employing additional safeguards, the difficulty of implementing the safeguards, and the extent to which the safeguards adversely affect the lawyer's ability to represent clients (e.g., by making a device or important piece of software excessively difficult to use).").

[20] *Id*.

[21] *See id.*

[22] Mark C. Palmer, *Can Lawyers Ethically Store and Transmit Client Info in the Cloud?*,

reasonable care[23] and best practices when using cloud computing may include the following steps:

- Investigate how the data is stored and secured; [24]
- Ensure that a confidentiality agreement is followed;[25]
- Stay up to date with emerging technology best practices;[26]
- Consult experts in technology if the attorney is not a technology expert;[27]
- Ensure "[r]easonable security precautions" are in place, such as password protection and encryption;[28]
- Ensure the vendor understands legal confidentiality requirements;[29]
- Consider whether certain types of information are so sensitive that client consent should be requested.[30]

The American Bar Association provides further guidance, recommending that lawyers ask and answer a series of questions concerning ethics and security when considering cloud computing.[31]

---

https://www.attorneyatwork.com/client-information-cloud-ethics/ (July 16, 2018).

[23] The Pennsylvania Bar Association has gone so far as to list fifteen practices that would meet the "standard of reasonable care." *See* Pa. Bar Ass'n Comm. on Legal Ethics & Prof'l Responsibility, Formal Op. 2011-200 (2011) (these practices include backing up data, installing firewalls, only providing necessary information to others, avoiding inadvertent disclosure of information, verifying the identity of individuals to whom the attorney provides information and refusing to disclose information without said verification, encrypting data, implementing audit trail procedures to monitor who accesses the data, creating plans to address security breaches, providing training on cloud computing, maintaining a physical copy of the information onsite, creating alternate ways to access the information, as well as a host of suggestions for the agreement between the attorney and provider).

[24] Ala. State Bar Office of General Counsel, Formal Op. 2010-02 (2010).

[25] *Id.*

[26] *Id.*

[27] State Bar of Calif. Comm. on Prof'l Responsibility & Conduct, Formal Op. 2010-179 (2010).

[28] State Bar of Ariz. Ethics Comm., Formal Op. 09-04 (2009).

[29] State Bar of Nev. Comm. on Ethics & Prof'l Responsibility, Formal Op. 33 (2006).

[30] N.H. Bar Ass'n Ethics Comm., Advisory Op. 2012-13/04 (2013).

[31] These questions include: (1) How does the vendor safeguard the privacy/confidentiality of stored data? (2) How often is the user's data backed up? Does the vendor backup data in multiple data centers in different geographic locations to safeguard against natural disaster? (3) What is the history of the vendor? Where do they derive their funding? How stable are they financially? (4) Can I get my data "off" their servers

III. USING SOCIAL MEDIA IN PRACTICE

Social media sites that allow parties to share information online create numerous ethical issues for attorneys. Stories concerning the misuse of online sharing platforms, such as Facebook, YouTube, Twitter, and blogs, abound in legal press. This type of social media makes it easy to instantaneously share stories and other information. This ease of use seems to be the root of the ethical violations resulting from the adoption of these technologies. Before adding any information to social media, lawyers need to carefully consider both the ethical rules at issue and how the anticipated posting can impact their professional reputations and careers.

Lawyers must be especially careful to avoid disclosure of confidential information, whether related to their own clients or arising out of their employment.[32] For example, bar disciplinary authorities suspended an Illinois attorney for five months after he used YouTube and Facebook to post a video of an undercover sting where his client had purchased drugs.[33] The attorney believed the video showed police planting evidence, and he titled the posting "Cops and Task Force Planting Drugs."[34] After the prosecutor suggested that the attorney carefully review the video, the attorney admitted that it showed the client had provided drugs and advised her to accept a plea.[35] The client suffered adverse consequences as a result, including damage to her reputation and loss of friends.[36] The attorney's suspension resulted because the information, though it could have been used in a criminal proceeding open to the public, was nevertheless confidential.[37] While the

---

for my own offline use/backup? If I decide to cancel my subscription to the software, will I get my data? Is data supplied in a non-proprietary format that is compatible with other software? (5) Does the vendor's Terms of Service or Service Level Agreement address confidentiality and security? If not, would the vendor be willing to sign a confidentiality agreement in keeping with your professional responsibilities? *Cloud Computing/Software as a Service for Lawyers*, ABA LAW PRACTICE DIVISION, http://www.americanbar.org/groups/departments_offices/legal_technology_resources/resources/charts_fyis/saas.html.

[32] In addition to confidentiality, solicitation through social media is another problematic area. The rules vary from jurisdiction to jurisdiction, so lawyers should carefully consider the applicable rule in their licensing jurisdiction. For example, the Missouri Bar Association does not permit lawyers to solicit clients via Twitter, but the New York Bar Association permits attorneys to offer prizes to join a social media site so long as the prize offered is not otherwise illegal. Mo. Bar Ass'n, Informal Op. 2009-0040 (2009); N.Y. State Bar Ass'n Comm. on Prof'l Ethics, Op. 873 (2011).

[33] *See In re Jesse Raymond Gilsdorf*, M.R. 26540 (Mar. 14, 2014), available at https://www.iardc.org/co_recentdiscdec_copy95.html. *See also* Debra Cassens Weiss, *Lawyer Suspended for Posting Video of Undercover Drug Buy in Mistaken Belief it Exonerated Client*, ABA JOURNAL, Mar. 19, 2014, http://www.abajournal.com/news/article/lawyer_suspended_for_posting_video_of_undercover_drug_buy_in_mistaken_belie/?utm_source=maestro&utm_medium=email&utm_campaign=weekly_email.

[34] Debra Cassens Weiss, *Lawyer Suspended for Posting Video of Undercover Drug Buy in Mistaken Belief it Exonerated Client*, ABA JOURNAL, Mar. 19, 2014, http://www.abajournal.com/news/article/lawyer_suspended_for_posting_video_of_undercover_drug_buy_in_mistaken_belie/?utm_source=maestro&utm_medium=email&utm_campaign=weekly_email.

[35] *Id*.

[36] *Id*.

client's informed consent might have made the posting permissible, in this particular case, the attorney did not adequately disclose and explain the risks and consequences of the posting.[38]

Similarly, a Florida public defender found herself without a job after making an off-the-cuff comment about a client in a Facebook posting. Unlike the Illinois case, the posting did not go to the substance of the legal matter but it nevertheless constituted a confidentiality violation, caused a mistrial, and resulted in her firing.[39] The offending post: a photo of the leopard-printed underwear her client's family brought for him to wear during court, with a caption making fun of its appropriateness as courtroom attire.[40]

Both Wisconsin and Illinois courts have addressed attorney use of blogs, disciplining attorneys who posted confidential information, but holding that blogs are permissible if ethical rules, specifically including confidentiality, are followed.[41] The American Bar Association weighed in on blogging in 2018. According to its formal ethics opinion on the topic, lawyers must remember that the confidentiality rule means that they cannot reveal client information without a client's informed consent unless the rules permit the disclosure.[42]

Attorneys should also exercise caution when participating in online chat rooms and using listservs. For example, the Oregon Bar Association disciplined a lawyer for sending an e-mail on a listserv disclosing confidential information related to the representation of a difficult client, including personal and medical information.[43] However, the Oregon Bar Association has held that an attorney may consult with other attorneys via a listserv so long as the content remains general rather than disclosing specific information about the case or client.[44]

---

[37] *Id*.

[38] *Id.*

[39] Martha Neil, *Lawyer Puts Photo of Client's Leopard-Print Undies on Facebook; Murder mistrial, Loss of Job Result*, ABA JOURNAL, Sept. 13, 2012, http://www.abajournal.com/news/article/lawyer_puts_photo_of_clients_leopard-print_undies_on_facebook_murder_mistri.

[40] *Id.*

[41] *In re Peshek,* Ill. Attorney Registration & Discovery Comm'n, 09 P.R. 0089 (effective June 8, 2010); *In re* Peshek, 334 Wis.2d 373 (2011).

[42] *See* American Bar Association, Formal Opinion 480, Confidentiality Obligations for Lawyer Blogging and Other Public Commentary (Mar. 6, 2018) ("Lawyers who blog or engage in other public commentary may not reveal information relating to a representation, including information contained in a public record, unless authorized by a provision of the Model Rules.").

[43] Ore. State Bar Bulletin No. 80098 (Jan. 2007).

[44] Ore. State Bar, Formal Op. 2011-184 (2011).

When a lawyer is tempted to share any information about the representation of clients or that arises in the course of legal employment, he or she should carefully consider the confidentiality rules and obtain the proper authorizations. Sharing of confidential information generally requires a client's informed consent after a consultation that outlines all of the potential risks of the disclosure.[45]

IV. PROTECTING AGAINST CYBERSECURITY THREATS

Cybersecurity threats to lawyers, their firms and their clients have become even more commonplace in recent years. The news is full of stories of hackers stealing sensitive information or holding computer systems hostage until the victim pays a ransom to get the data back. In fact, "[l]aw firms are in the front line of cyber security threats, with hackers increasingly targeting the legal profession for the goldmine of sensitive and confidential client data firms hold."[46] Lawyers must learn about these threats and take steps to protect their clients and their firms from them.

A. Cybercriminals Target Law Firms

Panamanian law firm Mossack Fonseca faced every lawyer's nightmare after a huge data breach resulted in 11.5 million electronic files being shared with journalists, released by an activist claiming that the law firm was helping criminals.[47] If there is one group the Panama Papers leak shouldn't surprise, it is lawyers. For years, experts have described lawyers as soft targets for hackers.[48] The threat comes from foreign governments interested in learning state secrets.[49] Criminals also target law firms, seeking profit on confidential deals and even hot stock tips.[50] And,

---

[45] ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 457 (2010) (explaining that a lawyer may, with informed consent as required under Rules 1.6 and 1.9, identify current or former clients, or the scope of the matters involved, on the lawyer's website).

[46] Jonathan Ames, *Cyber Security: Lawyers are the Weakest Link*, The Lawyer (October 28, 2013), available at https://www.thelawyer.com/issues/28-october-2013/cyber-security-lawyers-are-the-weakest-link/.

[47] Caroline Mortimer, *Panama Papers: Whistleblower Breaks Silence to Explain why they Leaked the 11.5m Files*, available at http://www.independent.co.uk/news/world/politics/panama-papers-whistleblower-breaks-silence-to-explain-why-he-leaked-the-115m-files-a7017691.html.

[48] Melissa Maleske, *A Soft Target for Hacks, Law Firms Must Step up Data Security*, Law360 (September 23, 2015), available at http://www.law360.com/articles/706312/a-soft-target-for-hacks-law-firms-must-step-up-data-security; Daniel A. Cotter, *The Use of Technology by Lawyers and the Rules of Professional Conduct*, CBA Rec., at 30, 31 (Sept. 2016) ("Attorneys and firms are increasingly the targets of hacking and phishing scams, and some law firms have been sued, facing allegations that the firms' data security practices were insufficient to protect confidential client information.").

[49] Ellen Rosen, *Most Big Firms Have Had Some Hacking: Business of Law*, Bloomberg (March 11, 2015), available at http://www.bloomberg.com/news/articles/2015-03-11/most-big-firms-have-had-some-form-of-hacking-business-of-law.

[50] Martha Neil, *Cybercriminals target 50 BigLaw Firms for Phishing Attacks Seeking Corporate Deal Info*, ABA Journal (March 30, 2016), available at http://www.abajournal.com/news/article/posts_on_cyber_criminal_forum_outline_plans_for_law_firm_hack_attacks_seeki/.

the advent of leak activism makes it more likely that the lawyers, who have access to their clients' deepest secrets, are targeted.[51]

Shortly after the data breach became public, Mossack Fonseca released a statement alleging that its actions were entirely legal and that it was not engaged in any activity that violated the law.[52] Assuming that the law firm's statement as to the legality of its actions is correct, the firm's concurrent outrage at the breach of privacy should ring true for American lawyers. Data breaches and hactivism threaten the core of the client-lawyer relationship: the lawyer's duty to maintain client secrets.

While it might be easy to characterize Mossack Fonseca's security breach as an anomaly due to the particularly secretive nature of their work and privacy demands of their clientele,[53] a lawyer who thinks she is immune from such threats acts at the peril of her clients.[54] Think about the information attorneys obtain in order to competently represent their clients. From social security numbers, bank accounts, tax returns, business secrets and future plans, we are privy to the most sensitive of information and our clients can be seriously damaged if that information gets into the wrong hands.

B. Lawyers' Networks are Vulnerable to Virtual Kidnappers

In May 2017, work across the globe ground to a halt after a malicious program locked computer networks at hospitals, government agencies, and private companies in more than 150 countries.[55] The culprit, a ransomware program named "WannaCry," likely started as a link or file attachment in an email that then executed a program that locks up the infected user's computer, and, potentially, networked devices, until the impacted user pays a set sum, usually in Bitcoin.[56] The Federal Trade Commission describes ransomware as "one of the most serious online threats facing people and business today."[57] Lawyers are not immune from this threat. One law firm paid

---

[51] Arne Hintz, *Whistleblowers and Leak Activists Face Powerful Elites in Struggle to Control Information*, The Conversation (April 6, 2016), available at http://theconversation.com/whistleblowers-and-leak-activists-face-powerful-elites-in-struggle-to-control-information-57368.

[52] *Mossack Fonseca's Response to ICIJ* (April 3, 2016), available at https://panamapapers.icij.org/blog/20160403-mossack-fonseca-response-icij.html.

[53] *See Panama Grants bail to Mossack Fonseca Founders in Brazil Corruption Case*, Reuters (Apr. 21, 2017), available at http://www.reuters.com/article/us-panama-corruption-idUSKBN17O018 ("Mossack Fonseca emerged from obscurity in April 2016 with the Panama Papers, millions of documents stolen from the firm and leaked to the media that illustrated how the wealthy use offshore corporations to avoid taxes.").

[54] *See* Karen M. Kroll, *Cybersecurity Insurance is a 'Must Have' for Law Firms*, ABA Journal (Nov. 1, 2016), available at http://www.abajournal.com/magazine/article/data_breach_insurance_coverage ("Nearly a quarter of law firms with 500 or more attorneys have experienced a cybersecurity breach…").

[55] Russell Goldman, *What We Know and Don't Know About the International Cyberattack*, THE NEW YORK TIMES (May 12, 2017).

[56] *Id.*

[57] Federal Trade Commission, *How to Defend Against Ransomware* (November 10, 2016), available at https://www.consumer.ftc.gov/blog/how-defend-against-ransomware.

$25,000 in ransom after suffering a three-month computer lockout due to a ransomware attack.[58] The 2016 attack cost the law firm more than the ransom payment: a lawsuit against the firm's insurance company claims that the attack cost the firm $700,000 in lost billings.[59]

C. Protect Yourself and Your Clients by Learning about the Threats

So, how exactly do lawyers meet the obligation to protect client information in a world where nefarious figures lurk in the dark and develop ever more dangerous cyber tools to profit illicitly? This is where ABA Model Rule 1.1's refusal to require specific advice becomes so important: due to the ever changing and quickly evolving threats and opportunities, lawyers must learn about how the changing technology can impact them.[60] Recognizing that lawyers are experts in law, and not necessarily technology, the American Bar Association launched a Cybersecurity Legal Task Force to "examine[] risks posed by criminals, terrorists and nations that hope to steal personal and financial information, disrupt critical infrastructure, and wage a new kind of warfare on a battlefield of ones and zeroes."[61] The Cybersecurity Task Force compiles information and resources to help lawyers learn, prepare, and respond to cyber threats.[62] Among the simplest ways to learn about technological threats is to review ABA Cyber Alerts.[63] The American Bar Association transmits FBI alerts to member lawyers as threats are identified by law enforcement.[64] The alerts describe the risk and outline how lawyers can protect their clients and their practices.[65]

Another step lawyers can take to protect from these risks is to adopt good technological hygiene habits. Experts recommend the use of anti-virus software.[66] Ensure that software is up-to-date.[67] Exercise caution before opening a link in an email or downloading an email attachment.[68]

---

[58] Debra Cassens Weiss, *Victimized by Ransomware, Law Firm Sues Insurer for $700k in Lost Billings*, ABA Journal (May 2, 2017), available at http://www.abajournal.com/news/article/victimized_by_ransomware_law_firm_sues_insurer_for_700k_in_lost_billings/.

[59] *Id*.

[60] *See* MODEL RULES OF PROF'L CONDUCT r. 1.1 cmt. 8.

[61] American Bar Association, About the Task Force, https://www.americanbar.org/groups/cybersecurity/.

[62] *Id.*

[63] *Id*.

[64] *Id*.

[65] *See, e.g., FBI Flash*, available at http://www.americanbar.org/content/dam/aba/administrative/law_national_security/FLASH_WannaCry_FINAL.authcheckdam.pdf (describing WannaCry Ransomware risk and outlining prevention and remediation measures).

[66] Federal Trade Commission, *How to Defend Against Ransomware* (November 10, 2016), available at https://www.consumer.ftc.gov/blog/how-defend-against-ransomware.

[67] *Id*.

Indeed, according to one study, "[c]orporate legal departments are more likely to open phishing emails than most other corporate departments."[69] Maintain a secure backup maintained in a location other than your primary system.[70] Lawyers may also want to consider purchasing cybersecurity insurance separate from any endorsement offered on their general policy.[71]

Finally, lawyers should take notice of American Bar Association guidance through formal advisory opinions after the conclusion of the Ethics 20/20 revision of the Model Rules of Professional Conduct to provide additional information given these more frequent threats. In 2017, for example, the American Bar Association issued Formal Opinion 477R, outlining lawyers' responsibilities to secure communications that involve client information subject to the confidentiality rule.[72] In that opinion, the ABA described how the landscape has changed since 1999 when email was considered generally safe without encryption and outlined when additional steps of securing client information may be warranted.[73] The opinion reaffirmed that email is an acceptable means of communication, while noting that client demands or the nature of some types of client information require much higher levels of security than normal email or internet use provides.[74] Similarly, in fall 2018, the ABA described how lawyers must respond if client information has been compromised in a data breach.[75] In addition to keeping clients whose data has or might have been impacted informed, law firms may have to take additional steps.[76] Such steps should include information "for the client to make an informed decision as to what to do next, if anything" as well as "the lawyer's plan to respond to the data breach, from efforts to recover information (if feasible) to steps being taken to increase data security."[77] Finally, firms should

---

[68] *Id.* ("According to one panelist, 91% of ransomware is downloaded through phishing emails. You can also get ransomware from visiting a compromised site or through malicious online ads.").

[69] Debra Cassens Weiss, *Corporate Legal Departments are More Likely Than Others to Click on Phishing Emails, Study Finds*, ABA Journal, available at http://www.abajournal.com/news/article/corporate_legal_departments_are_more_likely_than_others_to_click_on_phishin/?utm_source=maestro&utm_medium=email&utm_campaign=weekly_email (Aug. 27, 2015).

[70] Federal Trade Commission, *How to Defend Against Ransomware* (November 10, 2016), available at https://www.consumer.ftc.gov/blog/how-defend-against-ransomware. ("[M]ake it part of your routine to back up files on your computers and mobile devices often. When you're done, log out of the cloud and unplug external hard drives so hackers can't encrypt and lock up your back-ups, too.").

[71] *See* Karen M. Kroll, *Cybersecurity Insurance is a 'Must Have' for Law Firms*, ABA Journal (Nov. 1, 2016), available at http://www.abajournal.com/magazine/article/data_breach_insurance_coverage (outlining characteristics of effective cybersecurity insurance policies).

[72] American Bar Association, Formal Opinion 477R, *Securing Communication of Protected Client Information* (issued May 11, 2017 and revised May 22, 2017).

[73] *Id*.

[74] *Id*.

[75] *See* American Bar Association, Formal Opinion 483, Lawyers' Obligations After an Electronic Data Breach or Cyberattack (Oct. 17, 2018).

[76] *Id*.

keep in mind state laws that outline obligations related to data breaches containing certain confidential and personal information.[78]

V. Understanding Capabilities of New Technologies

As Amazon's Alexa is nearly everywhere, her impact on the legal system is already being felt. Her capability to record background conversations has led some prosecutors to subpoena her for recordings during their investigation of crimes.[79] Her capabilities have also led to programs for lawyers – it appears that she "can even keep track of an attorney's billable hours." [80] Other technology, including smart televisions, have the same capabilities and capture background conversations even if users do not employ the voice-recognition capabilities of the device.[81] In 2017, the President signed Senate Joint Resolution 34 which nullified a December 2016 Federal Communications Commission rule that prohibited internet service providers (ISPs) from selling the results of their customers' web searches.[82] After the resolution passed Congress, opponents of the repeal announced that they would seek to purchase the web histories of every member of Congress who voted in favor of the repeal.[83] The thought of seeing a senator's online search history probably makes us curious, and maybe even laugh a bit. But if Siri, voice-recognition equipped TVs, and internet search histories are fair game, what does that mean for lawyers and law firms?

Think of it this way: what would opposing counsel be able to discover if they can legally obtain your or your law firm's web search history? Law firms are already prime targets for state-sponsored hackers due to the confidential information they possess, including their work on potential acquisitions, securities offerings, treaties, and even representation of celebrities.[84] Allowing the purchase of search histories would make such confidential information legally

---

[77] *Id*. at 14.

[78] *Id*.

[79] Victor Li, Amazon's Alexa Can Now Track Billable Hours, ABA Journal (May 10, 2017, available at http://www.abajournal.com/news/article/amazons_alexa_can_now_track_billable_hours/?utm_source=maestro&utm_medium=email&utm_campaign=weekly_email.

[80] *Id*.

[81] Martha Neil, *Be Careful What you Say When Your Smart TV is on, Samsung Warns Customers*, ABA Journal (February 9, 2015), available at http://www.abajournal.com/news/article/be_careful_what_you_say_when_your_smart_tv_is_on_samsung_warns_customers/.

[82] *See* S.J.Res.34, available at https://congress.gov/bill/115th-congress/senate-joint-resolution/34/.

[83] *See, e.g.,* Don Reisinger, *'Cards Against Humanity' Creator Threatens to Expose Congress Web History,* Fortune (Mar. 30, 2017), available at http://fortune.com/2017/03/30/cards-of-humanity-congress/.

[84] *See, e.g., China-based Hackers Target Law Firms to get Secret Deal Data*, Bloomberg News (Feb. 2, 2012), available at http://www.dailybusinessreview.com/id=1202541018550/Chinabased-hackers-target-law-firms-to-get-secret-deal-data?mcode=0&curindex=0&curpage=ALL&slreturn=20170303164616.

available and permit savvy individuals to obtain advance information about financially lucrative events or their competitors' legal strategies.[85] This change, coupled with the 2012 technology amendments to the ABA Model Rules of Professional Conduct, raises substantial questions for lawyers and law firms.

Lawyers should investigate their ethical obligations to protect client confidential information revealed in conversations surrounding voice-recognition technology and internet searches and understand the risks that arise should they fail to do so. While it is unclear whether lawyers will be permitted, or even required, under ethics rules to purchase web searches from competitor law firms' ISPs, we nevertheless owe our clients the duty of confidentiality and should endeavor to protect sensitive information from collection and even potential waiver of the attorney-client privilege. At the very least, before launching any new technology in your office, read the terms and conditions to understand if any information is being tracked, how it may be used, and whether you can opt out of the information collection.

VI. PREVENTING CLIENT HARM FROM TECHNOLOGY

Lawyers face increasing pressure from clients to ensure that their systems are secure. Banks and financial services companies understand the risk of data security and are under intense scrutiny from regulators to ensure that they maintain sensitive information in a secure fashion. Financial services companies with these responsibilities are increasingly viewing their outside lawyers as one of the greatest data security risks that they face.[86] Lawyers and firms even face legal liability for information security vulnerabilities. For example, December 2016, Chicago law firm Johnson & Bell became the first firm in the United States sued in a putative class action for alleged data security vulnerabilities.[87]

While not all clients will broach the issue of information security with their lawyers, lawyers should broach the topic with their clients. Individual clients may not raise the information security and efficiency standards that the most sophisticated corporate clients will request, but technology can nevertheless impact their cases, sometimes in an extremely detrimental fashion. The risks can come from oversharing by providing too much access to information or not fully understanding the duty to preserve evidence.

Lawyers should also be concerned with their clients' use of social media, both pre-existing social media and any use of social media during the course of the matter. Before accepting a case, many lawyers review a potential client's social media accounts and advise the client, as permitted

---

[85] *See, e.g.,* Michael Barbaro and Tom Zeller Jr., *A Face is Exposed for AOL Searcher No. 4417749*, NY Times (Aug. 9, 2006) (detailing how AOL list of 20 million search queries in three month period allowed searchers to locate identity of users with ease).

[86] Jonathan Ames, *Cyber Security: Lawyers are the Weakest Link*, The Lawyer (Oct. 28, 2013), available at https://www.thelawyer.com/issues/28-october-2013/cyber-security-lawyers-are-the-weakest-link/.

[87] Roy Strom, *Chicago's Johnson & Bell First US Firm Publicly Named in Data Security Class Action*, The American Lawyers (Dec. 9, 2016), available at http://www.americanlawyer.com/id=1202774361560/Chicagos-Johnson--Bell-First-US-Firm-Publicly-Named-in-Data-Security-Class-Action?slreturn=20170419115647.

in some jurisdictions, to change social media privacy settings to render information posted on a social networking site non-public.[88] It is important to distinguish the deleting of one's content, which could very likely give rise to serious repercussions, such as spoliation sanctions, from changing one's privacy settings.[89] Importantly, when a client changes a privacy setting, the client does not delete the material but changes the ability of other social media users to view it.

Some lawyers advise their clients to take a "social media vacation" during the course of a proceeding and not make any postings. Clients should similarly be cautioned about the impact of reaching out to participants in the matter, such as the decision maker(s) or other parties, which could constitute impermissible contacts.

Prudent lawyers should also advise their clients about how their social media use can impact their case even after it concludes. Failure to do so can have a serious impact on a client's interests. In one recent example, a Florida man lost an $80,000 settlement from his former employer because of his daughter's Facebook post about the confidential settlement.[90] According to the Miami Herald, the confidentiality clause of the settlement agreement was breached as a result of the following post: "'Mama and Papa Snay won the case against Gulliver'. . . 'Gulliver is now officially paying for my vacation to Europe this summer. SUCK IT.'"[91] To prevent our own clients from suffering the same fate, lawyers should have a conversation with their clients concerning the depth and breadth of the confidentiality clauses in a potential settlement agreement before the client signs it and remind the client about the provisions when the payment is received.

Lawyers should also discuss their client's email use prior to communication with the client over that media. Some clients, particularly in older generations, share email accounts with their spouses or even children. If a lawyer sends a client communications via such an account, the attorney-client privilege may be waived if others who have access to the account are not clients. Similarly, lawyers should caution clients about the risks of using a work email account for communicating concerning the case as the client may not have any expectation of privacy when using the employer's account and many work accounts provide access to individuals beyond the client (such as assistants or team members) who are not necessary parties to the representation. At the very least, lawyers should have a discussion with their clients about their email use, who has access to the accounts, and the risks of using a non-private account if the client insists upon doing so.

Finally, lawyers should take steps to understand the technology used during the pendency of a proceeding to ensure that it does not harm the client. In 2017, lawyers for Wells Fargo learned

---

[88] *E.g.*, PA Eth. Op. 2014-5 (Phila. Bar. Assn. Prof. Guid. Comm.), 2014 WL 3548813.

[89] ABA Model Rule of Professional Conduct 3.4(a) provides that a lawyer shall not "unlawfully obstruct another party's access to evidence or unlawfully alter, destroy or conceal a document or other material having potential evidentiary value." For a general discussion of spoliation in the internet age, see John G. Browning, *Burn After Reading: Preservation and Spoliation of Evidence in the Age of Facebook*, 16 SMU SCI. & TECH. L. REV. 273 (2013).

[90] *See* Amy Kluber, *Teen's Facebook Post Costs Father $80k*, ATLANTA JOURNAL CONSTITUTION, Mar. 2, 2014,available at https://www.ajc.com/news/teen-facebook-post-costs-father-80k/rgMCqLUIjtilQ8GbkrBuXN/.

[91] *Id*.

this lesson the hard way after 1.4 gigabytes of information related to over 50,000 Wells Fargo customers, including identifying information, financial details, and social security numbers, was produced without any protective order or confidentiality provisions in place.[92] The release purportedly occurred because the lawyer reviewing the documents did not fully understand the technology and the role of the vendor in the subsequent production.[93] In particular, the view used to review the documents excluded many documents such that the lawyer did not review all documents for responsiveness, confidentiality, or privilege.[94] In addition, documents that the lawyer marked for redaction were not redacted prior to production and the lawyer miscoded some documents for production that never should have been produced.[95] This lawyer's unfortunate, and well-publicized, mistakes serve as a warning for us all. Lawyers must understand how those we employ are using technology. We must understand not only our role and that of the expert, but also how to use the technology provided by the expert before completing a task. Finally, in the event of an inadvertent disclosure of information, we must immediately alert our client and take additional steps, including attempting to retrieve the data and advising the client of any state, federal, or even international laws that would require alerting any impacted third parties of the information release.

VII. Level of Technological Competence Required

Lawyers need not become experts in technology and every new technological innovation that might impact law practice. Instead, lawyers must strike a balance between focusing on their own expertise while recognizing that technology will change the way they practice and being open to learning about and incorporating those changes into their practice. Not every innovation will be the next telephone or email. Some advances in technology will. While lawyers might not be the first adopters of such new technologies, once they become ubiquitous, lawyers will be required to adopt them.

Nevertheless, lawyers cannot ignore technology simply because we are not an expert. To deliver competent legal services, we must study to become competent or associate with counsel or an expert who has the requisite competence.[96] More and more CLE providers offer training on

---

[92] Serge F. Kovaleski and Stacy Cowley, *Wells Fargo Accidentally Releases Trove of Data on Wealthy Clients*, NY Times (July 21, 2017), available at https://www.nytimes.com/2017/07/21/business/dealbook/wells-fargo-confidential-data-release.html?smid=pl-share.

[93] Debra Cassens Weiss, *Lawyer's E-discovery Error Led to Release of Confidential Info on Thousands of Wells Fargo Clients*, ABA Journal (July 27, 2017), available at http://www.abajournal.com/news/article/lawyers_e_discovery_error_led_to_release_of_confidential_wells_fargo_client/?utm_source=maestro&utm_medium=email&utm_campaign=weekly_email.

[94] *Id*.

[95] *Id*.

[96] Model Rules of Prof'l Conduct r. 1.1 cmt. 8 ("To maintain the requisite knowledge and skill, a lawyer should keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology, engage in continuing study and education and comply with all continuing legal education requirements to which the lawyer is subject."); *id.* at cmt. 2 ("A lawyer can provide adequate representation in a wholly novel field through necessary study. Competent representation can

technology, and specialty companies are developing certification programs to provide lawyers with the training they need to gain more experience with technologies outside their ken.[97] When facing a technological challenge outside your wheelhouse, consider bringing in another lawyer who has the requisite expertise or hiring a technology consultant.[98]

Bar associations and legal groups also provide significant resources to assist lawyers incorporating technology into their practices and ensuring that they abide by ethical requirements. For example, the American Bar Association maintains a Legal Technology Resource Center that "educates and assists [American Bar Association] members with the latest legal technology, allowing lawyers to boost efficiency and ultimately provide clients with the highest quality service."[99] Similarly, Delaware's courts established a Commission on Law and Technology to provide lawyers with information and guides about technology and its impact on practice.[100] The Commission maintains a webpage with white papers on technological issues including, among others, papers on basic skills, cloud technology, courtroom technology, data security, eDiscovery, and social media.[101] State and local bar associations likewise emphasize technology and maintain online resources for lawyers and law office staff.[102] In many jurisdictions, ethics hotlines afford lawyers easy access to guidance on emerging issues and to answer questions that have not formally been answered by ethics experts in advisory opinions.[103]

---

also be provided through the association of a lawyer of established competence in the field in question.").

[97] *See, e.g.,* Jason Karuse, *Tech Training Helps Lawyers Meet Client Expectations*, ABA Journal (Aug. 1, 2016) (describing Legal Technology Core Competencies Certification program).

[98] *See* M. H. Hoeflich & Frank Siler, *New Technologies and Lawyer Competence*, J. Kan. B. Ass'n, July/August 2016, at 38, 43 ("when lawyers find themselves involved in a case that requires a sophisticated knowledge of e-discovery, they may bring on co-counsel with such knowledge"); *id.* ("hire a technical specialist and audit the office technology, make what changes in that technology may be required and establish procedures designed to implement the new technology.").

[99] American Bar Association, Technology, available at https://www.americanbar.org/topics/tech/. *See also* American Bar Association, Legal Technology Resource Center, http://www.americanbar.org/groups/departments_offices/legal_technology_resources.html.

[100] Delaware Commission on Law and Technology, *What is the DECLT*, available at http://courts.delaware.gov/declt/index.aspx ("The Commission was created to develop and publish guidelines and best practices regarding the use of technology and the practice of law.").

[101] *See* Delaware Commission on Law and Technology, *Leading Practices*, available at http://courts.delaware.gov/declt/practices.aspx.

[102] *See, e.g.*, State Bar of Georgia, *Law Practice Management*, available at https://www.gabar.org/committeesprogramssections/programs/lpm/ ("Whether you need advice on technology, firm finances, organization or library materials, we have the resources and training to assist you.").

[103] *See, e.g.,* The State Bar of California, *Ethics Hotline*, available at http://ethics.calbar.ca.gov/Ethics/Hotline.aspx ("The Ethics Hotline, a confidential research service for attorneys only, helps lawyers identify and analyze their professional responsibilities.") (800-238-4427); State Bar of Georgia, *Ethics & Professionalism*, available at https://www.gabar.org/barrules/ethicsandprofessionalism/ ("Lawyers who would like to discuss an ethics dilemma with a member of the Office of General Counsel staff should contact the Ethics Helpline at 404-527-8741, 800-682-9806 or log in and submit your question by email."); New York City Bar, *Ethics Hotline*,

CONCLUSION

While technology changes on a seemingly daily basis, lawyers' core ethical responsibilities to protect client confidences and competently represent our clients remains constant. Understanding the ethical duties of confidentiality and competence provides lawyers the foundation with which to evaluate technology in law practice. Lawyers should keep doing what they do best – practicing law. While doing so, they should continue to learn about technology and carefully evaluate whether current and new technologies help or hinder their clients.

available at http://www.nycbar.org/member-and-career-services/ethics/hotline ("New York lawyers faced with ethical questions regarding their own prospective conduct can reach the Ethics hotline through Customer Service at 212.382.6663."); Virginia State Bar, *Ethics Questions and Opinions*, available at https://www.vsb.org/site/regulation/ethics ("Any member of the bar may seek informal ethics or unauthorized practice of law advice by calling the Ethics Hotline at (804) 775-0564."); State Bar of Arizona, *Ethics Hotline*, available at http://www.azbar.org/ethics/ethicshotline/ ("Ethics Hotline Number: 602.340.7284"); Pennsylvania Bar Association; *Ethics Hotline*, available at http://www.pabar.org/public/Membership/ethics.asp ("The Ethics Hotline provides free advisory opinions to PBA members based upon a review of a member's prospective conduct by members of the PBA Committee on Legal Ethics and Professional Responsibility. … The Ethics hotline can be reached at (800) 932-0311, ext. 2214."); State Bar of Texas, *Toll-Free Ethics Helpline for Lawyers*, available at https://www.texasbar.com/Content/NavigationMenu/ForLawyers/GrievanceandEthics/Toll_Free_Ethics_Helpline_for_Lawyers/default.htm (800.532.3947); State Bar of Michigan, *Ethics Article: Ethics Hotline – Frequently Asked Questions*, available at https://www.michbar.org/opinions/ethics/articles/july98 ("The Ethics Hotline at the State Bar of Michigan (877) 558-4760 receives approximately 20 calls per day from Michigan lawyers seeking guidance on a full array of ethics issues from lawyers."); The Florida Bar, *Ethics Hotline*, available at https://www.floridabar.org/ethics/ethotline/ ((800) 235-8619).

Imbedded losses in Covered-Calls

Finding the Invisible Case

31st PIABA ANNUAL MEETING

San Antonio, Texas

October 26 – Friday, October 28, 2022.

Jenice Malecki Esq. -Moderator
Frederick Rosenberg JD -Panelist
Sean Coughlin Esq. Bressler Amery & Ross- Panelist
Melinda Jane Steuer Esq. -Panelist

Introduction

- ***Investor Claims involving covered calls require isolating and analyzing the options and related underlying securities as a separate portfolio component***.
- This is necessary, especially with income accounts in distribution because in most cases, covered calls are recommended as an Enhancement Strategy to generate additional income at low risk in portfolios housing a broad range of investments and reported in one statement.
- The monthly account statements as well as typical account Profit and Loss, Matched trade, and NOP analyses all fail to isolate or quantify the variables that explain the Covered Call component's impact and portfolio impairment.
- The result has been that claimants with meritorious and often substantial covered call claims go unrepresented, or worse, settle for NOPs, or are denied in arbitration because their attorney simply lacked the data to prove loss causation.

Facts

- Pro-se Claimant calls, a late 40s divorcee pursuing an Art degree with 2 minor children living on the income from her $1mm settlement following her divorce. She was advised to write covered calls to enhance the income from her growth portfolio and support moderate withdrawals.
- In 10 years, withdrawals became unsustainable as her principal was halved.
- The covered calls reportedly generated 181k in net premium.
- Overall, the account broke even and there were no NOPs.
- 3 previous attorneys, unable to explain the portfolio decline in an up market with modest withdrawals, rejected her claim and Claimant filed pro-se.
- Defense was customer sophistication, market activity, excessive withdrawals accounting for the lack of portfolio growth plus any stock market losses, that the options were profitable, the covered call strategy conservative and suitable, and no NOPs and she took out the money.

Covered Calls

- Covered calls are combination investments generally considered to be low-risk and suitable for most investors – [when properly executed]
- Covered calls consist of owning stock and selling (writing) an out-of-the-money (OTM) call option to a speculator at a strike price above the current market, for a time premium giving the right to call the stock away at the strike price on or before the option's expiration date.
- For Covered Call sellers, keeping the stock and the premium is the typical expectation from a strategy promising "income" and growth. (Its not called a "sell call-lose stock" strategy).
- The call writer's goals are accomplished primarily by expiration in a neutral market, (time decay), and writing sufficiently OTM to allow stock growth and rewriting. Otherwise, options will be actively traded for a profit or loss or assigned for a market loss in the equities.

Speed of the Market and Risk

All options are a bet on the direction and speed of the market

- Option Purchasers are betting that the underlying security will be in-the-money prior to expiration
  - Unlimited leveraged upside
  - The risk of loss limited to the premium paid.
  - Premiums and Profits are greatest during periods of high or increasing volatility

- Option Sellers, covered call writers, are betting that the underlying security will remain out-of-the-money at expiration, keeping both the underlying security and the entire premium.
  - Maximum option return is the premium received
  - Potential unlimited risk of market loss in the underlying equities.
  - Success is highest in periods of low or declining volatility

Benchmarks-Baseline Standards

- Covered Call portfolio managers typically benchmark their performance to a recognized index, commonly the CBOE S&P500 Buy Write Index (BXM). Its algorithm/methodology:

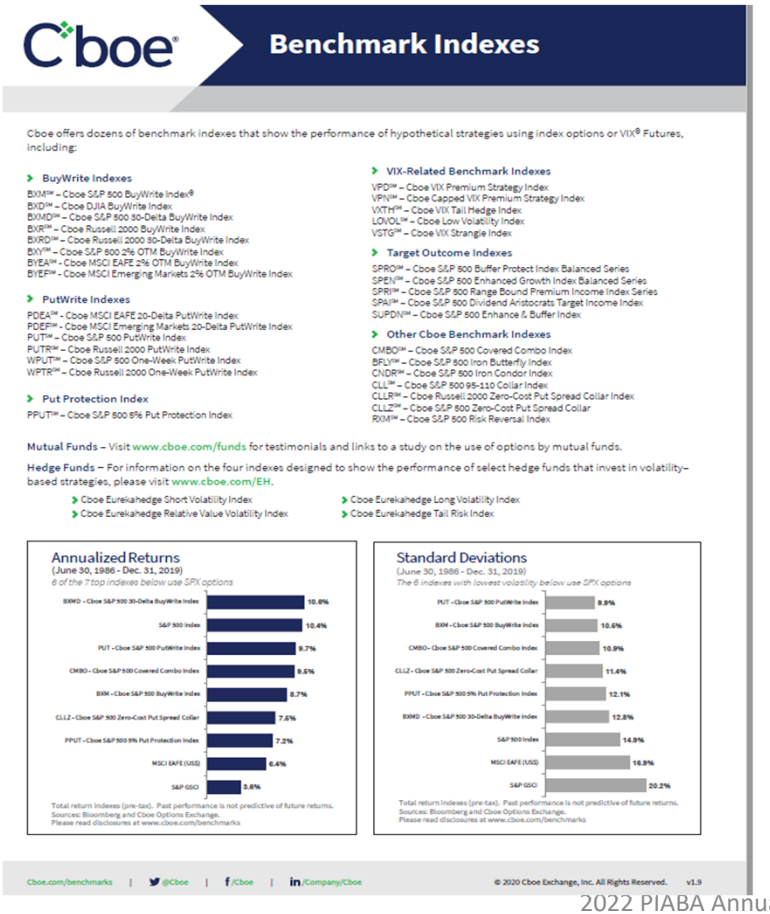
  1. The BXM writes near the money 30-day calls on the SP500
  2. Average Premium 1.69%*, **.
  3. Cash Settle on expiration
  4. Cannot be assigned or exercised prior to expiration
  5. Rewritten 12 x per year
  6. Total premium to market 20%/yr
  7. BXMD writes 30-day further OTM for less premium cushion and greater equity upside

- Broad Departures from established buy/write index methodologies (BXM) are typically undisclosed, misunderstood unsupervised, and opaque to the investor. Trading increases, expirations decline, risk increases, and returns will be impaired. In most cases the only similarity between conservative BXM methodology and the customer account is stock ownership.

* Ibbotson: “Highlights from Case Study on BXM Buy-Write Options Strategy”, 2004

** Callan and Associates: “An Historical Evaluation of the CBOE S&P 500 Buy-Write Index Strategy”, June 1, 1988 to August 31, 2006.

Index Data Comparison



Cboe

Benchmark Indexes

Cboe offers dozens of benchmark indexes that show the performance of hypothetical strategies using index options or VIX® Futures, including:

BuyWrite Indexes

BXM™ – Cboe S&P 500 BuyWrite Index®
BXD™ – Cboe DJIA BuyWrite Index
BXMD™ – Cboe S&P 500 30-Delta BuyWrite Index
BXR™ – Cboe Russell 2000 BuyWrite Index
BXRD™ – Cboe Russell 2000 30-Delta BuyWrite Index
BXY™ – Cboe S&P 500 2% OTM BuyWrite Index
BYEA™ - Cboe MSCI EAFE 2% OTM BuyWrite Index
BYEM™ - Cboe MSCI Emerging Markets 2% OTM BuyWrite Index

PutWrite Indexes

PDEA™ - Cboe MSCI EAFE 20-Delta PutWrite Index
PDEM™ - Cboe MSCI Emerging Markets 20-Delta PutWrite Index
PUT™ – Cboe S&P 500 PutWrite Index
PUTR™ – Cboe Russell 2000 PutWrite Index
WPUT™ – Cboe S&P 500 One-Week PutWrite Index
WPTR™ – Cboe Russell 2000 One-Week PutWrite Index

Put Protection Index

PPUT™ – Cboe S&P 500 5% Put Protection Index

VIX-Related Benchmark Indexes

VPD™ – Cboe VIX Premium Strategy Index
VPN™ – Cboe Capped VIX Premium Strategy Index
VXTH™ – Cboe VIX Tail Hedge Index
LOVOL™ – Cboe Low Volatility Index
VSTG™ – Cboe VIX Strangle Index

Target Outcome Indexes

SPRO™ – Cboe S&P 500 Buffer Protect Index Balanced Series
SPEN™ – Cboe S&P 500 Enhanced Growth Index Balanced Series
SPRI™ – Cboe S&P 500 Range Bound Premium Income Index Series
SPAI™ – Cboe S&P 500 Dividend Aristocrats Target Income Index
SUPDN™ – Cboe S&P 500 Enhance & Buffer Index

Other Cboe Benchmark Indexes

CMBO™ – Cboe S&P 500 Covered Combo Index
BFLY™ – Cboe S&P 500 Iron Butterfly Index
CNDR™ – Cboe S&P 500 Iron Condor Index
CLL™ – Cboe S&P 500 95-110 Collar Index
CLLR™ – Cboe Russell 2000 Zero-Cost Put Spread Collar Index
CLLZ™ – Cboe S&P 500 Zero-Cost Put Spread Collar
RXM™ – Cboe S&P 500 Risk Reversal Index

Mutual Funds – Visit www.cboe.com/funds for testimonials and links to a study on the use of options by mutual funds.

Hedge Funds – For information on the four indexes designed to show the performance of select hedge funds that invest in volatility–based strategies, please visit www.cboe.com/EH.

- Cboe Eurekahedge Short Volatility Index
- Cboe Eurekahedge Relative Value Volatility Index
- Cboe Eurekahedge Long Volatility Index
- Cboe Eurekahedge Tail Risk Index

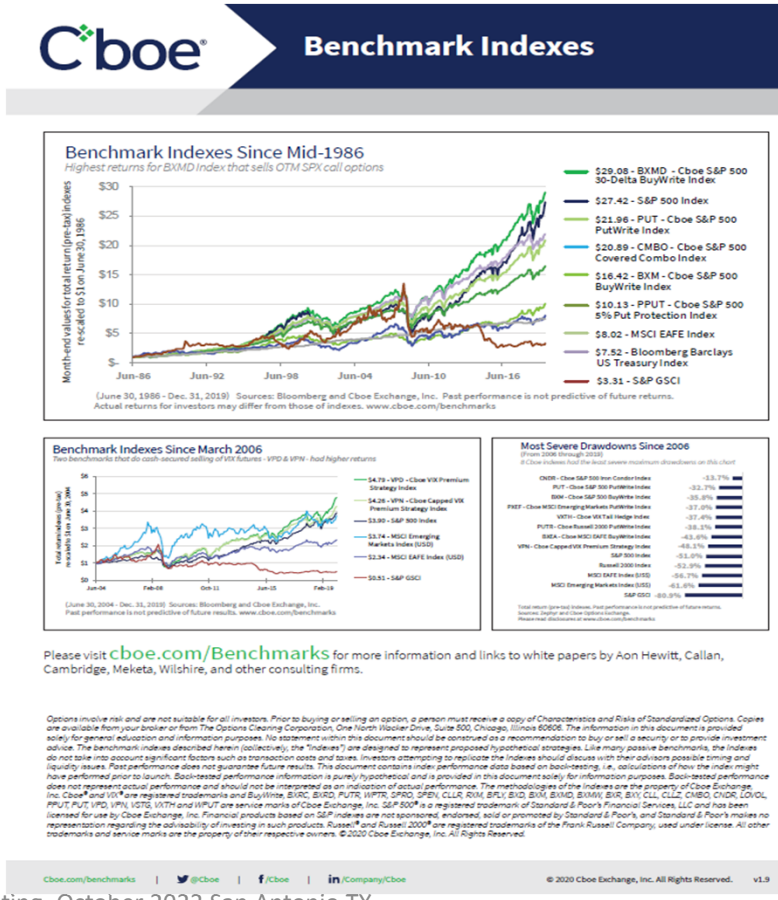
Annualized Returns
(June 30, 1986 - Dec. 31, 2019)
6 of the 7 top indexes below use SPX options

Total return indexes (pre-tax). Past performance is not predictive of future returns.
Sources: Bloomberg and Cboe Options Exchange.
Please read disclosures at www.cboe.com/benchmarks

Standard Deviations
(June 30, 1986 - Dec. 31, 2019)
The 6 indexes with lowest volatility below use SPX options

Total return indexes (pre-tax). Past performance is not predictive of future returns.
Sources: Bloomberg and Cboe Options Exchange.
Please read disclosures at www.cboe.com/benchmarks

Cboe.com/benchmarks | @Cboe | /Cboe | /Company/Cboe © 2020 Cboe Exchange, Inc. All Rights Reserved. v1.9



Cboe

Benchmark Indexes

Benchmark Indexes Since Mid-1986
Highest returns for BXMD Index that sells OTM SPX call options

(June 30, 1986 - Dec. 31, 2019) Sources: Bloomberg and Cboe Exchange, Inc. Past performance is not predictive of future returns.
Actual returns for investors may differ from those of indexes. www.cboe.com/benchmarks

Benchmark Indexes Since March 2006
Two benchmarks that do cash-secured selling of VIX futures - VPD & VPN - had higher returns

(June 30, 2006 - Dec. 31, 2019) Sources: Bloomberg and Cboe Exchange, Inc.
Past performance is not predictive of future results. www.cboe.com/benchmarks

Most Severe Drawdowns Since 2006
(From 2006 through 2019)
8 Cboe indexes had the least severe maximum drawdowns on this chart

Total return (pre-tax) indexes. Past performance is not predictive of future returns.
Sources: Zephyr and Cboe Options Exchange.
Please read disclosures at www.cboe.com/benchmarks

Please visit cboe.com/Benchmarks for more information and links to white papers by Aon Hewitt, Callan, Cambridge, Meketa, Wilshire, and other consulting firms.

Options involve risk and are not suitable for all investors. Prior to buying or selling an option, a person must receive a copy of Characteristics and Risks of Standardized Options. Copies are available from your broker or from The Options Clearing Corporation, One North Wacker Drive, Suite 500, Chicago, Illinois 60606. The information in this document is provided solely for general education and information purposes. No statement within this document should be construed as a recommendation to buy or sell a security or to provide investment advice. The benchmark indexes described herein (collectively, the "Indexes") are designed to represent proposed hypothetical strategies. Like many passive benchmarks, the Indexes do not take into account significant factors such as transaction costs and taxes. Investors attempting to replicate the Indexes should discuss with their advisors possible timing and liquidity issues. Past performance does not guarantee future results. This document contains index performance data based on back-testing, i.e., calculations of how the index might have performed prior to launch. Back-tested performance information is purely hypothetical and is provided in this document solely for information purposes. Back-tested performance does not represent actual performance and should not be interpreted as an indication of actual performance. The methodologies of the Indexes are the property of Cboe Exchange, Inc. Cboe® and VIX® are registered trademarks and BuyWrite, BXRC, BXRD, PUTR, WPTR, SPRO, SPEN, CLLR, RXM, BFLY, BXD, BXM, BXMD, BXMW, BXR, BXY, CLL, CLLZ, CMBO, CNDR, LOVOL, PPUT, PUT, VPD, VPN, VSTG, VXTH and iVPUT are service marks of Cboe Exchange, Inc. S&P 500® is a registered trademark of Standard & Poor's Financial Services, LLC and has been licensed for use by Cboe Exchange, Inc. Financial products based on S&P indexes are not sponsored, endorsed, sold or promoted by Standard & Poor's, and Standard & Poor's makes no representation regarding the advisability of investing in such products. Russell® and Russell 2000® are registered trademarks of the Frank Russell Company, used under license. All other trademarks and service marks are the property of their respective owners. ©2020 Cboe Exchange, Inc. All Rights Reserved.

Cboe.com/benchmarks | @Cboe | /Cboe | /Company/Cboe © 2020 Cboe Exchange, Inc. All Rights Reserved. v1.9

The VIX

- The VIX is the CBOE Volatility Index
- It measures the volatility of 30-day SPX contracts expressed as a percent.
- Calculated throughout the trading day
- Market Risk Trend Indicator
- When the VIX is high >20%, volatility and premiums are high and vice versa.
- Determining and recording the VIX on every trade date provides an important comparative basis for chronological risk analysis.

Covered Calls Basics

- The maximum gain on the short call is the premium received upon expiration.
- The maximum gain on the covering stock marked to market =(Strike Price – Market Price) on open.
- Writing options depends on time-value decay (Theta) for profitability, the expectation the stock will remain out-of-the-money and the option expire worthless.
- Breakeven price = Strike Price + Premium received. E.g., 100 stock, write $105 call for $1. Breakeven price is $106. Intrinsic loss is for above $106 plus remaining time premium to expiration
- ITM Covered Calls impair equity returns in rising markets. Enhancement?
- Covered Call writers collateralize the risk of in-the-money calls with the underlying stock and by allowing assignment must deliver the stock to cover option repurchase costs at a market loss equal to the difference between its appreciated market price and the strike price.
- Equity gains and losses are calculated marked to market on the trade date, not cost basis, to quantify option impact and impairment (a damages issue).

Three Exit strategies for Covered Calls

Options writers cannot exercise an option and have only three potential exits,

- expiration for an option profit and retain the Stock at lower cost basis with downside market risk
- trade the option for a profit or loss,-Volatility Trading.
- permit assignment of in-the-money options, deliver the underlying stock for a market loss, and retain the premium usually for a net combination loss.

Expirations

- Expirations measure success in covered call strategies intended to generate supplemental income at low risk in neutral markets
- Broad departures from established Benchmark 30-day methodologies increases trading and substantially reduces expirations lowering returns and increasing risk.
- Ideally, all short options expire worthless, (out of the money), netting the entire premium and retaining the underlying security.
- Collateralized Options Trading results when expirations constitute only a small fraction of all closing transactions. This usually can be traced to
  - Writing calls too long, expiring in 180+ days, for higher premium
  - Writing calls with a high probability of being in-the-money at expiration (high Delta)
  - Writing calls where time decay (Theta) has minimal impact
  - Writing Calls where Volatility determines pricing not time decay.
  - Writing ITM calls
  - Closing OTM positions with substantial time Premium remaining.

Assignments

- Options can only be exercised by the purchaser (never the seller), any time prior to expiration (typically to capture dividends).
- Once a short call is in-the-money, it will be assigned if not repurchased, usually at a loss, and the stock delivered out below market.
- Depending on the length of time to expiration, volatility and the underlying stock price, the potential market loss could be massive if the option is not repurchased early to free the stock before assignment occurs.
- *Assignments occur automatically without order tickets for supervisors to review.*

Assignment Impact

- The repurchase cost of an assigned option is the amount that would have closed the option position vs allowing assignment. It equals the difference between the closing market price of the underlying stock on the trade date and the strike price.
- Assignments transfer the repurchase cost of in-the-money options to the underlying equities that are called away below market by an amount equal to the repurchase cost.
- The transfer of repurchase costs to the equities permits accounting for assigned calls at zero cost and profitable when they are not, the same accounting as Expirations.
- With multiple assignments it is impossible to determine if an options strategy was profitable or not or whether it enhanced or impaired return without totaling the repurchase costs and subtracting them from the options p and l. (reversing assignment)
- With Assignments it is the Underlying Equities at market that absorb the option's repurchase cost and that must be calculated. (Take note to exclude Legacy stock and legacy profits unrelated to the covered calls)

The Data Needed to Assess Outcome

Neither the account statements nor confirmations report the information needed to determine causation and impact of options component underperformance. Specifically, analyzing Covered Call strategies requires

1. The closing market price of the underlying stock and the VIX on every trade date(The only data that requires additional research).
2. Moneyness, the amount by which an option is out or in the money on every trade date,
3. The percent of premium to market
4. Days to expiration on Open and Close
5. Average Holding period
6. Percent of Expirations
7. Percent of Assignments
8. The repurchase cost of assigned options on the trade date, (market loss).
9. Percent of Closing Repurchases, in-the-money, out of the money, average days to expiration
10. Percent of Short leaps and total premium received
11. Premiums Received
12. Premiums Paid

The Underlying Stock Price Matters

- The Options Clearing Corporation issues option series typically in $5 increments.
  - At $100 market price each strike price $5/100 is a 5% move. 1%=$1.00
  - The Notional Market Value @105: 105 x 100 = $10,500/call

  - At $2,500 market price each strike $5/2500=.2% move. 1%=$25.00
  - The Notional Market Value @ $2,525: 2,525 x 100 = $252,500/call

Option Trading Analysis-Summary

Short Options Summary				
	Trades	Premium	Days to Exp / Days Held	Commission
Open Short	1917	$ 2,103,921	300	$ 110,495
Close Short	1704	$ (1,922,491)	140	$ 88,611
Net Premium after Assignments		$ 181,430	160	$ 199,106
Statement Profit	$ 181,430			
Repo costs Assigned	$ (489,398)	baked in equity market loss		
Adj P/L if repurchased	$ (307,968)	Actual Option Trading Loss		
Option Commissions	$ 199,106			
Expiration	112	6.60%		
Repurchases to close	1435	84%		
Assignments allowed	157	9.20%	$ (489,398)	Repurch cost
Short Leaps to Open	808	42.1%	$ 1,030,535	Prem Received
Trading volume	$ 4,026,412			

Impact of Assignments on Underlying Equities

Underlying Equities Summary - Explaining Equity Losses				
		trades		Commissions
Purchases	$ (5,166,757)	577		$ 58,450
Sales	$ 4,319,355	404		$ 48,158
Trading Loss	$ (847,402)	981		$ 106,608
Statement Loss	$ (847,402)			
Assignments	$ 489,398			
Pre-Assignment Losses	$ (358,004)	In Component	Equities	
Trading volume	$ 9,486,112			

Total Option Impact- Summarized				
	Statement	assign	Adj Loss	Commissions
Option-Income or Loss?	$ 181,430	$ (489,398)	$ (307,968)	$ 199,106
Underlying Equities	$ (847,402)	$ 489,398	$ (358,004)	$ 106,608
	$ (665,972)	$ -	$ (665,972)	$ 305,714

Analyzing Underlying Equity Performance

- $489,389 of Equity losses were the direct result of option assignments baked in, not market activity or withdrawals as is often alleged.
- Absent the assignments, the losses in underlying equities would have been ($358k) vs ($847K)
- Often underlying Equity losses will turn profitable when assignments are reversed
- Profits and income derived from Legacy positions, low-basis stock, fixed Income… are typically offset (cannibalized) by option losses instead of being paid out.
- Ultimately the Risk of Covered Calls lies in the market volatility of the underlying equities purchased for or assigned to the account. E.g The $358k in losses is solely attributable to the market decline of the covering stocks purchased specifically for the implementation of the option strategy.

30-Day Calls vs Longer Expirations

Beating the Benchmark?

- The annualized return writing and rewriting covered calls with 30-day or shorter expirations consistently exceeds the annualized return of options written with long expirations for higher premiums.
- For example, writing $105 OTM calls expiring in 30 days for a 1.5% premium (18%/year) on a $100 volatile stock rewritten monthly is exponentially less risky with higher return than writing a $105 covered call expiring in 364 days and rewritten once every year for a single 6.5% premium on the same, $100 stock.
- In the time it takes for the 364-day option to expire, 1 year, the 30-day options would have generated 18% in gross premium at 1.5%/month, 11.5% more with lower risk and stock appreciation. Generally, the same holds true across the entire spectrum of expirations, the longer the days to expiration on open, the lower will be the annualized return vs 30-day expirations.
- Writing options long-term ultimately leads to a decline in expirations, a high level of trading out of positions with substantial time premium remaining, and increased assignments. Consequently, expirations decline and volatility trading increases in both options and equities.

Covered Call LEAPS:
Beyond the Benchmarks

CVX Covered Call LEAP @85 exp 01/21/12

Date	Buy Long Sell Sht	shares	Strike Price	Premium	%	Amount	Days to Expiration	CVX market price	Out-(in) moneyness	Repo Cost to close*	Option P/l
12/01/10	Sell Sht	2,000	$ 85	$ 6.80	8%	$ 13,600	416	$ 82.19	$ 2.81		$ 13,600
12/10/10		2,000	$ 85	$ 9.95			407	$ 87.00	$ (2.00)	$ (19,900)	$ (6,300)
03/10/11		2,000	$ 85	$ 17.13			317	$ 99.00	$ (14.00)	$ (34,260)	$ (20,660)
01/20/12		2,000	$ 85	$ 21.00			1	$ 106.00	$ (21.00)	$ (42,000)	$ (28,400)
01/21/12	Assigned	(2,000)	$ 85			$ -	0	$ 106.89	$ (21.89)	$ (43,780)	$ (30,180)
						$ 13,600	Reported Option Profit				$ 13,600

Comp @ 85	Months	Prem	Tot Prem	2000 shs
30-day	14	$ 1.15	$ 16.10	$ 32,200
Leap	14	$ 6.80	$ 6.80	$ 13,600

Chevron Stock

Date	buy/sell	shares	Price	Amount		market price	Market value	Baked-in Market loss
12/01/10	buy	2000	$ 82.19	$ (164,380)		$ 82.19	$ 164,380	$ -
01/21/12	sell	2000	$ 85.00	$ 170,000		$ 106.89	$ 213,780	$ (43,780)
				$ 5,620	Reported Statement Profit			

				$ 5,620
			Profit	$ 19,220

Statement Accounting	buy	Sell	Profit
shares	2000	2000	
cost basis	$ 75.39	$ 85.00	
cost	$ 150,780	$ 170,000	$ 19,220

Chevron Repurchase cost	$ 213,780
Actual Chevron Profit (un-enhanced)	$ 49,400
30-day excess premium	$ 18,600

*Intrinsic value of all ITM options increases dollar for dollar with the underlying stock plus time premium

Assigned Puts:

Qualcomm Put @125 exp			07/22/00							
Date	Buy Long Sell Sht	shares	Strike Price	premium		Days to Expiration	QCOM market price	Out-(in) moneyness	Repo Cost to close*	Option P/l
02/09/00	Sell Sht	300	$ 125	$ 16.75	$5,025	164	$ 133.32	$ 8.32		$ 5,025
04/07/00		300	$ 125	$ 2.06		106	$ 152.26	$ 27.26	$ (618)	$ 4,407
04/12/00		300	$ 125	$ 9.28		101	$ 125.12	$ 0.12	$ (2,784)	$ 2,241
05/15/00		300	$ 125	$ 22.05		68	$ 104.32	$ (20.68)	$ (6,615)	$ (1,590)
06/21/00	Assigned	300	$ 125	$ 60.50		31	$ 64.50	$ (60.50)	$(18,150)	*$ (13,125)*
				Reported Profit	$5,025					
Qualcomm Stock										
Date	Assigned buy/sell	shares	Price	Cost		market price	Market value	Baked-in Market loss		
06/21/00	buy	300	$ 125	$ (37,500)		$ 64.50	$ 19,350	$ (18,150)		

Conclusions

- What became apparent in the analysis is not simply option losses and the high-risk departures from conservative benchmarks, but also the intentional use of Assignments to hide option losses creating the illusion of net premium income while actively trading short calls for a loss.
- Analyzing short option strategies - such as covered calls - is principally data-driven and conclusions based on that analysis rely on numbers, methodologies and identified patterns, not opinion based on outcome.
- An options component's analysis must include the options and the covering stocks in combination since a short option strategy's losses are hidden most frequently in the underlying equities purchased specifically for writing calls, even if net premium is generated. E.g. ($358k) in covering stocks.
- Identifying elements of negligent methodologies can be as simple as a preliminary review of the assignments and expirations. That said, a complete option analysis is needed to establish causation.
- No!-the strategy was not conservative covered call writing!
- Yes!-the outcome was foreseeable and preventable!

Finra Rules: Rule 2111 .05 Components of Suitability Obligations

Rule 2111 is composed of three main obligations: reasonable-basis suitability, customer-specific suitability, and quantitative suitability.

(a) The reasonable-basis obligation requires a member or associated person to have a reasonable basis to believe, *based on reasonable diligence*, that the recommendation is suitable for at least some investors. In general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the member's or associated person's familiarity with the security or investment strategy. A member's or associated person's reasonable diligence must provide the member or associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy. The lack of such an understanding when recommending a security or strategy violates the suitability rule."

Finra Rules 3120. Supervisory Control System

(a) Each member shall designate and specifically identify to FINRA one or more principals who shall establish, maintain, and enforce a system of supervisory control policies and procedures that:

(1) test and verify that the member's supervisory procedures are reasonably designed with respect to the activities of the member and its associated persons, to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules; and

(2) create additional or amend supervisory procedures where the need is identified by such testing and verification. The designated principal or principals must submit to the member's senior management no less than annually, a report detailing each member's system of supervisory controls, the summary of the test results and significant identified exceptions, and any additional or amended supervisory procedures created in response to the test results.

Finra Rule 3260. Discretionary Accounts

3260. Discretionary Accounts
(a) Excessive Transactions

No member shall effect with or for any customer's account in respect to which such member or his agent or employee is vested with any discretionary power any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account.

(b) Authorization and Acceptance of Account

No member or registered representative shall exercise any discretionary power in a customer's account unless such customer has given prior written authorization to a stated individual or individuals and the account has been accepted by the member, as evidenced in writing by the member or the partner, officer or manager, duly designated by the member, in accordance with Rule 3110.

(c) Approval and Review of Transactions

The member or the person duly designated shall approve promptly in writing each discretionary order entered and shall review all discretionary accounts at frequent intervals in order to detect and prevent transactions which are excessive in size or frequency in view of the financial resources and character of the account.

Finra Rules 2360. Options: (18) Discretionary Accounts

(A) Authorization and Approval
(i) No member and no person associated with a member shall exercise any discretionary power with respect to trading in option contracts in a customer's account, or accept orders for option contracts for an account from a person other than the customer, in compliance with the provisions of Rule 3260 and unless:

a. The written authorization of the customer required by Rule 3260 shall specifically authorize options trading in the account; and

b. the account shall have been accepted in writing by a Registered Options Principal or Limited Principal—General Securities Sales Supervisor.

(C) Option Programs
Where the discretionary account utilizes options programs involving the systematic use of one or more options strategies, the customer shall be furnished with a written explanation of the nature and risks of such programs.

2360. Options | FINRA

(19) Suitability

(A) No member or person associated with a member shall recommend to any customer any transaction for the purchase or sale(writing) of an option contract unless such member or person associated therewith has reasonable grounds to believe upon the basis of information furnished by such customer after reasonable inquiry by the member or person associated therewith concerning the customer's investment objectives, financial situation and needs, and any other information known by such member or associated person, that the recommended transaction is not unsuitable for such customer.

(B) No member or person associated with a member shall recommend to a customer an opening transaction in any option contract unless the person making the recommendation has a reasonable basis for believing, at the time of making there commendation, that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position inthe option contract.

2360. Options | FINRA.org

((20) Supervision of Accounts

(A) Duty to Supervise

Each member that conducts a public customer options business shall ensure that its written supervisory system policies and procedures pursuant to Rules 3110, 3120, and 3130 adequately address the member's public customer options business.

(B) Branch Offices

No branch office of a member shall transact an options business unless the principal supervisor of such branch office accepting options transactions has been qualified as either a Registered Options Principal or a Limited Principal—General Securities Sales Supervisor; provided that this requirement shall not apply to branch offices in which no more than three registered representatives are located, so long as the options activities of such branch offices are appropriately supervised by either a Registered Options Principal or a Limited Principal—General Securities Sales Supervisor.

2360. Options | FINRA.org

((20) Supervision of Accounts

(C) Headquarters Review of Accounts

Each member shall maintain at the principal supervisory office having jurisdiction over the office servicing customer accounts, or have readily accessible and promptly retrievable, information to permit review of each customer's options account on a timely basis to determine:

(i) the compatibility of options transactions with investment objectives and with the types of transactions for which the account was approved;
(ii) the size and frequency of options transactions;
(iii) commission activity in the account;
(iv) profit or loss in the account;
(v) undue concentration in any options class or classes, and
(vi) compliance with the provisions of Regulation T of the Federal Reserve Board.

WINNING STRATEGIES FOR PROSECUTING ALTERNATIVE INVESTMENT CASES

Years of low interest rates in conjunction with a large number of people retiring have been the perfect environment for the development and sale of "Alternative" investments that often offer above-market returns in the form of a monthly distribution as well as stability and possible upside. This situation has created an explosion of sales in this formerly very limited area of the investing market.

The first question that must be answered is: What is an Alternative Investment? The term "alternative investment" is a securities industry catch all for investments that fall outside the normal categories of stocks and bonds. Over time, they have developed really into two categories: private equity and hedge funds. The major difference between the two is that private equity is, as its name suggests, a private investment that is not traded on an exchange or in any other public process. Hedge funds can be both traded and non-traded and tend to operate in a more transparent manner because of regulatory requirements. However, hedge funds are less regulated that other pooled investments, such as mutual funds, and, as a result, lack full transparency in the name of protecting proprietary trading information.

Most commonly, when we are talking about alternative investments in a typical retiree's account, they are private equity deals ranging from small, unregistered securities offerings (Reg. D offerings) to large, non-traded Real Estate Investment Trusts ("REITs"). There are also other, similar non-traded investment vehicles, such as Business Development Companies ("BDCs") that pool together money from investors to buy private businesses. Regardless of the type, virtually all alternative investments have less transparency and less liquidity than their publicly traded counterparts.

Historically, alternative investments were largely only marketed to and available to ultra-high net worth investors. However, two things have driven their growth to more traditional retail investors. First, investor demand has increased as volatile markets and reduced interest rates have resulted in many investors as well as their advisors questioning the value of a traditional stock and bond portfolio. Second, commissions for investments have compressed considerably over the past ten to twenty years and, as a result, firms and advisors are looking for new ways to make more money. Most alternative investments pay significantly higher commissions that other investment options.

1. The Problem with Alternative Investments

The principal problems with non-traded investments are known by the sponsors of such investments and disclosed: lack of transparency and lack of liquidity. However, such general statements of the risks of alternative investments and boilerplate disclosures in a prospectus do not fully capture the significance of these problems. The lack of transparency often materializes in unexpected ways. That includes the fact that it is virtually impossible to know the actual value of the investment at any given time. The lack of liquidity, while known, is a problem when the alternative investment does not obtain a liquidity event in the timeframe initially estimated, meaning that an investor could get locked into the alternative investment in perpetuity, which no disclosure could remedy.

But, the biggest problem with most alternative investments is their structure. That is, many alternative investments are structured to look very similar to a Ponzi scheme. In fact, one expert we have used in these cases came up with the best phrase: these may not be Ponzi schemes, but they are at least a close cousin.

A typical non-traded REIT structure is a good example of this Ponzi-like structure. The typical non-traded REIT will offer a monthly "distribution" of 8% of the invested amount. While an 8% return is incredible, that is actually misleading, as the return required to distribute the 8% is actually much higher. First, there is typically an 8% selling commission paid to the financial advisor who sells the REIT. In addition, the investment firm involved is typically paid a 3% "manager fee" or, alternatively, "due diligence" fee. So, that is 11% of the money send directly out before any investment can be made. In addition, there are typically ongoing management and administrative costs to the sponsor for the REIT and many sponsors also charge an "acquisition fee" for the acquisition of any real estate put into the REIT. Both of those fees can be ongoing to the REIT, costing the REIT 1.5% to 3% per year.

So, even from the very beginning, the most that could possible actually be invested into real estate is 89% of the capital invested. So, that means the return moves up to 9% minimum, just to keep up with the 8% promised distribution. However, that is not the reality of the situation for most REITs as there are ongoing costs of paying distributions, managing the REIT and providing profits to the sponsor of the REIT. For example, assuming that it takes one year from the initial investment until appropriate real estate can be acquired for the REIT, the costs go up between 9.5% and 11%. That is, if the REIT has to pay out distributions for a year even though there is no real estate and run operations for that year, the REIT will have 9.5% less to invest in real estate, if an acquisition fee of 1.5% is added for the real estate actually acquired that year, it moves the cost up 11%. In that situation, the REIT actually only has 78% of the funds invested to use to purchase real estate. And, now that means the break even for paying the 8% distribution is more than a 10% return on per year on the investment. Below is an illustration:

Initial Investment	$100,000
Sales Commission	($8,000)
Due Diligence Fee	($3,000)
Operating Costs	($1,500)
Acquisition fee	($1,500)
Year of Distributions	($8,000)
Left to Actually Invest in Real Estate	$78,000

In reality, a real estate investment paying a consistent cash return of over 10% does not exist anymore, but that is not disclosed or discussed with investors. Nor is the fact that the distribution is being paid without any income being generated from the REIT discussed. Because the promise of a "distribution" is immediate, even before any real estate investment has been made in the REIT that could have a possible, that raises the question of: where is the money coming from to pay investors? The answer is: other investors. This is why most alternatives are essentially

structured as Ponzi schemes because they pay out money to investors that is not based on the return of the investment or any profits, but rather, a stated return that is supported by the inclusion of new investor money. In many ways, that is the definition of a Ponzi scheme.

The above example is somewhat simplistic in comparison with the financing of the typical non-traded REIT. Most often, it is an ongoing process that involves buying multiple properties over several years and using significant leverage to accomplish the purchases. However, for almost all non-traded REITs, they real estate investments never produce sufficient cashflow to pay the promised distributions. So, even after the targeted real estate is acquired, there is a deficit between the income realized on that real estate and the amount paid out to investors. That gap has to be bridged using other investor's money. So, not only at the beginning, but really throughout the life of a non-traded REIT, it operates as a Ponzi scheme.

Of course, if all REITs were all Ponzi schemes, they would not exist for too long. But, even though operated as Ponzi schemes, many non-traded REITs actually work out, making all promised distributions and then, after 3 to 5 years, returning all principle as well as additional profits at closing. In fact, because these deals do work out so often, the fact that they are essentially Ponzi schemes is only uncovered when the sponsor cannot create a liquidity event, typically by selling the underlying real estate in the REIT at a profit.

Below is an example of the life cycle of a simple single raise with the purchase of a single property REIT model that shows the money the firm and advisor selling the investment would make as well as the money the sponsor would make. In this example, there is a $100 million capital raise for the REIT. That money is used, in part, to make a down payment of 25% on a $250 million real estate investment with a 6% cap rate that is financed at a favorable 5% interest rate.

Non-Traded REIT Lifecycle			
$100,000,000		**Costs/Income**	**Remaining from Investment**
Year One			
Sales Commissions	8%	$8,000,000	$92,000,000
Due Diligence Fee	3%	$3,000,000	$89,000,000
Operating Costs	1.50%	$1,500,000	$87,500,000
Acquistion Fee	1.50%	$3,750,000	$83,750,000
Investor Distributions	8%	$8,000,000	$75,750,000
Buy $250 million property			
$250,000,000			
Down Payment	25%	$62,500,000	$13,250,000
Year Two			
Operation Costs	1.50%	$1,500,000	$11,750,000
Investor Distributions	8%	$8,000,000	$3,750,000
Interest on loan	5%	$9,375,000	($5,625,000)
Income from property	6%	$15,000,000	$9,375,000
Yearly deficit			($3,875,000)

Year Three			
Operation Costs	1.50%	$1,500,000	$7,875,000
Investor Distributions	8%	$8,000,000	($125,000)
Interest on loan	5%	$9,375,000	($9,500,000)
Income from property	6%	$15,000,000	$5,500,000
Year Four			
Operation Costs	1.50%	$1,500,000	$4,000,000.00
Investor Distributions	8%	$8,000,000	($4,000,000.00)
Interest on loan	5%	$9,375,000	($13,375,000)
Income from property	6%	$15,000,000	$1,625,000
Liquidation Event	18%	$295,000,000	$296,625,000
Repayment of loan		($187,500,000)	$109,125,000
Disposal of asset fee	1.50%	$4,425,000	$104,700,000
Repayment to investors		($100,000,000)	$4,700,000
Ending Profit Percentage			4.700%
Cash Returned to Investors over life of the REIT			$36,700,000
Annualized Return for investors in the REIT			9.18%
Fees Paid to the Advisor and the Firm			$11,000,000
Percentage Fee to the Advisor and Firm			11%
Fees Paid to the Sponsor of the REIT			$14,175,000
Percentage Fee to the Sponsor of the REIT			14.18%

This example assumes a simple one-year time frame to raise the $100 million and to also acquire the subject $250 million property. In this situation, at the end of year one, the REIT has $13,250,000 remaining in cash and owns a $250 million property. However, the REIT has a $187,500,000 liability. When this plays out in year two, the REIT has expenses of $18,875,000 per year and an income of only $15 million per year (6% cap rate on the $250 million), which means the REIT is running at a deficit of $3,875,000 per year or, is negative cashflow almost $4 million a year. And, at the end of year two, the REIT now only has $9,375,000 in cash remaining. With a burn rate of almost $4 million a year, that means the REIT must have a liquidity event by the end of year four, our it will run out of money. And, indeed, that is what happens with some

non-traded REITs. When a liquidity even cannot be realized in time, non-traded REITs will often either reduce distributions or completely halt distributions because there is not sufficient money to pay distributions. In this example, that would mean cutting the distributions in half, at a minimum.

But, if a liquidity even can happen, the negative cashflow may never be uncovered and most investors remain oblivious to the fact that their monthly checks have been largely funded by other investors. In this example, after three years of holding the investment, the REIT sells for $295 million, representing an 18% gain on the asset. After all costs paid as well as the investors, there is additional profit of almost $5 million that is often then returned to the investors as additional return on the principle. So, when these investments work out, they appear to provide a steady monthly income and upside after holding the investment for only 3 or 4 years.

However, in order for the investment to work out, quite of few things have to go in favor of the REIT, including the real estate market, interest rates and no "surprises", such extraordinary costs related to the property or litigation concerning the property. In the event that any of these various factors turn against the REIT, the timeline may be shortened or the costs may make it impossible to obtain a profitable disposition of the property. When that happens, non-traded REITs tend to have spectacular collapses and the Ponzi scheme nature of the product is quickly exposed.

2. Pleading the Alternative Investment Case

One of the biggest mistakes of any pleading is to "overstate" your case. This is particularly important for FINRA pleadings. FINRA Rules provide little guidance in terms of what is required for a proper pleading, including that FINRA's rules only requirement for a Statement of Claim is that the claim "specify[sic] the relevant facts and remedies requested." FINRA Rule 13302(a)(2). There is no requirement that any cognizable cause of action be plead or that any of the facts or remedies be pled with any level of particularity. This type of a rule allows for, and in fact in some way encourages, a more generic pleading that gives options to the claimant to fit the ultimate evidence within the document filed.

Moreover, unlike court, amending FINRA pleadings is difficult. After the arbitration panel is appointed, FINRA rules require that a formal motion be filed with the panel under FINRA Rule 12503 and that the panel then grant the motion to amend the claim. *See* FINRA Rule 12309(b). This process necessarily requires that a claimant explain why the prior pleading is insufficient and needs to be amended, which could hurt the credibility of the claimant or claimant's counsel. As a result, amended pleadings are much less prevalent in FINRA arbitration than in other forums.

The other issue to avoid in your statement of claim is creating a higher bar for your client to hurdle than necessary. It is rarely necessary to prove that the claimant was ultra-conservative or a complete investment novice in order to win a case. Nevertheless, many claimants counsel tend to make these bold statements about the incredibly conservative nature of their client or the total lack of sophistication of their client in their statement of claim, before any discovery has been done. When that happens, the claimant's attorney has unnecessarily placed a burden of proof on the case that does not otherwise exist. And, too often, those attorneys are surprised in discovery when they learn of the client's actual prior trading history, which appears to show a willingness to take more risks than represented as well as being more sophisticated than the attorney thought. There is no need to prove the claimant has never invested before or is super conservative to win almost any case. So, making such statements in a statement of claim can only hurt the case.

3. Suitability in Alternative Investment Cases

Proving an investment is unsuitable for a customer is always an individual task as the entire nature of suitability is that it necessarily depends on the individual situation of each customer. However, FINRA's revised suitability rule as related interpretive guidance have helped to add some clearer definitions of suitability requirements. For example, FINRA has clarified that part of the suitability obligation is to perform sufficient due diligence on the product being recommended. In particular, FINRA says that an advisor must perform "reasonable diligence" on any recommendation and that reasonable diligence "must provide the member or associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy." FINRA Rule 2111.05. Many times, it becomes very clear when questioning a broker that the broker does not have a clear understanding of the alternative being recommended and proving so can be fatal to the defense that a recommendation was suitable. In fact, FINRA has made it a de facto suitability violation to recommend a security without an understanding of the risks and rewards of an investment, stating "[t]he lack of such an understanding when recommending a security or strategy violates the suitability rule." Id.

Additionally, alternative investments, because they have been abused so often, have been reviewed extensively by regulators. The result is that alternative investments, such as non-traded REITs, are the only investments that have specific concentration rules and suitability guidelines imposed by certain states. Below is a chart of the various states that impose their own suitability standards on these investments and the details of those standards.

State Concentration Limitations for Alternative Investments

State	Citation	Language	Prospectus Common Language
Alabama	830-X-6-.11	The investment is suitable for the purchaser upon the basis of the facts, if any, disclosed by the purchaser as to his other security holdings and as to his financial situation and needs. For the limited purpose of this condition only, it may be presumed that if the investment does not exceed 20% of the investors net worth (excluding principle residence, furnishings therein and personal automobiles) it is suitable;	Alabama investors may not invest more than 10% of their liquid net worth in us and our affiliates.

California			California investors may not invest more than 10% of their net worth in our shares. An investment by a California investor that is an accredited investor within the meaning of the Federal securities laws (17 C.F.R. §230.501) is not subject to the foregoing limitation.
Idaho			Idaho investors must have either (a) a net worth of $85,000 and annual income of $85,000 or (b) a liquid net worth of $300,000. Additionally, the total investment in us shall not exceed 10% of their liquid net worth.
Indiana	710 IAC 4-2-4	if the investment does not exceed ten percent (10%) of the investor's net worth, it is suitable.	
Iowa			Iowa investors must (i) have either (a) an annual gross income of at least $100,000 and a net worth of at least $100,000, or (b) a net worth of at least $350,000 (net worth should be determined exclusive of home, auto and home furnishings); and (ii) must limit their aggregate investment in this offering and in the securities of other non-traded real estate investment trusts (REITs) to 10% of such investor's liquid net worth (liquid net worth should be determined as that portion of net worth that consists of cash, cash equivalents and readily marketable

			securities). Investors who are accredited investors as defined in 17 C.F.R. § 230.501 of Regulation D under the Securities Act of 1933, as amended, are not subject to the foregoing 10% investment concentration limit.
Kansas			It is recommended by the Office of Kansas Securities Commissioner that Kansas investors limit their aggregate investments in us and other non-traded real estate investment trusts to not more than 10% of their liquid net worth.
Kentucky			Kentucky investors may not invest more than 10% of their liquid net worth in our shares or in any shares of our affiliated non-publicly traded REITs.
Maine			The Maine Office of Securities recommends that an investor's aggregate investment in this offering and other similar direct participation investments not exceed 10% of the investor's liquid net worth.

Massachusetts			Massachusetts investors may not invest more than 10% of their liquid net worth in us and in other illiquid direct participation programs.
Missouri	15 CSR 30-52.030	no more than ten percent (10%) of any one (1) Missouri investor's liquid net worth shall be invested in the securities being registered with the Securities Division. (B) The suitability standard in subsection (4)(A) is a guideline. Higher or lower suit-ability standards may be established or may be required by the Securities Division as a condition of registration. (C) The suitability standards must be dis-closed in the prospectus.	Missouri investors may not invest more than 10% of their liquid net worth in our shares.
Nebraska			In addition to the suitability standards above, a Nebraska investor must limit his or her aggregate investment in shares of us and other non-publicly traded REITs to 10% of the investor's net worth (exclusive of home, home furnishings, and automobiles). Investors who are "accredited investors" as defined in 17 C.F.R. 230.501 are not subject to the foregoing concentration limit.

New Jersey			New Jersey investors must have either (a) a minimum liquid net worth of $100,000 and a minimum annual gross income of $85,000, or (b) a minimum liquid net worth of $350,000. For these purposes, “liquid net worth” is defined as that portion of net worth (total assets exclusive of home, home furnishings, and automobiles, minus total liabilities) that consists of cash, cash equivalents, and readily marketable securities. In addition, a New Jersey investor’s investment in us, our affiliates, and other non-publicly traded direct investment programs (including real estate investment trusts, business development companies, oil and gas programs, equipment leasing programs, and commodity pools, but excluding unregistered, Federally and state exempt private offerings) may not exceed 10% of his or her liquid net worth.
New Mexico			New Mexico investors may not invest more than 10% of their liquid net worth in our shares, shares of our affiliates and other non-traded real estate investment trusts.
North Dakota			Purchasers residing in North Dakota must have a net worth of at least ten

			times their investment in us.
Oregon	ORS 59.105	The language is not specific. Was told this subject to "mayoral review" and should be taken on a case by case basis for the suitability of each investor. The 10% threshold might be predicated on the ULOE.	Oregon investors may not invest more than 10% of their net worth in this offering.
Nebraska			Purchasers residing in Nebraska who do not meet the definition of "accredited investor" as defined in Regulation D under the Securities Act of 1933, as amended, must limit their aggregate investment in this offering and in the securities of other non-publicly traded REITs to 10% of such investor's net worth.
Ohio			Purchasers residing in Ohio may not invest more than 10% of their liquid net worth in us, our affiliates and other non-traded real estate investment programs. For these purposes, "liquid net worth" is defined as that portion of net worth (total assets exclusive of home, home furnishings, and automobiles minus total liabilities) that comprises cash, cash equivalents, and readily marketable securities.
Pennsylvania			Purchasers residing in Pennsylvania may not invest more than 10% of their liquid net worth in us.

Puerto Rico Investors			Purchasers residing in Puerto Rico may not invest more than 10% of their liquid net worth in us, our affiliates and other non-traded real estate investment programs. For these purposes, “liquid net worth” is defined as that portion of net worth (total assets exclusive of primary residence, home furnishings, and automobiles minus total liabilities) consisting of cash, cash equivalents, and readily marketable securities.
Tennessee			Purchasers residing in Tennessee must have a liquid net worth of at least ten times their investment in us
Texas			Purchasers residing in Texas may not, in the aggregate, invest more than 10% of their liquid net worth in this offering and other similar direct participation investments.
Vermont			In addition to meeting the applicable suitability standards set forth above, each investor who is not an “accredited investor” as defined in 17 C.F.R. § 230.501 may not purchase an amount of shares in this offering that exceeds 10% of the investor’s liquid net worth. Vermont residents who are “accredited investors” as defined in 17 C.F.R. § 230.501 are not subject to the limitation described in this paragraph.

North Carolina		a	In addition to the general suitability standards, a North Carolina investor may not invest more than 10% of his or her liquid net worth in shares of our common stock and other similar programs, including direct participation programs, with liquid net worth being defined as that portion of net worth that consists of cash, cash equivalents and readily marketable securities. Investors who are accredited investors as defined in Regulation D under the Securities Act of 1933, as amended, are not subject to the foregoing investment concentration limit.
Washington			In addition to the general suitability standards, a Washington investor may not invest more than 10% of his or her liquid net worth in shares of our common stock and other similar programs, including direct participation programs, with liquid net worth being defined as that portion of net worth that consists of cash, cash equivalents and readily marketable securities. Investors who are accredited investors as defined in Regulation D under the Securities Act of 1933, as amended, are not subject to the foregoing investment concentration limit.

The suitability requirements for each state are listed in the prospectus of every alternative investment and, as a result, all of the above information is necessarily in the record for every case and the advisor and firm are charged with the knowledge of these suitability requirements.

4. Fighting FINRA Rule 12206 motions

The nature of alternative investments is such that the problems with the investment, including the misrepresentations that were made about the investment, are often not known and not knowable until many years after its purchase. Investors often do not know and are unclear on the actual risks and problems with an alternative investment until well after six years from the time of purchase. This means that investors are often bringing claims that are subsequently challenged under FINRA Rule 12206. Although not a statue of limitation, FINRA does have its "eligibility rule" that says "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." FINRA Rule 12206(a). While six years is easy to calculate, FINRA makes no effort in its rules to define what is the "occurrence or event giving rise to the claim."

Invariably, investment firms always argue that the "triggering event" for the "occurrence or event" is the purchase date of the investment. However, there are a number of good arguments and authorities that support the argument that the purchase date is not necessarily the triggering event for Rule 12206. First, if FINRA wanted the purchase date to be the triggering event, FINRA would have simply said so. In fact, FINRA is crystal clear the purchase date is not the triggering event that begins the running of the 6-year rule:

> 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.

In order to get around this obvious problem in arguing the purchase date as the definitive date, firms often attempt to cite decades old cases, some of which are from courts that, at that time and based on the facts of that particular case before the court, agreed that the occurrence or event should be the purchase date in that particular case. However, what the firms fail to tell the arbitrators is that none of those cases are good law anymore, and the firms know it. In 2002, the Supreme Court in the case of *Howsam v. Dean Witter Reynolds, Inc.,* addressed this issue as there was a split in authority on the rule among the various Circuit Courts. *See Howsam v. Dean Witter Reynolds, Inc.,* 537 U.S. 79 (2002). In *Howsam*, the Supreme Court determined that courts should not rule on the issue of interpreting the arbitration rules, but rather the sponsoring association (i.e., FINRA) and/or the arbitrators must make that decision. *See id.* Effectively, *Howsam* overruled all of those prior court decisions.

Similarly, firms like to cite old caselaw arguing that Rule 12206 is a "statute of repose" and, as such, it cannot be tolled based on the discovery rule. However, this is a completely bogus argument. First and foremost, Rule 12206 is **not a statute of anything**. Rather, Rule 12206 is a "FINRA Rule" that is neither subject to nor based on the restrictions of any state of federal statute. Instead, it is a simple "eligibility rule" that FINRA imposes on those who use FINRA's arbitration forum. Whether it can be "tolled" or how it is applied to each case is squarely in the hands of each arbitration panel, who must apply the facts of each case to determine whether it is appropriate to allow the case to go forward in FINRA or if it should be deemed ineligible. And, there is a good post-Howsam decision that clarifies that Rule 12206 is not a statute of repose.

"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**. If the arbitrators adopted tolling or discovery principles, that would be within the six-year period in Rule 12206. The FINRA panel had comparatively more expertise about the meaning of its own rule, and it therefore could weigh the propriety of tolling or the discovery rule in any particular case. The Court therefore will deny the motion to vacate based on FINRA Rule 12206." *Mid-Ohio Securities Corp. v. Est. of Burns*, 790 F. Supp. 2d 1263, 1270-72 (D. Nev. 2011) (emphasis added).

The *Mid-Ohio Securities Corp* court noted that there had been a split in authority between the various circuits on how to characterize the eligibility rule, i.e., as a statute of limitation or a statute of repose. *See id.* According to the *Mid-Ohio Securities Corp* court, that issue has been affirmatively decided by the Supreme Court in *Howsam. See id.* The court concluded that *Howsam* completely "undermined the basic premise 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." *Id.* The court continued that "*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." *Id* (emphasis added). As such, the law on this issue very clearly holds Rule 12206 is not a "statute of repose" that places an absolute date at the time of purchase.

And, once the courts are not the issue, FINRA actually supports that the purchase date is not the triggering event. As outlined in the Supreme Court's *Howsam* decision, the controlling question as to when the "occurrence or even" begins is one based on FINRA's interpretation of the rule. This issue has been repeatedly addressed in the past with a consistent finding that the purchased date is not the triggering event for the "occurrence or event" giving rise to a FINRA claim.

First, as previously noted, Rule 12206(a) does not say that a claim must be brought within six years of the <u>purchase</u> of a security (even though FINRA was clearly aware when the rule was drafted that most cases would revolve around securities). Instead, the Rule provides that a claim must be brought within six years of the "occurrence or event giving rise to the claim." As courts and arbitration panels have repeatedly pointed out, FINRA deliberately drafted the "occurrence or event" language of the Rule to allow arbitrators to consider more than just the purchase date when deciding this issue. Had FINRA wanted to limit the six-year period to just the purchase date, it would have chosen that specific language.

This view of why FINRA refused to use the limiting language of Rule 12206 to a "purchase date" is not mere conjecture, but it has been explicitly acknowledged. The National Association of Securities Dealers ("NASD") – FINRA's predecessor and drafter of the language still used in Rule 12206 – was specifically asked to review and amend the eligibility rule to stipulate that the eligibility rule is based upon the purchase or sale of the security at issue.

> The Committee was asked to review the determination made at the October 1990 meeting regarding the interpretation of [the eligibility rule], specifically the language regarding the occurrence or event giving rise to the act or dispute, claim or controversy. **The initial discussion focused on the Committee's feeling that administration of the rule would be easier for the staff if the occurrence or event language was strictly interpreted to mean transaction date**. The staff expressed the need for more latitude in interpreting instances where intervening

> events gave rise to the claim. In such instances, the panel of arbitrators would make the final determination of eligibility of the matter. Mr. Fletcher commented that strict adherence would tend to push cases to the court system and that the staff should err on the side of being more liberal in allowing these claims to be filed in arbitration. **The Committee voted to allow discretion to the staff in interpreting what was the occurrence or event giving rise to the act or dispute, claim or controversy**.

Prudential Securities, Inc. v. Mills, 944 F. Supp. 625, fn. 8 (W.D. Tenn. 1996) (emphasis added). The NASD chose to leave maximum flexibility to the triers of fact, the arbitrators, to interpret and apply the rule to the unique facts of each case.

Similarly, NASD/FINRA authorities up to and including the Director of Arbitration have repeatedly stated that:

> It has been determined that the purchase date is not the event or occurrence that gave rise to the dispute. Also, [the eligibility rule] does not refer specifically to the purchase date as the time that the six year period begins to run. Therefore, ***it is equally appropriate that the discovery by the claimant be treated as the occurrence or event giving rise to the dispute***.

Private Letter Rulings by Deborah Masucci, Esq., NASD Director of Arbitration, dated October 28, 1991 and January 16, 1993. *See also*, *Private Letter Ruling by Sarah Giambona*, dated September 17, 1991 and *Private Letter Ruling by Sara Giambona*, dated July 26, 1991 (emphasis added).

Similarly, NASD/FINRA addressed the issue of potential fraudulent concealment and that if such concealment occurred, it would toll the eligibility rule.

> [C]laimant's attorney alleges fraudulent concealment from discovering the wrongdoing until 1989. Since the allegations of continuing fraud fall within the eligibility requirements… that is within six (6) years of… the date claimant executed her submission agreement in this matter.

Private Letter Ruling by Donald Burney, dated October 20, 1992.

As FINRA has repeatedly stated, discovery of a harm can properly be used by an arbitration panel as the "event or occurrence" and any suggesting of a "hard and fast rule" is simply not supported anywhere in the rules or prior rulings.

While the Supreme Court's *Howsam* decision clearly placed the authority to address the six-year rule on FINRA and its arbitrators to the extent the issue was addressed before *Howsam* and after, Courts have repeatedly held that arbitrators are free to apply tolling or discovery rules to the interpretation of Rule 12206. See below for some examples:

- "This theory [that the purchase date is the only "trigger date"] does not comport with either the "occurrence or event" language contained in § 15 or the case law that has developed thereunder… Accepting Osler'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 manner." *Osler v. Ware*, 114 F.3d 91, 93 (6th Cir. 1997) (internal citations omitted).

- *J.E. Liss & Co. v. Levin*, 201 F.3d 848, 851 (7th Cir. 2000) (Holding that "[FINRA 12206(a)] does not bar a claim that arises within the six-year period merely because the securities involved in the claim were bought more than six years before the claim was filed.").
- *Oshidary v. Purpura-Andriola*, No. C 12-2092 SI, 2012 WL 2135375, at *16 (N.D. Cal. June 12, 2012) (discussing how the Arbitration Panel was free to interpret Rule 12206 as it saw fit, including deciding that the trigger date was subsequent to the date of investment).
- *Smith v. Dean Witter Reynolds Inc.*, 102 Fed. Appx. 940 (6th Cir. Ky. 2004) (Holding that Dean Witter Reynolds could not disclaim arbitration because it considered the claims stale. "There is also the possibility that the arbitrators might determine that the "occurrence or event" that triggered the time period began at some point later than [the purchase date].").

These courts have explicitly held that an interpretation of the eligibility rule that results in claimants being time barred from filing an arbitration claim before even being aware that they had been harmed, or before all of the elements of a cause of action could be met, is contrary to the liberal language of the rule. Instead, courts regularly rely upon the guidance which FINRA has given. In *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), the court adopted FINRA's rationale that discovery can be the occurrence or event giving rise to a dispute. The court explicitly quoted the then 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.

Courts have also recognized that the NASD/FINRA made a conscious decision, multiple times, to *not* draft the eligibility rule to state only claims for purchases within six years are eligible. That decision is meaningful. *See Smith Barney, Inc. v. Vogelle,* 967 F. Supp. 165, 170 (E.D. Va. 1997) ("Clearly, the drafters of the NASD Code could have provided that claims 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."). Because of tolling and the time it takes before an injury is known, the actual occurrence or event could have occurred far after six years from the purchase date. *See, C & H Prop. v. Morgan Keegan & Co., Inc.* 2012 WL 3257509 at *5 (FINRA Case No. 11-00263, July 30, 2012) ("The Rule treats as 'eligible' for FINRA arbitration claims arising out of 'occurrences' not more than six years preceding the initiation of a case, but… **such an event may occur, say, ten years after securities at issue were acquired."** (emphasis added).

5. Damages Analysis

Respondents almost always attempt to argue a "net-out-of-pocket" theory of damages that would give the firm credit for all distributions made to the investor, with no appreciation or value given to the result had the recommendation been suitable or even the simple time value of money. There is good law and reasoning to support that a market adjusted damages mode is more appropriate.

The purpose of awarding compensatory damages at all is to restore the victim to the position he or she would have been in had the wrongful conduct never occurred. *See Horizon Health Corp. v. Acadia Healthcare Co.,* 520 S.W.3d 848, 873 (Tex. 2017) ("[c]ompensatory damages redress

concrete losses caused by the defendant's wrongful conduct…"). The actual end-goal should be to make the wronged party whole, fully compensating for the losses. "[C]ompensatory damages… attempt to make a plaintiff whole…" *Toyota Motor Co. v. Cook,* 581 S.W.3d 278, 291 (Tex. Ct. App. 2019). The net-out-of-pocket measure of damages with or without interest fails to accomplish the basic objective of compensatory damages, which is to place the investor in the position he or she would have been in the wrongful conduct had not occurred.

Courts have properly rejected the net-out-of-pocket measure as a legitimate basis for computing damages. *See City of San Jose v. Paine Webber Jackson & Curtis Inc.*, 1991 WL 352485 (N.D. Cal. 1991) ("The cases seem to indicate, however, that the securities laws do not limit a plaintiff's recovery to mere out of pocket losses…"); *Kane v. Shearson Lehman Hutton, Inc.*, 916 F.2d 643, 646 (11th Cit. 1990) ("if the [net out-of-pocket]… methodology espoused by Shearson [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.").

Rather than net-out-of-pocket, the more appropriate damages is to award market adjusted damages, or damages based on a well-managed investment portfolio. The Supreme Court of the United States has held that in securities cases, "the correct measure of damages ... is the difference between the fair value of all that the plaintiff received and the fair value of what he would have received had there been no fraudulent conduct" *Randall v. Loftsgarden*, 478 U.S. 647, 661-62 (1986). The Court went on to reject 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.'" *Id*. Essentially, the "net out of pocket" theory of damages brokerage firms perpetuate ignores this Supreme Court precedent and attempt to "net" gains against the losses, which is inappropriate and unsupported in the law.

Federal Courts around the nation are in harmony with *Loftsgarden*, and there can no longer be any serious debate about whether market adjusted (well managed) damages are the proper measure in securities cases. In *Kane v. Shearson*, 916 F.2d 643, 646 (11th Cir. 1990), the appellate court affirmed the trial court's reversal of an arbitration decision that offset the Claimant's losses by his gains from the same unsuitable stock. The court concluded that "[t]here is no indication that other transactions are relevant to this calculation at all." *Id*. *See also Hatrock v. Edward D. Jones & Co*.,750 F.2d 767, 773-774 (9th Cir. 1984) (investor may recover the decline in value of the investor's portfolio in an amount equal to "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"); *Dasler v. E.F. Hutton*, 694 F. Supp. 624 (6th Cir. 1998); *Miley v. Oppenheimer & Company*, 637 F.2d 318 (5th Cir., 1981); *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"); *In Re. Drexel Burnham Lambert Group, Inc.*, 161 B.R. 902 (S.D.N.Y. 1993).

In *Rolf v. Blyth Eastman Dillon & Co.*, the Second Circuit held that 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. *See*, 570 F.2d 38, 49 (2d Cir. 1978), cert. denied, 439 U.S. 1039 (1978), modified, 637 F.2d 77 (2d Cir. 1980).

The *Rolf* court stated that the choice of an appropriate market index will depend on the circumstances of each case. For example, the court stated that where a plaintiff should have been in conservative securities but for the fraud, an index of conservative stocks might be the appropriate index. *See id*.

Finally on this issue, FINRA has spoken and it is clear that an award of well-managed damages is within the scope of available damages. FINRA instructs its arbitrators on this issue as follows:

> 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.

FINRA Dispute Resolution Arbitrator's Guide, p.67.

As a result, both the law and FINRA's own rules support the award of market adjusted or well-managed portfolio damages.

Another issue unique to alternative cases and damages analysis is how to determine the actual losses on an investment that is not publicly traded. Firms will often attempt to use the valuation the sponsor gives for each alternative investment. However, that valuation is typically based on theoretical values and even simple opinions, rather than any market value of the investment. Of course, everything is only worth as much as someone is willing to pay for it. For alternative investments, since there is not an exchange or public market for the securities, determining value is more difficult. There is a secondary market for many of the non-traded alternatives, but they do not publicly publish all the information concerning transactions. Rather, these site, typically run by a brokerage firm, require enrolling with the site and giving information about what alternative you are seeking to sell. These transactions have high fees and getting a price range can be difficult for claimant's attorneys, but the information is out there and should be tracked over a period of time to see the range of possible sales points and whether the prices has been moving up or down. The most notable example of this type of secondary market is Central Trade & Transfer, cttauctions.com.

6. Conclusion

Arbitrating and litigating alternative investment cases can pose a number of different challenges that can make them more difficult than traditional investment loss cases. However, they are also very strong cases in many situations, especially if there is a large concentration in the securities.

THE ETHICS OF ATTORNEY WELL-BEING IN A POST-COVID WORLD

Angela Hayden[1]

The legal profession is not known for being full of holistically healthy individuals. The challenges of the last couple of years have not been easy on anyone. Even before COVID, lawyers suffered greater rates of alcohol consumption and maladies of the unwell at rates greater than that of the general population. From stress-related physical ailments to mental health and substance use issues, many lawyers over the years have allowed their own well-being to take a back seat to the demands of career, clients, and courts. As more and more states shine a light on the importance of lawyers taking better care of themselves and requiring well-being specific CLEs, it seems clear that attorney wellness is not a concept that is just a fleeting topic du jour. Well-being is also not something that can be achieved simply by attending a once-a-year class just to check a CLE box. It requires a regular, ongoing commitment to looking after ourselves, caring about our colleagues, and shifting our profession's culture if there is a desire to make lasting change.

This article will address four questions:

Why does well-being even matter for lawyers in particular?

What is well-being?

What is the significance of well-being in a Post-Covid world?

How can greater well-being be achieved?

1) Why is attorney well-being even matter for lawyers in particular?

From an ethics perspective, the answer to this question is simple. "Attorney well-being is a critical component of our duty to represent our clients with competence. Recent studies showing high levels of depression and substance abuse among lawyers compel an increased awareness of, and focus on, wellness for attorneys." *See*, Vermont Bar Association, Attorney Well-Being, available at https://www.vtbar.org/attorney-well-being/. It is no secret that mental health and substance use issues can lead to a loss of productivity, lengthy interruptions to and absences from work, and an inability to perform necessary tasks properly, timely, and competently, all of which have a negative impact on a lawyer's ability to comply with ethical obligations. "Major depression and alcohol abuse is associated with impaired executive functioning, including diminished memory, attention, problem-solving, planning, and organizing—core features of competent lawyering." *See* Ann Brafford, JD, MAPP, PhD in progress, ABA "Well-Being Toolkit for Lawyers and Legal Employers," available at https://www.americanbar.org/content/dam/aba/administrative/lawyer_assistance/ls_colap_well-being_toolkit_for_lawyers_legal_employers.pdf.

Gone are the days where continuing education programs focused solely on our obligation to report others; bar associations are finally acknowledging that mental health and substance use

[1] Angela Hayden is the founder of Sage Legal LLC, an estate planning and FINRA arbitration practice located in Newmarket, NH and Big Life Leaps Coaching (www.biglifeleaps.com), a life coaching practice where she coaches other lawyers, financial services representatives, and other professionals with demanding careers from around the country find more meaning in work and life.

issues are widespread and those who battle these demons deserve support and acknowledgement, rather than simply sweeping individual problems under the proverbial rug and emphasizing the need of others to report them. For so long, the programming around these issues felt like "what to do when a colleague is not well" as opposed to "what to do if *you* are feeling unwell." The trend these days seems to be offering support to all lawyers and calling upon firms to create and cultivate a healthier culture for its employees.

Being a lawyer – whether in a firm or as a solo – often leads to sacrificing overall well-being to long hours in the office and the stress and pressure of dealing with weighty, serious substantive legal issues. Many lawyers report feeling a sense of hopelessness at times about the impact their work has on the world, feeling like Sisyphus pushing a rock up a hill day after day, and feeling regret about not spending more time with family and loved ones. Many others say they long for a greater sense of purpose and frequently feel overwhelmed by the non-billable administrative tasks that impact productivity.

In essence, practicing law does not bring a lot of good, happy feelings.

Add to the mix sizeable student loans, a feeling that there is never any time to get to the gym, and a heavy drinking culture that encourages ignoring problems and there is a formula for a perfect storm for creating unhealthy lawyers.

Not all states currently have wellness-specific CLE and the majority that do focus on substance and alcohol use problems. The approach that is desperately needed by so many attorneys is helping with the underlying pitfalls of practicing law that lead to unhappiness long before alcohol and substance use become a problem, long before the desire to numb the unhappiness, to drown out feelings of discomfort takes root and takes over. Being told that there is "help" and that Lawyer Assistance Programs ("LAPs") exist does not seem to be taking care of the problem.[2] Many lawyers still express fear of reaching out to a LAP, worried about the impact it may have on their career and the strength of confidentiality. In short, there is a lot of need for help, but until recently there has not been much help to be found.

The Important Ethical Rules Impacted by a Lack of Well-Being

While it may be argued that one could violate just about any ethical rule by creating first-year-of-law school style crazy hypothetical scenarios, there are a few rules in particular that stand out as problems for the unwell advocate. The American Bar Association's model rules serve as a foundation for every state's ethical rules. In 2017, the ABA House of Delegates adopted a Model Rule for Minimum Continuing Legal Education, urging states to adopt a number of new, specific, stand-alone (as opposed to general) CLE requirements, including Diversity, Equity and Inclusion programming and Mental Health and Substance Use Disorder credits. *See* American Bar Association, Adopted by the House of Delegates, Feb. 6, 2017, available at https://www.americanbar.org/content/dam/aba/directories/policy/midyear-2017/2017_hod_midyear_106.pdf. "Mental Health and Substance Use Disorders Programming" is defined as "CLE Programming that addresses the prevention, detection, and/or treatment of mental health disorders and/or substance use disorders, which can affect a lawyer's ability to perform competent legal services." *See id.* at 3. This article will focus on the rules and statistics that relate to attorney disciplinary problems when alcohol/substance use and mental health issues

[2] A directory listing of each state's Lawyer Assistance Program can be found on the ABA's website here: https://www.americanbar.org/groups/lawyer_assistance/resources/lap_programs_by_state/

arise. During the Annual Meeting presentation, we will be sharing 10 easy tips to improve well-being that can be implemented right away to address the prevention of mental health and/or substance use disorders before they occur. So often, substance use and mental health issues arise from a strong feeling of discontent. Learning to recognize, understand, and address discontent can facilitate making life changes that lead to greater happiness.

Many of the long-standing professional duties set forth in the ABA's existing rules are at risk of being violated when an attorney is battling a serious substance use or mental health challenge. The rules fall into two primary categories: 1) rules requiring competence and diligence of the actual lawyer; and 2) obligations regarding other lawyers (supervision, reporting, and confidentiality if participating in a lawyer assistance program). The first category of rules include Model Rules 1.1, 1.3, 1.4, 1.16, and 3.2, all of which relate to an individual lawyer's ability to practice competently and diligently – they involve being able to do the work necessary for clients, showing up, moving cases along, etc. Rule 5.1 and 8.3 relate to supervision of other attorneys and reporting misconduct.
Here are the highlights:

Rule 1.1 *Competence* "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation."

Rule 1.3 – *Client-Lawyer Relationship*

Diligence "A lawyer shall act with reasonable diligence and promptness in representing a client."

Rule 1.4 – Communications *Client-Lawyer Relationship*

(a) A lawyer shall:

(1) promptly inform the client of any decision or circumstance with respect to which the client's informed consent, as defined in Rule 1.0(e), is required by these Rules;

(2) reasonably consult with the client about the means by which the client's objectives are to be accomplished;

(3) keep the client reasonably informed about the status of the matter;

(4) promptly comply with reasonable requests for information; and

(5) consult with the client about any relevant limitation on the lawyer's conduct when the lawyer knows that the client expects assistance not permitted by the Rules of Professional Conduct or other law.

(b) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.

Rule 1.16 Declining or Terminating Representation

Client-Lawyer Relationship

(a) Except as stated in paragraph (c), a lawyer shall not represent a client or, where representation has commenced, shall withdraw from the representation of a client if:

(1) the representation will result in violation of the rules of professional conduct or other law;

(2) the lawyer's physical or mental condition materially impairs the lawyer's ability to represent the client; or

(3) the lawyer is discharged.

Rule 3.2 – Expediting Litigation – ***Advocate***

A lawyer shall make reasonable efforts to expedite litigation consistent with the interests of the client.

Rule 5.1 – Supervisory Lawyers *Law Firms And Associations*

(a) A partner in a law firm, and a lawyer who individually or together with other lawyers possesses comparable managerial authority in a law firm, shall make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that all lawyers in the firm conform to the Rules of Professional Conduct.

(b) A lawyer having direct supervisory authority over another lawyer shall make reasonable efforts to ensure that the other lawyer conforms to the Rules of Professional Conduct.

(c) A lawyer shall be responsible for another lawyer's violation of the Rules of Professional Conduct if:

(1) the lawyer orders or, with knowledge of the specific conduct, ratifies the conduct involved; or

(2) the lawyer is a partner or has comparable managerial authority in the law firm in which the other lawyer practices, or has direct supervisory authority over the other lawyer, and knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action.

Rule 8.3 Reporting Professional Misconduct *Maintaining The Integrity of The Profession*

(a) A lawyer who knows that another lawyer has committed a violation of the Rules of Professional Conduct that raises a substantial question as to that lawyer's honesty, trustworthiness or fitness as a lawyer in other respects, shall inform the appropriate professional authority.

(b) A lawyer who knows that a judge has committed a violation of applicable rules of judicial conduct that raises a substantial question as to the judge's fitness for office shall inform the appropriate authority.

(c) This Rule does not require disclosure of information otherwise protected by Rule 1.6 or information gained by a lawyer or judge while participating in an approved lawyers assistance program.

Rule 8.3 has a very important exception for lawyers participating in lawyer assistance programs. Comment 5 to Rule 8.3 provides: "Information about a lawyer's or judge's misconduct or fitness may be received by a lawyer in the course of that lawyer's participation in an approved lawyers or judges assistance program. In that circumstance, providing for an exception to the reporting requirements of paragraphs (a) and (b) of this Rule encourages lawyers and judges to seek treatment through such a program. Conversely, without such an exception, lawyers and judges may hesitate to seek assistance from these programs, which may then result in additional harm to their professional careers and additional injury to the welfare of clients and the public. These Rules do not otherwise address the confidentiality of information received by a lawyer or judge participating in an approved lawyers assistance program; such an obligation, however, may be imposed by the rules of the program or other law."

The Legal Profession Has a Drinking Problem

The concept of wellness extends far beyond just the ethical rules – many lawyers simply are not happy. Unhappiness often leads to alcohol consumption, substance use, and mental health problems – all of which are quick fix remedies for the discomfort of an unhappy brain. In addition, the legal profession has a notoriously strong drinking culture. According to Patrick R. Krill, the Legal Professionals Program Director at Hazelden Betty Ford (Yes, Betty Ford has an entire program just for lawyers!) "Unhealthy coping skills such as excessive drinking are the cultural norm — malignant, learned behaviors passed down through the profession with the frequency of a dominant gene. 'Stressed? Drink. Not happy? Drink. Happy? Drink, and invite some co-workers.' Need to entertain clients? Drink. Work hard, play hard, as the trite mantra goes, and don't let anyone know if you can't keep up." *See* Patrick Krill, "The Legal Profession's Drinking Problem," CNN Opinion, Feb. 6, 2016. https://www.cnn.com/2016/02/06/opinions/lawyers-problem-drinkers-krill/index.html

Despite every single state now having a Lawyers Assistance Program, there is still a substantial amount of stigma associated with lawyers seeking help from them. There is fear that the information shared will not truly be confidential and it will be only a matter of time before the lawyer seeking help will have a surprise client fund audit to search for some little issue that gets turned into a big issue (a past client provided an example of a lawyer he worked with receiving a private reprimand for not paying himself out of a retainer quickly enough after he performed work for a client). There is concern of being on the radar screen and scrutinized for any little thing to be turned into a disciplinary matter. And there is worry that word will get out and business will accordingly dry up.

It can be difficult to find alternative methods for dealing with stress, overwhelm, job dissatisfaction and whatever else is causing unhappiness when drinking is such an accepted way of life and getting help remains so intimidating.

A landmark 2016 study conducted by the ABA and the Hazelden Betty Ford Clinic revealed that, of the voluntary participants who responded to their survey, over 20% of them scored in a range "at a level consistent with problematic drinking," compared to only 6.8% of the general population – and roughly double the percentage of similarly educated professionals. The findings of the study were published in the January/February 2016 edition of Addiction Medicine, which can be found here: https://journals.lww.com/journaladdictionmedicine/Fulltext/2016/02000/The_Prevalence_of_Substance_Use_and_Other_Mental.8.aspx

In addition, 28% of the study respondents reported experiencing depression and 19% exhibited signs of anxiety, suggesting that mental health concerns are widespread. This study was conducted long before Covid.

A more recent study released in 2020 culled data from the National Health Interview Survey conducted by the CDC across the broader general population (also pre-Covid) to determine that lawyers do indeed have a drinking problem, but concluding that mental health issues are actually lower in the legal profession that the general population. *See*, Yair Listokin and Raymond Noonan, "Measuring Lawyer Well-Being Systemically: Evidence from the National Health Interview Survey," https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3667322. This 2020 study also provides an extensive analysis of other studies conducted on lawyer alcohol use and mental health concerns, challenging the methodology for many. For the data nerds in the group, this may be a fun read.

Ultimately, the one data point all studies seem to support is that lawyers have been drinking a lot more than non-lawyers for a good long time now.

2) What is the Significance of Well-Being in a Post-Covid World?

Prior to Covid, bar associations across the country were already paying attention to the high alcohol consumption rates documented in various studies. Task forces were formed, reports were written, proposals had been made. *See, e.g.*, Ann Brafford, JD, MAPP, PhD in progress, ABA "Well-Being Toolkit for Lawyers and Legal Employers," available at https://www.americanbar.org/content/dam/aba/administrative/lawyer_assistance/ls_colap_well-being_toolkit_for_lawyers_legal_employers.pdf. As a self-regulated profession, many members were calling for changes to the culture of the profession because unhappy – and unwell – attorneys were providing negative outcomes for clients.

During and after Covid, the general population saw a dramatic increase in "hazardous" alcohol use. *See* William D.S. Kilgore, "Alcohol Dependence During COVID-19 Lockdowns," Psychiatry Research, Feb. 2021, available at https://www.sciencedirect.com/science/article/pii/S0165178120333370. Particularly in lockdown restricted areas, alcohol consumption increased from 21% in April 2020 to an astounding 40.7% in September. For a profession that was already top of the list for alcohol consumption, it is unlikely that the additional stresses that COVID brought led to a reduction in alcohol use for lawyers. The ABA collected self-reported data from lawyers for the first quarter of 2021, revealing that two-thirds of junior and mid-level attorneys reported declines in well-being; to contrast, only 41% of senior associates claimed a declined in well-being for the same time period. *See* Debra Cassens Weiss, "Survey finds decline in lawyer well-being, particularly for early career respondents," ABA Journal, June 30, 2021, available at https://www.americanbar.org/groups/journal/articles/2021/survey-finds-decline-in-lawyer-well-

being-particularly-for-earl/ Higher rates of burnout were also reported. Alcohol consumption rates were not reported as a result of the Q1 2021 survey.

According to the World Health Organization, anxiety and depression increased by 25% in 2020-2021. See WHO, "COVID-19 pandemic triggers 25% increase in prevalence of anxiety and depression worldwide, March 2, 2022, available at https://www.who.int/news/item/02-03-2022-covid-19-pandemic-triggers-25-increase-in-prevalence-of-anxiety-and-depression-worldwide. While there do not appear any recent post-Covid large-scale studies regarding lawyers and alcohol consumption, odds are high that the consumption rate has *not* gone down in the last couple of years.

What we do about it as a profession is up to us. There is no one-size-fits-all approach to decreasing alcohol consumption rates, assuming there is consensus that we should do something. – an increase in alcohol consumption does not necessarily correlate to an increase in ethics rule violations. Only time will tell on this particular issue.

Pre-Covid there was clearly a growing movement to improvement lawyers' lives. The general public does not seem to have a great deal of sympathy for lawyers in general. Changes will have to come from us. Irrespective of whether increased alcohol consumption has occurred within the profession since Covid, there was and still is an apparent desire to reduce stress and improve lawyer lives

.

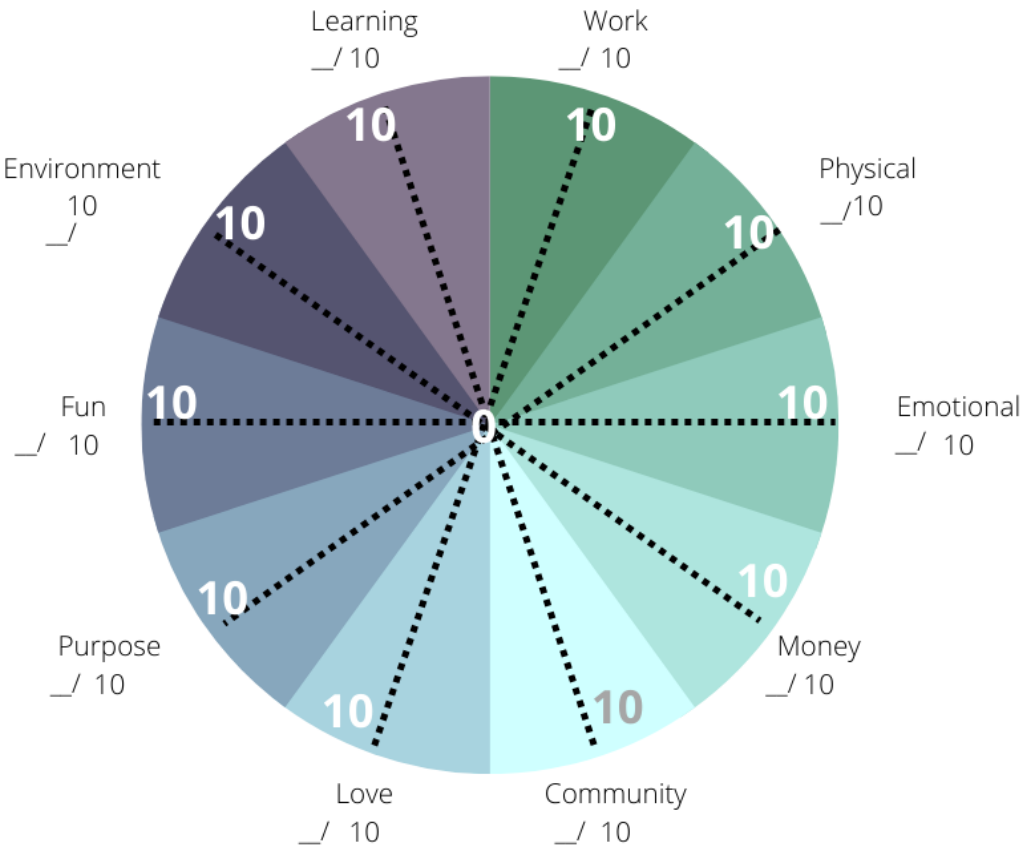
3) What is well-being?

The words wellness and well-being are often used interchangeably, but they have significant differences in definition. Merriam-Webster defines well-being as "the state of being happy, healthy, or prosperous." Wellness, on the other hand, is the quality or state of being in good health *especially as an actively sought goal* the quality or state of being in good health especially as an actively sought goal" (emphasis added).

Defining what happy, healthy, or prosperous means to you and taking active steps towards bringing more of that into your life if you feel you are lacking in those areas are good places to start to increase well-being.

The reality is that well-being and wellness are terms that have different meanings for different people. There is no one-size-fits-all answer. Achieving a state of well-being or wellness generally requires a multi-faceted approach and looking at all areas of life – not just work vs. the rest of life (I am a proponent of throwing the term "work life balance" out the window). Humans are complex beings and there are so many things that contribute to our happiness, many of which get overlooked or ignored by logical lawyer brains.

One of the oldest life coaching tools around is the Wheel of Life; it is a great way to evaluate your satisfaction with life in general and identify areas in which you may be lacking or that could use improvement. Often, improving just one area with a low score has a positive impact on other areas of life. I encourage you to look at each area of your life on the wheel and rate it on a scale of 0-10.



Rate your satisfaction in each area of your life on a scale of 0-10, 0 being the lowest, 10 the highest

Category Definitions

Work: This one is pretty self-explanatory. How does your work life feel to you right now? Don't overthink this exercise – just go with your gut and write down the first number that comes to mind.

Physical: Physical fitness and overall physical health

Emotional: How are you feeling in the world? Great, crappy, or something in between? Is there something heavy you have been carrying around and have yet to deal with? Perhaps it is time for a therapist (there are plenty out there these days, just have to look – online services abound, as well) or just some mindset shifts.

Money: How is your relationship with money? Good, bad, needs some work? Do you resent it going out and worry it won't come in? Perhaps there is some personal finance work to be done.

Community: Ever hear the saying "Your vibe attracts your tribe?" It's somewhat true, but really you can create your vibe through the tribe you select. Do you spend time with negative nellies or people with a positive attitude? Do you belong to any groups, clubs, or teams that make you feel alive? If not, why not?

Love: If you're in a relationship, how is it going? Perhaps there is work to be done. If not, then just love yourself as much as you can.

Purpose: Do you feel connected to a greater purpose in life that is beyond your own day-to-day existence? This is something that can be a major game-changer for professionals stuck in dissatisfaction, unhappiness, or just a bit of ennui.

Fun: Perhaps not everyone will agree, but I believe we are supposed to have fun in life. Having fun makes anything easier. Where are you on the fun scale? What is fun for you may not be what is fun for someone else and that is ok.

Environment: How are your physical surroundings? Your office, your kitchen, your car? Did you know that hospital patients recover faster when they have a view of nature? And slower when they have to look at "modern art?"

Learning: Our brains are designed to learn new things. What are you doing for yours? Have you always wanted to play guitar? Perhaps now is the perfect time to sign up for a class.

Achieving balance between all the various parts of your life can ultimately lead to greater happiness. You do not have to know how right away, all you have to do is bring awareness to what you need and then work on figuring out how.

Making big changes in life always boils down to three steps:

1) Deciding what you want to change;
2) Choosing how you are going to do it; and
3) Setting up an accountability system.

Small, incremental improvements ultimately lead to big changes – just like running a marathon or building Rome. Big changes do not usually happen in a day and every little incremental step eventually adds up to a whole lot of ground being covered.

4) How Can Greater Well-Being Be Achieved?

When all is going well and we feel balanced in life, we feel happy. Sometimes, simply learning to think differently about circumstances in life alone can lead to greater happiness. That is not something most lawyers I encounter are accustomed to doing, but it can be life changing. When we feel stuck in a box, doing the same thing again and again, it does not feel good. It leads to discomfort, which in turn usually leads to unhealthy behaviors that can carry undesirable consequences.

Over the years, I have asked other lawyers (in my own very non-scientific poll), what they think the profession needs to cultivate greater well-being the answers have been:

Culture change
More social events that get people out of the office
A greater sense of respect
Feeling like work means something
Less time on the non-billable tasks

Interestingly, the answers are not usually “make more money, get more clients, win more cases.” The things people typically express are less tangible. They fall into categories other than “work” on the Wheel of Life. Community, connection, feeling more attuned to a sense of purpose.

Understanding where unhappiness comes from is a good place to start to work on turning it around. Unhappiness often comes from a sense of discontent. Discontent can come from a deficiency in any of the sections on the Wheel of Life, but often for non-newbies in the legal field, discontent arises from frustration at doing too much stuff they do not like and not enough of what they love, feeling out of control of their own destiny. Work suffers, relationships suffer, physical and emotional health suffer.

The good news is that these things can be fixed pretty easily.

The first step to making changes is deciding *what* to change and it is usually the hardest. Going through the motions day after day, year after year reinforce patterns and reinforced patterns typically take away a belief that a pattern can change. It can be difficult to see the forest through the trees, so to speak.

Learning more about yourself, what you enjoy, how you work, what challenges you face in your daily life can all help identify what area to work on first.

Some tools for identifying **what** include:

The Wheel of Life

Self-assessments (Ennagram, Kolbe, Myers-Briggs)

Journaling (yes, I actually went there) – taking stock of what you love to do and what you do not

Brainstorming what a “perfect day” might look like if you could wave a magic wand

Tapping into EQ (emotional intelligence) can be a tremendous asset – *See* Mary Juetten, “Attorney Well-Being: Start with Emotional Intelligence,” Law Practice Today, Aug. 14, 2017, https://www.lawpracticetoday.org/article/attorney-well-being-emotional-intelligence/

Embracing your creative side – playing music, drawing, writing for fun, making a vision board – all of these things can lead you to discover things you want to have more of in your life. If you have never made a vision board, it can be both fun and enlightening. Taking a few minutes now and then to create a visual representation of what you want more of in your life can reinforce any efforts you may be taking to bring that in. Here is a recent example of one I created using Canva, a free online app I use for marketing purposes. Sometimes, letting the creative side out reminds me to schedule a hike with a client or referral partners as part of my work day. Those are the sort of things that help keep me sane!



Acknowledging the things you do not enjoy doing and questioning whether they are things you truly need to be doing can also lead to greater happiness. Once you get clear on what is *not* making you happy, you can work on changing them or clearing them out of your life. Perhaps not overnight, but over time. Doing so will create space for you to do more of the things you love. Examples include:

Non-billable admin tasks
Discovery motions
Going to the dry cleaner
Waiting four hours for a court hearing while many other cases go on ahead of you
Grocery Shopping

Brainstorming all of the things you do not enjoy doing creates an opportunity to determine whether you just need to do those things, find a better way to do them, ask someone else to do them, or decide they do not actually need to be done. Not quite sure where to start? For inspiration, check out the Virginia Bar Association President's Special Committee on Lawyer Well-Being Report, Occupational Risks of the Practice of Law, May 2019, available at https://www.vsb.org/docs/VSB_wellness_report.pdf

Other tools that can help figure out **what** to change include:

- Start with noticing. Noticing = awareness, awareness leads to curiosity, curiosity leads to ideas
- Listen to your inner voice – your gut feelings are usually right and are telling you something important. The more you listen, the easier they get to hear. So many busy professionals drown out that little voice inside (which is totally understandable – we are taught and trained to operate on logic, not intuition), but that little voice usually has valuable information to share that leads to greater happiness. If this idea calls to you, check out Martha Beck's book "Finding Your Own North Star." Martha is a Harvard educated sociologist who has helped countless professionals find greater happiness both in and outside of their careers
- Find others who seem to be living the kind of life you want to embody and spend time with them. Read their stuff, go to their workshops, get on their email lists. Maybe they are other lawyers, maybe they are not

After deciding on what one aspect to work on to increase happiness, figuring out how is a breeze. The internet is a treasure trove of infinite ways to do things. So many people share their knowledge easily on-line these days that it is simply a matter of doing a little research and choosing a method that resonates with you. Developing an accountability system is a whole other topic for another day, but some simplified ways to find accountability including joining a group, using your calendar, developing a reward system, hiring a coach, or putting sticky notes everywhere to remind you of what you are doing and why.

CONCLUSION

There is little doubt that many lawyers are struggling with well-being issues, from alcohol and drug use to mental health challenges. While committees and commissions attempt to develop rules, solutions, and cookie cutter methods to address the myriad of issues, it ultimately comes down to each of us deciding that we want to do better for ourselves and our colleagues. Supporting attorney wellness is more than attending a once-a-year CLE course, it requires a desire to make our lawyer lives better in and out of the courtroom. It requires letting go of the idea that we have to suffer and sacrifice in order to be effective advocates, it requires dropping the old attitudes that are driving younger lawyers to drink far more than the older generations, it requires embracing a belief that we all deserve to feel better.

It requires an acknowledgement that we are human beings, not human working machines.

But the simplest thing of all that is required is a belief that it is possible.

BLUE APRON AND THE FACIAL VALIDITY OF FEDERAL FORUM SELECTION CLAUSES

Carol Villegas and Lisa Strejlau

***Salzberg v. Sciabacucchi*, No. 346, 2019**
(Del. March 18, 2020) ("Blue Apron")

Background

SCOTUS Confirms Viability of State Courts' Jurisdiction Over Section 11 Claims in *Cyan*

- In *Cyan, Inc. v. Beaver Cty. Emps. Ret. Fund,* 138 S. Ct. 1061, 1066 (2018), the United States Supreme Court held that state courts shared concurrent jurisdiction to hear class actions asserting solely Securities Act claims and that defendants cannot remove these actions to federal court.

Delaware General Corporation Law (DGCL) Permits Forum Provisions

- Section 115 of the DGCL expressly permits the adoption of a charter or bylaw provisions designating Delaware as the exclusive forum for adjudicating "internal corporate claims." The statute defines "internal corporate claims" as those claims "(i) that are based upon a violation of a duty by a current or former director or officer or stockholder in such capacity, or (ii) as to which this title confers jurisdiction upon the Court of Chancery."

BLUE APRON & FEDERAL FORUM PROVISIONS

- In *Blue Apron*, the shareholder plaintiff purchased shares of Blue Apron Holdings, Inc., Roku, Inc., and Stitch Fix, Inc. in their initial public offerings or soon thereafter.

- All three companies had adopted nearly identical federal forum-selection provisions ("FFPs") in their corporate charters providing that "the federal district courts of the Unites States of America shall be the exclusive forum for the resolution of any complaint" under the 1933 Act.

- The plaintiff filed a declaratory judgment action against the individual directors who had signed the companies' registration statements, challenging the enforceability of these provisions.

BLUE APRON HOLDINGS, INC.	Unless the Corporation consents in writing to the selection of an alternative forum, the federal district courts of the United States of America shall, to the fullest extent permitted by law, be the sole and exclusive forum for the resolution of any complaint asserting a cause of action arising under the Securities Act of 1933. Any person or entity purchasing or otherwise acquiring or holding any interest in shares of capital stock of the Corporation shall be deemed to have notice of and consented to the provisions of this Article ….
ROKU, INC.	Unless the Company consents in writing to the selection of an alternative forum, the federal district courts of the United States of America shall be the exclusive forum for the resolution of any complaint asserting a cause of action arising under the Securities Act of 1933. Any person or entity purchasing or otherwise acquiring any interest in any security of the Corporation shall be deemed to have notice of and consented to the provisions of this Amended and Restated Certificate of Incorporation.
STITCH FIX, INC.	Unless the Company consents in writing to the selection of an alternative forum, the federal district courts of the United States of America shall be the exclusive forum for the resolution of any complaint asserting a cause of action arising under the Securities Act of 1933. Any person or entity purchasing or otherwise acquiring any interest in any security of the Company shall be deemed to have notice of and consented to the provisions of this Section ….

DELAWARE COURT OF CHANCERY INVALIDATES FFPS

- In a 2018 decision, the Delaware Court of Chancery (Vice Chancellor Travis Laster) acknowledged that Delaware law permits forum-selection provisions concerning a corporation's internal corporate governance, but held that a claim under the 1933 Act was an "external claim" resembling a third-party tort or contract claim, which "falls outside the scope of the corporate contract." *See Sciabacucchi v. Salzberg*, No. CV 2017-0931-JTL, 2018 WL 6719718 (Del. Ch. Dec. 19, 2018).

- According to the Court of Chancery, "first principles" of Delaware corporate law therefore dictated that a corporation could not include in its certificate of incorporation a provision setting the forum of a claim under the 1933 Act.

- Defendants appealed.

IN RE BRIGHTVIEW HOLDINGS, INC. SEC. LITIG.

BrightView's FFP:

- "[T]o the fullest extent permitted by law, the federal district courts of the United States will be the exclusive forum for resolving any complaint asserting a cause of action arising under the federal securities laws of the United States. To the fullest extent permitted by law, any person or entity purchasing or otherwise acquiring or holding any interest in shares of capital stock of the Corporation shall be deemed to have notice of and consented to the provisions of this Article …."

BrightView's Registration Statement:

- "[T]he enforceability of similar forum provisions in other companies' certificates of incorporation has been challenged in legal proceedings, and it is possible that a court could find these types of provisions to be unenforceable."

DELAWARE SUPREME COURT REVERSES

1. The Plain Language of DGCL Section 102(b)(1) Permits FFPs.

- The Delaware Supreme Court concluded that FFPs "could easily fall within either" of two broad categories of permissible charter provisions outlined by DGCL Section 102(b)(1): (1) "*any* provision for the management of the business and for the conduct of the affairs of the corporation" and (2) "*any* provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of the stockholders, . . . if such provisions are not contrary to the laws of this State."

- The Court explained that 1933 Act claims arise out of the directors' "management of its business and affairs and of its relationship with its stockholders," making the provisions facially valid under Section 102(b)(1) because they are tied to the "'management of the business' and the 'conduct of the affairs of the corporation.'"

2. FFPs Do Not Conflict With Delaware Public Policy.

- The Court also concluded that FFPs are not contrary to the policies or laws of Delaware, explaining that such stockholder-approved amendments "should be respected as a matter of policy" and "should not be deemed violative of Delaware's public policy."
- The Court also noted the flexibility embodied in Delaware's corporate law, which provides "immense freedom for businesses to adopt the most appropriate terms" to govern themselves.

3. FFPs Relate to Intra-Corporate Claims.

- The Court rejected the lower court's attempt to limit forum selection clauses to matters that are only "internal" or "intra-corporate" (e.g., breach of fiduciary duty claims), explaining that 1933 Act claims are "internal" insofar as "they arise from internal corporate conduct."

PRACTICAL IMPLICATIONS

- While Blue Apron settles the facial validity of a federal forum provision pursuant to Delaware law, left for another day are:
  - (1) any "as applied" challenges to a specific federal forum provision;
  - (2) the deference other states would give to a federal forum provision; and
  - (3) how federal courts will respond to federal forum provisions.

POST-BLUE APRON ENFORCEABILITY OF FEDERAL FORUM SELECTION CLAUSES
***Wong v. Restoration Robotics, Inc., et al.*, No. 18-CIV-02609 (Sept. 1, 2020)**
***In re Dropbox, Inc. Securities Litigation*, No. 19-CIV-05089**

BLUE APRON & FEDERAL FORUM PROVISIONS

- In *Blue Apron*, the Delaware Supreme Court upheld the facial validity of federal-forum provisions in the certificates of incorporation of Delaware corporations designating federal court as the exclusive forum for Securities Act claims.
- The Delaware Supreme Court held that FFPs were permitted under the DGCL and did not violate Delaware public policy.
- The Court left for another day the following implications:
- (1) any "as applied" challenges to a specific federal forum provision;
- (2) the deference other states would give to a federal forum provision; and
- (3) how federal courts will respond to federal forum provisions.

WONG V. RESTORATION ROBOTICS, INC.

- Prior to the Delaware Supreme Court's decision in *Blue Apron*, Restoration Robotics, a Delaware Corporation, moved to dismiss Plaintiff's Securities Act claims filed in San Mateo County Superior Court in California on the basis of the federal forum provision in its charter.
- The Court initially denied the motion, consistent with the Delaware Chancery Court's decision in *Blue Apron* that the federal forum provision was invalid.

- However, the defendants sought reconsideration when the Delaware Supreme Court reversed the Court of Chancery in *Blue Apron*, and held that federal forum provisions are facially valid under Delaware law.

- The Court considered the potential applicability of various standards, including those applicable to enforcement of arbitration provisions and settlement releases and determined that exclusive federal forum provisions are most analogous to mandatory forum selection clauses.

- In California, if a forum selection clause is mandatory, "the test is simply whether application of the clause is unfair or unreasonable; and the clause is usually given effect. Claims that the previously chosen forum is unfair or inconvenient are generally rejected."

- According to the Court, Defendants had shown that the FFP was mandatory, that it restricted "all Securities Act claims to federal court, without limitation on venue."

- While the FFP was not "mutual in its effect or application," it was "subject to [a] shareholder vote and approval, and was not applied retroactively herein, *i.e.*, it was effective before these lawsuits were filed. Accordingly, the burden of proof shifted to the Plaintiffs to demonstrate that the FFP is unenforceable, unconscionable, unjust or unreasonable."

- Ultimately, the Court determined that the Plaintiffs had not met their burden of proof and, exercising its discretion, declined "jurisdiction over the claims alleged against Restoration Robotics and its officers and directors only, pursuant to the FFP."

- The court declined to consider Plaintiff's constitutional arguments that, by permitting corporations to adopt charter provisions regulating shareholder claims that allegedly do not stem from internal corporate affairs, the Delaware Legislature and courts may be impermissibly regulating interstate commerce in violation of the federal Constitution's Commerce Clause. The court concluded that the argument needed to be pursued in a separate case.

- The FFP did not result in any "procedural loss of Due Process, as [shareholders] can present their federal law claims to a federal court, in a state or province of a state close to their residence, have the opportunity for discovery, and trial by jury. There is even greater authority in federal court to obtain personal jurisdiction over defendants, and to subpoena witnesses to trial."

- However, the court declined to dismiss the plaintiff's claims against Restoration Robotics' underwriters, holding that the underwriters had failed to show that they had standing to invoke rights conferred by Restoration Robotics' charter, and denied their motions without prejudice.

IN RE DROPBOX, INC. SECURITIES LITIGATION

- Investors sued Dropbox, a Delaware corporation, under Section 11 for its 2018 IPO in San Mateo County Superior Court in California.

- Dropbox filed a motion to dismiss the action, arguing in reliance on the *Blue Apron* decision that the federal forum provision in its corporate charter is valid on its face and therefore that the state court lawsuit must be dismissed because the provision does not "diminish the rights of California residents in a way that violates a statute or public policy of the state."

- Plaintiffs, making similar arguments as in *Restoration Robotics*, opposed Defendants' motion.

- Six former Delaware Chancery Court and Supreme Court judges filed an amicus brief defending Delaware's authority to determine the validity of the federal forum provisions, arguing that because the question of the validity of an FFP is a matter of the internal affairs doctrine, the question of the state law that governs these affairs is equally internal and Delaware law should govern the questions of validity and enforceability.

- Former SEC Chairman Harvey L. Pitt and 20 law professors also filed an amicus brief arguing that Dropbox's attempt to enforce its federal forum provisions would violate the Securities Act and circumvent U.S. Supreme Court precedent.

KeyCite Yellow Flag - Negative Treatment
Declined to Extend by Seafarers Pension Plan on behalf of Boeing Company v. Bradway, 7th Cir.(Ill.), January 7, 2022

227 A.3d 102
Supreme Court of Delaware.

Matthew B. SALZBERG, Julie M.B. Bradley, Tracy Britt Cool, Kenneth A. Fox, Robert P. Goodman, Gary R. Hirshberg, Brian P. Kelley, Katrina Lake, Steven Anderson, J. William Gurley, Marka Hansen, Sharon McCollam, Anthony Wood, Ravi Ahuja, Shawn Carolan, Jeffrey Hastings, Alan Hendricks, Neil Hunt, Daniel Leff, and Ray Rothrock, Defendants Below, Appellants,
and
Blue Apron Holdings, Inc., Stitch Fix, Inc., and Roku, Inc., Nominal Defendants Below, Appellants,
v.
Matthew SCIABACUCCHI, on behalf of himself and all others similarly situated, Plaintiff Below, Appellee.

No. 346, 2019
|
Submitted: January 8, 2020
|
Decided: March 18, 2020
|
Revised: April 14, 2020

Synopsis

Background: Purchaser of shares of stock in multiple Delaware corporations that launched initial public offerings brought putative class action against corporations, seeking declaratory judgment that federal forum provisions (FFPs) in certificates of incorporation, which designated federal courts as exclusive forum for resolution of claims brought under Securities Act of 1933, were facially invalid. The Court of Chancery, 2018 WL 6719718, entered summary judgment in purchaser's favor and ruled that FFPs were invalid. Appeal was taken.

Holdings: The Supreme Court, Valihura, J., held that:

[1] FFPs were facially valid, under Delaware statute governing contents of certificate of incorporation;

[2] FFPs did not violate policies or laws of Delaware;

[3] amended statute providing that "certificate of incorporation … may require … that any or all internal corporate claims shall be brought solely and exclusively in" Delaware Courts and that no provision may prohibit bringing such claims in Delaware courts did not apply to claims brought under Securities Act;

[4] amended statute did not amend existing statute governing contents of certificates of incorporation; and

[5] FFPs were consistent with full faith and credit principles.

Reversed.

Procedural Posture(s): On Appeal; Motion for Summary Judgment.

West Headnotes (49)

[1] Securities Regulation Registration Requirement in General

The Securities Act of 1933 requires persons offering securities for sale to the public to file a registration statement that makes full and fair disclosure of relevant information. Securities Act of 1933 § 5, 15 U.S.C.A. § 77e.

[2] Action Statutory rights of action

Securities Regulation Existence of private cause of action

The Securities Act of 1933 creates private rights of action so that purchasers of securities can enforce the registration and disclosure requirements of the Act. Securities Act of 1933 § 5, 15 U.S.C.A. § 77e.

[3] Securities Regulation Jurisdiction and venue

The Securities Act of 1933 provides that private plaintiffs may bring their claims under the Act

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

in either federal or state courts. Securities Act of 1933 § 22, 15 U.S.C.A. § 77v(a).

[4] **Removal of Cases** Restrictions by federal or state statutes

The Securities Act of 1933 bars the removal of an action to enforce the registration and disclosure requirements of the Act from state court to federal court; thus, if a plaintiff chooses to bring an action under the 1933 Act in state court, a defendant cannot change the forum. Securities Act of 1933 § 22, 15 U.S.C.A. § 77v(a).

[5] **Securities Regulation** Persons entitled to sue or recover

The Securities Act of 1933 authorizes purchasers of a registered security to sue certain enumerated parties in a registered offering when false or misleading information is included in a registration statement. Securities Act of 1933 §§ 11, 12, 15 U.S.C.A. §§ 77k(a), 77*l*(a)(1).

[6] **Securities Regulation** False Statements or Omissions; Accuracy

A plaintiff who purchased a security issued under a registration statement need only show a material misstatement or omission to establish his prima facie case of a violation of the registration requirements of the Securities Act of 1933. Securities Act of 1933 §§ 11, 12, 15 U.S.C.A. §§ 77k(a), 77*l*(a)(1).

[7] **Securities Regulation** Persons Liable

Securities Regulation Good faith; due diligence or reasonable investigation

In an action by a purchaser of registered securities for a violation of the registration requirements under the Securities Act of 1933, in addition to the issuer, other defendants, including the corporation's directors, are also potentially liable, although they may avoid liability by proving a due diligence defense. Securities Act of 1933 §§ 11, 12, 15 U.S.C.A. §§ 77k(a), 77*l*(a)(1).

[8] **Securities Regulation** False Statements or Omissions; Accuracy

The Securities Act of 1933 provides similar redress to purchasers of registered securities for violations of the registration requirements where the securities at issue were sold using prospectuses or oral communications that contain material misstatements or omissions. Securities Act of 1933 § 12, 15 U.S.C.A. § 77*l*(a)(2).

[9] **Securities Regulation** Sellers

Liability under the Securities Act of 1933 for violations of the registration requirements under the Act extends to statutory sellers of registered securities, including a person who passed title, or other interest in the security, to the buyer for value or successfully solicited the purchase of a security, motivated at least in part by a desire to serve his own financial interests or those of the securities' owner. Securities Act of 1933 § 12, 15 U.S.C.A. § 77*l*(a)(2).

[10] **Pretrial Procedure** Sequence and timing; condition of cause

Securities Regulation Forecasts, estimates, predictions or projections

Securities Regulation Damages

Securities Regulation Costs and Expenses; Attorney Fees

The provisions of the Private Securities Litigation Reform Act, aimed at the reduction of abusive class action securities litigation, limit recoverable damages and attorney's fees, provide a safe harbor for forward-looking statements, impose new restrictions on the selection of and compensation awarded to lead plaintiffs, mandate imposition of sanctions for frivolous litigation, and authorize a stay of discovery pending resolution of any motion to dismiss.

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

Securities Exchange Act of 1934 § 21D, 15 U.S.C.A. § 78u-4.

[11] **Appeal and Error** De novo review

The Supreme Court reviews the Court of Chancery's decision to grant summary judgment de novo.

2 Cases that cite this headnote

[12] **Judgment** Absence of issue of fact

A court may grant summary judgment only if, based on the undisputed material facts, the moving party is entitled to judgment as a matter of law.

[13] **Appeal and Error** Statutory or legislative law

Statutory interpretation is a question of law, which the Supreme Court reviews de novo.

3 Cases that cite this headnote

[14] **Corporations and Business Organizations** Form and requisites

In asserting a facial challenge to the validity of a corporate charter provision, the plaintiff must show that the provision cannot operate lawfully or equitably under any circumstances.

[15] **Corporations and Business Organizations** Form and requisites

In order to prove that a corporate charter provision is invalid on its face, the plaintiff must demonstrate that the charter provision does not address proper subject matters as defined by statute, and can never operate consistently with law.

[16] **Statutes** Language

The most important consideration for a court in interpreting a statute is the words the General Assembly used in writing it.

3 Cases that cite this headnote

[17] **Statutes** Natural, obvious, or accepted meaning

When interpreting a statute, the court must give the statutory words their commonly understood meanings.

2 Cases that cite this headnote

[18] **Corporations and Business Organizations** Form and requisites

Federal forum provisions (FFPs) in certificates of incorporation filed by corporate entities that launched public offerings, which designated federal courts as exclusive forum for resolution of claims brought under Securities Act of 1933, were facially valid, under Delaware statute authorizing contents of certificate of incorporation to include provisions for management of business and which defined and regulated powers of corporation, its directors, and stockholders; FFPs involved type of securities claim related to management of litigation arising out of corporation's disclosures to prospective stockholders in connection with initial public offering (IPO), and were provisions that defined powers of corporations, directors, and stockholders, as they prescribed where stockholders could bring claims against corporations and directors. Securities Act of 1933 § 1, et seq., 15 U.S.C.A. § 77a et seq.; 8 Del. Code § 102(b)(1).

[19] **Corporations and Business Organizations** Form and requisites

Federal forum provisions (FFPs) in certificates of incorporation filed by corporate entities that launched public offerings, which designated federal courts as exclusive forum for resolution of claims brought under Securities Act of 1933, did not violate policies or laws of State of Delaware, within meaning of statute governing contents of certificates; stockholders were permitted, by contract, to depart from rules of common law, so long as departures did not

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

transgress any statutory enactment or public policy, such contracts were entitled to deference, and statute granted to managers and stockholders with great leeway to structure their relations, subject to statutory constraints and to policing of director misconduct through equitable review. 8 Del. Code § 102(b)(1).

[20] **Corporations and Business Organizations** Form and requisites

The stockholders of a Delaware corporation may by contract embody in the certificate of incorporation a provision departing from the rules of the common law, provided that it does not transgress a statutory enactment or a public policy settled by the common law or implicit in the General Corporation Law itself. 8 Del. Code § 102(b)(1).

2 Cases that cite this headnote

[21] **Corporations and Business Organizations** Construction, operation, and effect

Corporations and Business Organizations Amendment

Recognizing that corporate charters are contracts among a corporation's stockholders, stockholder-approved charter amendments are given great respect under Delaware law. 8 Del. Code § 102(b)(1).

1 Cases that cite this headnote

[22] **Corporations and Business Organizations** Construction, operation, and effect

Federal forum provisions (FFPs) in stockholder-approved charter amendments requiring that any claim or dispute under the Sherman Act of 1933 be brought in federal court should be respected as a matter of policy; at a minimum, they should not be deemed violative of Delaware's public policy. Securities Act of 1933 § 1, et seq., 15 U.S.C.A. § 77a et seq.; 8 Del. Code § 102(b)(1).

[23] **Corporations and Business Organizations** Operation and effect in general

At its core, the Delaware General Corporation Law is a broad enabling act which leaves latitude for substantial private ordering, provided the statutory parameters and judicially imposed principles of fiduciary duty are honored. 8 Del. Code § 101 et seq.

2 Cases that cite this headnote

[24] **Corporations and Business Organizations** Form and requisites

The provision of the Delaware General Corporation Law governing the contents of a certificate of incorporation leaves the parties to the corporate contract (managers and stockholders) with great leeway to structure their relations, subject to relatively loose statutory constraints and to the policing of director misconduct through equitable review. 8 Del. Code § 102(b)(1).

1 Cases that cite this headnote

[25] **Corporations and Business Organizations** Form and requisites

Amended statute providing that "certificate of incorporation … may require … that any or all internal corporate claims shall be brought solely and exclusively in any or all of the courts in this State, and no provision of the certificate of incorporation or the bylaws may prohibit bringing such claims in the courts of this State" did not prohibit federal forum provisions (FFPs) in certificates of incorporation filed by corporate entities that launched public offerings, which designated federal courts as exclusive forum for resolution of claims brought under Securities Act of 1933; limitation unambiguously applied only to "internal corporate claims," not to claims brought under Act. Securities Act of 1933 § 1, et seq., 15 U.S.C.A. § 77a et seq.; 8 Del. Code § 102(f).

 © 2022 Thomson Reuters. No claim to original U.S. Government Works.

3 Cases that cite this headnote

[26] **Statutes** Statute as a Whole; Relation of Parts to Whole and to One Another

When interpreting a statute, the court must give meaning to every word in the statute.

[27] **Statutes** Construing together; harmony

When interpreting a statute, each part or section of a statute should be construed in connection with every other part or section to produce a harmonious whole.

1 Cases that cite this headnote

[28] **Statutes** Superfluousness

Statutes Giving effect to entire statute and its parts; harmony and superfluousness

When interpreting a statute, it is presumed that the General Assembly purposefully chose particular language, and the court will therefore construe statutes to avoid surplusage if reasonably possible.

1 Cases that cite this headnote

[29] **Statutes** Language

Statutes Similarity or difference

When interpreting a statute, the legislative body is presumed to have inserted every provision for some useful purpose and construction, and when different terms are used in various parts of a statute it is reasonable to assume that a distinction between the terms was intended.

[30] **Corporations and Business Organizations** Form and requisites

Amendment to Delaware General Corporation Act (DGCA) stating that "certificate of incorporation … may require … that any or all internal corporate claims shall be brought solely and exclusively in any or all of the courts in this State, and no provision of the certificate of incorporation or the bylaws may prohibit bringing such claims in the courts of this State" did not amend existing provision of DGCA governing contents of certificates of incorporation, which authorized federal forum provisions (FFPs) that designated federal courts as exclusive forum for resolution of claims brought under Securities Act of 1933; amendment did not explicitly bar forum-selection provision for claims other than "internal corporate claims" nor limited scope of provisions that were permissible. Securities Act of 1933 § 1, et seq., 15 U.S.C.A. § 77a et seq.; 8 Del. Code § 102(b)(1), (f).

4 Cases that cite this headnote

[31] **Statutes** Absence of Ambiguity; Application of Clear or Unambiguous Statute or Language

When interpreting statutes, courts do not resort to other statutes if the statute being construed is clear and unambiguous.

[32] **Statutes** Implied Repeal

Statutes should not be superseded or altered by implication unless there is an irreconcilable conflict.

[33] **Statutes** Earlier and later statutes

Statutes Similar or related statutes

It is assumed that, when the General Assembly enacts a later statute in an area covered by a prior statute, it has in mind the prior statute, and therefore statutes on the same subject must be construed together so that effect is given to every provision unless there is an irreconcilable conflict between the statutes, in which case the later supersedes the earlier.

[34] **Statutes** By inconsistent or repugnant statute

The court does not construe a newly enacted statute to impliedly amend or supersede other

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

statutes unless that intention of the General Assembly is manifestly clear.

[35] **Statutes** Plain Language; Plain, Ordinary, or Common Meaning

It is the obligation of the courts to construe the plain language of a statute.

[36] **Corporations and Business Organizations** Internal affairs doctrine in general

The "internal affairs doctrine" does not apply to disputes arising out of contracts entered between the corporation and individuals, torts, and dealings in personal and real property, for which choice of law decisions relating to such corporate activities are usually determined after consideration of the facts of each transaction; rather, the doctrine governs the choice of law determinations involving matters peculiar to corporations, that is, those activities concerning the relationships inter se of the corporation, its directors, officers and shareholders.

3 Cases that cite this headnote

[37] **Corporations and Business Organizations** Form and requisites

Federal forum provisions (FFPs) in certificates of incorporation filed by corporate entities that launched public offerings, which designated federal courts as exclusive forum for resolution of claims brought under Securities Act of 1933, did not violate federal law or policy as articulated by United States Supreme Court that federal law had no objection to provisions that preclude state litigation of Securities Act. Securities Act of 1933 § 1, et seq., 15 U.S.C.A. § 77a et seq.

1 Cases that cite this headnote

[38] **Contracts** Agreement as to place of bringing suit; forum selection clauses

Courts must give as much effect as possible to forum-selection clauses, and to only deny enforcement of them to the limited extent necessary to avoid some fundamentally inequitable result or a result contrary to positive law.

1 Cases that cite this headnote

[39] **Corporations and Business Organizations** Form and requisites

Generally, charter provisions are presumed to be valid, and the courts will construe them in a manner consistent with the law, rather than strike down the provisions.

[40] **Corporations and Business Organizations** Form and requisites

States Full faith and credit in each state to the public acts, records, etc. of other states

Federal forum provisions (FFPs) in certificates of incorporation filed by corporate entities that launched public offerings, which designated federal courts as exclusive forum for resolution of claims brought under Securities Act of 1933, were consistent with full faith and credit principles; FFPs were procedural mechanisms, not substantive limitations, that regulated where stockholders could file suit, not whether stockholder could file suit or remedy that stockholder could obtain on behalf of herself or corporation. U.S. Const. art. 4, § 1; Securities Act of 1933 § 1, et seq., 15 U.S.C.A. § 77a et seq.

[41] **Contracts** Agreement as to place of bringing suit; forum selection clauses

Corporations and Business Organizations Form and requisites

The question of enforceability of a forum selection clause for claims brought under the Securities Act of 1933 is a separate, subsequent analysis that should not drive the initial facial validity inquiry of the clause under the provision of Delaware's General Corporation Law governing the contents of a certificate of incorporation. Securities Act of 1933 § 1, et seq., 15 U.S.C.A. § 77a et seq.; 8 Del. Code § 102(b)(1).

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

4 Cases that cite this headnote

[42] **Contracts** Presumptions and burden of proof

In a contractual setting, the party seeking to avoid enforcement of a forum-selection clause bears the burden of establishing that its enforcement would be unreasonable.

[43] **Corporations and Business Organizations** Form and requisites

Whether the specific charter provision is enforceable depends on the manner in which it was adopted and the circumstances under which it is invoked.

[44] **Corporations and Business Organizations** Form and requisites

Charter and bylaw provisions that may otherwise be facially valid will not be enforced if adopted or used for an inequitable purpose.

[45] **Contracts** Agreement as to place of bringing suit; forum selection clauses

There are three bases on which forum-selection provisions might be invalidated on an "as applied" basis: (i) they will not be enforced if doing so would be unreasonable and unjust; (ii) they would be invalid for reasons such as fraud or overreaching; or (iii) they could be not enforced if they contravened a strong public policy of the forum in which suit is brought, whether declared by statute or by judicial decision.

[46] **Constitutional Law** Corporations and limited liability companies

Due Process concerns presented by the internal affairs doctrine address the officers' and directors' rights to know what law will be applied to their actions, as well as the stockholders' right to know by what standards of accountability they may hold those managing the corporation's business and affairs. U.S. Const. Amend. 14.

2 Cases that cite this headnote

[47] **States** Full faith and credit in each state to the public acts, records, etc. of other states

Full faith and credit commands application of the internal affairs doctrine except in the rare circumstance where national policy is outweighed by a significant interest of the forum state in the corporation and its shareholders. U.S. Const. art. 4, § 1.

2 Cases that cite this headnote

[48] **Commerce** Powers Remaining in States, and Limitations Thereon

Courts Exercise of jurisdiction beyond territorial limits

The limits on a State's power under the Commerce Clause to enact substantive legislation are similar to the limits on the jurisdiction of state courts; in either case, any attempt directly to assert extraterritorial jurisdiction over persons or property would offend sister states and exceed the inherent limits of the State's power. U.S. Const. art. 1, § 8, cl. 3.

[49] **Corporations and Business Organizations** Construction, operation, and effect

Forum-selection provisions in corporate charters for claims brought under the Securities Act of 1933 are process-oriented, and are not substantive; they regulate where stockholders may file suit, not whether the stockholder may file suit or the kind of remedy that the stockholder may obtain on behalf of herself or the corporation. Securities Act of 1933 § 1, et seq., 15 U.S.C.A. § 77a et seq.

1 Cases that cite this headnote

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

***108** Court Below: Court of Chancery of the State of Delaware, C.A. No. 2017-0931.

Upon appeal from the Court of Chancery. **REVERSED**.

Attorneys and Law Firms

William B. Chandler, III, Esquire (argued), Bradley D. Sorrels, Esquire, Lindsay Kwoka Faccenda, Esquire, Andrew D. Berni, Esquire, WILSON SONSINI GOODRICH & ROSATI, P.C., Wilmington, Delaware; Boris Feldman, Esquire, David J. Berger, Esquire, WILSON SONSINI GOODRICH & ROSATI, P.C., Palo Alto, California; Attorneys for Defendants-Appellants Katrina Lake, Steven Anderson, J. William Gurley, Marka Hansen, Sharon McCollam, Anthony Wood, Ravi Ahuja, Shawn Carolan, Jeffrey Hastings, Alan Hendricks, Neil Hunt, Daniel Leff, Ray Rothrock, Stitch Fix, Inc., and Roku, Inc.

Catherine G. Dearlove, Esquire, Anthony M. Calvano, Esquire, Tyre Tindall, Esquire, RICHARDS LAYTON & FINGER, P.A., Wilmington, Delaware; Michael G. Bongiorno, Esquire, WILMER CUTLER PICKERING HALE & DORR, LLP, New York, New York; Timothy J. Perla, Esquire, WILMER CUTLER PICKERING HALE & DORR, LLP, Boston, Massachusetts; Attorneys for Defendants-Appellants Matthew B. Salzberg, Julie M.B. Bradley, Tracy Britt Cool, Kenneth A. Fox, Robert P. Goodman, Gary R. Hirshberg, Brian P. Kelley, and Blue Apron Holdings, Inc.

Kurt M. Heyman, Esquire, Melissa N. Donimirski, Esquire, Aaron M. Nelson, Esquire, HEYMAN ENERIO GATTUSO & HIRZEL LLP, Wilmington, Delaware; Jason M. Leviton, Esquire, Joel A. Fleming, Esquire (argued), Lauren Godles Milgroom, Esquire, Amanda R. Crawford, Esquire, BLOCK & LEVITON LLP, Boston, Massachusetts; Attorneys for Plaintiff-Appellee Matthew Sciabacucchi.

Before SEITZ, Chief Justice; VALIHURA, VAUGHN, and TRAYNOR, Justices; and KARSNITZ, Judge, [*] constituting the Court en Banc.

Opinion

VALIHURA, Justice, for the Majority:

***109** We are asked to determine the validity of a provision in several Delaware corporations' charters requiring actions arising under the federal Securities Act of 1933 (the "Securities Act" or "1933 Act") to be filed in a federal court. Blue Apron Holdings, Inc., Roku, Inc., and Stitch Fix, Inc. are all Delaware corporations that launched initial public offerings in 2017. Before filing their registration statements with the United States Securities and Exchange Commission (the "SEC"), each company adopted a federal-forum provision. An example of such a federal-forum provision (or "FFP") provides:

> Unless the Company consents in writing to the selection of an alternative forum, the federal district courts of the United States of America shall be the exclusive forum for the resolution of any complaint asserting a cause of action arising under the Securities Act of 1933. Any person or entity purchasing or otherwise acquiring any interest in any security of [the Company] shall be deemed to have notice of and consented to [this provision]. [1]

Appellee Matthew Sciabacucchi ("Appellee") bought shares of each company in its initial public offering or a short time later. He then sought a declaratory judgment in the Court of Chancery that the FFPs are invalid under Delaware law. The Court of Chancery held that the FFPs are invalid because the "constitutive documents of a Delaware corporation cannot bind a plaintiff to a particular forum when the claim does not involve rights or relationships that were established by or under Delaware's corporate law." [2] Because such a provision can survive a facial challenge under our law, we **REVERSE**.

I. Overview

[1] [2] [3] [4] The Securities Act of 1933 requires persons offering securities for sale ***110** to the public to file a registration statement [3] that makes "full and fair disclosure of relevant information." [4] The 1933 Act creates private rights of action so that purchasers of securities can enforce the registration and disclosure requirements of the 1933 Act. [5] Unlike some other securities laws for which there are no private rights of action, the statute provides that private

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

plaintiffs may bring their claims under the 1933 Act in either federal or state courts.[6] The statute also bars the removal of such actions from state court to federal court.[7] Thus, if a plaintiff chooses to bring an action under the 1933 Act in state court, a defendant cannot change the forum.[8]

[5] **[6]** **[7]** Section 12(a)(1)[9] of the 1933 Act "imposes strict liability for violating" the securities registration requirements, which "are the heart of the Act."[10] Section 11[11] "allows purchasers of a registered security to sue certain enumerated parties in a registered offering when false or misleading information is included in a registration statement."[12] A plaintiff who purchased a security issued under a registration statement "need only show a material misstatement or omission to establish his *prima facie* case."[13] In addition ***111** to the issuer, other defendants, including the corporation's directors,[14] are also potentially liable, although they may avoid liability by proving a due diligence defense.[15]

[8] **[9]** Section 12(a)(2)[16] "provides similar redress where the securities at issue were sold using prospectuses or oral communications that contain material misstatements or omissions."[17] Liability under Section 12(a)(2) extends to "statutory sellers," including a person who "passed title, or other interest in the security, to the buyer for value" or "successfully solicited the purchase of a security, motivated at least in part by a desire to serve his own financial interests or those of the securities' owner."[18] Section 15 imposes liability on an individual or entity that "controls any person liable" under Sections 11 or 12.[19]

[10] Concerns over "perceived abuses of the class-action vehicle in litigation involving nationally traded securities" prompted Congress to adopt the Private Securities Litigation Reform Act in 1995 ("PSLRA").[20] The provisions of the PSLRA, aimed at the "Reduction of Abusive Litigation," "limit recoverable damages and attorney's fees, provide a 'safe harbor' for forward-looking statements, impose new restrictions on the selection of (and compensation awarded to) lead plaintiffs, mandate imposition of sanctions for frivolous litigation, and authorize a stay of discovery pending resolution of any motion to dismiss."[21] But the PSLRA "had an unintended consequence: It prompted at least some members of the plaintiffs' bar to avoid the federal forum altogether. Rather than face the obstacles set in their path by the [PSLRA], plaintiffs and their representatives began bringing class actions under state law, often in state court."[22]

Some corporations preferred to litigate 1933 Act claims in federal court and began adopting forum-selection provisions that designated the federal courts as the exclusive forum for such claims.[23] Each of the companies in this appeal is a Delaware corporation that launched a 2017 initial public offering. Before filing their registration statements with the SEC, each company adopted a federal-forum provision in its certificate of incorporation, designating the federal courts as the exclusive forum for the resolution of claims under the 1933 Act.

Roku's and Stitch Fix's federal-forum provisions provided:

> Unless the Company consents in writing to the selection of an alternative forum, the federal district courts of the United States of America shall be the exclusive forum for the resolution of any complaint asserting a cause of action arising ***112** under the Securities Act of 1933. Any person or entity purchasing or otherwise acquiring any interest in any security of [the Company] shall be deemed to have notice of and consented to [this provision].[24]

Blue Apron's provision differed slightly:

> Unless the Corporation consents in writing to the selection of an alternative forum, the federal district courts of the United States of America shall, *to the fullest extent permitted by law*, be the sole and exclusive forum for the resolution of any complaint asserting a cause of action arising under the Securities Act of 1933. Any person or entity purchasing or

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

> otherwise acquiring *or holding* any interest in *shares of capital stock* of the Corporation shall be deemed to have notice of and consented to [this provision]. [25]

Appellee bought shares of common stock of each company, either in the initial public offering or a short time later. On December 29, 2017, he filed a putative class-action complaint in the Court of Chancery against the individuals who had served as the companies' directors since they went public, and named the companies as nominal defendants. The complaint sought a declaratory judgment that the federal-forum provisions are invalid under Delaware law.

The Court of Chancery granted the motion for summary judgment. In reaching that result, the court examined its 2013 decision in *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, [26] this Court's 2014 decision in *ATP Tour, Inc. v. Deutscher Tennis Bund*, [27] federal case law, and what the Court of Chancery described as "first principles" of Delaware corporate law. The court decided that the "constitutive documents of a Delaware corporation cannot bind a plaintiff to a particular forum when the claim does not involve rights or relationships that were established by or under Delaware's corporate law." [28] Because "the Federal Forum Provisions attempt to accomplish that feat," the court held that the federal-forum provisions are "ineffective and invalid." [29]

II. Standard of Review

[11] **[12]** **[13]** This Court reviews the Court of Chancery's decision to grant summary judgment *de novo*. [30] A court may grant summary judgment only if, based on the undisputed material facts, the moving party is entitled to judgment as a matter of law. [31] There are no material facts in dispute in this appeal, and the issues on which we decide this appeal concern the interpretation of the statutes governing the permissible contents of a Delaware corporation's certificate of incorporation. Statutory interpretation is a question of law, which we review *de novo*. [32] The plaintiff must show that the federal-forum provisions do not address a proper subject matter of charter provisions under 8 *Del. C.* § 102(b)(1).

***113** *III. Analysis*

A. FFPs are Valid as They Fall Within the Plain Text of Section 102(b)(1)

1. This is a Facial Challenge

[14] **[15]** In asserting its facial challenge, the plaintiff must show that the charter provisions "cannot operate lawfully or equitably *under any circumstances*." [33] Plaintiffs must demonstrate that the charter provisions "do not address proper subject matters" as defined by statute, "and can never operate consistently with law." [34]

2. The FFPs Fall Within the Broad, Enabling Text of Section 102(b)(1)

[16] **[17]** The analysis must begin with the text of Section 102, the provision of the Delaware General Corporation Law ("DGCL") governing the matters contained in a corporation's certificate of incorporation. [35] The "most important consideration for a court in interpreting a statute is the words the General Assembly used in writing it." [36] The court must "give the statutory words their commonly understood meanings." [37]

Section 102(b)(1) provides:

> (b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters: (1) Any provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of the

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

> stockholders, or the governing body, members, or any class or group of members of a nonstock corporation; if such provisions are not contrary to the laws of this State. Any provision which is required or permitted by any section of this chapter to be stated in the bylaws may instead be stated in the certificate of incorporation .... [38]

Thus, Section 102(b)(1) authorizes two broad types of provisions:

> *any* provision for the management of the business and for the conduct of the affairs of the corporation,

and

> *any* provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of the stockholders, ... if such provisions are not contrary to the laws of this State.

***114 [18]** An FFP could easily fall within either of these broad categories, and thus, is facially valid. FFPs involve a type of securities claim related to the management of litigation arising out of the Board's disclosures to current and prospective stockholders in connection with an IPO or secondary offering. The drafting, reviewing, and filing of registration statements by a corporation and its directors is an important aspect of a corporation's management of its business and affairs and of its relationship with its stockholders. This Court has viewed the overlap of federal and state law in the disclosure area as "historic," "compatible," and "complimentary." [39] Accordingly, a bylaw that seeks to regulate the forum in which such "intra-corporate" litigation can occur is a provision that addresses the "management of the business" and the "conduct of the affairs of the corporation," and is, thus, facially valid under Section 102(b)(1).

*i. FFPs and Post-*Cyan *Efficiencies*

To elaborate, FFPs can provide a corporation with certain efficiencies in managing the procedural aspects of securities litigation following the United States Supreme Court's decision in *Cyan, Inc. v. Beaver County Employees Retirement Fund.* [40] There, the United States Supreme Court unanimously held that federal and state courts have concurrent jurisdiction over class actions based on claims brought under the 1933 Act, and that such claims are not removable to federal court. Following *Cyan*, in 2018, the filing of 1933 Act cases in state courts escalated. The 2018 Year in Review Report by Cornerstone Research found that, "[t]here were 55 percent more state-only filings than federal-only filings in 2018." [41] Claims brought under Section 11 of the 1933 Act "decreased in federal courts as a portion of filing activity moved to state courts." [42] The 2018 report observed that, "[t]he uptick in state actions following the *Cyan* decision indicates a change in approach by plaintiffs." [43]

The recently released Cornerstone 2019 Year in Review Report states that, "[t]he number of state 1933 Act filings in 2019 increased by 40 percent from 2018," and that "[a]bout 45 percent of all state 1933 Act filings in 2019 had a parallel action in federal court." [44] In 2019, the combined ***115** number of federal Section 11 filings and state 1933 Act filings was 65, approximately a 59 percent overall increase from 2018. [45] Of the 65 filings, 22 were parallel filings, 27 were state-only filings (a 69 percent increase from 2018), and 16 were federal-only filings. [46] State-only and parallel filings made up over 75 percent of all federal Section 11 and state 1933 Act filings in 2019. [47] Since *Cyan*, 43 parallel class actions have been filed in multiple jurisdictions. [48] The 2019 report observes that, "[t]he 65 filings in 2019 was historically unprecedented," and that, "[p]rior to 2015, there were only a handful of state court filings, and the highest number of federal Section 11 filings previously was 57 in 1998." [49]

When parallel state and federal actions are filed, no procedural mechanism is available to consolidate or coordinate multiple suits in state and federal court. The

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

costs and inefficiencies of multiple cases being litigated simultaneously in both state and federal courts are obvious. [50] The possibility of inconsistent judgments and rulings on other matters, such as stays of discovery, also exists. By directing 1933 Act claims to federal courts when coordination and consolidation are possible, FFPs classically fit the definition of a provision "for the management of the business and for the conduct of the affairs of the corporation." An FFP would also be a provision "defining, limiting and regulating the powers of the corporation, the directors and the stockholders," since FFPs prescribe where current and former stockholders can bring Section 11 claims against the corporation and its directors and officers. [51]

ii. FFPs are Not Contrary to Policies or Laws of Delaware

a. FFPs Do Not Violate Section 102

[19] Section 102(b)'s broad authorization is constrained by the phrase, "if such provisions are not contrary to the laws of this State." [52] FFPs do not violate the policies or laws of this State.

[20] First, Section 102(b)(1)'s scope is broadly enabling. For example, in *Sterling v. Mayflower Hotel Corp.*, [53] this Court held that Section 102(b)(1) bars only charter provisions that would "achieve a result forbidden by settled rules of public policy." [54] Accordingly, "the stockholders of a Delaware corporation may by contract embody ***116** in the [certificate of incorporation] a provision departing from the rules of the common law, provided that it does not transgress a statutory enactment or a public policy settled by the common law or implicit in the General Corporation Law itself." [55]

[21] **[22]** Further, recognizing that corporate charters are contracts among a corporation's stockholders, stockholder-approved charter amendments are given great respect under our law. In *Williams v. Geier*, [56] in commenting on the "broad policies underlying the Delaware General Corporation Law," this Court observed that, "all amendments to certificates of incorporation and mergers require stockholder action," and that, "Delaware's legislative policy is to look to the will of the stockholders in these areas." [57] *Williams* supports the view that FFPs in stockholder-approved charter amendments should be respected as a matter of policy. [58] At a minimum, they should not be deemed violative of Delaware's public policy.

[23] **[24]** Finally, the DGCL allows immense freedom for businesses to adopt the most appropriate terms for the organization, finance, and governance of their enterprise. [59] "At its core, the [DGCL] is a broad enabling act which leaves latitude for substantial private ordering, provided the statutory parameters and judicially imposed principles of fiduciary duty are honored." [60] In fact, "Delaware's corporate statute is widely regarded as the most flexible in the nation because it leaves the parties to the corporate contract (managers and stockholders) with great leeway to structure their relations, subject to relatively loose statutory constraints and to the policing of director misconduct through equitable review." [61]

In sum, FFPs are facially valid under both the enabling text of Section 102(b)(1) and as a matter of Delaware public policy.

b. The 2015 Amendments Did Not Alter Section 102(b)(1)'s Broad Scope

[25] Section 115, added in the 2015 amendments to the DGCL, supports the view that FFPs are valid under Delaware law, and in particular, Section 102(b)(1). Section 115 provides:

> The certificate of incorporation or the bylaws may require, consistent with applicable jurisdictional requirements, that any or all internal corporate claims shall be brought solely and exclusively in any or all of the courts in this State, and no provision of the certificate of incorporation or the bylaws may prohibit bringing such claims in the courts of this State. "Internal corporate claims" means claims, including claims in the right of the corporation, (i) that are based upon a violation of a duty by a current or ***117** former director or officer or

> stockholder in such capacity, or (ii) as to which this title confers jurisdiction upon the Court of Chancery. [62]

The 2015 amendments were intended, in part, to codify *Boilermakers*, [63] and to preclude a charter or bylaw provision from excluding Delaware as a forum for internal corporate claims. Notably, Section 102(b)(1) was not amended. The synopsis to the bill introducing the legislation states that, "Section 115 is also not intended to authorize a provision that purports to foreclose suit in a federal court based on federal jurisdiction, nor is Section 115 intended to limit or expand the jurisdiction of the Court of Chancery or the Superior Court." [64] FFPs do not foreclose suits in federal court. Rather, they direct 1933 Act claims (federal claims) to federal court.

[26] **[27]** **[28]** **[29]** The 2015 amendment adding Section 102(f) further supports the view that Section 102(b)(1) remains expansive enough to include FFPs. Section 102(f) prohibits fee-shifting as against stockholders (of stock corporations) in connection with an "internal corporate claim," as defined in Section 115. Specifically, Section 102(f) provides:

> (f) The certificate of incorporation may not contain any provision that would impose liability on a stockholder for the attorneys' fees or expenses of the corporation or any other party in connection with an internal corporate claim, as defined in § 115 of this title. [65]

The language in Section 102(f) implies that Section 102(b)(1) can address claims other than "internal corporate claims." Otherwise, the reference to "internal corporate claims" in new Section 102(f) would not have been necessary. We must give meaning to every word in the statute. [66] Each part or section of a statute should be construed in connection with every other part or section to produce a harmonious whole. [67] "Statutory construction ... is a holistic endeavor." [68] It is presumed that "the General Assembly purposefully chose particular language and [we] therefore ***118** construe statutes to avoid surplusage if reasonably possible." [69] This reading is also consistent with our holding in *ATP*.

[30] The Appellee contends the 2015 amendments adding Section 115*implicitly* amended Section 102(b)(1). More specifically, the Appellee contends that Section 115 "reflects either prohibition [of FFPs] or implicit recognition that [FFPs] were never authorized by Section 102(b)(1) in the first place." [70] The Appellants disagree, arguing that because Section 115 does not explicitly state that a charter may not contain a forum-selection provision that addresses claims other than "internal corporate claims," Section 115 does not limit the scope of provisions that are permissible under Section 102(b)(1). [71]

[31] The Appellee's argument runs afoul of a number of well-established principles of statutory construction. First, "[c]ourts do not resort to other statutes if the statute being construed is clear and unambiguous." [72] Section 102(b)(1) is clear and unambiguous. By its terms, it does not incorporate Section 115.

[32] **[33]** Second, principles of statutory construction instruct that statutes should not be superseded or altered by implication unless there is an irreconcilable conflict. [73] The Appellee attempts to create a conflict between Section 102(b)(1) and Section 115 by reading Section 115 as modifying Section 102(b)(1). But the two statutes do not conflict—at least not irreconcilably. Indeed, an interpretation that harmonizes the two—as opposed to one that puts them in conflict with each other—is readily available here. Section 115 simply clarifies that *for certain claims*, Delaware courts may be the only forum, but they cannot be excluded as a forum. Section 102(b)(1)'s general and broad provisions govern all ***119** other claims. Thus, Section 115 is not properly viewed as modifying Section 102(b)(1).

Instead, Section 115 merely confirms affirmatively, as held in *Boilermakers*, that a charter may specify that internal

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

corporate claims must be brought in "the courts in this State" (presumably, including the federal court),[74] while prohibiting provisions that would preclude bringing internal corporate claims "in the courts of this State." Section 115, read fairly, does not address the propriety of forum-selection provisions applicable to other types of claims. If a forum-selection provision purports to govern intra-corporate litigation of claims that do not fall within the definition of "internal corporate claims," we must look elsewhere (back to Section 102(b)(1)) to determine whether the provision is permissible. This is because intra-corporate litigation relates to the business of the corporation (*see* *ATP*), and such provision is authorized under Delaware law and is facially valid.

[34] The Appellee's "implicit prohibition" also fails to account for the fact that, when the General Assembly enacted the 2015 amendments, it included explicit prohibitions against fee-shifting (*see* Section 102(f)) and forum-selection provisions that precluded litigation of internal corporate claims in Delaware state courts. The Appellee does not explain why the General Assembly, having explicitly prohibited certain provisions, did not do so as to others —*i.e.*, forum-selection provisions governing claims that are not internal corporate claims—if that is what it intended to do. Had the General Assembly intended for Section 115 to circumscribe the scope of Section 102(b)(1), it would have amended that subsection in the 2015 amendments as well. Prohibiting fee-shifting provisions for internal corporate claims in the new subsection (f) of Section 102, while leaving Section 102(b)(1) untouched, does not indicate that the General Assembly intended to impliedly amend Section 102(b)(1) to restrict its scope. Rather, it signals that the General Assembly intended to leave the scope of Section 102(b)(1) intact. Courts do not impliedly amend or supersede other statutes unless that intention is "manifestly clear."[75]

Moreover, the synopsis of Section 115 suggests that Section 115 did not impliedly amend Section 102(b)(1). The synopsis states, among other things, that "Section 115 does not address the validity of a provision of the certificate of incorporation or bylaws that selects a forum other than the Delaware courts as an additional forum in which internal corporate claims may be brought."[76] Although this caveat is tethered to internal corporate claims, the Appellee's reasoning (that a forum-selection provision not expressly permitted by Section 115, is implicitly prohibited) runs ***120** head-first into it. After all, if, Section 115's permissive provision defines the whole universe of permitted forum-selection provisions, the synopsis's clarification that provisions allowing "Delaware plus another" jurisdiction should be written directly in the statute's text. Without that direct permission, the *expressio unius* doctrine should cause Section 115 to prohibit such "Delaware plus another" provisions.[77]

Finally, the Appellee's analogy between Section 115 and 102(b)(7) is a faulty one.[78] These amendments differ in that, before the amendment of Section 102(b)(7), the default under our common law was that such provisions were impermissible. The opposite is true with respect to forum-selection provisions, which, prior to Section 115, were valid under Section 102(b) and Section 109(b). It is logical for the express language of a permissive statute like Section 102(b)(7) to designate the outer bounds of its scope if it were impermissible initially. That is not the case with Section 115. Forum provisions were valid prior to Section 115's enactment.

Read holistically, Section 115 indicates a concern for centering particular claims—"internal corporate claims"—in Delaware. This makes sense given Delaware's interest and expertise in corporate law. As Section 11 claims are not "internal corporate claims," Section 115 does not apply.[79] In sum, FFPs, which direct Section 11 claims to federal courts (which are most experienced in adjudicating them), do not violate Section 115 and are facially valid.

B. Section 102(b)(1) is Not Limited to "Internal Affairs" Matters

We disagree with the trial court's analysis in a number of respects. Among them, the Court of Chancery appears to have narrowed the broad enabling scope of Section 102(b)(1) in a way that is inconsistent with decisions by this Court and with the overall statutory scheme in Title 8.

 © 2022 Thomson Reuters. No claim to original U.S. Government Works.

***121** *1. ATP Suggests FFPs are Permissible Under Section 102(b)(1)*

FFPs involve intra-corporate claims. *ATP* concerned intra-corporate claims.[80] *ATP* supports the view that FFPs can fall within Section 102(b)(1) and be deemed facially valid.

In *ATP*, this Court considered certified questions regarding fee-shifting provisions in the bylaws of a non-stock corporation. The plaintiffs were members of the defendant ATP, a Delaware membership corporation that operated a global professional tennis tour. ATP amended its bylaws in 2006 to include a fee-shifting provision. The provision applied to any claim asserted by a member against the corporation whereby the member was required to reimburse the corporation for legal fees and costs incurred in connection with litigating the claim if the member did not obtain a judgment on the merits that substantially achieved, in substance and amount, the full remedy sought. Thus, the ATP bylaw "applie[d] in the event that a member brings a claim against another member, a member sues the corporation, or the corporation sues a member."[81] We referred to this scenario as "intra-corporate litigation."[82]

In 2007, ATP changed the tour schedule in a manner adverse to the plaintiff members. The members sued ATP based on federal antitrust, Delaware fiduciary duty, and other grounds. Specifically, the plaintiffs asserted that ATP and its Board violated sections 1 and 2 of the Sherman Act (Counts I–IV of the complaint), breached their fiduciary duties (Counts V–VII), tortiously interfered with the plaintiffs' contractual and business interests (Count VIII), and converted membership rights (Count IX). After trial, ATP prevailed on all claims.[83] Citing the fee-shifting bylaw, it then sought to recover its litigation fees and costs. The District Court denied ATP's motion, concluding that Article 23.3(a), the fee-shifting bylaw, was contrary to the policy underlying the federal antitrust laws.[84] It reasoned that federal law preempts the enforcement of fee-shifting agreements where antitrust claims are involved.

ATP appealed to the United States Court of Appeals for the Third Circuit. The Third Circuit vacated the District Court's order, and held that the District Court should have decided whether Article 23.3(a) was enforceable as a matter of Delaware law before addressing the federal preemption question.

After finding that the enforceability of the fee-shifting bylaw presented a novel question of Delaware law, the District Court certified four questions of law to the Delaware Supreme Court. The first question, relevant here, asked:

> ***122** May the Board of a Delaware non-stock corporation lawfully adopt a bylaw (i) that applies in the event that a member brings a claim against another member, a member sues the corporation, or the corporation sues a member (ii) pursuant to which the claimant is obligated to pay for "all fees, costs, and expenses of every kind and description (including, but not limited to, all reasonable attorneys' fees and other litigation expenses)" of the party against which the claim is made in the event that the claimant "does not obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought"?[85]

Responding to this question, this Court held as follows:

> A fee-shifting bylaw, like the one described in the first certified question, is facially valid. Neither the DGCL nor any other Delaware statute forbids the enactment of fee-shifting bylaws. A bylaw that allocates risk among parties in *intra-corporate litigation* would also appear to satisfy the DGCL's requirement that bylaws must "relat[e] to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees." The corporate charter could permit fee-shifting provisions, either explicitly or implicitly by silence. Moreover, no principle of common law prohibits directors from enacting fee-shifting bylaws.[86]

This Court held that the fee-shifting bylaw fell within both broad prongs of Section 102(b)(1)—namely, that it relates (i) to the "business of the corporation" and the "conduct of its affairs," and (ii) to the powers of the corporation or "the rights or powers of its stockholders, directors, officers or employees."[87]

The Court of Chancery suggests that since this Court was dealing with a facial challenge in *ATP*, so long as the claims involved a state law breach of fiduciary duty claim, that was enough for the bylaw in *ATP* to survive a facial

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

challenge. It then states that our Court in *ATP* "did not suggest that the corporate contract can be used to regulate other types of claims."[88] We disagree with these points for at least three reasons. First, *ATP* held that the fee-shifting bylaw fell within the scope of Section 109(b) and 102(b)(1). It did not purport to define the outer limits of either Section 109(b) or 102(b)(1). Similarly, *Boilermakers* only held that the forum-selection bylaw (which addressed only internal affairs)[89] easily fell within Section 109(b). ***123** Contrary to what the Court of Chancery suggests, *Boilermakers* did not establish the outer limit of what is permissible under either Section 109(b) or Section 102(b)(1). Second, not even Appellants are contending that Section 11 claims are "internal affairs" claims,[90] because Section 11 claims are not governed by substantive Delaware law. Rather, they are governed by federal law. But Section 11 claims are often asserted along with parallel state fiduciary duty and disclosure claims and very often involve the same or similar predicate facts and defenses.[91] As such, Section 11 claims are "internal" in the sense that they arise from internal corporate conduct on the part of the Board and, therefore, fall within Section 102(b)(1). *ATP* supports, rather than undermines, this conclusion. Third, the argument that *ATP*'s holding encompasses only state law fiduciary duty claims ignores the significance in that case of the federal antitrust claims as evidenced by this Court's repeated mention of those claims, and this Court's repeated use of the phrase "intra-corporate litigation," as opposed to the phrase, "internal affairs" claims.[92] At a minimum, this Court did not distinguish between the validity of the bylaw's application to the state law fiduciary claims and the federal antitrust claims.

2. The Trial Court Improperly Restricted the Scope of Section 102(b)(1)

The Court of Chancery narrowly interpreted *ATP* by concluding that "intracorporate litigation" was synonymous with only the state law fiduciary duty claims.[93] ***124** The court then relied primarily on *Boilermakers* to suggest that *Boilermakers* defined the permissible limits of Section 109(b) and confined it to only the "internal affairs" claims that were the subject of the bylaw at issue there. In eliminating the potentially broader reach of "internal" or "intra-corporate" claims (as evidenced by our holding in *ATP*), it basically stated that everything other than an "internal affairs" claim was "external" and, therefore, not the proper subject of a bylaw or charter provision.

To elaborate, the court below reasoned that, "[t]he *Boilermakers* distinction between internal and external claims answers whether a forum-selection provision can govern claims under the 1933 Act."[94] The court stated that, "a 1933 Act claim is external to the corporation,"[95] and then explained what it meant by an "external" claim:

> Federal law creates the claim, defines the elements of the claim, and specifies who can be a plaintiff or defendant. The 1933 Act establishes a statutory regime that applies when a particular type of property—securities—is offered for sale in particular scenarios that the federal government has chosen to regulate. The cause of action belongs to a purchaser of a security, and it arises out of an offer or sale. The defined term "security" encompasses a wide range of financial products. Shares of stock are just one of many types of securities, and shares in a Delaware corporation are just one subtype. A claim under the 1933 Act does not turn on the rights, powers, or preferences of the shares, language in the corporation's charter or bylaws, a provision in the DGCL, or the equitable relationships that flow from the internal structure of the corporation. Under *Boilermakers*, a 1933 Act claim is distinct from "internal affairs claims brought by stockholders *qua* stockholders."[96]

This result, it said, "derives from first principles."[97]

But *Boilermakers'* holding does not address external claims. Further, the dicta in *Boilermakers* regarding "external" claims suggests that its definition of "external" claims would exclude "intra-corporate" claims which, as explained above, do fall within Section 102(b)(1)'s broad scope. The two examples of external claims given in *Boilermakers* do not relate to the "affairs" of the corporation or the "powers" of its constituents (a tort claim for personal injury suffered by the plaintiff on the premises of the company or a contract claim involving a commercial contract).[98] As for these types of claims, no Board action is present as it necessarily is in Section 11

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

claims, and those claims are unrelated to the corporation-stockholder relationship. And in any event, the FFPs are limited to 1933 Act claims. Thus, FFPs are not "external," and *Boilermakers* does not suggest that they are.

***125 [35]** But by creating a binary world of only "internal affairs" claims and "external" claims, the Court of Chancery superimposed the "internal affairs" doctrine onto and narrowed the scope of Section 102(b)(1)—contrary to its plain language. It then concluded that Delaware corporations cannot regulate "external" claims that arise under the laws of other jurisdictions.[99] If our General Assembly wishes to narrow the scope of Section 102(b)(1) to be aligned perfectly with the boundaries of the internal affairs doctrine, it could do so. But until then, it is the obligation of our courts to construe the plain language of the statute.[100]

There is a category of matters that is situated on a continuum between the *Boilermakers* definition of "internal affairs" and its description of purely "external" claims. *ATP* suggests that certificate of incorporation provisions governing certain types of "intracorporate" claims that are not strictly within *Boilermakers'* "internal affairs," can be within the boundaries of the DGCL, and specifically Section 102(b)(1). And because we are dealing here with a facial challenge, it is possible to have a scenario where an FFP could apply to an intra-corporate claim. For example, existing stockholders could assert that a prospectus relating to shares of stock the directors were selling in a registered offering, signed by the directors of a Delaware corporation, contained material misstatements and omissions. That is enough to survive a facial challenge.

3. The Trial Court Also Narrowed the Definition of "Internal Affairs"

The Court of Chancery not only narrowed the scope of Section 102(b)(1), but it also narrowed the definition of "internal affairs" from both the established definition in the United States Supreme Court's decision in *Edgar v. MITE Corp.*[101] (which *Boilermakers* follows) and this Court's parallel definition in *McDermott v. Lewis*.[102] The following illustrates the point:

Table 1—Internal Affairs Definitions:
***126**

Edgar v. MITE Corp.	*McDermott v. Lewis*	*Sciabacucchi v. Salzberg*
"The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs—*matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders*—because otherwise a corporation could be faced with conflicting demands."[103]	"Internal corporate affairs involve those matters which are peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders."[104]	"A claim under the 1933 Act does not turn on the rights, powers, or preferences of the shares, language in the corporation's charter or bylaws, a provision in the DGCL, or the equitable relationships that flow from the internal structure of the corporation."[105]

[**Editor's Note:** The preceding image contains the references for footnotes [103], [104], [105]]

Focusing on the exact words used by the United States Supreme Court, the Delaware Supreme Court, and our General Assembly, the Court of Chancery's definition, on its face, is narrower than the traditional definition of "internal affairs" as used in *Edgar* and *McDermott*.

In *Edgar*, the United States Supreme Court reviewed a challenge to the Illinois Business Take-Over Act, which imposed certain requirements for takeover actions that were more onerous than the federal Williams Act regime. The United States Supreme Court struck down the Illinois law on Supremacy Clause and Commerce Clause grounds. It found that the Illinois law was a "direct restraint on interstate commerce and that it has a sweeping extraterritorial effect. Furthermore, if Illinois may impose such regulations, so may other States; and interstate commerce in securities transactions generated by tender offers would be thoroughly stifled."[106] It also held that the local interests that Illinois sought to protect did not outweigh the burden the law imposed on interstate commerce. The United States Supreme Court then described the internal affairs doctrine as follows:

> The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should

 © 2022 Thomson Reuters. No claim to original U.S. Government Works.

> have the authority to regulate a corporation's internal affairs—*matters peculiar to the relationships* ***127** *among or between the corporation and its current officers, directors, and shareholders*—because otherwise a corporation could be faced with conflicting demands. [107]

As applied to the Illinois law, the Court found that the internal affairs doctrine was "of little use to the State in this context" because "[t]ender offers contemplate transfers of stock by stockholders to a third party and do not themselves implicate the internal affairs of the target company." [108] Finally, the Court noted that the Illinois law extended to non-Illinois corporations with principal places of business outside of Illinois, and "Illinois has no interest in regulating the internal affairs of foreign corporations." [109]

Five years later, in *CTS Corp. v. Dynamics Corp. of America*, [110] the United States Supreme Court stated:

> It thus is an accepted part of the business landscape in this country for States to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares. A State has an interest in promoting stable relationships among parties involved in the corporations it charters, as well as in ensuring that investors in such corporations have an effective voice in corporate affairs. [111]

In *CTS*, the United States Supreme Court again reviewed a state takeover statute, this time belonging to the State of Indiana. The Court ruled that this law did not violate the Commerce Clause because the limited effect the tender offer rules had on interstate commerce were outweighed by the State's interest in defining attributes of its corporations' shares and in protecting shareholders. The Court also noted that the "free market system depends at its core upon the fact that a corporation—except in the rarest situations—is organized under, and governed by, the law of a single jurisdiction, traditionally the corporate law of the State of its incorporation." [112]

In *McDermott v. Lewis*, [113] this Court agreed with the scope of internal affairs established by the United States Supreme Court:

> Internal corporate affairs involve those matters which are *peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders*. It is essential to distinguish between acts which can be performed by both corporations and individuals, and those activities which are peculiar to the corporate entity. [114]

[36] As explained by this Court in *McDermott*, "[c]orporations and individuals alike enter into contracts, commit torts, and deal in personal and real property." ***128** [115] As to these types of matters, "[c]hoice of law decisions relating to such corporate activities are usually determined after consideration of the facts of each transaction." [116] The choice of law determination often turns on whether the corporation had sufficient contacts with the forum state in order to satisfy the constitutional requirements of due process. But, "[t]he internal affairs doctrine has no applicability in these situations." [117] "Rather, this doctrine governs the choice of law determinations involving matters *peculiar* to corporations, that is, those activities concerning the relationships *inter se* of the corporation, its directors, officers and shareholders." [118]

The Court in *McDermott* observed that, under Delaware conflict of law principles and the United States Constitution, there are appropriate circumstances which mandate application of the internal affairs doctrine. It held that Delaware's well-established conflict of laws principles required that the laws of the jurisdiction of incorporation (the Republic of Panama) govern the dispute involving the

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

Panamanian corporation's voting rights. It then explained that, "[t]he traditional conflicts rule developed by courts has been that internal corporate relationships are governed by the laws of the forum of incorporation." [119] We stated that, "[t]he internal affairs doctrine requires that the law of the state of incorporation should determine issues relating to internal corporate affairs." [120]

The *McDermott* decision rejected the notion that the more flexible Restatement approach of "weighing" various interests should apply to internal affairs matters. It observed that, following a California state court case in 1961 where a California court upheld an order of the California Commissioner of Corporations directing a Delaware corporation having major contacts with California to follow the cumulative voting requirements imposed by California law, commentators had suggested a "conflicts revolution" had started. The Court, citing the Restatement (Second) of Conflicts of Laws, §§ 302–06, 09 (1971), observed that the "new" conflicts theory "weighs the interests and policies of the forum state in determining whether the law of the forum—lex fori—should be applied." [121] But in rejecting the idea that this "new theory" should apply to internal affairs matters, this Court noted that, in reviewing cases over the prior twenty-six years, in all but a few, the law of the state of incorporation had been applied. Citing a 1968 article, this Court stated that the following statement had remained "apt:"

> The umbilical tie of the foreign corporation to the state of its charter is usually still religiously regarded as conclusive in determining the law to be applied in *intracorporate disputes*. The fundamental reexamination of the nature of conflict of laws over the past few years has virtually left foreign corporation matters remaining as a pocket of the past in a subject area which has otherwise been characterized by free inquiry, change and flux. [122]

***129** It then stated that the policy underlying the internal affairs doctrine "is an important one," and it declined to "erode the principle" by applying the Restatement's policy of weighing the interests and policies of the forum state. Instead, "[g]iven the significance of these considerations, application of the internal affairs doctrine is not merely a principle of conflicts law." [123] Rather, "[i]t is also one of serious constitutional proportions—under due process, the commerce clause and the full faith and credit clause —so that the law of one state governs the relationships of a corporation to its stockholders, directors and officers in matters of internal corporate governance." [124] Thus, we concluded that "the application of the internal affairs doctrine is mandated by constitutional principles, except in 'the rarest situations,' " [125] and that the alternatives present "almost intolerable consequences to the corporate enterprise and its managers." [126]

C. Section 102(b)(1) is More Expansive than Section 115's Definition of Internal Corporate Claims

As explained above, trial court erred in narrowing Section 102(b)(1) in a manner that prohibits FFPs. In addition to the statutory construction points above, other aspects of our statutory scheme show that Section 102(b)(1) is unquestionably broader than, and is not circumscribed by, Section 115's definition of "internal corporate claims." This is supported by the fact that other sections of the DGCL have an impact on conduct with persons who are not yet stockholders, such as Section 202 ("Restrictions on Transfer and Ownership of Securities"). [127] Section 202(a) provides that transfer restrictions in a stock certificate "may be enforced against the holder of the restricted security or securities or any successor or transferee of the holder." [128] Section 202(b) authorizes charter provisions that place "[a] restriction on the transfer or registration of transfer securities of a corporation, or on the amount of a corporation's securities that may be owned by any person or group of persons." [129]

Moreover, although it is clear that various provisions of our DGCL regulate certain transactions by which one can become a stockholder, it is arguable, from a plain reading of Section 115, that, in certain instances, claims arising from the purchase of stock could be an "internal corporate claim." For example, we observe that Section 111 was amended in 2003 to empower the Court of Chancery to interpret, apply, enforce or determine the validity of agreements pertaining to sales of stock by the corporation. [130] The Court of Chancery's

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

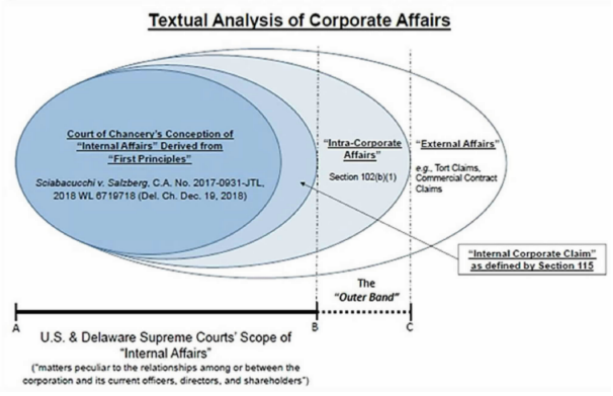
jurisdiction was expanded again in 2016 to ***130** include stock purchase agreements whereby one or more stockholders of the corporation sells or offers to sell their stock, and to which the stockholder or holders and the corporation are parties. [131] Section 115 includes within its definition of "internal corporate claims," claims "as to which this title confers jurisdiction upon the Court of Chancery." [132] Accordingly, that language, on its face, could include claims arising under Title 8 involving transactions with persons who are not yet stockholders, but who are parties to a stock purchase agreement where jurisdiction is based upon Section 111.

The trial court's main argument for deeming Section 11 claims to be "external" is that they arise from the purchase of shares, as opposed to share ownership. First, that is not necessarily the case. [133] Second, it does not matter as an FFP can survive a facial challenge based upon claims asserted by existing stockholders. Third, as shown above, our DGCL addresses a number of situations involving the purchase or transfer of shares. FFPs regulating the fora for Section 11 claims involving at least existing stockholders are neither "external" nor "internal affairs" claims. Rather, they are in-between in what might be called Section 102(b)(1)'s "Outer Band," as explained below.

D. FFPs as "Outer Band" Matters—Outside "Internal Affairs," but Within Section 102(b)(1)

The previous discussion lends to the inevitable conclusion that there is a category ***131** of matters that is situated on a continuum between the *Boilermakers* definition of "internal affairs" and its description of purely "external" claims. This conclusion logically follows from the points established thus far: (i) Section 102(b)(1)'s plain language encompasses "intra-corporate" matters that are not necessarily limited to "internal affairs;" (ii) our Delaware definition of "internal affairs" is consistent with the United States Supreme Court precedent; (iii) the Court of Chancery has narrowed our traditional definition of "internal affairs;" and (iv) there are purely "external" claims, *e.g.*, tort and commercial contract, which are clearly outside the bounds of Section 102(b)(1). These points are illustrated in Figure 1 below:

Figure 1:



Based upon our reasoning above, the universe of matters encompassed by Section 102(b)(1) is greater than the universe of internal affairs matters. This means that there is an area outside of the "internal affairs" boundary but within the Section 102(b)(1) boundary (between points B and C on Figure 1), which, for convenience, we refer to as Section 102(b)(1)'s "Outer Band." It is well-established that matters more traditionally defined as "internal affairs" or "internal corporate claims" are clearly within the protective boundaries (from points A to B) of *Edgar*, *McDermott*, and their progeny, where only one State has the authority to regulate a corporation's internal affairs—the state of incorporation. There are matters that are not "internal affairs," but are, nevertheless, "internal" or "intracorporate" and still within the scope of Section 102(b)(1) and the "Outer Band," represented in Figure 1 between points B to C. FFPs are in this Outer Band, and are facially valid under Delaware law because they are within the statutory scope of Section 102(b)(1), as explained above.

The Court of Chancery unduly constricted the scope of "internal affairs" by using "first principles." Perhaps this was out of a concern that upholding FFPs might be viewed unfavorably by our sister states and result in jeopardizing even the *Edgar*/*McDermott*-protected "solid ground" represented from points A to B—the traditional "internal affairs" or "internal corporate ***132** claims" territory. But Section 102(b)(1) makes room for FFPs in the Outer Band, even if FFPs are outside the more traditional realm of "internal affairs."

It is potentially problematic for our State to have a definition of "internal affairs" that diverges from, and is narrower than, the long-established definition set forth

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

in *Edgar*/*McDermott* and their progeny. Further, its narrower focus, based upon self-limiting "first principles," could create confusion and erode the established borders of the internal affairs doctrine, inviting encroachment from other jurisdictions into matters traditionally governed by that doctrine.

E. FFPs Survive a Facial Challenge as a Policy Matter

The FFPs survive a facial challenge as a policy matter as well. FFPs do not offend federal law and policy, nor do they offend principles of horizontal sovereignty.

1. FFPs Do Not Violate Federal Law or Policy

[37] FFPs do not violate federal law or policy. We refer to *Rodriguez de Quijas v. Shearson/American Express, Inc.*,[134] where the United States Supreme Court held that federal law has no objection to provisions that preclude state litigation of Securities Act claims. Specifically, the Supreme Court upheld an arbitration provision in a brokerage firm's standard customer agreement that precluded state court litigation of Securities Act claims. In enforcing the provision, the Court described it as "in effect, a specialized kind of forum selection clause" that "should not be prohibited under the Securities Act, since they, like the provision for concurrent jurisdiction [of federal and state courts], serve to advance the objective of allowing buyers of securities a broader right to select the forum for resolving disputes, whether it be judicial or otherwise."[135] The holding in *Rodriguez* provides forceful support for the notion that FFPs do not violate federal policy by narrowing the forum alternatives available under the Securities Act.

The Court of Chancery did not cite *Rodriguez*. It did address *Cyan*, but nothing in *Cyan* prohibits a forum-selection provision from designating federal court as the venue for litigating Securities Act claims.

[38] **[39]** Forum-selection provisions traditionally have been evaluated under the *Bremen*/*Ingres* line of cases. In *Ingres Corp. v. CA, Inc.*, this Court held that forum-selection clauses are presumptively valid and enforceable under Delaware law.[136] *Ingres* follows United States Supreme Court precedent in *M/S Bremen v. Zapata Off-Shore Co.* which requires courts to give as much effect as possible to forum-selection clauses,[137] and to "only deny enforcement of them to the limited extent necessary to avoid some fundamentally inequitable result or a result contrary to positive law."[138] It is unlikely that the ***133** Supreme Court in *Cyan* intended to limit *Rodriguez* or *Bremen* without explicitly discussing those cases.[139] Thus, we think the better view is that *Bremen* and *Rodriguez* still govern the enforcement of such provisions.

Appellee acknowledges that, "[t]here is no tension with the generic federal policy in favor of traditional, contractual, forum-selection clauses," and that, "[i]f sophisticated investors want to bind themselves to a federal forum by contract, they can."[140] He further acknowledges that, "Delaware generally enforces forum-selection provisions contained in a contract."[141] FFPs, as charter provisions, must be subjected to, and approved by a vote of the stockholders.[142] The logic underlying the validity of traditional contractual forum-selection clauses has some force in this stockholder-approved charter context.[143]

Other United States Supreme Court and Delaware Supreme Court cases in other contexts support the position that FFPs are not violative of federal policy. For example, in *Matsushita Electric Industrial Co. v. Epstein*,[144] the United States Supreme Court held that Delaware courts can settle claims subject to exclusive federal jurisdiction without violating federal law or policy. Similarly, in *Nottingham Partners v. Dana*,[145] this Court held that a settlement approved by the Court of Chancery that provided for the *extinguishment* of federal claims was valid and not violative of federal jurisdiction. If it is permissible for a Delaware state court to settle federal claims as part of a state court settlement (resulting in the *extinguishment* of the federal claims), then it follows that a provision in a Delaware corporation's charter requiring stockholders of the corporation to litigate federal claims in federal court is not violative of federal policy.

2. FFPs and Inter-State Policy

[40] Perhaps the most difficult aspect of this dispute is not with the facial validity of FFPs, but rather, with the "down

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

the road" question of whether they will be respected and enforced by our sister states. If FFPs are not "internal affairs" matters within the traditional *Edgar*/*McDermott* sense, and are not "internal corporate claims" within the meaning of Section 115,[146] then does that suggest ***134** that *Edgar's* protective boundaries may not fully encompass FFPs? Assuming that may be the case, can and should FFPs, nevertheless, be enforced by corporations when plaintiffs challenge them in state court?[147] We believe the answer is "yes."

[41] The question of enforceability is a separate, subsequent analysis that should not drive the initial facial validity inquiry. But we recognize that it is a powerful concern that has infused much of the briefing here. The fear expressed in some of the briefing is that our sister states might react negatively to what could be viewed as an out-of-our-lane power grab. Some say that this perception, in turn, could invite greater scrutiny of even the well-established and respected "internal affairs" territory. Or it could invite a move towards federalization of our corporate law. These are legitimate concerns. Delaware historically has, and should continue to be, vigilant about not stepping on the toes of our sister states or the federal government.

But there are persuasive arguments that could be made to our sister states that a provision in a Delaware corporation's certificate of incorporation requiring Section 11 claims to be brought in a federal court does not offend principles of horizontal sovereignty—just as it does not offend federal policy.

Given that FFPs are valid under Section 102(b)(1) even though they are not internal affairs matters, what is the proper framework for analyzing matters in this Outer Band? The analytical framework on each end of the continuum is fairly well-established. One commentator has described the framework for internal affairs matters, and for external matters, as follows:

> Typical choice-of-law analysis weighs various factors to determine which state has the most significant relationship to, therefore the greatest interest in regulating, the parties and matters at issue. This is the analysis most courts would apply to determine the law governing the corporation's *external* business activities, such as the corporation's relationships with its employees, contractors, suppliers, customers, and more broadly the general public.
>
> But with respect to *internal corporate matters*—matters involving the relationship between the corporation, its officers, directors, and shareholders—the internal affairs doctrine provides a different rule. Rather than trying to determine which state has the most significant relationship and interest in regulating these parties, the doctrine focuses instead on a single, decisive factor: the corporation's state of incorporation.[148]

Although FFPs are somewhere in-between, the rules for determining the validity of forum-selection provisions in the contractual context lend themselves well to ***135** the corporate charter context in Section 102(b)(1)'s Outer Band area. This is because corporate charters are viewed as contracts among the corporation's stockholders, as we recently reiterated in *BlackRock Credit Allocation Income Trust v. Saba Capital Master Fund, Ltd.*[149]

[42] **[43]** **[44]** **[45]** Typically, in a contractual setting, the party seeking to avoid enforcement of a forum-selection clause bears the burden of establishing that its enforcement would be unreasonable.[150] The subsequent court faced with an enforcement decision has a number of safety valves, as our own courts have recognized. Relying on the *Bremen*/*Ingres* principles, this Court recently observed that forum-selection clauses are "presumptively valid."[151] Given that we are addressing a facial challenge, we are not considering hypothetical, contextual situations regarding the adoption or application of FFPs. Such "as applied" challenges are an important safety valve in the enforcement context. As emphasized in *ATP*, whether the specific charter provision is enforceable "depends on the manner in which it was adopted and the circumstances under which it [is] invoked."[152] Charter and bylaw provisions that may otherwise be facially valid will not be enforced if adopted or used for an inequitable purpose.[153] *Bremen* identifies three bases on which forum-selection provisions might be invalidated on an "as applied" basis: (i) they will not be enforced if doing so would be "unreasonable and unjust;" (ii) they would be invalid for reasons such as fraud or overreaching; or (iii) they could be not enforced if they "contravene[d] a strong public policy of the forum in which suit is brought, whether declared by statute or by judicial decision."[154] In this facial challenge, none of these potential "as applied" challenges are implicated.

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

[46] **[47]** Given that many Section 11 claims closely parallel state law breach of fiduciary duty claims, many of the same reasons requiring application of the internal affairs doctrine would support the enforcement of FFPs. [155] As this Court noted ***136** in *McDermott* [156] and *VantagePoint*, [157] the internal affairs doctrine raises important Constitutional concerns—namely, under the Fourteenth Amendment Due Process Clause, the Full Faith and Credit Clause, and the Commerce Clause. Due Process concerns address the officers' and directors' rights "to know what law will be applied to their actions," as well as stockholders' "right to know by what standards of accountability they may hold those managing the corporation's business and affairs." [158] As this Court stated in *McDermott*, "full faith and credit commands application of the internal affairs doctrine except in the *rare* circumstance where national policy is outweighed by a significant interest of the forum state in the corporation and its shareholders." [159] The need for uniformity and predictability that FFPs address suggest that they fall closer to the "internal affairs" side of the spectrum, which would argue in favor of deference being given to them.

[48] **[49]** Further, a well-developed body of law, including Commerce Clause precedent, already exists to prevent a valid state law from having extraterritorial application. [160] "The limits on a State's power to enact substantive legislation are similar to the limits on the jurisdiction of state courts. In either case, any attempt directly to assert extraterritorial jurisdiction over persons or property would offend sister states and exceed the inherent limits of the State's power." [161] But as the Court of Chancery recognized in *Boilermakers*, forum-selection provisions "are process-oriented," and are not substantive. [162] They "regulate *where* stockholders may file suit, not *whether* the stockholder may file suit or the kind of remedy that the stockholder may obtain on behalf of herself or the corporation." [163] Thus, FFPs, as procedural ***137** mechanisms, do not offend these constitutional principles.

Finally, Delaware forum provisions sanctioned by *Boilermakers*, and respected by other states in recent years, are arguably more restrictive than FFPs. That is so because they may require non-resident stockholders to litigate their internal affairs claims exclusively in Delaware—potentially far from their geographic home-base. By contrast, FFPs require that non-residents bring Section 11 claims in federal court (which could be in their home state).

In sum, FFPs, as a facial matter, do not violate principles of horizontal sovereignty.

F. The Fee Award

In view of our decision above, we reverse the fee award.

IV. Conclusion

FFPs are a relatively recent phenomenon designed to address the post-*Cyan* difficulties presented by multi-forum litigation of Securities Act claims. The policies underlying the DGCL include certainty and predictability, [164] uniformity, [165] and prompt judicial resolution to corporate disputes. [166] Our law strives to enhance flexibility in order to engage in private ordering, and to defer to case-by-case law development. Delaware courts attempt "to achieve judicial economy and avoid duplicative efforts among courts in resolving disputes." [167] FFPs advance these goals.

Our General Assembly has also recognized the need to maintain balance, efficiency, fairness, and predictability in protecting the legitimate interests of all stakeholders, and to ensure that the laws do not impose unnecessary costs on Delaware entities. [168] FFPs do not violate that sense of balance as they allow for litigation of federal Securities Act claims in a federal court of plaintiff's choosing, but also allow for consolidation and coordination of such claims to avoid inefficiencies and unnecessary costs. [169]

Finally, our DGCL was intended to provide directors and stockholders with flexibility and wide discretion for private ordering and adaptation to new situations. [170] "[T]hat a board's action might involve a new use of plain statutory authority does not make it invalid under our law, and the boards of Delaware corporations have the ***138** flexibility to respond to changing dynamics in ways that are authorized by our statutory law." [171]

For the reasons set forth above, we **REVERSE** the decision of the Court of Chancery.

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

All Citations

227 A.3d 102

Footnotes

* Sitting by designation under Del. Const. Art. IV § 12.

1 *Sciabacucchi v. Salzberg*, 2018 WL 6719718, at *6 (Del. Ch. Dec. 19, 2018) [hereinafter *Opinion*]. Defendants Stitch Fix, Inc. and Roku, Inc. adopted substantively identical provisions, while Blue Apron, Inc. qualified its FFP to have effect "to the fullest extent permitted by law." *Id.; see* App. to Opening Br. at A69, A84, A100.

2 *Opinion*, 2018 WL 6719718, at *3.

3 15 U.S.C. § 77e.

4 *Cyan, Inc. v. Beaver Cty. Emps. Ret. Fund*, —— U.S. ——, 138 S.Ct. 1061, 1066, 200 L.Ed.2d 332 (2018) (internal quotation marks omitted).

5 *Id.; see also Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, 575 U.S. 175, 179, 135 S.Ct. 1318, 191 L.Ed.2d 253 (2015) ("The Securities Act of 1933 ... protects investors by ensuring that companies issuing securities (known as 'issuers') make a 'full and fair disclosure of information' relevant to a public offering.").

6 *Cyan*, 138 S. Ct. at 1079; *see*15 U.S.C. § 77v(a) ("The district courts of the United States and the United States courts of any Territory shall have jurisdiction of offenses and violations under this subchapter ... and, concurrent with State and Territorial courts, except as provided in section 77p of this title with respect to covered class actions, of all suits in equity and actions at law brought to enforce any liability or duty created by this subchapter.").

7 *See*15 U.S.C. § 77v(a) ("Except as provided in section 77p(c) of this title, no case arising under this subchapter and brought in any State court of competent jurisdiction shall be removed to any court of the United States."); *see also Cyan*, 138 S.Ct. at 1078 ("[The Securities Litigation Uniform Standards Act of 1998 ('SLUSA')] did nothing to strip state courts of their longstanding jurisdiction to adjudicate class actions alleging only 1933 Act violations. Neither did SLUSA authorize removing such suits from state to federal court.").

8 *Cyan*, 138 S.Ct. at 1066.

9 15 U.S.C. § 77*l*(a)(1).

10 *Pinter v. Dahl*, 486 U.S. 622, 638, 108 S.Ct. 2063, 100 L.Ed.2d 658 (1988).

11 15 U.S.C. § 77k(a).

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

12 *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381, 103 S.Ct. 683, 74 L.Ed.2d 548 (1983).

13 *Id.* at 382, 103 S.Ct. 683 (citations omitted); *see also* *Omnicare*, 575 U.S. at 179, 135 S.Ct. 1318 ("Section 11 thus creates two ways to hold issuers liable for the contents of a registration statement—one focusing on what the statement says and the other on what it leaves out. Either way, the buyer need not prove (as he must to establish certain other securities offenses) that the defendant acted with any intent to deceive or defraud." (citation omitted)); *In re Morgan Stanley Info. Fund Sec. Litig.*, 592 F.3d 347, 358–59 (2d Cir. 2010) (stating that, to state a claim under Section 11, a plaintiff must allege that "(1) she purchased a registered security, either directly from the issuer or in the aftermarket following the offering; (2) the defendant participated in the offering in a manner sufficient to give rise to liability under section 11; and (3) the registration statement 'contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading' " (quoting 15 U.S.C. § 77k(a))).

14 *See*15 U.S.C. § 77k(a)(1)–(5) (listing potential defendants).

15 *Huddleston*, 459 U.S. at 382, 103 S.Ct. 683.

16 15 U.S.C. § 77*l*(a)(2).

17 *Morgan Stanley*, 592 F.3d at 359; *see*15 U.S.C. §§ 77z–1, 78u–4.

18 *Morgan Stanley*, 592 F.3d at 359 (internal quotations and alterations omitted).

19 15 U.S.C. § 77*o*(a).

20 *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 81, 126 S.Ct. 1503, 164 L.Ed.2d 179 (2006).

21 *Id.* (summarizing 15 U.S.C. § 78u–4).

22 *Id.* at 82, 126 S.Ct. 1503.

23 *Opinion*, 2018 WL 6719718, at *6.

24 App. to Opening Br. at A84, A100.

25 *Id.* at A69 (emphasis added). The language difference between the two provisions is immaterial to our decision.

26 73 A.3d 934 (Del. Ch. 2013).

27 91 A.3d 554 (Del. 2014).

28 *Opinion*, 2018 WL 6719718, at *3.

29 *Id.*

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

30 *In re Krafft-Murphy Co., Inc.*, 82 A.3d 696, 702 (Del. 2013).

31 *Id.*

32 *Corvel Corp. v. Homeland Ins. Co. of N.Y.*, 112 A.3d 863, 868 (Del. 2015).

33 *Cedarview Opportunities Master Fund, L.P. v. Spanish Broad. Sys., Inc.*, 2018 WL 4057012, at *20 (Del. Ch. Aug. 27, 2018) (quoting *Boilermakers*, 73 A.3d at 948) (internal quotation marks omitted).

34 *Boilermakers*, 73 A.3d at 949 (citing *Stroud v. Grace*, 606 A.2d 75, 79 (Del. 1992) and *Frantz Mfg. Co. v. EAC Indus.*, 501 A.2d 401, 407 (Del. 1985)).

35 8 *Del. C.* § 102. *See State v. Barnes*, 116 A.3d 883, 888 (Del. 2015) ("The starting point for the interpretation of a statute begins with the statute's language."); *Friends of H. Fletcher Brown Mansion v. City of Wilmington*, 34 A.3d 1055, 1059 (Del. 2011) ("[T]he meaning of a statute must, in the first instance, be sought in the language in which the act is framed, and if that is plain ... the sole function of the courts is to enforce it according to its terms." (quoting *Caminetti v. United States*, 242 U.S. 470, 485, 37 S.Ct. 192, 61 L.Ed. 442 (1917)) (internal quotation marks omitted)).

36 *Boilermakers*, 73 A.3d at 950 (citing *New Cingular Wireless PCS v. Sussex Cty. Bd. Of Adjustment*, 65 A.3d 607, 611 (Del. 2013)).

37 *Kofron v. Amoco Chems. Corp.*, 441 A.2d 226, 230 (Del. 1982).

38 8 *Del. C.* § 102(b)(1).

39 *Malone v. Brincat*, 722 A.2d 5, 13 (Del. 1998); *see id.* at 12 ("When corporate directors impart information they must comport with the obligations imposed by both the Delaware law and the federal statutes and regulations of the [SEC]."); *id.* at 13 (observing that, "[t]he historic roles played by state and federal law in regulating corporate disclosures have been not only compatible but complimentary" (citing *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 474–80, 97 S.Ct. 1292, 51 L.Ed.2d 480 (1977))).

40 —— U.S. ——, 138 S.Ct. 1061, 200 L.Ed.2d 332.

41 Stanford Law Sch. Secs. Class Action Clearinghouse & Cornerstone Research, *Securities Class Action Filings 2018 Year in Review* 22 (2019). The report notes that in 2018, the combined number of federal Section 11 filings and state 1933 Act filings was 41. This consisted of 13 parallel filings, 17 state-only filings, and 11 federal-only filings. Further, "these filings in federal and state courts increased by 52 percent compared to 2017 due to the rise in state filing activity." *Id.* at 21. In 2018, 16 class actions alleging 1933 Act violations were filed in California state courts, 13 were filed in New York state courts, and four were filed in other state courts. The 2018 Report concludes that, "[f]ilings in New York state courts appear to have markedly increased in 2018 as a result of the *Cyan* decision," and that, "[a]ll 13 1933 Act filings in New York were filed after the U.S. Supreme Court's ruling in March." *Id.* at 19.

42 *Id.* at 10.

43 *Id.* at 21.

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

44 Stanford Law Sch. Secs. Class Action Clearinghouse & Cornerstone Research, *Securities Class Action Filings 2019 Year in Review* 4 (2020). The report notes that 1933 Act filings in California state courts decreased from 2018 to 2019, but filings in New York and other states rose substantially, with New York state courts becoming the preferred state venue for 1933 Act plaintiffs. *Id.*

45 *Id.* at 22.

46 *Id.* at 25.

47 *Id.*

48 *Id.* at 24.

49 *Id.* at 25.

50 The 2019 report notes "as an example of post-*Cyan* jurisdictional complexities," that in 2019, SmileDirectClub was the subject of securities class action filings in New York federal court, Tennessee federal and state courts, and Michigan federal and state courts. *Id.* at 24.

51 In *Boilermakers*, the Court of Chancery held that as "a matter of easy linguistics," the forum bylaws were valid under Section 109(b) "because they regulate *where* stockholders may file suit." 73 A.3d at 950–52. They also "plainly relate to the 'business of the corporation[s],' the 'conduct of [their] affairs,' and regulate the 'rights and powers of [their] stockholders.' " *Id.* at 939.

52 8 *Del. C.* § 102(b)(1).

53 93 A.2d 107 (Del. 1952).

54 *Id.* at 118.

55 *Id.* There are a few statutory provisions that cannot be limited in a certification of incorporation. *See* Edward P. Welch & Robert S. Saunders, *Freedom and Its Limits in the Delaware GeneralCorporation Law*, 33 Del. J. Corp. L. 845, 856–60 (2008) (discussing cases concerning the rights of stockholders to periodically elect directors, to inspect books and records, and directors' duty of loyalty).

56 671 A.2d 1368 (Del. 1996).

57 *Id.* at 1381.

58 *See Nat'l Indus. Grp. (Hldg.) v. Carlyle Inv. Mgmt. L.L.C.*, 67 A.3d 373, 387 (Del. 2013) ("The enforcement of an international forum selection clause is not an issue of comity. It is a matter of contract enforcement and giving effect to substantive rights that the parties have agreed upon.").

59 Welch & Saunders, *supra* note 55, at 847.

60 *Williams*, 671 A.2d at 1381.

61 *Jones Apparel Grp., Inc. v. Maxwell Shoe Co., Inc.*, 883 A.2d 837, 845 (Del. Ch. 2004).

62 8 *Del. C.* § 115. A similar provision was adopted in 2000 in the alternative entity context in response to this Court's decision in *Elf Atochem N. Am., Inc. v. Jaffari*, 727 A.2d 286 (Del. 1999). In that case, this Court

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

upheld a forum-selection clause in the company's operating agreement which designated a foreign jurisdiction as the exclusive jurisdiction for internal disputes. In response, our General Assembly adopted Section 18-109(d) of the Delaware LLC Act prohibiting a Delaware LLC from designating a foreign jurisdiction as its exclusive jurisdiction for internal disputes. The Delaware Limited Partnership Act was similarly amended.

63 73 A.3d 934.

64 Del. S.B. 75 syn., 148th Gen. Assem. (2015).

65 8 *Del. C.* § 102(f). The 2015 amendments do not disturb the ruling in *ATP Tour Inc. v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014), in relation to nonstock corporations. Del. S.B. 75 syn. The synopsis also states that, "[n]ew subsection (f) is not intended, however, to prevent the application of such provisions pursuant to a stockholders agreement or other writing signed by the stockholder against whom the provision is to be enforced." *Id.*

66 *Doroshow, Pasquale, Krawitz & Bhaya v. Nanticoke Mem. Hosp., Inc.*, 36 A.3d 336, 344 (Del. 2012) (affirming the "canon of statutory construction that every word chosen by the legislature (and often bargained for by interested constituent groups) must have meaning").

67 *Grimes v. Alteon Inc.*, 804 A.2d 256, 265 n.35 (Del. 2002) (*en banc*) (citing 2A Norman J. Singer, *Sutherland on Statutory Construction* § 46:05 (2000)).

68 *Terex Corp. v. S. Track & Pump, Inc.*, 117 A.3d 537, 543 (Del. 2015); *see also Spielberg v. State*, 558 A.2d 291, 293 (Del. 1989) (stating that, statutes "must be viewed as a whole").

69 *Sussex Cty. Dep't of Elections v. Sussex Cty. Republican Comm.*, 58 A.3d 418, 422 (Del. 2013) (citing *CML V, LLC v. Bax*, 28 A.3d 1037, 1041 (Del. 2011)); *see Clark v. State*, 65 A.3d 571, 578 (Del. 2013); *Zhurbin v. State*, 104 A.3d 108, 110 (Del. 2014); *Chase Alexa, LLC v. Kent Cty. Levy Ct.*, 991 A.2d 1148, 1152 (Del. 2010) ("[W]ords in a statute should not be construed as surplusage if there is a reasonable construction which will give them meaning, and courts must ascribe a purpose to the use of statutory language, if reasonably possible." (quoting *Oceanport Indus., Inc. v. Wilmington Stevedores, Inc.*, 636 A.2d 892, 900 (Del. 1994)) (internal quotation marks omitted)). "The legislative body is presumed to have inserted every provision for some useful purpose and construction, and when different terms are used in various parts of a statute it is reasonable to assume that a distinction between the terms was intended." *Giuricich v. Emtrol Corp.*, 449 A.2d 232, 238 (Del. 1982) (citation omitted). *See Leatherbury v. Greenspun*, 939 A.2d 1284, 1291 (Del. 2007) (stating that, "[i]t is well established that a court may not engraft upon a statute language which has clearly been excluded therefrom," and that, "when provisions are expressly included in one statute but omitted from another, we must conclude that the General Assembly intended to make those omissions").

70 Answering Br. at 18.

71 Opening Br. at 24; Reply Br. at 8–11.

72 2A Norman J. Singer, *Sutherland Statutory Construction* § 51:1 (7th ed.).

73 "It is assumed that when the General Assembly enacts a later statute in an area covered by a prior statute, it has in mind the prior statute and therefore statutes on the same subject must be construed together so that effect is given to every provision unless there is an irreconcilable conflict between the statutes, in which case

 © 2022 Thomson Reuters. No claim to original U.S. Government Works.

the later supersedes the earlier." *State v. Fletcher*, 974 A.2d 188, 193 (Del. 2009) (quoting *State, Dept. of Labor v. Minner*, 448 A.2d 227, 229 (Del. 1982)); *State v. Cook*, 600 A.2d 352, 355 (Del. 1991); *State ex. rel. Green v. Foote*, 168 A. 245, 247 (Del. 1933) ("When there are two Acts on the same subject the rule is to give effect to both if possible. But if the two are repugnant in any of their provisions, the later Act, without any repealing clause, operates to the extent of the repugnancy as a repeal of the first.").

74 "New Section 115 confirms, as held in *Boilermakers Local 154 Retirement Fund v. Chevron Corporation*, 73 A.3d 934 (Del. Ch. 2013), that the certificate of incorporation and bylaws of the corporation may effectively specify, consistent with applicable jurisdictional requirements, that claims arising under the DGCL, including claims of breach of fiduciary duty by current or former directors or officers or controlling stockholders of the corporation, or persons who aid and abet such a breach, must be brought only in the courts (including the federal court) in this State." Del. S.B. 75 syn.

75 *Foote*, 168 A. at 247 ("Whether such statutes repeal the previously existing law, in the absence of a repeal in express terms, depends upon the presence or absence of an irreconcilable inconsistency between them, unless it is manifestly clear that the later enactment is intended to supersede the earlier law and embrace the whole subject-matter.").

76 Del. S.B. 75 syn.; *see* R. Franklin Balotti & Jesse A. Finkelstein, *Delaware Law of Corporation & Business Organizations, Statutory Deskbook* 114-M (2017 ed.).

77 The *expressio unius est exclusio alterius* doctrine ("*expressio unius*" for short) is "[a] canon of construction holding that to express or include one thing implies the exclusion of the other, or of the alternative." *Expressio unius est exclusion alterius*, Black's Law Dictionary (11th ed. 2019). However, it "properly applies only when the *unius* (or technically *unum*, the thing specified) can reasonably be thought to be the expression of *all* that shares in the grant or prohibition involved. Common sense often suggests when this is or is not so." Antonin Scalia & Bryan A. Garner, *Reading Law: The Interpretation of Legal Texts* 107 (2012); *see also* William N. Eskridge, Jr. *Interpreting Law: A Primer on How to Read Statutes and the Constitution* 408 (2016) (stating that, the *expressio unius* canon is "[i]napplicable if statutory purpose or context suggests listing is not comprehensive"). Section 115 merely confirms, as held in *Boilermakers*, that charters and bylaws may effectively specify that internal corporate claims must be brought in "the courts in this State." 2A Norman J. Singer, *Sutherland Statutory Construction* § 47:23 (7th ed.) ("*[E]xpressio unius* is a rule of statutory construction and ... is subordinate to the primary rule that legislative intent governs the interpretation of a statute ....").

78 *See* Answering Br. at 18–19 (arguing that, "Section 102(b)(7)'s express prohibition of some exculpatory provisions ... could be read to implicitly authorize any exculpatory provision not expressly forbidden.").

79 Neither side in this case argues that Section 115's definition of "internal corporate claims" encompasses Section 11 claims. We think Section 115 likely was intended to address claims requiring the application of Delaware corporate law as opposed to federal law. Stated differently, we do not think the General Assembly intended to encompass federal claims within the definition of internal corporate claims. Thus, Section 115 is not implicated. And the fact that Section 102(b)(1) was not amended indicates that it remains broad enough to address other than internal corporate claims.

80 91 A.3d 554.

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

81 *Id.* at 557; *see* *id.* at 559.

82 *See* *id.* at 557, 558.

83 The District Court granted judgment as a matter of law to ATP and the individual defendants on all of the state law counts, and to the individual defendants on the antitrust claims. A jury found ATP not liable for any antitrust violations. The Third Circuit affirmed the judgment. *Deutscher Tennis Bund v. ATP Tour, Inc.*, 610 F.3d 820 (3d Cir. 2010), *cert. denied*, 562 U.S. 1064, 131 S.Ct. 658, 178 L.Ed.2d 482 (2010).

84 *Deutscher Tennis Bund v. ATP Tour, Inc.*, 2009 WL 3367041, at *4 (D. Del. Oct. 19, 2009), *vacated*, 480 Fed.Appx. 124 (3d Cir. 2012). The District Court relied primarily on the Third Circuit's decision in *Byram Concretanks, Inc. v. Warren Concrete Prods. Co. of N.J.*, 374 F.2d 649, 651 (3d Cir. 1967), which held that, "in the absence of specific legislative authorization[,] attorneys' fees may not be awarded to defendants in private anti-trust litigation." Accordingly, the District Court refused to give effect to Article 23.3.

85 *ATP*, 91 A.3d at 557.

86 *Id.* at 558 (emphasis added).

87 *Id.*

88 *Opinion*, 2018 WL 6719718, at *13.

89 The bylaw provision in *Boilermakers* provided:

> Unless the Corporation consents in writing to the selection of an alternative forum, the Court of Chancery of the State of Delaware shall be the sole and exclusive forum for (i) any derivative action or proceeding brought on behalf of the Corporation, (ii) any action asserting a claim of breach of a fiduciary duty owed by any director, officer or other employee of the Corporation to the Corporation or the Corporation's stockholders, (iii) any action asserting a claim arising pursuant to any provision of the Delaware General Corporation Law, or (iv) any action asserting a claim governed by the internal affairs doctrine. Any person or entity purchasing or otherwise acquiring any interest in shares of capital stock of the Corporation shall be deemed to have notice of and consented to the provisions of this [bylaw].

Boilermakers, 73 A.3d at 942. Although prong (iv) of this bylaw refers explicitly to "internal affairs," the Court of Chancery appropriately observed that all four prongs concern internal affairs. *Id.*

90 During the oral argument before this Court, the following exchange occurred:

> Justice Valihura: Are you arguing then, that these provisions are not within the internal affairs doctrine as say articulated by *Edgar v. MITE*? And I think there the U.S. Supreme Court said "matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders" and I think this Court used a similar description in the *VantagePoint* case.
>
> Mr. Chandler: You did. You did, a very similar description. My argument Your Honor, our argument, is that these provisions are intra-corporate claims. They touch upon the very same kind of internal relationships and conduct that the internal affairs doctrine, the difference is, there's only one difference. Even though the

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

> claim is internal in the same sense as an internal affairs claim, it doesn't arise under the same law. It arises under federal law. That's the only difference. Otherwise, it's the same relationships involved, boardroom conduct, stockholder status as a stockholder. That's the same thing as it is in an internal affairs claim, but it's not the same because it arises under a different law. And our point is a simple one, just because it arises under federal law, doesn't mean that it is now an external claim. That suddenly translates into an external claim, no it doesn't. Because it involves the same intra-corporate conduct as an internal affairs claim does. So they're the same. And that's why they can be treated under our law the same and the forum selection-provision can be applied to them. Just as this one, these three do.

Oral Argument Video at 21:55–23:22, https://livestream.com/DelawareSupremeCourt/events/8952021/videos/200564724.

91 *See* *Malone*, 722 A.2d at 12.

92 Moreover, we think it is more likely that the "novelty" of the issue perceived by the federal court seeking certification (and by this Court in accepting certification) involved the question of whether a Delaware charter or bylaw provision could properly address an intra-corporate claim (*e.g.*, a federal antitrust claim) that was not an "internal affairs" claim.

93 This is evident from the following passage in the Opinion below, explaining this Court's holding in *ATP*:

> Although the plaintiffs in the underlying action also asserted claims for antitrust violations, tortious interference, and conversion, the Delaware Supreme Court interpreted the certified question as only asking about the validity of the bylaw for purposes of "intra-corporate litigation." The Delaware Supreme Court then held that the bylaw was facially valid because it "allocate[d] risk among parties in intracorporate litigation ...." The Delaware Supreme Court did not suggest that the corporate contract can be used to regulate other types of claims.

Opinion, 2018 WL 6719718, at *13. But, there is nothing that suggests this Court narrowed its focus so as to mean that "intra-corporate" litigation referred only to the state law fiduciary duty claims.

94 *Id.* at *1.

95 *Id.*

96 *Id.*

97 *Id.* at *2.

98 *See* 73 A.3d at 952.

99 Commentators also have viewed the choice as a binary one. *See*, *e.g.*, Mohsen Manesh, *The Contested Edges of Internal Affairs*, 87 Tenn. L. Rev. (forthcoming 2020) (manuscript at 48) (available at https://dx.doi.org/10.2139/ssrn.3435165) ("Delaware has much staked on the basic distinction that the [internal affairs] doctrine makes—the distinction between internal corporate affairs versus external matters."); *see also id.* at 54 ("So again, which is it? Are the rights of shareholders arising under federal securities law—rights that arise upon the purchase or sale of a corporation's shares—an internal corporate affair or an external matter?").

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

100 *See* *In re Adoption of Swanson*, 623 A.2d 1095, 1099 (Del. 1993) ("We have long held that our courts do not sit as a superlegislature to eviscerate proper legislative enactments." (citation omitted)).

101 457 U.S. 624, 102 S.Ct. 2629, 73 L.Ed.2d 269 (1982).

102 531 A.2d 206 (Del. 1987).

103 457 U.S. at 645, 102 S.Ct. 2629 (citing Restatement (Second) of Conflict of Laws § 302, Comment *b*, pp. 307–08 (1971)).

104 531 A.2d at 214 (citing *Edgar*, 457 U.S. at 645, 102 S.Ct. 2629 and Restatement (Second) of Conflict of Laws § 313, Comment *a* (1971)).

105 2018 WL 6719718, at *1. The court also stated:

> As the sovereign that created the entity, Delaware can use its corporate law to regulate the corporation's internal affairs. For example, Delaware corporate law can specify the rights, powers, and privileges of a share of stock, determine who holds a corporate office, and adjudicate the fiduciary relationships that exist within the corporate form. When doing so, Delaware deploys the corporate law to determine the parameters of the property rights that the state has chosen to create.

Id. at *2.

106 *Edgar*, 457 U.S. at 642, 102 S.Ct. 2629.

107 *Id.* at 645, 102 S.Ct. 2629.

108 *Id.*

109 *Id.* at 645–46, 102 S.Ct. 2629.

110 481 U.S. 69, 107 S.Ct. 1637, 95 L.Ed.2d 67 (1987).

111 *Id.* at 91, 107 S.Ct. 1637.

112 *Id.* at 90, 107 S.Ct. 1637.

113 531 A.2d 206.

114 *Id.* at 214 (citing *Edgar*, 457 U.S. at 645, 102 S.Ct. 2629 and Restatement (Second) of Conflict of Laws § 313, Comment *a* (1971)); *see also* *VantagePoint Venture P'rs 1996 v. Examen, Inc.*, 871 A.2d 1108, 1113 (Del. 2005) ("The internal affairs doctrine applies to those matters that pertain to the relationships among or between the corporation and its officers, directors, and shareholders."); *Sagarra Inversiones, S.L. v. Cementos Portland Valderrivas, S.A.*, 34 A.3d 1074, 1082 (Del. 2011).

115 *McDermott*, 531 A.2d at 214. These types of matters are clearly "external."

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

116 *Id.* at 214–15 (citing Reese and Kaufman, *The Law Governing Corporate Affairs: Choice of Law and the Impact of Full Faith and Credit*, 58 Colum. L. Rev. 1118, 1121 (1958)).

117 *Id.* at 215.

118 *Id.*

119 *Id.*

120 *Id.*

121 *Id.*

122 *Id.* at 216 (citing Kaplan, *Foreign Corporations and Local Corporate Policy,* 21 Vand. L. Rev. 433, 464 (1968)) (emphasis added).

123 *Id.*

124 *Id.* "If the doctrine is only a choice-of-law rule, then any state is free to adopt or reject it." Hon. Jack Jacobs, *The Reach of State Corporate Law Beyond State Borders*, 84 N.Y.U. L. Rev. 1149, 1164 (2009).

125 *McDermott*, 531 A.2d at 217.

126 *Id.* at 216. *See also* *VantagePoint*, 871 A.2d at 1112 ("The internal affairs doctrine is a longstanding choice of law principle which recognizes that only one state should have the authority to regulate a corporation's internal affairs—the state of incorporation.").

127 8 *Del. C.* § 202. *See also* 8 *Del. C.* § 152 (regulating the form of payment of stock subscriptions); 8 *Del. C.* § 157 (authorizing provisions governing the rights and options to acquire stock). Further, DGCL Section 166, addressing stock subscriptions, provides that a "subscription for stock of a corporation ... shall not be enforceable against a subscriber, unless in writing and signed by the subscriber or by such subscriber's agent." 8 *Del. C.* § 166.

128 8 *Del. C.* § 202(a).

129 8 *Del. C.* § 202(b).

130 Section 111 was amended and restated in 2003. The 2003 version stated:

> (a) Any civil action to interpret, apply, enforce, or determine the validity of the provisions of ... (2) any instrument, document or agreement by which a corporation creates or sells, or offers to create or sell, any of its stock, or any rights or options respecting its stock ... [m]ay be brought in the Court of Chancery, except to the extent that a statute confers exclusive jurisdiction on a court, agency, or tribunal other than the Court of Chancery.

8 *Del. C.* § 111 (2003); Del. S.B. 127 syn., 142nd Gen. Assem. (2003). This revision covers instruments, documents, or agreements pertaining to sales of stock by the issuing corporation, including offering materials and purchase agreements, and thus could include persons who are not yet stockholders. *See* Lewis S. Black, Jr. & Frederick H. Alexander, *Analysis of the 2003 Amendments to the Delaware General Corporation Law*

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

4 (2003) (noting that, "[a]s revised, Section 111 goes well beyond covering actions involving charters and bylaws, and provides that actions involving documents concerning the sale of stock, restrictions on transfer, proxy relationships, voting trusts, mergers, conversions, domestications, and instruments required by any provision of the General Corporation Law, as well as any action to interpret, apply or enforce any provision of the statute, may be brought in [the] Court of Chancery"). The 2003 jurisdictional expansion predates *Boilermakers*, issued by the Court of Chancery in 2013, and Section 115, which was added to the DGCL in 2015. The General Assembly is presumed to be aware of the statutory scheme. *Hudson Farms, Inc. v. McGrellis*, 620 A.2d 215, 218 (Del. 1993) (stating that, "it is presumed that the General Assembly is aware of existing law when it acts").

131 Del. H.B. 371, 148th Gen. Assem. (2016). "The 2016 amendments expanded the Delaware Court of Chancery's jurisdiction under Section 111 to empower the Court to interpret, apply, enforce or determine the validity of (i) stock purchase agreements whereby one or more stockholders of the corporation sell or offer to sell their stock, and to which the stockholder or holders and the corporation are parties (i.e., stock transactions), and (ii) agreements to sell, lease or exchange the corporation's property or assets, which, by the terms of the agreement, requires that one or more of the corporation's stockholders approve of or consent to the sale, lease or exchange (i.e., asset transactions)." Jeffrey R. Wolters and James D. Honaker, *Analysis of the 2016 Amendments to the Delaware General Corporation Law* 1 (2016).

132 8 *Del. C.* § 115.

133 For a thorough discussion of this point, *see* Joseph A. Grundfest, *The Limits of Delaware Corporate Law: Internal Affairs, Federal Forum Provisions, and Sciabacucchi*, 75 Bus. L. 1319 (2020).

134 490 U.S. 477, 109 S.Ct. 1917, 104 L.Ed.2d 526 (1989).

135 *Id.* at 482–83, 109 S.Ct. 1917.

136 8 A.3d 1143, 1146 (Del. 2010).

137 407 U.S. 1, 15, 92 S.Ct. 1907, 32 L.Ed.2d 513 (1972). Generally, "charter provisions are presumed to be valid," and the courts will construe them "in a manner consistent with the law rather than strike down" the provisions. *Cedarview*, 2018 WL 4057012, at *20. In *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 111 S.Ct. 1522, 113 L.Ed.2d 622 (1991), the Supreme Court applied *Bremen's* presumption of validity to forum provisions continued in the fine print of cruise line tickets (which provisions were obviously not the subject of bargaining).

138 *Boilermakers*, 73 A.3d at 949 (citing *Bremen*, 407 U.S. at 15, 92 S.Ct. 1907). *See also* *Bremen*, 407 U.S. at 12, 92 S.Ct. 1907 (holding that, "absent some compelling and countervailing reason [a forum-selection clause] should be honored by the parties and enforced by the courts").

139 "Congress ... does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions—it does not, one might say, hide elephants in mouseholes." *Whitman v. Am. Trucking Ass'ns*, 531 U.S. 457, 468, 121 S.Ct. 903, 149 L.Ed.2d 1 (2001).

140 Answering Br. at 30 n.116.

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

141 *Id.* at n.117; *see also* *Boilermakers*, 73 A.3d at 953 ("The bylaws cannot fairly be argued to regulate a novel subject matter: the plaintiffs ignore that, in the analogous contexts of LLC agreements and stockholder agreements, the Supreme Court and this court have held that forum-selection clauses are valid.").

142 8 *Del. C.* § 242(b).

143 *See also* *Richards v. Lloyd's of London*, 135 F.3d 1289 (9th Cir. 1998) (applying *Bremen* analysis and holding that the anti-waiver provision of the 1933 Act did not void forum clause in international agreements).

144 516 U.S. 367, 377, 382, 116 S.Ct. 873, 134 L.Ed.2d 6 (1996).

145 564 A.2d 1089 (Del. 1989).

146 As stated above, we do not believe Section 11 claims come under Section 115's definition of "internal corporate claims." If they were "internal corporate claims" within the meaning of Section 115, then arguably, they would run afoul of Section 115's requirement that "no provision of the certificate of incorporation or the bylaws may prohibit bringing such claims in the courts of this State." For a different view on this point, *see* Grundfest, *supra* note 133, at 1378–79.

147 This question was not a central focus of the briefing before us (which understandably centered on the initial question now before this Court of facial validity).

148 Manesh, *supra* note 99, at 8–9 (emphasis added). *See also* *First Nat. City Bank v. Banco Para El Comercio Exterior de Cuba*, 462 U.S. 611, 621, 103 S.Ct. 2591, 77 L.Ed.2d 46 (1983) ("[T]he law of the state of incorporation normally determines issues relating to the *internal affairs* of the corporation. Application of that body of law achieves the need for certainty and predictability of result while generally protecting the justified expectations of parties with interests in the corporation .... Different conflicts principles apply, however, where the rights of third parties *external* to the corporation are at issue." (first emphasis added)).

149 224 A.3d 964 (Del. 2020) ("Because corporate charters and bylaws are contracts, our rules of contract interpretation apply.").

150 *Ingres Corp.*, 8 A.3d at 1146 ("Forum selection [ ] clauses are presumptively valid and should be specifically enforced unless the resisting party [ ] clearly show[s] that enforcement would be unreasonable and unjust, or that the clause [is] invalid for such reasons as fraud and overreaching." (citing *Bremen*, 407 U.S. at 15, 92 S.Ct. 1907)); *see also* *Bonanno v. VTB Hldgs., Inc.*, 2016 WL 614412, at *9 (Del. Ch. Feb. 8, 2016) (finding that under New York law, though forum-selection clauses are presumed valid, the court may refuse to enforce it if the challenging party can show cause); *Drulias v. 1st Century Bancshares, Inc.*, 30 Cal.App.5th 696, 703, 241 Cal.Rptr.3d 843 (2018) ("Ordinarily, the party seeking to avoid enforcement of a forum selection clause bears the 'burden of establishing that [its] enforcement ... would be unreasonable.' " (citation omitted)).

151 *Germaninvestments AG v. Allomet Corp.*, 225 A.3d 316, 331 n.63 (Del. 2020) (citing *Ingres Corp.*, 8 A.3d at 1146); *see also* *Prestancia Mgmt. Grp., Inc. v. Va. Heritage Found. II LLC*, 2005 WL 1364616, at *6 n.54 (Del. Ch. May 27, 2005); *Mitek Sys., Inc. v. United Servs. Auto. Ass'n*, 2012 WL 3777423 (D. Del. Aug. 30, 2012).

152 *ATP*, 91 A.3d at 558.

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

153 *Id.* (citing *Schnell v. Chris-Craft, Indus., Inc.*, 285 A.2d 437 (Del. 1971)).

154 *Bremen*, 407 U.S. at 15, 92 S.Ct. 1907.

155 Even if conflicts of law principles of the type typically applied to external claims were applied, these principles support the validity of FFPs. The Restatement (Second) of Conflicts of Laws explains that the needs of predictability and uniformity of result support application of the local law of the state of incorporation. Restatement (Second) of Conflicts of Laws § 302, cmt. e (1971). FFPs are designed to achieve such predictability and uniformity of result. Comment (g) to Section 302 of the Restatement explains that the law of the state of incorporation is applied "almost invariably to determine issues involving matters that are peculiar to corporations." *Id.* at cmt. g. Comment (g) further explains that many factors and the force of precedent support this result "except in the extremely rare situation where a contrary result is required by the overriding interest of another state having its rule applied." *Id.*

156 531 A.2d 206.

157 871 A.2d 1108.

158 *McDermott*, 531 A.2d at 216–17.

159 *Id.* at 218.

160 *See* *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977), *overruled on other grounds by* *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983); *see also* *FdG Logistics LLC v. A&R Logistics Hldgs., Inc.*, 131 A.3d 842, 846 (Del. Ch. 2016) (concluding that A&R's claim under the Delaware Securities Act failed to state a claim for relief because it had not established the requisite factual nexus between the challenged merger and Delaware to trigger application of the act, and observing that A&R's argument that the act automatically applied because of a Delaware choice-of-law provision in the merger agreement "would lead to the bizarre result of converting a blue-sky statute that the Legislature intended to regulate *intrastate* securities transactions into one that would regulate *interstate* securities transactions"). Our Court affirmed that result. *A&R Logistics Hldgs., Inc. v. FdG Logistics LLC*, 148 A.3d 1171 (Del. 2016) (Table).

161 *Edgar*, 457 U.S. at 643, 102 S.Ct. 2629 (citation and internal quotation marks omitted).

162 73 A.3d at 951.

163 *Id.* at 951–52; *see also* *Rodriguez*, 490 U.S. at 482, 109 S.Ct. 1917 (finding that the arbitration clause is a procedural provision, and that there is "no sound basis" for construing a prohibition on waiving compliance with any provision of the 1933 Act to apply to the arbitration clause).

164 *Broz v. Cellular Info. Sys., Inc.*, 673 A.2d 148, 159 (Del. 1996).

165 *Carvel v. Andreas Hldgs. Corp.*, 698 A.2d 375, 379 (Del. Ch. 1995).

166 *Id.*

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

167 *Cantor Fitzgerald v. Chandler*, 1999 WL 1022065, at *4 (Del. Ch. Oct. 14, 1999).

168 *See, e.g.,* Del. S.J. Res. 12, 147th Gen. Assem. (2014).

169 Much of the opposition to FFPs seems to be based upon a concern that if upheld, the "next move" might be forum provisions that require arbitration of internal corporate claims. Such provisions, at least from our state law perspective, would violate Section 115 which provides that, "no provision of the certificate of incorporation or the bylaws may prohibit bringing such claims in the courts of this state." 8 *Del. C.* § 115; *see* Del. S.B. 75 syn. ("Section 115 does not address the validity of a provision of the certificate of incorporation or bylaws that selects a forum other than the Delaware courts as an additional forum in which internal corporate claims may be brought, but it invalidates such a provision selecting the courts in a different State, *or an arbitral forum*, if it would preclude litigating such claims in the Delaware courts." (emphasis added)).

170 *See, e.g., Jones Apparel,* 883 A.2d at 845 ("[Delaware corporations have] the broadest grant of power in the English-speaking world to establish the most appropriate internal organization and structure for the enterprise.").

171 *Boilermakers*, 73 A.3d at 953. "[O]ur corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs. Merely because the [DGCL] is silent as to a specific matter does not mean that it is prohibited." *Id.*

End of Document

© 2022 Thomson Reuters. No claim to original U.S. Government Works.

2020 WL 6050540 (Cal.Super.) (Trial Order)
Superior Court of California,
Complex Civil Litigation.
San Mateo County

Sunny C. WONG, individually and on behalf of all others similarly situated, Plaintiffs,
v.
RESTORATION ROBOTICS, INC., et al., Defendants.

No. 18CIV02609.
September 22, 2020.

***1** (consolidated with 19CIV03173)
CLASS ACTION
Assigned for all purposes to Dept. 2

Judgment of Dismissal without Prejudice as to Defendant Restoration Robotics Inc. and Individual Defendants

James Jaconette, Robbins Geller Rudman & Dowd LLP, 655 West Broadway, Suite 1900, San Diego, CA 92101-8498, (619) 231-1058, for plaintiffs.

Frank Johnson, Phong Tran Johnson Fistel LLP, 655 West Broadway, Suite 1400, San Diego, CA 92101, (619) 230-0063.

Mark Molumphy, Tyson Redenbarger, Cotchett Pitre & McCarthy LLP, 840 Malcolm Road, Suite 200, Burlingame, CA 94010, (650) 697-6000, mmolumphy@cpmlegal.com, tredenbarger@cpmlegal.com.

Matthew Rawlinson, Hilary Mattis, Daniel Gherardi, Latham & Watkins LLP, 140 Scott Drive, Menlo Park, CA 94025, (650) 328-4600, Matt.rawlingson@lw.com, Hilary.mattis@lw.com, Daniel.gherardi@lw.com, for defendants.

Gavin Masuda, Michael Waks, Latham & Watkins LLP, 505 Montgomery Street, Suite 2000, San Francisco, CA 94111, (415) 391-0600, Gavin.masuda@lw.com, Michael.waks@lw.com.

John Loftus, Christine Ellice, Adam Snyder, Stroock & Stroock & Lavan LLP, 2029 Century Park East, Suite 1800, Los Angeles, CA 90067-3086, (310) 556-5800.

Patrick Gibbs, Jeffrey Lombard, Cooley LLP, 3175 Hanover Street, Palo Alto, CA 94304-1130, (650) 843-5000, pgibbs@cooley.com, jlombard@cooley.com, jsimpsonlagoy@cooley.com.

Hon. Marie S. Weiner, Judge.

WHEREAS, by Order filed and issued September 1, 2020, this Court GRANTED the Renewed/Reconsidered Motion to Dismiss filed by Defendant Restoration Robotics Inc. and the Individual Defendants against Plaintiffs, upon the Court's exercise of discretion to decline jurisdiction, pursuant to Code of Civil Procedure Section 410.30(a), on the basis of federal forum limitation provision contained in Restoration Robotics' Amended and Restated Certificate of Incorporation;

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, that Judgment of Dismissal Without Prejudice be entered in favor of Defendants Restoration Robotics Inc., Ryan Rhodes, Charlotte Holland, Frederic Moll, Jeffrey Bird, Gil Gliman, Emmett Cunningham Jr., Craig Taylor, Shelley Thunen, and against Plaintiffs Sunny Wong and Yanming Li.

DATED: September 21, 2020

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

<<signature>>

HON. MARIE S. WEINER

JUDGE OF THE SUPERIOR COURT

SERVICE LIST

***Wong v. Restoration Robotics*, Class Action 18CIV02609 As of July 2020**

Attorneys for Plaintiffs:

JAMES JACONETTE

ROBBINS GELLER RUDMAN & DOWD LLP

655 West Broadway, Suite 1900

San Diego, CA 92101-8498

(619) 231-1058

FRANK JOHNSON

PHONG TRAN JOHNSON FISTEL LLP

655 West Broadway, Suite 1400

San Diego, CA 92101

(619) 230-0063

MARK MOLUMPHY

TYSON REDENBARGER

COTCHETT PITRE & McCARTHY LLP

840 Malcolm Road, Suite 200

Burlingame, CA 94010

(650) 697-6000

mmolumphy@cpmlegal.com

tredenbarger@cpmlegal.com

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

Attorneys for Defendants:

MATTHEW RAWLINSON

HILARY MATTIS

DANIEL GHERARDI

LATHAM & WATKINS LLP

140 Scott Drive

Menlo Park, CA 94025

(650) 328-4600

Matt.rawlingson@lw.com

Hilary.mattis@lw.com

Daniel.gherardi@lw.com

GAVIN MASUDA

MICHAEL WAKS

LATHAM & WATKINS LLP

505 Montgomery Street, Suite 2000

San Francisco, CA 94111

(415) 391-0600

Gavin.masuda@lw.com

Michael.waks@lw.com

JOHN LOFTUS

CHRISTINE ELLICE

ADAM SNYDER

STROOCK & STROOCK & LAVAN LLP

2029 Century Park East

Suite 1800

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

Los Angeles, CA 90067-3086

(310) 556-5800

PATRICK GIBBS

JEFFREY LOMBARD

COOLEY LLP

3175 Hanover Street

Palo Alto, CA 94304-1130

(650) 843-5000

pgibbs@cooley.com

jlombard@cooley.com

jsimpsonlagoy@cooley.com

End of Document

© 2022 Thomson Reuters. No claim to original U.S. Government Works.

2020 WL 6161502
United States District Court, N.D. California,
San Jose Division.

IN RE DROPBOX SECURITIES LITIGATION

Case No. 19-cv-06348-BLF
|
Signed 10/21/2020

CORRECTED ORDER GRANTING MOTIONS TO DISMISS WITH LEAVE TO AMEND

[Re: ECF 71, 73]

BETH LABSON FREEMAN, United States District Judge

***1** Lead Plaintiff Ognjen Kuraica represents a putative class of investors who purchased or otherwise acquired the common stock of Dropbox, Inc. ("Dropbox") pursuant or traceable to the Registration Statement associated with its Initial Public Offering ("IPO"). Consolidated Amended Complaint ("CAC") at ¶¶ 1-2.

Plaintiffs' complaint forwards various securities violations against four groups of defendants (collectively, "Defendants"): Dropbox; Andrew W. Houston, Ajay V. Vashee, Timothy J. Regan, Arash Ferdowsi, Robert J. Mylod, Jr., Donald W. Blair, Paul E. Jacobs, Condoleezza Rice, R. Bryan Schreier, and Margaret C. Whitman (collectively, the "Registration Statement Defendants"); Sequoia Capital XII, L.P., Sequoia Capital XII Principals Fund, LLC, Sequoia Technology Partners XII, L.P., and SC XII Management, LLC (collectively, the "Sequoia Defendants"); and Goldman Sachs & Co. LLC, J.P. Morgan Securities LLC, Deutsche Bank Securities Inc., BofA Securities, Inc. (f/k/a Merrill Lynch, Pierce, Fenner Smith Incorporated), Allen Company LLC, RBC Capital Markets, LLC, Jefferies LLC, Macquarie Capital (USA) Inc., Canaccord Genuity LLC, JMP Securities LLC, KeyBanc Capital Markets Inc., and Piper Sandler & Co. (f/k/a Piper Jaffray Co.) (collectively, the "Underwriter Defendants"). *See* CAC at ¶¶ 12-34 (describing Defendants).

On April 16, 2020, Dropbox and the Registration Statement Defendants moved to dismiss the litigation under Fed. R. Civ. P. 12(b)(6). ECF 71. The Underwriter Defendants filed a joinder to that motion, ECF 74, and the Sequoia Defendants filed a joinder and a separate motion to dismiss, ECF 73. For the reasons discussed below and at the September 24, 2020 hearing, the Court GRANTS both motions WITH LEAVE TO AMEND.

I. BACKGROUND

Dropbox provides users with cloud-based storage and collaboration services on a free and paid subscription basis. CAC ¶¶ 35-36. In preparation for its IPO, Dropbox filed its Form S-1 Registration Statement with the Securities Exchange Commission. ECF 72 at Ex. 1 ("Registration Statement" or "RS"). The Registration Statement was declared effective on March 22, 2018. *Id.*

The Registration Statement disclosed that Dropbox had more than 500 million registered users, RS at 1, and generated revenue from users who purchase subscription products, RS at 62-64 ("Our Subscription Plans"). Only 11 million Dropbox users were paying users at the time of the filing. RS at 1, 61. The Registration Statement explained that Dropbox's business model was premised on three core factors: (1) new user sign ups (whether free or paying), (2) increasing the conversion of free users to paying users, and (3) upgrading and expanding the subscriptions used by existing paying users. RS at 4-5 ("Our Growth Strategy"), 64-65 ("Our Business Model"). It highlighted numerous risk factors that its business model was subject to, to include:

- Our business depends on our ability to retain and upgrade paying users, and any decline in renewals or upgrades could adversely affect our future results of operations.

***2** • Our future growth could be harmed if we fail to attract new users or convert registered users to paying users.

- Our revenue growth rate has declined in recent periods and may continue to slow in the future.

RS 5. The Registration Statement detailed historical performance metrics, to include revenue, paying users, and average revenue per paying user ("ARPU"). RS at 1, 76, 78, 81 (revenue); RS at 14, 76, 78 (paying users); RS at 14, 70 (ARPU). Dropbox noted that its revenue growth was primarily based on its growth in paying users, but was also tied to ARPU. *See* RS 76, 78, 81. Dropbox did not disclose any metrics about the rate at which it converted free users into paid users ("user conversion rate") in its Registration Statement or elsewhere.

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

On March 23, 2018, Dropbox completed its IPO, issuing over 26 million shares of common stock and generating over $500 million. CAC ¶ 39. The next day, the Underwriter Defendants exercised their option to purchase an additional 5.4 million shares. CAC ¶ 40. Before and after the IPO, the Sequoia Defendants "controlled 25% of the voting shares of Dropbox and were in league with other large shareholders and company insiders to further increase their control over Dropbox and its affairs." CAC ¶ 28. In each quarter following the IPO, Dropbox announced that its revenue and paying userbase had increased. *See* ECF 72 at Exhs. 2-9 (Form 10-Q for 1Q'18 through 3Q'19 and Form 10-K for fiscal year 2019).

Plaintiffs filed their initial complaint on October 4, 2019. ECF 1. In their CAC, filed March 2, 2020, Plaintiffs raised claims under Section 11 of the Securities Act against Dropbox, the Registration Statement Defendants, and the Underwriter Defendants and under Section 15 of the Securities Act against the Registration Statement Defendants and the Sequoia Defendants. CAC ¶¶ 63-80. Plaintiffs allege that the Registration Statement failed to disclose "that the rate at which Dropbox was converting its non-paying registered users to paying subscription users was decelerating," causing Dropbox "to experience a material decline and/or slowdown in revenue growth." CAC at ¶ 3. Plaintiffs further allege that had Dropbox disclosed information about this declining user conversion rate, they "would not have purchased Dropbox's stock at the prices they did (if at all)." CAC ¶¶ 3-4.

To support this theory, Plaintiffs highlight three sets of statements in Dropbox's Registration Statement that they believe run afoul of securities law (hereinafter, "Paid Users Statement," "Conversion Characteristics Statement," and "Cohort Statements"). *See* CAC ¶¶ 56-62.

Paid Users Statement: First, in Dropbox's "Prospectus Summary," the company provided a table summarizing the number of users who paid for its services from 2015-17:

	2015	*2016*	*2017*
Paying users	6.5 million	8.8 million	11.0 million

CAC ¶ 56. Plaintiffs alleged that this chart "was materially misleading in light of the fact that at the time of the IPO the company was materially decelerating in terms of converting its non-paying registered users to paying subscription users." It argued that by omitting information about the conversion rate, "Dropbox provided investors with a materially false understanding of the company's current and future prospects concerning user conversions" and "failed to disclose a material and negative trend in violation of Item 303 of Regulation S-K." CAC ¶ 57.

***3** *Conversion Characteristic Statement*: Plaintiffs next point to a section within the Registration Statement titled "Growth Strategy":

> We believe that our current registered user base represents a significant opportunity to increase our revenue. We estimate that approximately 300 million of our registered users have characteristics—including specific email domains, devices, and geographies—that make them more likely than other registered users to pay over time. Substantially all of our paying users share at least one of these characteristics.

CAC ¶ 58. Plaintiffs contend that because "Dropbox's user-conversion and revenue were flagging," this statement was rendered "materially misleading because it had become increasingly unlikely that the '300 million' registered users would convert to paying users." CAC ¶ 59.

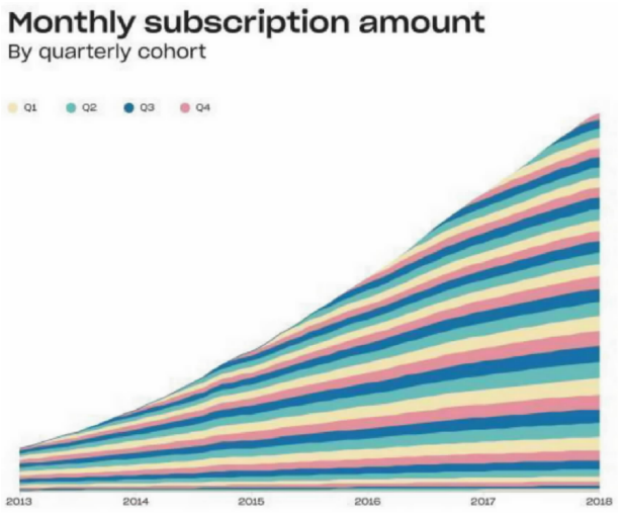
Cohort Statements: Plaintiffs highlight a section titled "Our Attractive Cohort Economics" within "Management's Discussion and Analysis." The section in its entirety reads:

> We define a cohort as all registered users who signed up for Dropbox in a given period of time. We track the total monthly subscription amount of all paying users in each cohort as of the end of the month, or the monthly subscription amount. For paying users who opt for our monthly plans, the monthly subscription amount is equal to the price of the monthly plan. For paying users who opt for our annual plans, which a majority of our users do, the monthly subscription amount is equal to the price of the annual plan divided by twelve. These amounts increase as more registered users

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

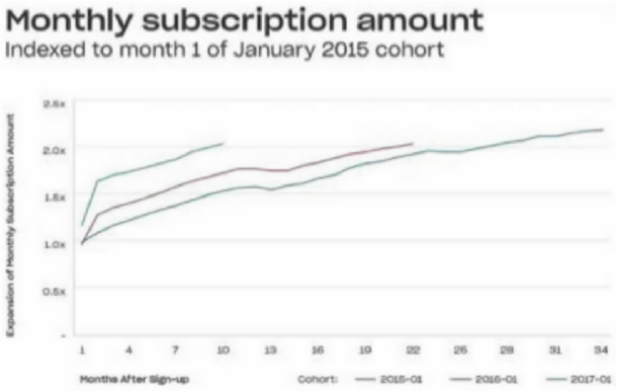
in each cohort convert to paying users, paying users upgrade to premium subscription offerings, and team administrators purchase additional licenses. These amounts decrease when paying users terminate their subscriptions, downgrade their subscriptions to a lower tier, or team administrators reduce the number of licenses on their subscription plans. We continuously focus on adding new users and increasing the value we offer to them. As a result, each cohort of new users typically generates higher subscription amounts over time.

The chart below reflects the monthly subscription amount from January 2013 to December 2017 of all paying users in each quarterly cohort, including those who signed up for our platform prior to 2013.



We continuously focus on adding new users and increasing the value we offer to them. As a result, each cohort of new users typically generates higher subscription amounts over time. For example, the monthly subscription amount generated by the January 2015 cohort doubled in less than three years after signup. We believe this cohort is representative of a typical cohort in recent periods.

Moreover, as we continue to innovate and optimize our go-to-market strategy, we have successfully increased monetization for subsequent cohorts. Comparing January cohorts from the last three years, at virtually every point in time after signup, the January 2017 cohort generated a higher monthly subscription amount than the January 2016 cohort, which in turn generated a higher monthly subscription amount than the January 2015 cohort.



***4** CAC ¶ 60. Plaintiffs reason that this section "falsely represented that Dropbox's historical user-conversions and subscription revenue was indicative of current and future results."

II. LEGAL STANDARD

"A motion to dismiss under Federal Rule of Civil Procedure 12(b)(6) for failure to state a claim upon which relief can be granted 'tests the legal sufficiency of a claim.' " *Conservation Force v. Salazar*, 646 F.3d 1240, 1241–42 (9th Cir. 2011) (quoting *Navarro v. Block*, 250 F.3d 729, 732 (9th Cir. 2001)). When determining whether a claim has been stated, the Court accepts as true all well-pled factual allegations and construes them in the light most favorable to the plaintiff. *Reese v. BP Exploration (Alaska) Inc.*, 643 F.3d 681, 690 (9th Cir. 2011). However, the Court need not "accept as true allegations that contradict matters properly subject to judicial notice" or "allegations that are merely conclusory, unwarranted deductions of fact, or unreasonable inferences." *In re Gilead Scis. Sec. Litig.*, 536 F.3d 1049, 1055 (9th Cir. 2008) (internal quotation marks and citations omitted). While a complaint need not contain detailed factual allegations, it "must contain sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face.' " *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (quoting *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007)). A claim is facially plausible when it "allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." *Id.*

III. DISCUSSION

A. Judicial Notice

A court generally cannot consider materials outside the pleadings on a motion to dismiss for failure to state a claim.

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

*See*Fed. R. Civ. P. 12(b)(6). A court may, however, consider items of which it can take judicial notice without converting the motion to dismiss into one for summary judgment. *Barron v. Reich*, 13 F.3d 1370, 1377 (9th Cir. 1994). A court may take judicial notice of facts "not subject to reasonable dispute" because they are either "(1) generally known within the territorial jurisdiction of the trial court or (2) capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned." Fed. R. Evid. 201. A court may additionally take judicial notice of " 'matters of public record' without converting a motion to dismiss into a motion for summary judgment." *Lee v. City of Los Angeles*, 250 F.3d 668, 689 (9th Cir. 2001) (quoting *MGIC Indem. Corp. v. Weisman*, 803 F.2d 500, 504 (9th Cir. 1986)). Under the incorporation by reference doctrine, courts may consider documents "whose contents are alleged in a complaint and whose authenticity no party questions, but which are not physically attached to the [plaintiff's] pleading." *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 986 (9th Cir. 1999) (quoting *Branch v. Tunnell*, 14 F.3d 449, 454 (9th Cir. 1994)) (alteration in original).

Defendants seek notice of ten exhibits: Dropbox's Registration Statement (Exh. 1), Form 10-Q for 1Q'18-3Q'19 (Exhs. 2-8), Form 10-K for the 2019 fiscal year (Exh. 9), and a copy of Dropbox stock prices from March 23, 2018, to August 8, 2019, as obtained from Yahoo! Finance (Exh. 10). ECF 71 at 7-8; *see* ECF 72 (exhibits). Plaintiffs do not oppose this request "to the extent that the Court takes notice of the fact that statements contained in those documents were made" but oppose it if "Defendants attempt to use these exhibits to defeat Plaintiffs' adequately pleaded claims" as such practice is disfavored by the Ninth Circuit. ECF 80 at 8. Plaintiffs also request that the Court take judicial notice of a financial analyst report referenced by the CAC. ECF 80 at 8.

***5** The Court grants judicial notice of Dropbox's Registration Statement and the financial analyst report under the incorporation by reference doctrine. *See* CAC ¶¶ 1 fn. 1, 52. It also takes judicial notice of the SEC Filings and the copy of Dropbox's stock prices. *See* *Metzler Inv. GMBH v. Corinthian Colleges, Inc.*, 540 F.3d 1049, 1064 n.7 (9th Cir. 2008) (granting judicial notice of publicly available financial documents such as SEC filings); *Heliotrope Gen., Inc. v. Ford Motor Co.*, 189 F.3d 971, 981 n.18 (9th Cir. 1999) (granting judicial notice of publicly available articles or other news releases of which the market was aware). The Court considers these documents for the sole purpose of determining what representations Dropbox made to the market. The Court does not take notice of the truth of any of the facts asserted in these documents. *See*City of Sunrise Firefighters' Pension Fund v. Oracle Corp., 2019 WL 6877195, at *23 (N.D. Cal. Dec. 17, 2019)

B. Section 11 of the Securities Act

"Section 11 creates a private right of action for any purchaser of a security where 'any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading.' " *Rieckborn v. Jefferies LLC*, 81 F. Supp. 3d 902, 914 (N.D. Cal. 2015) (quoting 15 U.S.C. § 77k(a)). "To prevail on a Section 11 claim, a plaintiff must demonstrate (1) that the registration statement contained a misrepresentation or omission; and (2) that the misrepresentation or omission was material." *Id.* (citing *In re Daou Sys.*, 411 F.3d 1006, 1027 (9th Cir. 2005)). A misrepresentation or omission is material where it "would have misled a reasonable investor about the nature of his or her investment." *In re Daou*, 411 F.3d at 1027. "No scienter is required for liability under § 11; defendants will be liable for innocent or negligent material misstatements or omissions." *Id.*

Defendants argue Plaintiffs' overall theory of liability fails because, among other things, "the CAC has no factual allegations regarding user conversion." ECF 71 at 8. Plaintiffs organize their response by statement set. They contend that the Conversion Characteristic Statements "created the false and misleading impression that Dropbox's growth of user conversions was not declining or slowing down." ECF 80 at 9. Similarly, they argue that Dropbox's Cohort Statements "materially misled Plaintiffs about Dropbox's operations because it omitted the fact that the Dropbox's user conversion rate was dropping." ECF 80 at 13-14. Finally, they contend that the Paid Users Statements were misleading because "[d]isclosing the total number of paid users increasing as of each calendar year created a misleading impression that the Company's rate of converting registered users to paying users was also growing." ECF 80 at 14.

The Court has run a fine-tooth comb through the Plaintiffs' CAC and cannot find a single factual allegation about Dropbox's user conversion rate. *See* *Sprewell v. Golden*

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

State Warriors, 266 F.3d 979, 988 (9th Cir. 2001) (the Court is not "required to accept as true allegations that are merely conclusory, unwarranted deductions of fact, or unreasonable inferences"); *Belodoff v. Netlist, Inc.*, 2009 WL 1293690, at *11 (C.D. Cal. Apr. 17, 2009) (dismissing Section 11 allegations where plaintiffs made "no factual showing whatsoever" regarding the alleged omission); *cf.* *Welgus v. TriNet Grp., Inc.*, 2017 WL 167708, at *13 (N.D. Cal. Jan. 17, 2017) (rejecting control person allegations under Section 15 of the Securities Act as "too conclusory" in the absence of "any facts to show that [the defendant] had the power to and did control the [issuers'] activities"). This is an elephant-sized hole in Plaintiffs' theory of liability as its entire complaint is premised on the alleged decline of Dropbox's user conversion rate. Indeed, Dropbox itself noted that this is not a metric it releases. ECF 71 at 9. In short, Plaintiffs' assertion that Dropbox's user conversion rate was declining is nothing more than speculation. Unfortunately, Plaintiffs spend most of their persuasive energy discussing the actionability of the statement at issue instead of responding to the global flaws highlighted by Defendants. *See, e.g.,* ECF 80 at 2, 9-14.

***6** In the few areas where they do offer factual allegations, Plaintiffs seem to conflate user conversion rate with paying user and revenue growth rates. For example, Plaintiffs contend that "Dropbox's disclosures that its business model was largely based on converting registered users to paying users (RS at 68) and that over 90% of its revenue came from users purchasing subscriptions through the app or website (¶ 44)." ECF 80 at 5. As the Court noted above, one of Dropbox's *three* main revenue sources was from converting free users into paid users. And the Plaintiffs' focus on the 90% metric misses the mark as it does not speak to what part of Dropbox's revenue came from converting already-signed-up free users into paid users. Similarly, Plaintiffs include two charts that they believe illustrate "the [declining] rate at which Dropbox was converting its nonpaying registered users." ECF 80 at 5. However, the charts instead depict Dropbox's declining paying user and revenue growth rates—both of which Dropbox disclosed in its Registration Statement. ECF 80 at 6. *See* *McGovney v. Aerohive Networks*, Inc., 367 F. Supp. 3d 1038, 1056 (N.D. Cal. 2019) (dismissing Section 10(b) where company "disclos[ed] exactly what Plaintiffs claim" it omitted); *see, e.g.*, RS 1 (yearly revenue and growth rate), 14 (yearly paying users), 76 (yearly revenue, paying user growth rate), 78 (same), 80 (quarterly revenue); 81 (same).

To the extent this conflation is actually an invitation for the Court to use disclosed statistics to make an assumption about the user conversion rate, the Court declines. It is equally plausible that Dropbox's revenue rate decline could be traced to Dropbox's other two revenue drivers or to some combination of all three metrics. *See* *In re Century Aluminum Co. Sec. Litig.*, 729 F.3d 1104, 1105 (9th Cir. 2013) ("When faced with two possible explanations, only one of which can be true and only one of which results in liability, plaintiffs cannot offer allegations that are 'merely consistent with' their favored explanation but are also consistent with the alternative explanation. Something more is needed, such as facts tending to exclude the possibility that the alternative explanation is true." (citations omitted)). In *Belodoff v. Netlist*, plaintiffs brough a Section 11 claim against a technology manufacturer alleging that it failed to disclose "a significant decline in customer demand." 2009 WL 1293690, at *11. However, the only express statement plaintiffs alleged about this "dwindling customer demand" concerned excessive inventory levels. The Court declined to infer a decrease in customer demand from the excess inventory levels because the "inference lack[ed] factual support and actually contradict[ed] portions of the FAC that allege[d] that Netlist was creating excess inventory without any regard to customer demand." *Id.* As such, the claim "[did] not rise above the speculative level." *Cf.* *Welgus*, 2017 WL 167708, at *13 (refusing to draw an inference regarding control person liability when allegations were based on "speculation"). So too here.

Although the insufficiency of Plaintiffs' pleadings about Dropbox's user conversion rate is fatal to the Section 11 claims, the Court addresses an additional flaw. For Plaintiffs to state an omission-based Section 11 claim, it is not enough that the Registration Statement omitted relevant or material facts. *See* *In re Rigel Pharm., Inc. Sec. Lit.*, 697 F.3d 869, 880 n.8 (9th Cir. 2012) (citing *Matrixx Initiatives v. Siracusano*, 563 U.S. 27, 38 (2011)); *Brody*, 280 F.3d at 1006. Instead an omission "must affirmatively create an impression of a state of affairs that differs in a material way from the one that actually exists" to be actionable. *Brody*, 280 F.3d at 1006. Plaintiffs' lawsuit is largely predicated on Dropbox's omission of allegedly declining user conversion rate in its Registration Statement. *See* CAC ¶¶ 53, 54, 57, 59, 62.

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

Defendants argue that "Dropbox was not required to disclose its free-to-paid user conversion numbers because that number was subsumed within the total number of paying users, which Dropbox did disclose." ECF 71 at 8-9. They also argue that, in light of this disclosure, "Dropbox had no duty to disclose any further detail about free-to-paid user conversions" because "[t]he Ninth Circuit has 'expressly declined to require a rule of completeness for securities disclosures because "[n]o matter how detailed and accurate disclosure statements are, there are likely to be additional details that could have been disclosed but were not." ' " ECF 71 at 9 (quoting *Police Ret. Sys. of St. Louis v. Intuitive Surgical, Inc.*, 759 F.3d 1051, 1061 (9th Cir. 2014) (quoting *Brody v. Transitional Hosps. Corp.*, 280 F.3d 997, 1006 (9th Cir. 2002))). Plaintiffs appear to generally contend that the three sets of statements created a false and misleading impression that Dropbox's growth of user conversions was not slowing down. *See, e.g.*, ECF 80 at 9.

***7** The Court agrees with Dropbox. Plaintiffs fail to explain why Dropbox's omission of its allegedly flagging user conversion rate created an "impression of a state of affairs that differs in a material way from the one that actually exists." *Brody*, 280 F.3d at 1006. Dropbox's state of affairs is defined by its three-prong business model of (1) attracting new users (free or paid), (2) converting free users to paid users, and (3) upgrading paid user subscriptions. The success of the model is captured through Dropbox's total number of paid users, its total revenue, and ARPU. Dropbox explained and published these metrics in its Registration Statement. And despite the fact that it disclosed revenue growth metrics, it also explicitly stated that its revenue growth rate had begun to decline. While the metric Plaintiffs are fixated on, user conversion rate, was not explicitly disclosed by Dropbox, it was captured by the total number of paid users, a metric regularly disclosed by Dropbox. Plaintiffs do not explain why these disclosures are insufficient, let alone why they are so insufficient as to create a materially different impression of Dropbox's financial health. *See In re Netflix, Inc. Sec. Litig.*, 2005 WL 1562858, at *6 (N.D. Cal. June 28, 2005) (rejecting allegations based on failure to disclose number of subscription cancellations where the "number could be calculated through simple arithmetic using other numbers that were disclosed."); *see also Brody*, 280 F.3d at 1006 n.8 (where a company makes a disclosure about sales growth, it need not provide "a detailed breakdown of the company's region by region or month by month sales."). Plaintiffs also fail to allege facts showing how Dropbox's truthful disclosures of declining revenue and paid user rates could plausibly infer that one of the three contributors to that disclosure was, in fact, increasing. Without further detail, the only plausible inference is that all three indicators were declining. Plaintiffs' theory would be a fantastical view that Dropbox's disclosure of declining rates caused a reasonable investor to conclude that one of the three indicators that makes up the disclosed declining rate was actually increasing when it was not.

Although not necessary to this Order, the Court also briefly addresses the Defendants' argument that the statements at issue are not actionable because they are accurate statements of historical fact or statements of opinion. *See* ECF 71 at 11-17. Courts in this district have repeatedly refused to find disclosure of accurate historical data misleading. *Wenger v. Lumisys, Inc.*, 2 F. Supp. 2d 1231, 1245 (N.D. Cal. 1998) ("Disclosure of accurate historical data does not become misleading even if less favorable results might be predictable by the company in the future."); *see also Bodri v. GoPro, Inc.*, 252 F. Supp. 3d 912, 928 (N.D. Cal. 2017) ("[T]he Court cannot conclude that any reasonable investor would take the statements about past and present [pricing] as an objective assurance of future [pricing] stability."); *Monachelli v. Hortonworks, Inc.*, 225 F. Supp. 3d 1045, 1055 (N.D. Cal. 2016) ("[D]isclosures of accurate historical data accompanied by general statements of optimism ... are not actionable.") (quoting *In re VeriFone Sec. Litig.*, 784 F.Supp. 1471, 1483 (N.D. Cal. 1992)). Plaintiffs do not allege that any of Dropbox's statements at issue are false, but rather insist that they created a misleading impression that Dropbox's user conversion growth rate was not declining. *See, e.g.,* ECF 80 at 13 (Cohort Statements), 14 (Paid Users Statement). But Plaintiffs fail to allege any facts that directly—or even indirectly—undermine these statements.

Plaintiffs fare no better in showing that Dropbox's User Characteristics Statement is actionable. Under the Supreme Court's decision in *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 575 U.S. 175 (2015), opinion statements are only actionable where (1) "the speaker did not hold the belief she professed," (2) "the supporting fact[s] [the speaker] supplied [are] untrue," or (3) the opinion omitted information that rendered the opinion misleading. *City of Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Align Tech., Inc.*, 856 F.3d 605, 615 (9th Cir. 2017),

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

856 F.3d at 615-16 (citing *Omnicare*, 575 U.S. at 185-86, 194). With respect to the third prong, Plaintiffs must allege "facts going to the basis for the issuer's opinion—facts about the inquiry the issuer did or did not conduct or the knowledge it did or did not have—whose omission makes the opinion statement at issue misleading to a reasonable person reading the statement fairly and in context." *Omnicare*, 575 U.S. at 194. Plaintiffs do not allege that Dropbox did not hold the beliefs it stated, nor do they allege that any of the fact's supporting Dropbox's statements were untrue. And under *Omnicare*'s the third prong the Plaintiffs fail to read Dropbox's User Characteristics Statement fairly and in context, *see, e.g.*,*West v. eHealth, Inc.*, 2016 WL 948116, at *5 (N.D. Cal. Mar. 14, 2016) (rejecting "interpretations of the statements that are taken out of context and are not plausible on [their] face."), let alone plead "facts about the inquiry the issuer did or did not conduct or the knowledge it did or did not have," *Omnicare*, 575 U.S. at 194 (emphasis added). As the Supreme Court acknowledged in *Omnicare*, this is "no small task for an investor." *Id.*

***8** Accordingly, the Court GRANTS the Motion to Dismiss the Section 11 claims.

C. Section 11 Claims Premised on S-K Item 303

Plaintiffs allege that Dropbox's IPO registration statement failed to disclose a material and negative trend in violation of Item 303 of SEC Regulation S-K, 17 C.F.R. § 229.303. CAC ¶¶ 54, 57, 63-73. They specifically contend that Defendants should have disclosed that "Dropbox was experiencing a material decline and/or slowdown in terms of user-conversions and revenue growth at the time of the IPO." CAC ¶¶ 54, 57. In this Motion to Dismiss, Defendants argue that Plaintiffs fail to allege facts supporting (1) the existence of the declining user conversion rate, (2) Dropbox's knowledge of the alleged trend, and (3) the materiality of this trend. ECF 71 at 18-19.

Item 303 of Regulation S-K requires that a company disclose "known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." 17 C.F.R. § 229.303(a)(3)(ii). "Allegations which state a claim under Item 303(a) of Regulation S-K also sufficiently state a claim under Sections 11 and 12(a)(2)." *Steckman v. Hart Brewing, Inc.*, 143 F.3d 1293, 1296 (9th Cir. 1998).

The Court will not linger on Plaintiffs' allegation that Dropbox did not disclose a trend of declining growth rate. Put simply, and as discussed at length above, there is abundant evidence in the Registration Statement to the contrary. *See Belodoff.*,2009 WL 1293690, at *12 ("[disclosed] facts cannot form the basis for a Regulation S–K violation or the nondisclosure of an adverse trend."); *Mallen v. Alphatec Holdings, Inc.*, 861 F. Supp. 2d 1111, 1127 (S.D. Cal. 2012) (finding no Item 303 liability where defendant disclosed trend in Form 10-K); *see, e.g.*, RS at 1, 80-81 (disclosing growth rates for eight quarters preceding the IPO). Anyone with basic mathematical skills could discern that while Dropbox's revenue was increasing, it did so at a declining rate. Dropbox disclosed its yearly and quarterly revenue, and simple arithmetic shows that the rate of increase was declining. *See e.g.*,*In re Skechers USA, Inc. Sec. Litig.*, 2020 WL 1233759, at *14 n.13 (S.D.N.Y. Mar. 12, 2020) (rejecting purportedly undisclosed trend where "any reasonable investor could have calculated the allegedly omitted trend").

Plaintiffs' argument about Dropbox's declining user conversion rate has only marginally more steam. At the motion hearing, Plaintiffs acknowledged that this Item 303 issue is the focal point of its complaint. But at no point do Plaintiffs forward any factual allegations about Dropbox's user conversation rate, let alone a data point or trend line. While the Court must accept all factual allegations as true during a motion to dismiss under Fed. R. Civ. P. 12(b)(6), there are no facts for the Court to accept true here—only conclusory allegations. The Court has discussed this at length. *See* Section III.B.

The complaint is similarly devoid of any factual pleading regarding how Dropbox's allegedly waning user conversion rate had a materially adverse impact on the company's revenue. *See*17 C.F.R. § 229.303(a)(3)(ii) (requiring disclosure where a trend "will have a material favorable or unfavorable impact on net sales or revenues or income"); *Welgus v. TriNet Grp., Inc. ("Welgus II")*, 2017 WL 6466264, at *24 (N.D. Cal. 2017) ("This one-off allegation does not support an inference that the 'adverse trends' were either known to Defendants or could have reasonably been expected to have a material impact on TriNet's net sales, revenues or income"); *Mallen*, 861 F. Supp. 2d at 1127 ("Plaintiffs fail to allege any facts to show that such delays ... could *reasonably be expected to* have a *material* impact") (emphasis in original). This explanation is particularly crucial in light

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

of the fact Dropbox's revenue continued to grow after its IPO. And, because Dropbox's revenue is driven by three core factors, Plaintiffs must allege facts that illustrate that a declining user conversion rate was the specific reason for Dropbox's decreasing revenue growth rate, as opposed to the other two factors or some combination of the three. *See* *Fresno Cty. Emps. Ret. Ass'n v. Alphatec Holdings, Inc.*, 607 F. App'x 694, 695 (9th Cir. 2015) (holding plaintiffs failed to allege that inventory problems materially impacted defendant's revenue because it did not explain "how the quality of [that] inventory factored into [defendant's] revenue projections"). Here, Plaintiffs fail to allege any facts demonstrating that the role user conversion plays in Dropbox's revenue creation trumps the role of the other two indicators.

***9** Plaintiffs also fail to allege knowledge. Plaintiffs seem to contend that they have satisfied this requirement because "the Motion [to Dismiss] explicitly concedes that Defendants knew the 'rate of paying user growth had slowed at the time of the IPO and that its rate of revenue growth had slowed as well.' " ECF 80 at 15. The Court is baffled by this explanation. It is simply nonsensical for Plaintiffs to contend, on one hand, that the Court should infer Defendants knew of a declining user conversion trend because of a slowing rate of paying user growth and, on the other, that Dropbox's disclosure of this paying user growth statistic was insufficient to relieve them of liability under Item 303. Defendants cannot have it both ways.

Plaintiffs have failed to allege sufficient facts to show that the Defendants omitted a known material trend from Dropbox's Registration Statement that was not adequately captured by the disclosure of declining revenue and paying user growth rates. The Court thus GRANTS the Motion to Dismiss the claims predicated on Item 303.

D. Section 15 of the Securities Act

To state a claim for controlling person liability under Section 15 of the Securities Act, 15 U.S.C. § 77***o***, Plaintiffs must establish that (1) there was a primary violation of federal securities laws and (2) the defendant possessed actual power or control over the primary violator. *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1065 (9th Cir. 2000). For the reason's discussed above, Plaintiffs fail to establish a primary violation of federal securities law. Accordingly, the Court GRANTS the motions to dismiss the claims based on Section 15.

E. Statute of Limitations

The Court's determination that Plaintiffs failed to adequately plead claims under Section 11 and 15 is dispositive in resolving Defendants' motion. The statute of limitations, however, poses yet another threat to the survival of Plaintiffs' claims.

Claims brought under the Securities Act are barred "unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence." 15 U.S.C. § 77m. The one-year period "begins to run once the plaintiff did discover or a reasonably diligent plaintiff would have discovered the facts constituting the violation—whichever comes first." *Merck & Co. v. Reynolds*, 559 U.S. 633, 653 (2010). "Plaintiffs are considered to have discovered a fact when a 'reasonably diligent plaintiff would have sufficient information about that fact to adequately plead it in a complaint ... with sufficient detail and particularity to survive a 12(b)(6) motion to dismiss.' " *F.D.I.C. v. Countrywide Fin. Corp.*, 2012 WL 5900973, at *2–3 (C.D. Cal. Nov. 21, 2012) (quoting *City of Pontiac Gen. Emps.' Ret. Sys. v. MBIA, Inc.*, 637 F.3d 169, 175 (2d Cir. 2011)). This is a "fact intensive" inquiry, and some courts have held it is "usually not appropriate" to conduct it at the pleading stage. *Rafton v. Rydex Series Funds*, 2011 WL 31114, at *9 (N.D. Cal. Jan. 5, 2011) (citation omitted); *Booth v. Strategic Realty Trust, Inc.*, No. 13-cv-4921, 2014 WL 3749759, at *4 (N.D. Cal. July 29, 2014). A defendant seeking to establish that a Section 11 claim is time-barred on a motion to dismiss faces an "especially high burden." *Rafton*, 2011 WL 31114, at *10. "At the pleading stage, the question is whether it is plausible that [the] disclosures were insufficient to supply a reasonably diligent plaintiff with the information necessary to plead the Section 11 claims with sufficient detail and particularity to survive a 12(b)(6) motion." *Booth*, 2014 WL 3749759, at *6.

Defendants contend that Plaintiffs "were on notice of the facts underlying their claims over a year before they filed their initial complaint on October 4, 2019." ECF 71 at 19. They specifically claim that the statute of limitations was triggered, at the very latest, when Dropbox made its 2Q'18 financial disclosure on August 10, 2018 because at that point the company "had reported 18 quarters of revenue and three and a half years of paying users, from which any reasonably diligent

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

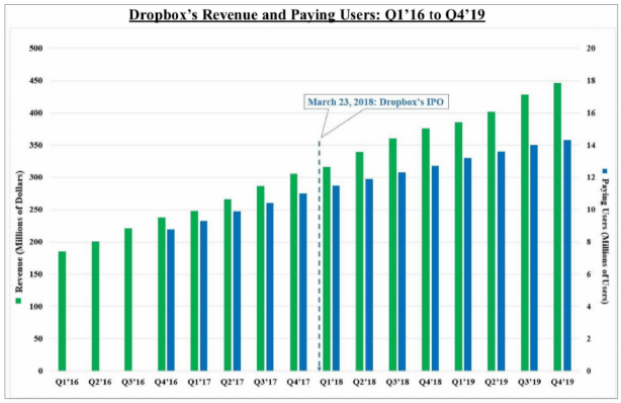
plaintiff could easily calculate Dropbox's growth rates." ECF 71 at 19-20. They further argue Plaintiffs could not have become aware of any declining user conversion rate trend because the company did not disclose this information during the announcement—or during any announcement—and "the results for that quarter reflected growth in both metrics that were entirely consistent with Dropbox's past performance." ECF 84 at 13.

***10** In response, Plaintiffs contend that they "first became aware" of their claims during Dropbox's 3Q'18 disclosure on November 9, 2018 because it was only then that it was revealed that the "ongoing trend of decelerating revenue growth and user conversion rates had been exacerbated, and that Dropbox had still only converted 12.3 million" paying users. ECF 80 at 19. They further explain that (1) "the point in time in which a trend becomes meaningful, material, or actionable is a fact-intensive inquiry that is inappropriate at the pleading stage," (2) Defendants' focus on August 10, 2018 is arbitrary, and (3) the Defendants' invocation of the Registration Statement disclosures to prove notice flies in the face of Plaintiffs' allegations on the merits that such disclosures were misleading and deficient. ECF 80 at 19-21.

The Court rejects Plaintiffs' third rationale straight off the bat. As discussed above, Defendants' Registration Statement disclosures were not deficient in the context of Plaintiffs' pleadings. The Court credits Plaintiffs' second concern about the fact-intensive nature of this inquiry. But while the motion to dismiss is *usually* not the appropriate juncture for the Court to make a conclusion about inquiry notice, the Court is not categorically precluded from doing so.

The Court thus turns to the heart of this dispute, whether Plaintiffs were on inquiry notice of Dropbox's allegedly declining user conversion rate. A brief traipse down memory lane is instructive. Plaintiffs filed the instant lawsuit on October 4, 2019. ECF 1. As such, a reasonably diligent plaintiff must have been on notice of the claims in the CAC no earlier than October 4, 2018. Dropbox filed its Registration Statement with the SEC on March 22, 2018, which contained a slew of financial information. *See* ECF 72, Exh. 1. Dropbox's IPO was on March 23, 2018. CAC ¶ 39. After its IPO, Dropbox made quarterly financial announcements from announced quarterly financial updates. *See* ECF 72, Exhs. 2-9 (Form 10-Q for 1Q'18 through 3Q'19, Form 10-K for fiscal year 2019). Relevant here, Dropbox made quarterly announcements for 2Q'18 on August 10, 2018 and for 3Q'18 on November 9, 2018. On November 8, 2019, after this lawsuit was filed the financial firm D.A. Davidson published a report on Dropbox's 3Q'19 finances, noting that the company "reported a solid 3Q, marked by stable revenue growth, the first in at least 11 quarters" and that this previous revenue growth deceleration "ha[d] been an ongoing concern for investors." *See* ECF 81, Exh. 1. The report made various references to users' adoption of paid Dropbox plans, noting that "Dropbox is seeing fewer users than expected adopting annual plans" and "the Plus plan repricing and repackaging has driven healthy conversion." *Id.* It did not, however, discuss the user conversion metric within the meaning of this lawsuit.

The Defendants also provided a chart summarizing Dropbox's financials over time. Plaintiffs do not dispute the legitimacy of the underlying financial data.



ECF 71 at 11.

As an initial matter, the Court notes that any inquiry notice must be derived from information about Dropbox's revenue and paying user metrics—not user conversion rate. The Defendants state that Dropbox has never released any information regarding its user conversion rate, and the Plaintiffs' do not plead facts to the contrary. [1] As such, the Court considers "whether it is plausible that [the revenue and paying user] disclosures were insufficient to supply a reasonably diligent plaintiff with the information necessary to plead the Section 11 claims with sufficient detail and particularity to survive a 12(b)(6) motion." *Welgus*, 2017 WL 167708, at *20 (internal quotation marks and citation omitted).

***11** Although the Court has already determined Plaintiffs' claims lack sufficient detail and particularly, the Court nonetheless concludes Plaintiffs have not met their burden to plead facts supporting delayed discovery either. The

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

information available to the Plaintiffs from March through October of 2018 was abundant and largely consistent with the Registration Statement. The Registration Statement disclosed slowing revenue and paying user growth rates in March 2018. *See* *Rudman v. CHC Grp. LTD*, 217 F. Supp. 3d 718, 724 (S.D.N.Y. 2016) (statute of limitations triggered where an allegedly concealed "fact was largely obvious from disclosures in the Registration Statement itself."). Dropbox made financial announcements consistent with this disclosure in the following two quarters. *See* ECF 72, Exhs. 2-3 (Form 10-Q for 1Q'18 through 2Q'18); *see also* ECF 80 at 6 (charts of revenue and paying user growth).

While Plaintiffs contend that the November 2019 financial report crystallized the trend, the report itself contradicts Plaintiffs' theory of notice. See ECF 97 at 19:4-22 (transcript of motion 14 hearing). The report notes that "[Dropbox] reported a solid 3Q, marked by stable revenue growth, the first in at least 11 quarters" and that "this was the first quarter (in at least eleven quarters) where growth did not decelerate." *See* ECF 81, Exh. 1 at 2. If anything, the report announced the reversal of the downward trend. And, given the straightforward nature of the metrics at issue, the Court is not otherwise inclined to credit the report as finally providing the Plaintiffs the sufficient insight they needed to be on notice absent factual allegations supporting Plaintiffs' contention. Unlike Plaintiffs' cited authorities, this case involves easily digestible, regularly disclosed metrics. *Compare with* *In re Bare Escentuals, Inc. Securities Litigation*, 745 F. Supp. 2d 1052 (N.D. Cal. 2010) (claims based on "self-cannibalizing sales operations, premium product image dilution through sales to big-box discounters, failing efforts to revitalize the infomercial sales and to cross-sell, and heavy reliance on the negative option club program"); *Booth, Inc.*, 2014 WL 3749759 (N.D. Cal. July 29, 2014) (claims based on the sufficiency of a corporation's internal controls over conflicts of interest); *Rafton*, 2011 WL 31114 (N.D. Cal. Jan. 5, 2011) (claims based on a " 'mathematical compounding effect' that would cause the Fund to deviate from its benchmark, the inverse price of the 30–Year U.S. Treasury Bond"). The "evidence irrefutably demonstrates [P]laintiff[s] discovered or should have discovered" that the Registration Statement contained misstatements or omissions at least a year before October 4, 2019. *Gray v. First Winthrop Corp.*, 82 F.3d 877, 881 (9th Cir. 1996) (citation and internal quotation marks omitted).

The COURT GRANTS Defendants' motions to dismiss on the alternate ground that the claims alleged in Plaintiffs' complaint are time-barred.

F. Leave to Amend

In deciding whether to grant leave to amend, the Court must consider the factors set forth by the Supreme Court in *Foman v. Davis*, 371 U.S. 178 (1962), and discussed at length by the Ninth Circuit in *Eminence Capital, LLC v. Aspeon*, Inc., 316 F.3d 1048 (9th Cir. 2009). A district court ordinarily must grant leave to amend unless one or more of the *Foman* factors is present: (1) undue delay, (2) bad faith or dilatory motive, (3) repeated failure to cure deficiencies by amendment, (4) undue prejudice to the opposing party, or (5) futility of amendment. Eminence Capital, 316 F.3d at 1052. "[I]t is the consideration of prejudice to the opposing party that carries the greatest weight." *Id.* However, a strong showing with respect to one of the other factors may warrant denial of leave to amend. *Id.*

Although Defendants request that the Court dismiss Plaintiffs' claims with prejudice because they are time barred, ECF 71 at 19-20, the Court concludes that it is not yet futile for Plaintiffs to cure this deficiency, along with the others discussed above. As stated at the hearing, Plaintiffs must, at a minimum, identify some factual circumstance that plausibly distinguishes their state of awareness of these claims in November 2018 that was not disclosed in the August 2018 quarterly report or earlier. As such, the Defendants' motions to dismiss with respect to all claims are GRANTED WITH LEAVE TO AMEND.

IV. ORDER

***12** For the foregoing reasons, the Defendants' Motions to Dismiss are GRANTED WITH LEAVE TO AMEND. Plaintiffs shall file an amended complaint **no later than January 6, 2020**.

All Citations

Slip Copy, 2020 WL 6161502, Fed. Sec. L. Rep. P 100,934

WESTLAW © 2022 Thomson Reuters. No claim to original U.S. Government Works.

Footnotes

1 Plaintiffs' contend that Dropbox's 10-Q Form from 3Q'18 disclosed that "Dropbox had still only converted 12.3 million of its more than 500 million registered users into paying users." ECF 80 at 19. Because this allegation cannot be found in the CAC, the relevant Form 10-Q, or the financial report, the Court disregards it. The Court notes that Dropbox's Form 10-Q from 3Q'18 does state that "[w]e've built a thriving global business with 12.3 million paying users." *See* ECF 72, Exh. 4. The difference between the metric cited in the 10-Q Form and Plaintiffs' characterization of this metric further highlights the Court's earlier discussion about the insufficiency of Plaintiffs' claims. *See* Section III.B-C.

End of Document © 2022 Thomson Reuters. No claim to original U.S. Government Works.

LOOKING CLASSY WHILE VETTING NEW CASES

Elizabeth Kramer & Adam Polk

Identifying Class Actions

Public investors who raise disputes with the securities industry may also have claims that can be pursued in a class action. The same is true if you are approached regarding an intra-industry dispute. The following is intended to help PIABA members identify potential class actions.

Threshold Questions

- Is there liability? Did the Defendant or Defendants do something wrong that impacted a large group of investors, either due to loss of investment, or decline in value of investment?

- Is there class potential? Is the harm inherently individualized, or have other investors been subjected to the same misconduct?
    - Look for harm caused by uniform offering materials, policies and procedures, representations, contract terms; the service or product itself causes harm similarly across investors
    - Avoid affirmative fraud claims
    - Types of cases: securities fraud, common law misrepresentation claims, aiding and abetting, breach of contract, breach of fiduciary duty, consumer protection law violations, data breach/privacy, employment law violations.

- Is there collectability? Who are possible defendants?
    - Are they registered with FINRA? SEC? CFTC? Other regulatory agencies?
    - What contracts or user agreements might apply?
        - Potential defendants with no direct contractual relationship to the client means you likely avoid arbitration provisions and class action waivers
    - Do the Defendants have the ability to satisfy a judgment? Look for whether there is insurance, and whether the defendants have assets or are subject to parallel SEC or bankruptcy proceedings.

- Are there damages? How much is enough to make a class approach sensible?

Elements of Rule 23

The Rule 23(a) requirements must be satisfied for all class cases.

1. Numerosity. Generally more than 40 members.
2. Commonality. Common questions susceptible to common answers.
3. Typicality. As go the claims of the class representatives, so go the claims of the class.
4. Adequacy of class representative and counsel. (1) The class representatives must have no major conflicts of interest with absent class members; (2) Counsel must have experience with the claims and with class actions.

At least one subsection of 23(b) must also be satisfied.

1. 23(b)(1)(A): A class can be certified if there is a risk of inconsistent rulings establishing incompatible standards of conduct for the party opposing a class. These are cases where a determination about whether the defendant's conduct violated the law will have a bearing on the defendant's future conduct with respect to many similarly situated individuals.
2. 23(b)(1)(B): Cases with limited fund settlements. Where the funds available for settlement are less than aggregate damages, a class can be certified to ensure that the funds are allocated appropriately. In this instance, there is an optional notice procedure, and opt outs are not permitted. The class mechanism is useful, for example, because if there is a limited pot of money, then an individual resolution will impact the relief available to the remainder of the plaintiffs.
3. 23(b)(2): Classes seeking declaratory or injunctive relief. Injunction-only classes have no notice requirement or opt outs. The rule requires only that the defendant "acted or refused to act on grounds that apply generally to the class."
4. 23(b)(3): For cases in which the class seeks damages, the named plaintiffs must establish predominance and superiority.
    1. Predominance: common issues must predominate over individual issues. Issues that could present problems for plaintiffs on this prong include unique or unsanctioned interactions with specific brokers, financial advisors, or others who "break the chain" to the misconduct that is otherwise common to the class.
    2. Superiority: the class action mechanism is better than other means of litigating the case, focusing on factors like the class's interest in concentrating case in one forum; (2) the interests of class members in controlling their own litigation; (3) problems with managing the class case; and (4) the extent of other similar litigation.

There are also implicit requirements to Rule 23.

1. The plaintiff must be a member of the proposed class. Make sure that your client's facts align with those of the class. Special roles (such as acting as a trustee) could remove them from the class definition or implicate typicality or adequacy. If you have sub-classes that hinge on specific facts (used ABC services in XYZ state), be absolutely sure one of your clients has those facts to represent the subclass.

2. The plaintiff must have a live claim against the defendant. A defendant may offer the plaintiff an individual settlement to render the class case moot. While case law has developed to limit the impact of a strategic "buy-off" of a lead plaintiff, best practice is to thoroughly discuss this issue with clients in advance of filing. You may also include more than one named plaintiff on the complaint so that if one is eager to resolve their claim, the others can continue with the class action.

RIA Supervisory Duties:
Claims and Resources for RIA Cases

Jorge L. Riera

RIERA LAW FIRM
INVESTOR ADVOCATE

What You Should Know About Supervision of RIAs

- What Is an Investment Adviser?
- Growth of RIAs
- What Is the Standard of Conduct for an RIA?
- RIA Prohibited Transactions
- Compliance Obligations
- Code of Ethics
- Supervision of RIAs
- Resources

WHAT IS AN RIA?

What Is an Investment Adviser?

- An Investment Adviser Representatives ("IAR") and Registered Investment Advisers ("RIA") provide advice to others about investments for a fee.
- Characteristics of an investment adviser are:
  - Provides advice or analysis about securities either by making direct or indirect recommendations to clients or by providing research or opinions on securities or securities markets.
  - Receives compensation in any form for the advice provided.
  - Engages in a regular business of providing advice about securities.

GROWTH OF RIAs

Growth of RIAs
Did you know?

- There are more than 5,000 SEC-registered investment advisers (RIAs) compared to 3,400 FINRA brokerage firms
- Over 35% of all RIAs manage approximately $18 trillion in private fund
- In the past five years:
  - 70% increase in the assets managed by advisers to private funds
  - Total number of RIAs has increased from 12,250 to 14,800 (increase of 900 RIAs year-over-year)

RIA CONDUCT STANDARDS

What Is the Standard of Conduct for Investment Advisers?

- Obligation to act in the best interest of its client encompasses:
  - Duty of Care – Provide investment advice in the best interest of the client based on a reasonable understanding of the client's objectives
  - Duty of Loyalty – Make full and fair disclosure of all material facts relating to the advisory relationship, and all conflicts of interest to provide impartial advice
- Provide advice and may provide monitoring over the course of the relationship

What Is the Standard of Conduct for Investment Advisers? (Part 2)

- Provide full and fair disclosure of all material facts related to the advisory relationship
- Cannot put their own interests before their clients' interests
- Eliminate, or at least disclose, all conflicts of interest

RIA PROHIBITED TRASACTIONS

RIA Prohibited Transactions
Section 206 of the Advisers Act

It shall be unlawful for any investment adviser—

- (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
- (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

RIA COMPLIANCE OBLIGATIONS

Chief Compliance Officer (CCO)
Rule 206(4)-7(c)

- Under Rule 206(4)-7(c), RIAs are required to appoint a CCO
- A CCO must be identified on Form ADV, Part 1, Schedule A, Item 2(a)
- CCO should be competent and knowledgeable regarding the Advisers Act
- CCO should be empowered with full responsibility and authority to develop and enforce the Compliance Manual
- CCO who does not carry supervisory responsibilities will not be deemed to have failed to supervise

Compliance Officer
Failure to Supervise Defense

- Section 203(e)(6) of the Advisers Act states that Compliance officer shall not be deemed to have failed to reasonably supervise another person if:
- (i) the adviser had adopted procedures reasonably designed to prevent and detect violations of the federal securities laws;
- (ii) the adviser had a system in place for applying the procedures; and
- (iii) the supervising person had reasonably discharged his supervisory responsibilities in accordance with the procedures and had no reason to believe the supervised person was not complying with the procedures.

The Compliance Rule
Rule 206(4)-7

- Under the Compliance Rule, to be able to provide investment advice to clients, an RIA is legally obligated to:
- (1) adopt and enforce written P&P reasonably designed to prevent violation, by the adviser and its supervised persons, of the Advisers Act and the rules adopted under the Advisers Act;
- (2) reviews, at least annually, the sufficiency of its P&P and the effectiveness of their implementation; and
- (3) designate a chief compliance officer

Florida Compliance Rule
F.A.C. Rule 69W-600.0131

- Under the Florida Compliance Rule 69W-600.0131, an RIA is legally obligated to:
- (1)(w) adopt, maintain and enforce written P&P reasonably designed to achieve compliance, by the adviser and its supervised persons, with Chapter 517, F.S., and the rules adopted under Division 69W, F.A.C.;
- (2) The federal statutory and regulatory provisions referenced herein shall apply to investment advisers, associated persons of investment advisers and federal covered advisers, which is incorporated by reference in Rule 69W-200.002, F.A.C.

The Compliance Rule - Written Supervisory Procedure

- WSPs must be reasonably tailored to the RIA's business practices.
- Compliance programs must take into account business practices such as:
  - RIA's particular investment strategies
  - types of clients
  - trading practices
  - valuation procedures
  - advisory fees

The Compliance Rule - Annual Reviews

- RIAs must conduct an annual review of its Compliance Manual
- Annual reviews must address:
  - the adequacy of the RIA's Compliance Manual, and
  - the effectiveness of RIA's implementation of the Compliance Manual
- RIA's must address or correct problems identified during the annual review

The Compliance Rule - Oversight of Key Areas

RIA oversight duties include regulatory and business responsibilities for advisers managing investor assets, such as:

- Monitoring the appropriateness of client account types:
  - Review at account opening to determine whether account selected is appropriate (e.g., wrap fee vs. separately managed account)
  - Document assessment including factors considered

The Compliance Rule - Exam Deficiencies

- RIA's Compliance Manuals were "off the shelf" and not tailored to its business practices
- Compliance P&P were inconsistent with actual practice such as commissions, fees and oversight of compensation practices
- RIA's did not review their Compliance Manuals annually or those who did failed to document the reviews and assess risk areas

RIA ETHICS CODE

Code of Ethics
Advisers Act Rule 204A-1

Under the Code of Ethics Rule, RIAs are required to:

- (1) establish and enforce standards of business conduct that reflect the RIA's fiduciary obligations and those of all its supervised persons
- (2) include provision requiring supervised persons to comply with Federal securities laws
- (3) ensure “access persons” report their personal securities transactions and holdings to the CCO or designated supervisor for review
- (4) provide a copy of the Code of Ethics to all supervised persons require written acknowledgement of receipt

Enforcing Code of Ethics

- Under Rule 204A-1, RIAs are required to maintain and enforce their Codes of Ethics.
- An RIA's CCO, or persons under his authority, must have primary responsibility for enforcing the RIA’s Codes of Ethics.
- Enforcement of the Codes of Ethics must include reviewing access persons' personal securities reports and holdings

RIA SUPERVISORY DUTIES

Supervision of RIAs

- **Advisers Act Rule 206(4)-7(a)** requires SEC-registered advisers to **adopt and implement written policies and procedures that are reasonably designed to prevent violations** of the Advisers Act and rules thereunder by advisers and their supervised persons.
- **Advisers Act Section 203(e)(6) establishing supervisory procedures** reasonably designed to prevent and detect such violations and following these procedures are important steps advisers should take in supervising persons subject to their oversight.

Supervised Person
Section 202(a)(25) of the Advisers Act

- **Supervised person** is defined as "any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser")

Supervision of RIA
Portfolio management

Oversight of Portfolio management processes include:

- a) allocation of investment opportunities
- b) consistency of portfolios with clients' investment objectives
- c) disclosures by the adviser, and
- d) applicable regulatory restrictions

Supervision of RIA
Portfolio management – Part 2

Examples of conduct that compliance procedures should be designed to prevent:

- (1) Style drift - chasing returns
- (2) Violation of investment restrictions
- (3) Window dressing and portfolio pumping
- (4) Unfair allocation of securities, including initial public offerings

Supervision of RIA
Trading practices

Oversight of Trading practices include:

- a) best execution obligation
- b) use of client brokerage to obtain research and other services ("soft dollar arrangements"), and
- c) allocates aggregated trades among clients.

Supervision of RIA
Trading practices – Part 2

Examples of Trading practice conduct that compliance procedures should be designed to prevent include:

- Failure to obtain best execution;
- Failure to periodically and systematically review execution quality and to route and reroute orders accordingly;
- Use of commissions outside of 12b-1 to pay for distribution, or use of commissions to pay for client referrals, without disclosure; and
- Failure to clearly disclose to clients the use of their commission dollars.

Supervision of RIA
Proprietary Trading & Personal Trading

Oversight of Proprietary Trading & Personal Trading requires RIAs to adopt and enforce a Code of Ethics to:

- Protect material nonpublic information by limiting access of MNPI regarding client securities holdings and transactions to supervised persons who need to know the information to perform their duties
- Requiring pre-clearance before a supervised person can place a personal trade

Supervision of RIA
Proprietary & Personal Trading – Part 2

Examples of Proprietary & Personal Trading conduct that compliance procedures should be designed to prevent include:

- (1) Market timing, insider trading, front-running or other abusive personal or proprietary trading
- (2) Untimely or failure to report personal securities transactions
- (3) Codes of ethics violations
- (4) Failure to properly identify and monitor trading by all access persons

Supervision of RIA

Disclosure Obligations – Form ADV, Part II

Under federal and state law, RIAs have an affirmative obligation to disclose all material facts to their clients:

- the disclosure must be clear enough so that a client is fully apprised of the specific facts including conflicts,
- the client is in a position to give informed consent, and
- this disclosure must be timely if is to be meaningful and effective.
- Robare v. SEC "[R]egardless of what Form ADV requires, [investment advisers have] a fiduciary duty to fully and fairly reveal conflicts of interest to their clients."

Supervision of RIA
Disclosure Obligations – Part 2

- RIAs must provide full and truthful disclosures in their brochure and brochure supplements
- SEC-registered RIAs are not required to file your brochure supplements through the IARD
- State-registered RIAs must file a copy of the brochure supplement for each supervised person doing business in that state through the IARD

Supervision of RIA
Disclosure Obligations -CRS – Part 3

- Rule 204-5 under the Advisers Act requires that SEC-registered IAs deliver their CRS to each client before/at the time they enter into a contract.
- For existing client, RIAs must deliver their CRS before/at the time they:
  - (a) open a new account;
  - (b) recommend a client to roll over assets from a retirement account into an account/investment; or
  - (c) recommend or provide a new investment advisory service or investment.

Supervision of RIA
Disclosure Obligations – Part 4

Examples of Disclosure conduct that compliance procedures should be designed to prevent include:

- Inaccurate or misleading performance numbers;
- Inadequate supporting documentation for performance claims;
- Misleading advertisements;
- Inappropriate use of after-tax returns; and
- Any statement in an ADV, brochure, prospectus, SAI or other document that is not 100% accurate.

Supervision of RIA

Disclosure Obligations – Enforcement Actions

- In the Matter of The Robare Group, Ltd. (adviser's disclosure that it may receive a certain type of compensation was inadequate because it did not reveal that the adviser actually had an arrangement pursuant to which it received fees that presented a potential conflict of interest)
- In the Matter of Larry C. Grossman (the use of "may" in the Form ADV disclosures is misleading because it suggested the mere possibility that the broker would make a referral and/or be paid 'referral fees' at a later point, when a commission-sharing arrangement was already in place and generating income)
- Dolphin & Bradbury, Inc. v. SEC, ("The Commission noted the critical distinction between disclosing the risk that a future event might occur and disclosing actual knowledge the event will occur.")

Supervision of RIA

Florida Disclosure Obligations –

- Under Rule 69W-600.0131(1)(k), RIAs must disclose to customers in writing, before any advice is rendered, any material conflict of interest relating to the adviser or any of its employees which could reasonably be expected to impair the rendering of unbiased and objective advice including:
  - 1. Compensation arrangements connected with advisory services to customers which are in addition to compensation from such customers for such services; and,
  - 2. Charging a customer an advisory fee for rendering advice when a commission for executing securities transactions pursuant to such advice will be received by the adviser or its employees.

Supervision of RIA
Safeguarding Client Assets

- RIAs must safeguard their client assets from conversion or misuse by advisory personnel
- Examples of conduct that policies and procedures should be designed to prevent include:
  - Improper or inadvertent access to client assets;
  - Unauthorized trading in clients' accounts;
  - Improper disclosure of client account information;
  - Delivery of false custodial statements to clients; and
  - Discrepancies between the records of the firm and custodian.

Supervision of RIA
Books & Records

- RIAs must create and maintain accurate books and records.
- Examples of conduct that policies and procedures should be designed to prevent include:
  - Failure to maintain and have accessible all required books and records, including emails;
  - Failure to protect records and information from unauthorized access and manipulation; and
  - Maintaining inaccurate books and records - e.g., revenue and expense numbers are not accurate or timely; and
  - Failure to produce business records required by inspection staff.

Supervision of RIA
Marketing Advisory Services

- RIAs must have written agreements set forth procedures to supervise solicitation activities conducted by 3rd Parties on behalf of Adviser.
- Examples of conduct that policies and procedures should be designed to prevent include:
  - Failure to disclose or inadequate disclosure of solicitation arrangements;
  - Failure of solicitor to deliver adviser's ADV;
  - Failure to disclose payments to employees for referrals; and
  - Failure to contract for solicitation.

Supervision of RIA
Valuation & Fees

- RIAs must accurately Value clients' holdings and assess fees based on those valuations.
- Examples of conduct that policies and procedures should be designed to prevent include:
  - Illiquid or fair-valued assets not valued appropriately, or not back-tested; and
  - Inaccurate computation of fees, or fees based on inaccurate computation of client assets.

Supervision of RIA

Protect Privacy of Client Records

- RIAs must establish safeguards to protect the privacy of client records and information.
- Examples of conduct that policies and procedures should be designed to prevent include:
  - Failure to safeguard the privacy of clients;
  - Failure to notify clients of policies on safeguarding;
  - Lack of verification that client data is compiled accurately; and
  - Integrity of client data is not protected from unauthorized changes.

Supervision of RIA
Business Continuity

- RIAs must establish Business Continuity Plans.
- Examples of conduct that policies and procedures should be designed to prevent include:
  - Failure to prepare for, and test operations during human or natural emergencies;
  - Failure to provide for availability of critical personnel and systems;
  - Failure to verify continuity plans of third-party providers; and
  - Failure to protect records from unplanned destruction.

RESOURCES
SEC – RIA Risk Alerts

- Observations from OCIE's Examinations of Investment Advisers: Supervision, Compliance and Multiple Branch Offices (Nov. 9, 2020) – https://www.sec.gov/files/Risk%20Alert%20-%20Multi-Branch%20Risk%20Alert.pdf
- Observations from Examinations of Investment Advisers: Compliance, Supervision, and Disclosure of Conflicts of Interest (Jul. 23, 2019) - https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Supervision%20Initiative.pdf
- The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers (Feb. 7, 2017) - https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf
- Examinations of Supervision Practices at Registered Investment Advisers (Sep. 12, 2016) - https://www.sec.gov/ocie/announcement/ocie-2016-risk-alert-supervision-registered-investment-advisers.pdf

RESOURCES

SEC – RIA Compliance, Conduct & Ethics

- Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Rel. No. IA-2204 (Dec. 17, 2003) - https://www.sec.gov/rules/final/ia-2204.htm
- Commission Interpretation Regarding Standard of Conduct for Investment Advisers (Jul. 12, 2019) - https://www.sec.gov/rules/interp/2019/ia-5248.pdf
- Investment Adviser Code of Ethics, Advisers Act Rel. No. IA-2256 (Jul. 2, 2004) - https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf

THANK YOU!



IS VIRTUAL MEDIATION HERE TO STAY?

Courtney Werning, Michael Bixby, Melanie Cherdack, Jeffrey Grubman

I. Introduction

When the news of the Coronavirus started to spread in early 2020, many of us were scrambling to adjust to the sudden inability to be physically present with our co-workers and clients. Our calendars full of trials, arbitrations, and mediations were suddenly and unthinkably cleared. Offices were shut down, travel was halted, and the pace at which we handle our dockets dwindled. At the time, we did not know that this would be the "new normal" for the foreseeable future, but our practices adjusted (maybe quickly, maybe reluctantly) to a virtual-based approach. Team and client meetings started taking place over virtual software. Attorneys and their staff cleared off countertops at their homes to set up workstations with dual monitors, and children and pets inevitably made cameo appearances during Zooms with important clients. The point is, we adapted our practices because we had to. Operating our practices online was the only option.

Now, almost nearly three years later, the effects of the Coronavirus pandemic are still pervasive - both in our personal and professional lives. One of the lingering outcomes is the way we mediate our cases. Pre-covid, most lawyers and mediators would insist that mediation needed to take place in person for the process to be effective. Indeed, building trust with our clients and mediator is critical for it to be an effective process. Reading body language, listening to clients, and getting face-to-face time with people to build trust is why we agree to mediate in the first place - it works.

But when the top mediators in the country switched out their roller bags and hotel conference rooms for tennis shoes and home offices, we followed suit. Many of us have chosen not to go back to traditional in-person mediations for a variety of reasons, and the question that the legal community faces is whether we should continue to use online mediation in the future. This article will discuss the good and bad of virtual mediations, suggestions for best practices, and what to consider from an ethical standpoint.

II. Benefits of Virtual Mediation

Using videoconferencing software such as Zoom, Teams, WebEx, and Go To Meeting, mediators discovered that they could mirror some of the same functions as in-person mediations - separate caucuses, breakout rooms, communicating with parties and counsel quickly and easily. The virtual mediation option removes geographical constraints and promotes expediency. Mediators, parties, and counsel have discovered many benefits and advantages to virtual mediation, such as:

- **Savings on costs.** No longer will parties and counsel have to consider the travel costs associated with an in-person mediation. Most of our practices are nationwide (or farther) and the expenses for traveling to and from mediations, lodging, meals, etc. can add up quickly. Taking that out of the equation when considering "net to client" numbers can be very beneficial and allow for the possibility of mediation for smaller cases.
- **Quicker scheduling** since travel is not involved. Mediators and counsel do not lose half a day each way to travel for mediations, so all of the interested parties' availability is

greater. This allows a wider selection of available and qualified mediators and quicker scheduling.

- **Greater participation** in the process for individuals and decision-makers who otherwise could not have been there for time or travel restrictions.
- **Less stress** level for parties. Most of our clients are going through this process for the first time, and unfamiliar situations can be highly stressful. When our clients can work from their homes or offices and be in a surrounding in which they are familiar and comfortable, it takes the stress of the unknown out of the day.
- **Better outcomes.** When the parties are less stressed out and emotional, we tend to get better outcomes.
- **Productivity.** Participants can turn off the screen during downtime instead of bouncing around a conference room with nothing to do, and that downtime can be used to do other productive things.
- **Seeing it through to the end.** If the mediation runs late no one has to leave for the airport.
- **Ease of organizing caucuses.** Different break out rooms easily done (e.g. both opposing counsel; just attorney with mediator; attorneys alone with clients)
- **Quick and easy document sharing.** Can easily share documents and focus a mediator in on the part of the document that you want them to see.
- **Humanizing.** Seeing people in their homes (with a kid or animal popping in) can remind parties that they are dealing with a human being on the other side, and it can help break barriers to negotiation.
- **Continuing the process** at another time, if necessary, is reasonable and easy when travel is not involved.

We have had no problems mediating claims for clients in China and Australia. Before virtual mediation was commonplace, that would have been difficult, ineffective, or considered not possible. Mediations can now be affordably conducted for smaller claims that might not have otherwise justified the air travel and hotel costs for counsel. There seems little doubt that virtual mediation is a tool that will continue to be utilized in the future given the vast amount of benefits it offers.

III. Challenges of Virtual Mediation

Virtual mediation does not exist without some challenges and drawbacks. Initially, the legal world was unprepared to move to a completely remote world and did not have the software, hardware, and processes set up to accommodate it. We all suffered growing pains as we tried to master the best ways to conduct our practices, and mediation was no different. Virtual mediation brought some unique challenges, including:

- **Distraction.** Participants and mediators can easily get distracted with other things while sitting on the computer.
- **Technologically-challenged clients.** Some clients are not tech-savvy and do not understand how to work video platforms. While this can be overcome with patient instruction, the added layer of stress for clients who may get frustrated at a process they do not like or feel comfortable with can hinder settlements.
- **Endless mediation.** With no flight home, mediations can last until midnight. While it can be nice to have extra time to settle cases that are nearly done without someone having to catch a flight home, this can lead to wasted time without any sense of urgency. Lawyers tend to use the time given to them. With a cut-off time of 5:00, you can often expect the process to be quicker and more efficient.

- **Harder to read people.** Much of a mediator's job involves things like reading body language, listening to what is not said, interpreting subtext, reading the room, and taking cues from a party's eye contact or tone of voice. The way a mediator responds to these cues can be the difference between a successfully settled dispute and one that falls apart.
- **Privilege issues.** It is difficult to monitor or manage who is in the room with your client if you are not there in person. Issues concerning attorney-client privilege can arise with third-parties attending or hearing a private discussion during a mediation. Couple that with the ability (perceived or real) to record sessions in secret, and we can have real problems with confidentiality and the security of the mediation process.
- **Tech problems.** Even the most tech savvy can expect to occasionally experience issues - a Zoom meeting that will not load without a required update, a microphone that will not connect, a web camera that starts flickering halfway through a discussion. These things are distractions and take focus away from the mediation process.
- **Inability to build rapport** with client. Trust between a client and an attorney is so critical. Before a mediation, counsel and his client may have only ever spoken on the phone. Virtual mediations make it more difficult to connect with a person across the screen to gain your client's trust and confidence.
- **Lack of commitment to the process.** Without the investment of the cost and effort of an in person mediation, parties and counsel could take the process less seriously, or perhaps agree to a mediation when they have no intention of negotiating - what do they have to lose?
- **Less small talk.** There are always things to be learned about your client and the case found within the conference room small talk. You have the ability to learn more about your client's background and story without sounding like you're deposing them.
- **Perception of informality.** Virtual mediation may not seem as formal as in person. Sometimes, the mere use of law firm conference room can change both parties' perceptions. Without the formality of getting together, a client may feel deprived of his or her "day in court."

IV. Best Practices for Effective Virtual Mediations

There are a number of best practices for effective virtual mediations, which include the typical best practices for an in-person mediation. Preparation is always key, and virtual mediations likely require more preparation than an in-person mediation to ensure the process runs smoothly.

Some best practices include:

- **Zoom Practice Session**: Determining in advance of the mediation what your client's technological skills and tools is a must to avoid time wasting and frustration during the day of the mediation. It is advisable to do a practice session with your client to ensure that you and your client have the right technology and ability to effectively use it. Be prepared to provide your client with a camera or microphone if necessary to ensure they can fully participate.
- **Prepare and Clearly Set Expectations**: Both your preparation and the client preparation will likely be more detailed than for in-person mediations. Your client will benefit from a thorough discussion of the process, how the virtual mediation will flow, and what to expect. Make sure your client understands the time commitment and importance of setting aside the time to focus on the mediation.

- **Develop a Plan for Communicating and Taking Breaks During the Mediation**: It is useful to have a backup plan in place in case of technical difficulties. While you can still enjoy some of the benefits of a typical mediation in further getting to know your clients and further preparing for and developing your case, it is important to remember that breaks are necessary to avoid screen fatigue. Encourage your clients to step away from the screen when possible, but make sure you have a good cell phone number or other means to quickly get them.
- **Be Ready to Share Your Key Documents or Analysis**: Be sure to communicate with the mediator and opposing parties regarding sharing any documents and files in advance of the mediation. Be prepared to provide electronic copies, printed copies, and ready to share-screen as necessary.
- **Avoid Distractions**: A clean background, clear schedule, and focus from lawyers, clients, and interested stakeholders will dramatically increase the efficiency and effectiveness of the mediation.
- **Hybrid Mediations May be Useful in Some Cases**: Consider the needs of your specific case, if it would be helpful to have some participants in the same location (e.g., you, the client, the mediator) many mediators are amenable to conducting hybrid virtual and in-person mediations.

V. Conclusion

The pandemic has established that dispute resolution and mediation can be done virtually and can be effective, particularly when the tips discussed above are followed. As people begin to resume normal life again, there is a desire to return to what we know. Yet it is hard to imagine abandoning a process that we have mastered and has allowed us opportunities we never had in the past. Despite all the horrors and tragedy that the pandemic has brought, the wide adoption of virtual mediation is a silver lining that is likely here to stay.

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

Christine Lazaro and Michael S. Edmiston[1]

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

Reg. BI contains four component duties for brokers and firms: Disclosure, Care, Conflicts of Interest, and Compliance. While the SEC stated that it did not believe Reg. BI creates any new private right of action or right of rescission,[6] the Rule sets forth duties to which a broker and firm must adhere. Therefore, these obligations may be used to support a claim for negligence[7] for a recommendation that is not in the investor's best interests, as well as the firm's failure to supervise. While this article will walk through how to assess each of the obligations when pleading and advocating a potential negligence claim in FINRA arbitration, conduct that violates Reg. BI may also support other claims, such as breach of contract, negligent or intentional misrepresentation, and state Blue Sky law claims.

I. When Does Regulation Best Interest Apply?

Reg. BI has similarities to FINRA's Suitability Rule, but there are also differences. For Reg. BI to apply, like the Suitability Rule, a broker must make a *recommendation*. The term "recommendation" has the same meaning it currently has under FINRA rules.[8] It is a fact-based determination. Factors to consider are "whether the communication 'reasonably could be viewed

---

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

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

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

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

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

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

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

[8] 84 Fed. Reg. 33,318, 33,337.

as a 'call to action'' and 'reasonably would influence an investor to trade a particular security or group of securities.'"[9] Recommendations include, for example, advice about the type of securities account to open, as well as advice to roll over or transfer assets from one account to another.[10] Additionally, a broker may be deemed to have made an implicit hold recommendation, triggering the obligations of the Rule, if the broker has agreed to perform periodic account monitoring.[11] Communications such as general financial and investment information; descriptive information about an employer-sponsored retirement plan; certain asset allocation models; and interactive investment materials would not be considered recommendations.[12]

Reg. BI applies to a different universe of customers than the Suitability Rule. Brokerage firms and brokers owe their Reg. BI obligations to "retail customers," which are natural persons and their legal representatives, seeking advice for personal, family, or household purposes.[13] This means that Reg. BI does not apply to recommendations to *entities*, but does apply to recommendations to individuals regardless of their sophistication so long as the advice is for personal purposes. The Suitability Rule will still apply to any accounts that are not captured by Reg. BI.

II. What are the Broker's Specific Obligations?

Reg. BI is comprised of four components: (i) the Disclosure Obligation; (ii) the Care Obligation; (iii) the Conflict of Interest Obligation; and (iv) the Compliance Obligation.[14] If a broker or firm violates any of these duties, and the investor has been damaged as a result, there may be a claim for negligence.

a. Disclosure Obligation

i. Duties Under Regulation Best Interest

The Disclosure Obligation requires that a broker or brokerage firm make full and fair disclosure in writing of "material facts relating to the scope and terms of the relationship" with the customer; and "material facts relating to such conflicts of interest that are associated with the recommendation" prior to or at the time of the recommendation.[15] "Materiality" has the same meaning that the Supreme Court articulated in *Basic v. Levinson*: a fact is material if there is "a substantial likelihood that a reasonable shareholder would consider it important."[16]

---

[9] *Id.* at 33,335.

[10] *Id.* at 33,338.

[11] *Id.* at 33,340.

[12] *Id.* at 33,337 – 33,338.

[13] *Id.* at 33,343.

[14] 17 C.F.R. §240.15l-1(a)(2).

[15] 84 Fed. Reg. at 33,347.

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

While not required, it is likely that the disclosures related to the scope and terms of the relationship will be primarily made through the account agreements, usually completed at the beginning of the relationship. Some of these disclosures will also now be made through the Form CRS.[17] There is no requirement that these disclosures be made every time a recommendation is made.
Material facts related to the scope of the relationship must include the following types of information: (i) the capacity in which the broker is acting (as a broker-dealer or investment adviser); (ii) fees and costs associated with the transactions and the accounts more generally; and (iii) the type and scope of services the brokerage firm will offer, including any limitations on those services.[18]

Regardless of whether the firm and individual are dually registered as both brokers and investment advisers, both still have to disclose the capacity in which they are acting. Reg. BI also limits who may use the term “advisor” or “adviser” in their title. A broker may call themself an “advisor” or “adviser” if they are also registered as an investment adviser, regardless of whether they are acting in an advisory capacity with a specific client. If a broker calls themselves “advisor” or “adviser” and is not dually registered, then they have likely violated their disclosure obligation.[19] It remains unclear whether the broker will need to make any further disclosures when acting as both a broker and an investment adviser with the same client or acting solely in a brokerage capacity with an investor while dually registered. If the brokerage firm is dually registered but the broker is not, the broker must disclose that they cannot offer advisory services.[20]

With respect to fees and costs, the SEC expects that brokerage firms will build on the disclosure of fees and costs that are set forth in Form CRS.[21] The obligation does not require that the brokerage firm provide “individualized” costs and fees, but rather may provide standardized or hypothetical amounts or percentage ranges.[22] Brokerage firms may also satisfy this part of their disclosure obligations by providing mandated disclosure documents, such as prospectuses, and trade confirmations.[23]

With respect to the type of services the brokerage firm offers, the firm must disclose whether it monitors transactions and strategies.[24] As part of this disclosure, the brokerage firm must be specific as to the frequency and duration of the services offered.[25] The brokerage firm may rely on information disclosed in the Form CRS, but it will likely need to expand on that information to

---

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

[18] 84 Fed. Reg. at 33,349.

[19] *Id.* at 33,352.

[20] *Id.* at 33,357.

[21] *Id.* at 33,354.

[22] *Id.* at 33,355.

[23] *Id.*

[24] *Id.* at 33,356.

[25] *Id.*

meet this disclosure obligation.[26] However, the brokerage firm may rely on other documents, including account agreements, to make these disclosures.[27] As mentioned above, the broker may be deemed to have made an implicit recommendation if the broker has agreed to periodic monitoring.

The conflicts of interest disclosure obligation should summarize how the brokerage firm and the brokers are compensated for their recommendations as well as the conflicts that the compensation arrangements create.[28] These conflicts need not be disclosed on a recommendation-by-recommendation basis.[29]

While the disclosure obligation requires that the disclosures be made in writing, the SEC recognizes that it may be necessary to supplement, clarify, or update written disclosures with oral disclosures.[30] If the brokerage firm does supplement the written disclosures, however, the brokerage firm must keep a record of the fact that an oral disclosure was provided.[31]

ii. FINRA's Perspective on Inadequate Procedures

In its 2022 Report on FINRA's Examination and Risk Monitoring Program, FINRA identified ineffective practices found during routine exams.[32] FINRA found that some firms failed to make full and fair disclosures of material fees received as a result of the recommendation, including whether the firm received revenue sharing.[33] Brokers did not adequately disclose conflicts, including whether they were trading in the same security in their own personal account.[34] Additionally, firms did not adequately disclose material limitations in their securities offerings.[35] Brokers also continued to use the term "advisor" or "adviser" in their title even though they were not dually registered.[36]

---

[26] *Id.* at 33,357.

[27] *Id.*

[28] *Id.* at 33,363.

[29] *Id.*

[30] *Id.* at 33,368.

[31] *Id.*

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

[33] *Id.*

[34] *Id.*

[35] *Id.*

[36] *Id.*

iii. Important Considerations and Documents

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

One of the more significant aspects of Reg. BI's Disclosure Obligation is the requirement to set forth the degree to which a firm or a broker will monitor an investor's account and holdings. This information will be set forth in the Form CRS and may also now be included in other account documents such as the account agreement. It will be important to review the Form CRS and other account documents to determine what duties a broker has assumed with respect to monitoring. Moreover, the Rule recognizes that the disclosure may be supplemented orally. Therefore, if a broker has told an investor that they will review the investor's account annually, this should form the basis of the broker's obligations, regardless of whether the Form CRS states that the firm does not monitor accounts. If there is a representation that the account will be monitored or reviewed periodically, the broker may be deemed to have made an implicit recommendation to hold at the timing of the review if no changes are made to the investor's account. Therefore, if circumstances have changed, and a security that was appropriate at the time of the recommendation is no longer appropriate, and the broker does not make a recommendation to sell, one may argue that the broker has made an implicit recommendation to hold, which will trigger the Care Obligation, to be discussed next.

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

Most of the disclosure obligations must be in writing. Therefore, when initially assessing the case, it will be important to review the Form CRS and the account agreements to determine what the broker has represented it will do. In discovery, it will be important to ask for any documents reflecting any oral disclosures made pursuant to Reg. BI, as the brokerage firm is obligated to keep a record of any oral disclosures made. To the extent oral disclosures have not been documented, the firm will have violated its recordkeeping obligations, which may be relevant to further support a negligence claim focused on failure to supervise.

b. Care Obligation

i. Duties Under Regulation Best Interest

The Care Obligation, in many ways, mirrors the FINRA Suitability Rule. It requires that the broker, when making a recommendation, exercise "reasonable diligence, care, and skill to:"

(A) Understand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers;
(B) Have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks, rewards, and costs associated with the recommendation and does not place the financial or other interest of the broker, dealer, or such natural person ahead of the interest of the retail customer; and
(C) Have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile and does not place the financial or other interest of the broker, dealer, or such natural person making the series of recommendations ahead of the interest of the retail customer.[37]

The first prong is similar to the "reasonable basis" obligation under the Suitability Rule.[38] As a threshold issue, the broker or brokerage firm must understand the security or investment strategy recommended before being capable of determining whether the recommendation is in the best interest of a particular customer.[39] Factors that the broker or brokerage firm should consider when investigating the security or investment strategy include: "the security's or investment strategy's investment objectives, characteristics (including any special or unusual features), liquidity, volatility, and likely performance in a variety of market and economic conditions; the expected return of the security or investment strategy; as well as any financial incentives to recommend the security or investment strategy."[40]

Cost of the investment is now an explicit factor in evaluating securities or strategies, as it is always relevant when evaluating a recommendation.[41] "Costs" includes both costs associated with purchasing a security, as well as future costs associated with exchanging or selling a security.[42] However, the Rule does not require that a broker recommend the lowest cost option.[43]

---

[37] 17 C.F.R. §240.15l-1(a)(2)(ii) (2019).

[38] *See* FINRA Rule 2111.05(a).

[39] 84 Fed. Reg. at 33,375 – 33,376.

[40] *Id.* at 33,376.

[41] *Id.* at 33,373.

[42] *Id.*

[43] *Id.*

The second prong of the Care Obligation incorporates the "customer specific" prong of the Suitability Rule,[44] but enhances it by replacing "suitable" with a best interest standard.[45] In sum, the broker must determine that a recommendation is in the customer's best interest based on that customer's investment profile. The customer's investment profile includes "age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance," and any other information that may be disclosed.[46] This is the same information that firms must currently consider as part of the investor's profile under the Suitability Rule.[47] If a customer does not provide the information, the SEC cautions that a firm may not have sufficient information to make a best interest determination.[48] Note the presumption that the lack of customer-specific information is the responsibility of the firm to resolve or not make the recommendation.

In evaluating whether a recommendation is in the customer's best interest, the broker must consider reasonably available alternatives offered by the broker's firm.[49] The broker need not recommend the "best" of all possible alternatives.[50] The Rule also does not require that the broker be familiar with every product available by the brokerage firm.[51] The scope of the reasonably available alternatives that are considered with respect to any particular recommendation will depend on several factors, including, the broker's customer base; the products available to the broker to recommend; and specific limitations on the available products, including that products may only be available in certain geographical locations or to particular types of accounts.[52]

For dually registered brokers, the options with respect to account type must be considered as reasonably available alternatives.[53] If the broker may only offer brokerage accounts, the broker must consider the customer's objectives before recommending a brokerage account.[54] For example, if the customer is requesting that the broker have unlimited discretion, a brokerage account would not be appropriate and should not be offered even if it is the only option available to the broker.[55]

---

[44] *See* FINRA Rule 2111.05(b).

[45] 84 Fed. Reg. at 33,377.

[46] 17 C.F.R. §240.15l-1(b)(3) (2019).

[47] *See* FINRA Rule 2111(a).

[48] 84 Fed. Reg. at 33,379.

[49] *Id.* at 33,381.

[50] *Id.*

[51] *Id.*

[52] *Id.* at 33,382.

[53] *Id.* at 33,383.

[54] *Id.*

[55] *Id.*

When recommending that an investor rollover a retirement account into an IRA, the broker must consider a number of factors, including, "fees and expenses; level of service available; available investment options; ability to take penalty-free withdrawals; application of required minimum distributions; protection from creditors and legal judgments; holdings of employer stock; and any special features of the existing account."[56] A broker may not just consider whether the rollover may offer additional options beyond the customer's current plan. While there is no requirement to document the basis for the recommendation, it is likely that firms will require some documentation when a broker makes a rollover recommendation.

The final component is similar to the "quantitative suitability" requirement,[57] except that the "control" element has been eliminated.[58] This component is intended to prevent trading that is so excessive, colloquially defined as "churning," that a positive return is virtually impossible.[59]

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

In the 2022 Report, FINRA also discussed deficiencies found with respect to the Care Obligation. For example, FINRA found that brokers made recommendations that were not in the investor's best interests based on their investment profile and the potential risks, rewards, and costs associated with the investment.[60] Brokers also made trading recommendations that were excessive.[61]

The FINRA Report also set forth practices that it deemed effective that it came across during its routine exams. For example, firms (i) created worksheets for the broker to compare costs and reasonably available alternatives; (ii) explicitly set forth the factors to consider when evaluating reasonably available alternatives, such as considering similar investment types from the same issuer or considering less complex or risky products at the firm; and/or (iii) updated their client relationship management (CRM) tools to automatically compare reasonably available alternatives.[62]

FINRA also found that firms (i) limited high-risk or complex products or strategies to particular categories of clients; (ii) required heightened supervision of any recommendations of complex or high-risk products; and/or (iii)established new exception reports to track the sale of the same product to high numbers of clients.[63]

---

[56] *Id.*

[57] *See* FINRA Rule 2111.05(c).

[58] 84 Fed. Reg. at 33,384.

[59] *Id.*

[60] *See* FINRA Report, *supra* note 32.

[61] *Id.*

[62] *Id.*

[63] *Id.*

iii. Important Considerations and Documents

The Care Obligation is the part of Reg. BI most similar to the Suitability Rule. Many of the same considerations and documents will be relevant when assessing whether there was a violation of the Care Obligation as were considered when assessing whether the Suitability Rule had been violated.

1. Reasonable Basis Component Considerations

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

The relevant factors that the SEC has set forth provide a basis for assessing whether it is likely that the broker has satisfied the reasonable basis component of the obligation. It will be important to review the offering documents for complex investments to see what the issuer has said about the investment's objectives. Importantly, the broker or the firm should be aware of how the investment or strategy is likely to perform in volatile, bullish and/or bearish market conditions. The broker and the firm must also evaluate financial incentives to recommend the investment, including whether the firm or the broker receives any additional compensation from the recommendation. Notes, e-mails, and memorandums from the brokerage firm's due diligence committee should detail the degree of understanding the firm, its officers, directors, and control persons had of the product or strategy at issue.

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

2. Customer-Specific Component Considerations

The customer-specific component is very similar to the corresponding component under the Suitability Rule. Once the investment is evaluated and approved, the next step is to determine the investor's profile. The information the firm and the broker must gather about the investor is the same as that required by the Suitability Rule.

The SEC has brought its first enforcement action in connection with Reg. BI, alleging a violation of the Care Obligation.[64] The firm and the brokers charged allegedly recommended high-risk debt securities to investors, many of whom were on fixed incomes with moderate risk tolerances.[65] The issuer of the securities stated that the securities were high-risk, illiquid, and suitable for investors with substantial financial resources.[66] Therefore, the SEC has alleged that the brokers did not

---

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

[65] *Id.*

[66] *Id.*

have a reasonable basis to believe the recommendations were in the investors' best interests.[67] The assessment in the SEC's action is very similar to the assessment that would have occurred under the Suitability Rule.

Unlike the Suitability Rule, the Reg. BI customer-specific best interest analysis does not stop after a finding that the investment at issue was suitable for the investor. The broker must also have considered reasonably available alternatives. While the investment need not be the "best" investment, the burden will be on the broker to establish whether the recommendation was reasonable in light of the reasonably available alternatives. This will likely be most relevant in the context of complex products. If a simpler investment with lower costs is available and aligns with the investor's profile, it will be difficult to defend the recommendation of the costly, more complex investment.

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

3. Quantitative Component Considerations

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

4. Final Considerations for the Care Obligation

It is likely that firms will require that a broker document decisions they have made throughout the recommendation process. For example, FINRA recognized that a best practice would be for the firm to utilize a worksheet to establish that the broker assessed the investment and considered alternatives. Therefore, in discovery, it will be important to request documents that reflect the broker's and the firm's assessment that the investment satisfies the reasonable basis and customer-specific components of the obligation. Additionally, there may be documents setting forth the reasonably available alternatives considered. In connection with the election of account type when the firm is dually registered as a broker and an investment adviser, the firm may document why a brokerage account is more appropriate for the investor rather than an advisory account. Finally, the broker may be required to document why the rollover of a retirement account is appropriate. The catchall document request should be for any documents reflecting the rationale or basis for the recommendation at issue.

---

[67] *Id.*

c. Conflict of Interest Obligation

i. Duties Under Regulation Best Interest

The Conflict of Interest Obligation requires a firm to adopt policies and procedures designed to identify and, at a minimum, disclose all conflicts associated with a recommendation.[68] The obligation further requires that a brokerage firm mitigate or eliminate certain types of conflicts.[69] With respect to the content of the policies and procedures, like FINRA under the Supervision Rule,[70] the SEC contemplates that brokerage firms will have the flexibility to design policies and procedures that are risk-based rather than requiring a detailed review of each recommendation.[71] The SEC suggests certain components that a brokerage firm should consider when adopting policies and procedures including:

> [P]olicies and procedures outlining how the firm identifies conflicts, identifying such conflicts and specifying how the broker-dealer intends to address each conflict; robust compliance and monitoring systems; processes to escalate identified instances of noncompliance for remediation; procedures that designate responsibility to business line personnel for supervision of functions and persons, including determination of compensation; processes for escalating conflicts of interest; processes for periodic review and testing of the adequacy and effectiveness of policies and procedures; and training on policies and procedures.[72]

Under this obligation, the brokerage firm has a duty to, at a minimum, disclose all conflicts of interest.[73] Disclosure must be full and fair; if it is not possible to fully and fairly disclose a conflict, it must be mitigated such that full and fair disclosure is possible.[74]

Brokerage firms also have a duty to identify and mitigate conflicts of interest that create an incentive for the broker to place the interests of the broker or the firm ahead of the interests of the customer.[75] The SEC has primarily chosen to limit the duty to mitigate to broker-level conflicts, allowing the brokerage firms to generally deal with firm-level conflicts through disclosure.[76] The requirement to identify and mitigate broker-level conflicts applies only to incentives provided to the broker, either by the firm or third parties that are within the control of or associated with the

---

[68] *Id.* at 33,385.

[69] *Id.*

[70] FINRA Rule 3110.

[71] *Id.* at 33,386.

[72] *Id.* at *note* 688.

[73] *Id.* at 33,388.

[74] *Id.*

[75] *Id.* at 33,390.

[76] *Id.*

firm.[77] Accordingly, the requirement does not create an obligation with respect to private securities transactions.[78] The SEC does provide examples of conflicts that must be mitigated: (i) compensation from the brokerage firm or third parties, including fees and other charges associated with the service or recommendation provided; (ii) employment incentives, including those tied to asset accumulation, special awards, variable compensation, and compensation tied to performance reviews; and (iii) commissions, sales charges, or other fees whether paid by the customer, the brokerage firm, or a third party.[79]

Mitigation measures should be based on the nature and significance of the incentive, as well as other factors related to the brokerage firm's business model, such as the size of the firm, the types of customers, and the complexity of the security product or strategy.[80]

The SEC provides a list of best practices for brokerage firms developing policies and procedures for mitigation methods:

- Avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales;
- Minimizing compensation incentives for employees to favor one type of account over another; or to favor one type of product over another, proprietary or preferred provider products, or comparable products sold on a principal basis, for example, by establishing differential compensation based on neutral factors;
- Eliminating compensation incentives within comparable product lines by, for example, capping the credit that an associated person may receive across mutual funds or other comparable products across providers;
- Implementing supervisory procedures to monitor recommendations that: are near compensation thresholds; are near thresholds for firm recognition; involve higher compensating products, proprietary products or transactions in a principal capacity; or, involve the roll over or transfer of assets from one type of account to another (such as recommendations to roll over or transfer assets in an ERISA account to an IRA) or from one product class to another;
- Adjusting compensation for brokers who fail to adequately manage conflicts of interest; and
- Limiting the types of retail customer to whom a product, transaction or strategy may be recommended.[81]

If a brokerage firm materially limits its securities offerings or investment strategies, the brokerage firm must prevent such limitations from causing the firm to put its interests ahead of its

---

[77] *Id.* at 33,391.

[78] *Id.* at *note* 744.

[79] *Id.* at 33,391.

[80] *Id.*

[81] *Id.* at 33,392.

customers'.[82] The SEC considers that recommending only proprietary products, products with revenue sharing arrangements, or a specific asset class would be material limitations.[83] The SEC recommends that brokerage firms offering limited menus consider establishing a "product review process" that includes evaluating the use of preferred lists; restrictions on the customers to whom a product may be sold; requiring brokers selling certain products to have minimum knowledge requirements; as well as period product reviews to further evaluate conflicts.[84]

Certain practices are completely prohibited pursuant to this obligation. For example, brokerage firms must eliminate "sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited time."[85] Non-cash compensation includes merchandise, gifts and prizes, travel expenses, meals and lodging.[86] This obligation is not intended to eliminate all incentives, only those that create high-pressure situations to sell specific securities within a limited period of time.[87] It likely will not capture contests or other incentives tied to total products sold or asset accumulation and growth.[88] Brokerage firms may also continue to hold annual conferences, so long as attendance is not premised on the sale of specific securities within a limited period of time.[89]

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

In the 2022 Report, FINRA also discussed deficiencies found with respect to the Conflict of Interest Obligation. For example, certain firms did not identify conflicts, or if identified, did not adequately address them.[90] In terms of best practices, some firms flattened their commission schedules within particular product types.[91] Flattening commission schedules may work to eliminate the financial incentives to recommend certain product types or products that are preferred by the firm because of revenue sharing or they are proprietary products. '

iii. Important Considerations and Documents

Pursuant to this obligation, firms will have greater documentation obligations than previously. For example, the firm must identify conflicts of interest and then assess whether the conflict should be disclosed, mitigated, or eliminated. Therefore, firms will have to review their compensation programs, paying particular attention to any incentives offered. In addressing this component in

---

[82] *Id.* at 33,393.

[83] *Id.*

[84] *Id.* at 33,394.

[85] 17 C.F.R. §240.15l-1(a)(2)(iii)(D) (2019).

[86] 84 Fed. Reg. at 33,396.

[87] *Id.*

[88] *Id.*

[89] *Id.*

[90] FINRA Report, *supra* note 32.

[91] *Id.*

a claim, it will be important to assess what conflicts have been disclosed and whether disclosure was appropriate. When disclosure is not appropriate, the firm must take additional steps to mitigate or eliminate the conflict. In discovery, it will be important to request any documents reflecting the identification of conflicts of interest and how the firm addressed each of the conflicts. While the SEC has not set forth specific obligations, as discussed above, it has set forth best practices. It may be appropriate to argue that if a firm's policies and procedures fell short of the best practices outlined in the release, that the firm's supervision of the conflicts was not reasonable.

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

d. Compliance Obligation

i. Duties Under Regulation Best Interest

The Compliance Obligation is an overarching requirement to adopt policies and procedures that are reasonably designed to achieve compliance with the Rule as a whole.[92] The Rule does not specify which policies and procedures must be adopted. The SEC expects brokerage firms to design policies and procedures that "prevent violations from occurring, detect violations that have occurred, and to correct promptly any violations that have occurred."[93] Brokerage firms are expected to tailor their policies and procedures to account for the "scope, size, and risks associated with the operations of the firm and the type of business in which the firm engages."[94] The Compliance Obligation is one that is already captured by the FINRA Supervision Rule, which requires that the establishment of a supervisory system that is "reasonably designed to achieve compliance with applicable securities laws and regulations."[95]

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

In the 2022 Report, FINRA also discussed deficiencies found with respect to the Compliance Obligation. For example, FINRA found that some firms' written supervisory policies were not adequately precise because they did not identify individuals responsible for supervising compliance with Reg. BI or they had not addressed how the firm would actually comply with their obligations under the Rule.[96] Some firms failed to modify their policies and procedures to reflect the new requirements of Reg. BI. For example, the firms did not address (i) how costs and

[92] *Id.* at 33,397.

[93] *Id.*

[94] *Id.*

[95] FINRA Rule 3110.

[96] *See* FINRA Report, *supra* note 32.

reasonably available alternatives were to be considered when a broker makes a recommendation; .(ii) recommendations of account types; and/or (iii) conflicts of interest that create incentives for the broker to place their own interests ahead of the investor's interests. Finally, some firms did not create procedures to ensure the new recordkeeping obligations were captured, and did not include testing of the policies, procedures, and controls.[97]

Some firms adopted new policies and procedures. For example, some firms (i) limited high-risk or complex products or strategies to particular categories of clients; (ii) required heightened supervision of any recommendations of complex or high-risk products; and/or (iii) established new exception reports to track the sale of the same product to high numbers of clients.[98]

iii. Important Considerations and Documents

At a fundamental level, the Compliance Obligation replicates the Supervision Rule to require that the firm adopt policies and procedures that will ensure compliance with the Rule. Firms should have explicit sections of their Compliance Manual that address the assessment and recordkeeping obligations of Reg. BI. As discussed above, certain disclosures must be documented, certain Care Obligation assessments must or should be documented, and the analysis of Conflicts of Interest should be documented. In the first action under Reg. BI, the SEC alleged that the firm violated its Compliance Obligation because it did not adequately establish, maintain, and enforce policies and procedures designed to achieve compliance with Reg. BI.[99]

Additionally, it will be important to determine whether the firm has adopted any restrictive policies and procedures. For example, some firms have determined that certain products should not be sold to certain investors. If a firm has adopted such policies, then a recommendation of such an investment to that type of investor will likely be deemed to be unreasonable under the Rule.

III. Conclusion

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

In discovery, Reg. BI's new recordkeeping obligations should lead to relevant, discoverable documents. While many of the documents may fall into one or more categories of presumptively discoverable documents enumerated in the FINRA Discovery Guide, practitioners need to be well versed in identifying and/or describing the Reg. BI specific documents. In meeting and conferring with opposing counsel, explaining the Reg. BI documents that should exist in their clients' possession, custody, and/or control has to be part of the early sensitization of this new regulatory scheme and its recordkeeping requirements. In addition to reviewing what the SEC has included

---

[97] *Id.*

[98] *Id.*

[99] *See* SEC Action, *supra* note 64.

in the rulemaking package, many defense oriented law firms are publishing guides, which will also be useful in describing documents within a discovery request and supporting motions to compel.

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

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